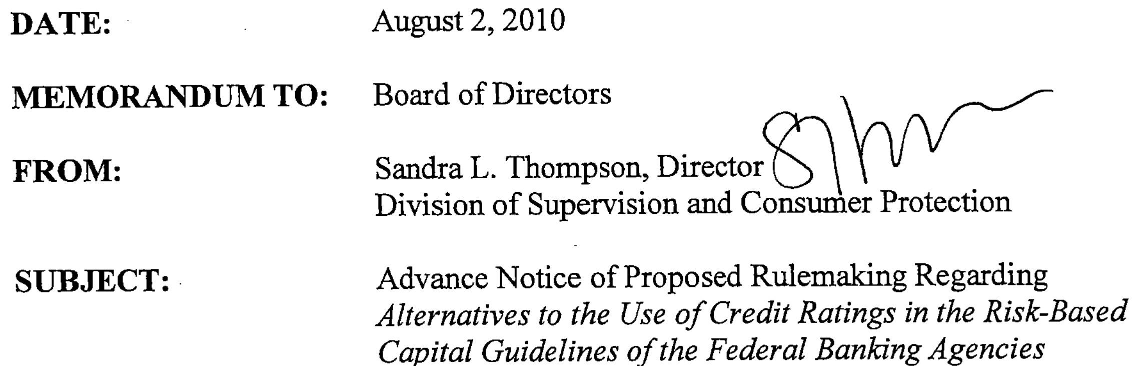


DATE: August 2, 2010

MEMORANDUM TO: Board of Directors

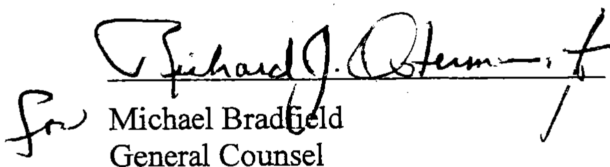
FROM: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

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

Proposal: That the Board of Directors (Board) of the Federal Deposit Insurance Corporation (FDIC) approve publication of the attached *Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of External Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies* (ANPR), in the *Federal Register* for a 60-day comment period. The ANPR would be issued on an interagency basis by the FDIC, the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) (the agencies).

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), enacted on July 21, 2010, requires Federal agencies to review their regulations that (1) require an assessment of the credit-worthiness of a security or money market instrument and (2) contain references to or requirements regarding credit ratings. In addition, the agencies are required to remove such requirements that refer to or rely upon credit ratings, and to substitute in their place uniform standards of credit-worthiness. The ANPR seeks comment on alternative standards of credit-worthiness that may be used for risk-based capital requirements.

Concur:



Michael Bradfield
General Counsel

The agencies' existing risk-based capital standards reference the use credit ratings in four general areas: (1) the assignment of risk weights for securitization exposures under the general risk-based capital rules and advanced approaches rules, (2) the assignment of risk weights for claims on, or guaranteed by, qualifying securities firms under the general risk-based capital rules, (3) the assignment of standardized specific risk add-ons under the agencies' market risk rule, and (4) the determination of eligibility for certain guarantors and collateral for purposes of the credit risk mitigation framework under advanced approaches rules. In 2008, the agencies issued a notice of proposed rulemaking that sought comment on implementation in the United States of certain aspects of the standardized approach in the capital adequacy framework published by the Basel Committee on Banking Supervision in 2006. The Basel standardized approach for credit risk relies extensively on credit ratings to assign risk weights to various exposures.

Generally, the agencies are considering a wide range of approaches of varying complexity and risk-sensitivity for developing credit-worthiness standards for the risk-based capital standards. These include the development of risk weights for exposure categories based on objective criteria established by regulators, similar to the current risk-bucketing approach of the general risk-based capital rules. Other potential approaches also include the development of broad quantitative and qualitative credit-worthiness standards that banking organizations could use, subject to supervisory oversight, to measure the credit risk associated with exposures within a particular exposure category.

The ANPR identifies approaches within the existing risk-based capital rules that do not rely on external credit ratings. These methods may be modified in such a way to allow them to be used for various exposure types. The ANPR also solicits comment on any other alternative credit-worthiness standards that may be used for risk-based capital purposes.

Recommendation: DSC recommends that the Board approve publication of the ANPR for a 60-day public comment period.

I. Introduction

During the recent financial crisis, banking organizations and other investors suffered significant market value and credit losses from once highly-rated exposures, especially certain structured finance exposures, which experienced rapid and severe downgrades of their external credit ratings. A major cause of these downgrades was the inaccurate estimation of credit-worthiness by NRSROs in the assignment of initial credit ratings. As initial credit ratings migrated lower, credit rating agencies were criticized for possible bias in the structure of the rating process and the potential for conflicts of interests to occur among credit rating agencies, investors, and issuers. Furthermore, many banking organizations placed undue reliance on external credit ratings and failed to perform an independent analysis of the credit-worthiness of externally-rated exposures.

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires all federal agencies to review their regulations that reference or require the use of credit ratings to assess the credit-worthiness of an instrument. In addition, the agencies are further directed to remove such requirements that refer to or rely upon credit ratings, and to substitute in their place uniform standards of credit-worthiness.

