October 12, 2010

Office of the Comptroller of the
Currency ("OCC")
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219
Docket ID OCC-2010-0016
RIN 1557-AD35

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 3064-AD62

Jennifer J. Johnson
Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1391
RIN 7100-AD53

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: OTS-2010-0027
RIN 1550-AC43

Re: Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies

Dear Sir or Madam:

The Clearing House Association L.L.C. ("**The Clearing House**"), an association of major commercial banks,[1] appreciates the opportunity to comment on the advance notice of proposed rulemaking issued by the federal banking agencies to revise their risk-based capital guidelines and regulations to remove any reference to, or requirement of reliance on, credit ratings and to substitute other standards of creditworthiness (the "**ANPR**").[2]

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[1] Established in 1853, The Clearing House is the nation's oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Clearing House Association is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

[2] 75 Fed. Reg. 52283 (Aug. 25, 2010).

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Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act[3] ("**Dodd-Frank Act**") requires removal of any reference to, or requirement of reliance on, credit ratings from all of the agencies' rules, including the capital ones cited in the ANPR. That this will be challenging is rightly reflected in the questions posed in the ANPR. At the meeting of the board of directors of the Federal Deposit Insurance Corporation at which the ANPR was approved on August 10, 2010, Chairman Bair, then-Comptroller Dugan and Acting Director of the Office of Thrift Supervision John Bowman expressed deep concerns about the law's requirements. In a subsequent speech, Daniel Tarullo, Governor of the Federal Reserve Board, noted that:

> "[T]he substantial effort expended by staff at the Board and the Federal Reserve Bank of New York to evaluate the creditworthiness of a relatively small number of securitizations in the Term Asset-Backed Securities Loan Facility suggests the enormity of that task [replacing ratings]."[4]

Further, Acting Comptroller of the Currency John Walsh, in prepared testimony before the Senate Committee on Banking, Housing, and Urban Affairs on September 30, 2010, observed:

> "[T]he prohibition against references to ratings in regulations under section 939A goes further than is reasonably necessary to respond to [concerns that credit ratings contributed to the financial crisis]. Rather than disregard credit ratings, it may be more appropriate to assess their strengths and weaknesses and to supplement ratings with additional analysis in appropriate cases. We suggest that section 939A be amended to direct regulators to require that ratings-based determinations be confirmed by additional risk analysis in circumstances where ratings are likely to present an incomplete picture of the risk presented to an institution, or where those risks are heightened due to concentrations of particular asset classes."[5]

Even the European Parliament has taken note of the concerns raised by Section 939A, stating, in recent resolutions concerning the Basel Committee's proposals to revise capital and liquidity standards, that the European Parliament

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[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010).

[4] Daniel Tarullo, *speech before the Brookings Panel on Economic Activity* (Sept. 17, 2010), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20100917a.htm.

[5] John Walsh, *testimony before the United States Senate Committee on Banking, Housing, and Urban Affairs* (Sept. 30, 2010), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=bfae9142-8caf-465d-b473-a04fecd13f3a.

> "is therefore very much concerned that limitations laid down in various national laws adopted in response to the crisis (in particular in the US Wall Street Reform and Consumer Protection Act, limiting recognition of external ratings) would result in a serious fragmentation of the application of this global standard."[6]

The Clearing House shares these concerns and believes that implementation of Section 939A could reduce the risk sensitivity of bank capital if risk weights become more uniform by asset class. We also believe that Section 939A could, more generally, reduce the effectiveness of the agencies' supervision and oversight of banks, not only with respect to capital regulation, but also in other areas affected by the provision.[7] Additionally, its implementation could impede credit issuances if potential buyers are required to perform an independent analysis of each new transaction. Such a requirement would thereby increase the cost of access for all participants and make it impractical for smaller banks to participate in some markets altogether.

