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October 25, 2010

BY EMAIL:

The Honorable Sheila C. Bair, Chairman
Federal Deposit Insurance Corporation
RIN 3064-AD62

The Honorable Ben S. Bernanke, Chairman
Board of Governors of the Federal Reserve System
Docket No. R-1391

The Honorable John G. Walsh, Acting Comptroller
U.S. Comptroller of the Currency
OCC-2010-0016

The Honorable John E. Bowman, Acting Director
Office of Thrift Supervision
OTS-2010-0027

Chairmen of the Agencies:

On behalf of Sandler O'Neill + Partners, L.P., we are commenting on the Advance Notice of Proposed Rulemaking (ANPR), *Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies,* published for comment by October 25, 2010 in the *Federal Register*, 75 FR 52283 (August 25, 2010). The agencies include the FDIC, FRB, OCC, and OTS.

Sandler O'Neill is a full-service investment-banking firm focused on the U.S. financial services sector.[1] Our clients include a wide variety of financial firms, among them almost a thousand banks and thrifts and their holding companies, including hundreds of regional and community depository institutions. As a firm of financial professionals who work closely with many banking firms, Sandler O'Neill frequently comments on supervisory and other issues important to our clients.

Overview

In the Dodd-Frank Act, the United States Congress directed each of the federal banking agencies to revise its regulations to remove references to and reliance on credit ratings of nationally recognized statistical rating organizations (NRSROs) and to adopt

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appropriate and uniform substitute standards of creditworthiness for securities and money market instruments.[2]

The agencies note that criteria for considering substitute standards include granularity, transparency, uniformity, timeliness and accuracy, simplicity, and promotion of safety and soundness. To these we add another requisite implied by the others but worthy of highlighting: certainty. Banks, thrifts, and their holding companies must know with certainty the permissibility of investments and the risk weightings of those investments.

As the agencies observe, one of the challenges the legislative direction poses is its inconsistency with the standardized approach to credit risk of the Basel Accord, as revised and enhanced, which relies extensively on credit ratings to assign capital risk weights to various exposures.[3] Additional challenges include:

- the inadvisability of the only two feasible approaches to implementing the Congressional mandate, and
- the possibility of severe unintended consequences to bank and thrift capital and lending capacity arising from disruptions in pricing and liquidity in the market for mortgage-backed and other asset-backed securities and increases in the capital required to hold such assets.

As we quantify below, banks and thrifts account for 15%, or $1.5 trillion, of the market for MBS and other ABS, and additional shocks to this market would work at cross-purposes to Congressional and Administration efforts to foster lending in support of economic recovery and growth.

For these reasons, at the conclusion of this letter we propose a middle path between the Dodd-Frank Act and the status quo that would impose more competition and supervisory discipline on the NRSROs as a means of giving substantial effect to the Congressional mandate without its attendant problems.

Discussion

At the outset, it must be said that it seems impossible to reconcile fully the direction of the Dodd-Frank Act with the extensive reliance on credit ratings in the standardized approach to credit risk of the Basel Accord. We believe the best the agencies can do is to report this unavoidable conflict to the Congress. The agencies have been placed in an untenable position vis-à-vis their foreign counterparts in implementing the capital

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[2] See Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[3] See Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version* (June 2006); *Revisions to the Basel II Market Risk Framework* (July 2009); and *Enhancements to the Basel II Framework* (July 2009), each available at www.bis.org.

standards of Basel III, and the Congress may wish to reconsider its direction, particularly in light of the additional difficulties discussed below.

Turning to consideration of the means of implementing the Congressional directive consistent with the sensible criteria the agencies have advanced, we devote most of our discussion to the harder task of assigning capital risk weights to assets rather than determining the permissibility of investment.

Permissibility of Investment

Existing supervisory guidance provides a workable alternative to credit ratings for determining permissibility of investment. Specifically, OCC guidance provides:

> It is not unsafe or unsound to purchase non-rated securities. However, to show that a non-rated security is the credit equivalent of investment grade, a bank must document, through its own credit assessment and analysis, that the security is a strong "pass" asset under its internal credit rating standards.

A footnote explains:

> Because most internal bank rating systems "pass" some credit exposures that are not, or would not be, rated investment grade, a security will generally have to be rated higher than the bottom tier of internal credit rating "pass" standards in order to be the credit equivalent of investment grade.[4]

We note that many states have parity statutes that grant state-chartered banks the same investment powers granted to national banks.

Because current OCC guidance provides an alternative to credit ratings for determining the permissibility of fixed-income investments that is broadly understood and used, we believe analysis and discussion of the Congressional mandate should focus on assigning capital risk weights. However, because implementation of the mandate with respect to capital risk weighting would be counterproductive, the OCC guidance should remain what it is: a means of determining the permissibility of investing in non-rated securities.