This ANPR seeks comment on alternative standards of credit-worthiness that may be used for purposes of the risk-based capital requirements. The agencies generally believe that any credit-worthiness standard should:

- Appropriately distinguish the credit risk associated with a particular exposure within an asset class;
- Be sufficiently transparent, replicable, and defined to allow banking organizations of varying size and complexity to arrive at the same assessment of credit-worthiness for similar exposures and to allow for appropriate supervisory review;
- Provide for the timely and accurate measurement of negative and positive changes in credit-worthiness;
- Minimize opportunities for regulatory capital arbitrage;

- Be reasonably simple to implement and not add undue burden on banking organizations; and
- Foster prudent risk management.

II. Summary of the ANPR

The agencies are considering a wide range of approaches of varying complexity and risk-sensitivity for developing credit-worthiness standards for purposes of the risk-based capital standards. These include the development of risk weights for exposure categories based on objective criteria established by regulators, similar to the current risk-bucketing approach of the general risk-based capital rules. Other approaches include the development of broad quantitative and qualitative credit-worthiness standards that banking organizations could use, subject to supervisory oversight, to measure the credit risk associated with exposures within a particular exposure category.

Risk Weights Based on Exposure Category: Prior to the implementation of the risk-based capital treatment for recourse obligations, direct credit substitutes, residual interests and mortgage- and asset-backed securities in 2001 (recourse rule), the agencies' general risk-based capital rules did not rely on credit ratings to determine risk weights. In addition to establishing a risk-weighting framework based on credit ratings, the recourse rule established an alternative risk-weight framework for securitization exposures (a "gross-up" treatment reflecting the risk of more subordinated tranches of securitizations). The agencies could simply eliminate all sections of their capital regulations which refer to credit ratings and retain the remainder of the general risk-based capital rules. Under this approach, if no alternative risk-weight scheme was introduced, all affected assets and exposures generally would receive a 100 percent risk-weight unless otherwise specified by the gross-up requirements. Alternatively, the agencies could revise the risk-weight categories for exposures by type of entity (for example, sovereign, bank, public sector entity (PSE), corporate, and securitization exposures), which could increase the risk sensitivity of the risk-based capital requirements.

Exposure-Specific Risk Weights: Under this approach, banking organizations could assign risk weights to individual exposures using specific qualitative and quantitative credit risk measurement standards established for various exposure types that are broadly based on credit-worthiness metrics commonly used in the marketplace. For instance, exposures could be assigned a risk weight based on certain market-based measures, such credit spreads or ranges of probability of default (PD bands); obligor-specific financial data, such as debt-to-equity ratios; or other sound underwriting criteria.

Alternatively, banking organizations might engage a third-party service providers for quantitative data, such as probabilities of default, or otherwise outsource the measurement of credit-worthiness. While this method increases risk-sensitivity, it could result in inconsistent application of capital charges across exposure categories and banking organizations with similar portfolios.

The agencies could consider an approach for debt securities similar to that adopted by the National Association of Insurance Commissioners, under which a third-party financial assessor would inform the agencies' understanding of risks and their ultimate determination of the risk-based capital requirements for individual securities. One potential drawback of this approach is excessive reliance on a single third-party assessment of risk.

Exposure-Specific Options for Measuring Credit-worthiness: The agencies identified several exposure types that rely on the use of credit ratings in the risk-based capital rules. These exposures include sovereign, public sector entity, bank, corporate, and securitization exposures. Credit ratings are also employed to define eligibility for certain guarantees and collateral.

There are several methodologies that could be used for each of these areas of the risk-based capital rules that do not rely on credit ratings. For example, the current rules do not use credit ratings to assign a risk weight to sovereign, public sector entity, or

corporate exposures. One option would be to continue with the general risk-based capital treatment for these exposure types. Alternatively, banking organization could differentiate the credit risk of exposures based on key financial and economic parameters. Relevant market-based information could also be used to enhance risk sensitivity. For example, credit spreads may be used to differentiate risk. Additionally, banking organizations could assign default probabilities based on objective criteria established by the agencies. Finally, banking organizations could use credit assessments from qualified third parties that are based upon a set of objective criteria established by the agencies.

The agencies could also review the internal modeling methods in the advanced approaches capital rules (12 CFR part 325, Appendix D) to determine whether certain models could be simplified to allow banking organizations of different sophistication levels to risk weight exposures. For example, the supervisory formula approach, used to assign a capital charge to certain securitization exposure, possibly could be modified for use by all banking organizations.

FDIC staff does not generally view the use of banks' internal models as an appropriate basis for establishing risk-weights under the generally applicable risk-based capital standards. Nevertheless, discussion of these issues is included in the ANPR to solicit a full range of views.

III. Recommendation

DSC recommends that the Board approve for publication in the *Federal Register* the attached interagency ANPR, which seeks comment on alternatives to the use of external credit ratings in the regulatory capital guidelines of the FDIC, FRB, OTS, and OCC.

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