We, therefore, hope that Congress will reconsider Section 939A, either by repealing it or by requiring the agencies to ensure that banks do not place undue reliance on third-party credit assessments as a condition to using them as a measure of creditworthiness, as Acting Comptroller Walsh supported in his testimony quoted above. Recognizing, however, that, absent the law's repeal or modification, the agencies must remove ratings references, we outline constructive alternatives to ratings in this comment letter and commit to working with the agencies going forward to refine those alternatives or others that may be proposed during the comment process by other commenters. We suggest that supervisors continue to allow banks to rely on common industry practices, including the use of third-party analytics such as ratings assigned by credit-rating agencies ("**CRAs**"), in establishing the creditworthiness of exposures, subject to regulatory supervision of internal ratings methods. Long-standing industry experience has determined that the use of third-party analytics remains one of the most replicable, transparent, timely, accurate, and efficient methods of assessing credit risk, especially for assets held in the banking book for which market prices and other risk measures may not be appropriate or available.

As detailed in this letter, The Clearing House believes that:

- third-party analytics, including ratings assigned by CRAs, are helpful differentiators of relative risk and remain a useful tool in developing accurate credit-risk judgments;

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[6] *European Parliament Resolution of 7 October 2010 on Basel II and Revision of the Capital Requirements Directives* (CRD 4), paragraph 11 (2010/2074 (INI)).

[7] These areas include, for example, measuring the liquidity and marketability of certain investment securities. See Office of the Comptroller of the Currency, *Alternatives to the Use of External Credit Ratings in the Regulations of the OCC*, 75 Fed. Reg. 49423 (Aug. 13, 2010).

- prohibiting the use of third-party analytics by banks in assessing credit-risk could result in a set of unmanageable alternatives for banks and regulators, putting U.S. institutions at a competitive disadvantage, severely impairing the sensitivity of risk-based capital, and limiting liquidity; and

- while it may be possible to develop alternatives to sole reliance on ratings, any alternative requires careful scrutiny to ensure that it can be verified by regulators, used by all banking organizations (including those without a sophisticated modeling capacity), and reflected in U.S. implementation of global prudential and regulatory standards.

We here propose some options and offer our analytical services to the banking agencies to refine these options into specific proposals suitable for the next round in the agencies' rulemaking in this area.

I. Rating-Agency References Remain a Useful Tool in Developing Accurate Credit-Risk Judgment, Especially Upon Implementation of Dodd-Frank Reforms to Rating-Agency Methodology.

The Clearing House understands and respects Congress's goal of removing the appearance of a government imprimatur on the opinions of CRAs as well as the goal of global regulators to reduce uncritical CRA reliance.[8] We concur that unquestioned reliance on CRAs has concentrated risk in certain instruments and, in some cases, led to systemic risk. However, we note that much else in Title IX of the Dodd-Frank Act addresses these concerns and brings reforms to the CRA industry. For example, Section 932 of the Act now requires CRAs to make far more extensive disclosures of their methodology, including estimates of probability of default and loss given default that are key credit-risk drivers never before disclosed in CRA modeling. Further, Section 939B of the law for the first time imposes new liability on CRAs, including legal and reputational risk as well as tough new standards related to controls on conflicts of interest.

Indeed, Section 939F of the law even allows the Securities and Exchange Commission ("**SEC**") to impose a new government-dictated approach to selecting CRAs, putting significant pressure on them and encouraging full implementation of Dodd-Frank reforms. Exercising this option could promote the development of a subscriber-paid rating-agency model that could meet many of Congress's objectives. Were the SEC to move beyond mandated reforms and to create a government board, issuer-paid ratings would be subject to even more extensive regulation. The sum total of all of these changes makes

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[8] International Organization of Securities Commissions ("**IOSCO**"), *The Role of Credit Rating Agencies in Structured Finance Markets* (May 2008), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf.

ratings still more suitable as criteria for relative credit-risk determinations by federal banking agencies.

All of these new legal, regulatory and market disciplines have yet to be imposed, let alone tested. To conclude that they will prove insufficient is thus at best premature. While the agencies must act on the requirements in Section 939A to delete CRA references, they can, under law, and should, by virtue of critical policy and prudential interests, ensure that CRA determinations are still used in a prudent, transparent, replicable and open fashion subject to regulatory supervision of internal ratings methods.

Nothing in the Dodd-Frank Act prohibits the regulators from basing capital standards on credit-risk judgments developed by banking organizations that use CRA ratings as part of well-founded, disciplined credit-risk assessment. Use of external credit ratings in this way would accomplish the Congressional goal of removing the federal imprimatur from the CRAs without leading to a system of wholly subjective credit-risk determinations by banks or reinstatement of credit-risk weightings in the capital rules that may permit arbitrage and the development of risky structures. Section 939A does not institute a prohibition against private institutions using third-party analytics in developing internal credit analyses, and the capital rules should reflect this when external ratings judgments are combined with internal due diligence and supervisory assessment.

The Clearing House opposes several alternatives suggested in the ANPR in this regard. For example, reinstatement of simple risk weightings based on asset type would signal a return to the 1988 Basel I rules, incentivizing banks to hold assets with the riskiest characteristics within a particular asset class. Any return to those rules could sow the seeds for a renewed crisis, while informed, tempered and well-grounded use of third-party analytics would permit replicable, transparent and disciplined credit-risk judgments, especially at smaller banking organizations.

II. U.S. Rules Should Not Put U.S. Institutions at Undue Competitive Disadvantage or Place the U.S. at Additional Credit and Liquidity Risk.

The wholesale deletion of CRA references mandated in the Dodd-Frank Act is at variance with other national regimes. As noted, IOSCO and global regulators are moving to improve the use of CRA analytics, rather than to bar them. As recently as July of this year, the Committee of European Banking Supervisors stated that "credit institutions may rely on financial models developed by an [external credit-assessment institution], provided that credit institutions can demonstrate, when requested, that they took due care prior to investing to validate the relevant assumptions in and structuring of the models and to understand methodology, assumptions, and results."[9] Indeed, the European Union is

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[9] Committee of European Banking Supervisors ("**CEBS**"), *Consultation Paper on Guidelines to Article 122a of the Capital Requirements Directive (CP 40)*, paragraph 4 at page 28 (July 1, 2010), *available at* http://www.c-ebs.org/documents/Publications/Consultation-papers/2010/CP40/CP40.aspx.

moving to establish government-sanctioned CRAs. As a result, the Basel III proposals, at least as drafted, include CRA references. The final market-risk rules,[10] proposed liquidity-risk rules,[11] and resecuritization standards[12] do so as well, although the resecuritization rules rightly require banking organizations to substantiate CRA determinations through their own analytics. The Clearing House suggests that this is one approach available to U.S. regulators under the Dodd-Frank Act, as substantiation by banking organizations of CRA ratings does not mean undue reliance on them. An added benefit of this approach is that it would adhere to principles of international comity while removing the appearance of a government endorsement of CRA ratings.

Simply deleting CRA references in U.S. regulations, without due regard to the impact on critical global markets, could likely lead to insurmountable internal credit-risk analytical burdens, especially at smaller banking organizations. Wholesale elimination of ratings references would also create a significant disparity between the applicable U.S. capital requirements and various Basel capital approaches. This lack of uniformity would make it difficult for U.S. banks that participate in global finance or, at the very least, result in reduced competitiveness for U.S. institutions, especially those operating under the advanced approaches. Additionally, elimination of rating references would all but preclude U.S. regulators from implementing Basel II's standardized approach[13] (something that smaller banks, in particular, have sought), with its reliance on ratings to measure gradations of credit risk, unless a similarly applicable alternative to ratings could be developed.

The Clearing House respectfully draws the agencies' attention to the use of CRA references in the asset-securitization market. We understand that the SEC and other U.S. regulators will follow the requirements of the Dodd-Frank Act and delete CRA references applicable to investors such as money-market funds. However, liquidity in the asset-securitization market depends on objective, transparent and replicable credit-risk measurements. Thus the banking agencies should permit prudent reliance on CRAs so long as internal procedures, reviewed by supervisors, evaluate the discipline, objectivity and asset-appropriate methodology used for these determinations. A supervisory assessment of internal rating processes should ensure that internal ratings methods consider a variety of inputs and not rely too much on any single factor.

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[10] Basel Committee on Banking Supervision ("**BCBS**"), *Changes to the Revisions to the Basel II Market Risk Framework* (June 18, 2010), *available at* http://www.bis.org/press/p100618/annex.pdf, and *Revisions to the Basel II Market Risk Framework*, (July 13, 2009), *available at* http://www.bis.org/publ/bcbs158.pdf.

[11] BCBS, *International Framework for Liquidity Risk Measurement, Standards and Monitoring* (Dec. 17, 2009), *available at* http://www.bis.org/publ/bcbs165.pdf.

[12] BCBS, *Enhancements to the Basel II Framework* (July 13, 2009), *available at* http://www.bis.org/publ/bcbs157.htm.

[13] BCBS, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version*, (June 2006) *available at* http://www.bis.org/publ/bcbs128.pdf.

III. The Clearing House Looks Forward to Working with Regulators to Develop CRA Alternatives.

As noted, The Clearing House believes that external ratings are an intrinsic part of internal credit-risk methodology that regulators should continue to recognize. Reforms mandated by provisions in the Dodd-Frank Act other than Section 939A will, we believe, ameliorate the problems that exacerbated the financial crisis, together with increased supervisory scrutiny and investor attention to CRA credit-risk and related determinations. However, as noted above, we understand that the agencies must be responsive to Section 939A's requirements. Alternatives to CRAs cannot solely rely on each bank's internal methodology such that disclosure, replication and supervision are unduly complex or burdensome for regulators, financial institutions, or other market participants.

To that end, we have begun to assess alternatives to CRAs. While our analysis is at this point only preliminary, we suggest the following for consideration:

- Reliance on Credit-Risk-Related Spreads: Numerous comments to the SEC on its initial concept release[14] related to CRA alternatives suggested reliance on the interest-rate spreads that reflect market judgments of credit risk, while the agencies, in the ANPR's discussion of the specific-exposure approach, reference credit spreads as a measure that could be used to establish risk weights. The Clearing House understands that this approach is best suited to trading-book assets, not those held in the banking book (where daily spreads may reflect temporary market factors such as trading liquidity, not the longer-term judgment of the likelihood of payment of principal and interest in full). However, given the need to develop CRA alternatives for the U.S. versions of the Basel market-risk rules,[15] the agencies could consider the degree to which credit spreads or the prices of credit-default swaps could be used for capital purposes with sufficient flexibility to account for changeable market conditions. We would be pleased to assist the agencies in further exploring this approach and assessing the value of spreads over time on selected asset categories (e.g., asset-backed securities).

- Independent Risk Assessments: Another option would be for an independent entity to provide credit-risk judgments on which supervisors could base capital determinations. Reflecting the hard lesson of the CRAs, any such entity would need to be compensated in a fashion that ensured rigorous, unconflicted risk

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14 Securities and Exchange Commission, *Proposed Rules for Nationally Recognized Statistical Rating Organizations*, 73 Fed. Reg. 36212 (June 25, 2008).

15 BCBS, *Changes to the Revisions to the Basel II Market Risk Framework* (June 18, 2010), *available at* http://www.bis.org/press/p100618/annex.pdf, and *Revisions to the Basel II Market Risk Framework*, (July 13, 2009), *available at* http://www.bis.org/publ/bcbs158.pdf.

judgments. There are many such examples of entities that support regulatory determinations, including the self-regulatory organizations on which the SEC has long relied. Further, trade associations have provided objective risk judgment to regulators on instruments such as mortgage-backed securities suitable for exemptions from securities-law registration requirements (the "to-be-announced" or "TBA" market) and qualified financial contracts ("**QFCs**"), which were most recently recognized in Title II of the Dodd-Frank Act. QFCs are largely documented using master netting and similar agreements that are crafted by private-industry trade associations and that, if used and enforced, perfect interests in QFCs and ensure settlement according to anticipated terms and conditions. It is clear from this long experience that, under suitable controls and supervisory review, market-based structures can provide sophisticated, transparent and replicable risk judgments on which regulatory determinations such as capital requirements may be based.

The Clearing House appreciates your consideration of the views expressed in this letter. If you have any questions, or need further information, please contact me at (212) 613-9812 (email: mark.zingale@theclearinghouse.org) or Eli Peterson at (202) 649-4602 (email: eli.peterson@theclearinghouse.org).

Very truly yours,

Senior Vice President and
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