Capital Risk Weighting

By contrast, the task of assigning capital risk weights without relying on credit ratings is a more difficult one because the binary determination of permissibility of investment is

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[4] OCC Bulletin 2002-19, *Unsafe and Unsound Investment Portfolio Practices* (May 22, 2002), at p. 3, discussed in the OCC's related ANPR, *Alternatives to the Use of External Credit Ratings in the Regulations of the OCC*, 75 FR 49423 (August 13, 2010), at p. 49424 (comment period closed October 12, 2010).

much simpler than the more graduated determination of capital risk weights for bank-eligible investments. Asset-backed securities, including mortgage-backed securities, are a particular challenge because risk weighting them relies more extensively on credit ratings than do other asset categories. For this reason, we discuss them as a test case of the feasibility and effects of the Congressional mandate.

The agencies have done an admirable job of identifying and surveying available alternatives to NRSRO credit ratings for purposes of assigning capital risk weights consistent with Congressional direction. However, only two of these alternatives seem feasible, and both also seem to us inadvisable because neither completely satisfies the agencies' sensible criteria. Moreover, both alternatives run the risk of severe unintended consequences for bank capital and economic growth.

The first approach would be for the agencies to employ a third-party financial assessor that, as the ANPR puts it, "would inform the agencies' understanding of risks and their ultimate determination of the risk-based capital requirement for individual securities." The principal defect of such a solution would be the complexity and expense of creating a super-NRSRO charged with second-guessing the NRSROs, whose ratings would likely be the starting point, and in many (if not most) instances the end point of its determinations. We believe the costs to banks and thrifts of funding such an entity would be large, and would increase exponentially were a more ambitious role assigned to it.[5]

The second approach would be to abandon altogether the ratings-based approach to risk weighting asset-backed securities and either (i) revert to a regime of 100% risk weights regardless of relative credit quality, or (ii) adopt the Basel Committee's "concentration ratio" approach based on the level of subordination and type of underlying exposures. The first option would not be granular in distinguishing among degrees of credit risk exposure within asset classes, while the second option would increase the complexity of calculating capital charges. Both options would generally result in much higher capital charges than Basel's ratings-based approach to securitization exposures and would put U.S. banks at a severe competitive disadvantage to their foreign competitors.

Unintended Consequences

As the agencies recognize, the safety and soundness of banks must be the primary focus of their deliberations in revising their rules. For this reason, the potential impact of

[5] If the super-NRSRO were required to re-rate all existing bonds, the task would be enormous and time-consuming, even if qualified analysts existed in sufficient numbers. A related concern is the ability of the super-NRSRO to provide ratings in a timely enough manner not to hobble the secondary-market investment decisions of banks and thrifts. See the SEC's *Annual Report on Nationally Recognized Statistical Rating Organizations* (September 2009), available at http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0909.pdf.

rule revisions on the markets – and hence on asset pricing and capital levels of banks – cannot be overlooked. In this regard, we reviewed bank holdings of mortgage-backed and other asset-backed securities with an eye to unintended adverse consequences.

From the $11.225 trillion of MBS and other ABS outstanding in the U.S. bond market we deducted the $1.103 trillion of MBS on the balance sheet of the Federal Reserve System to calculate an effective float of $10.122 trillion. U.S. banks and thrifts hold $1.523 trillion, or 15.05% of that float. MBS and other ABS are 26% of the median bank's securities portfolio and 53% of the median thrift's securities portfolio. U.S. banks alone hold $1.133 trillion of MBS in their available-for-sale portfolios.[6]

At 15% of float, bank and thrift holdings of MBS and other ABS are material to the market for such securities, and even more material to their investment portfolios. Compliance with the Congressional mandate to purge credit ratings from the agencies' regulations as a basis for determining permissibility of investment and capital risk weighting could further damage the pricing and liquidity of the market for such securities and further erode bank capital. Even without such market effects, bank capital could be stretched thin by higher capital charges resulting from the new risk-weighting regime.

A Middle Path

Such unintended consequences could reduce lending capacity at a time when other Congressional initiatives, such as the Small Business Jobs Act, are attempting to increase lending in the hope of supporting recovery from the recent financial crisis and future economic growth. Congressional cross-purposes of this magnitude are an additional, important reason for the agencies to report to the Congress the difficulties and uncertainties inherent in its direction for the purpose of providing the Congress the opportunity to reconsider before the agencies implement its mandate.

In their report to the Congress, we suggest that the agencies propose a middle path between the status quo and the mandate of the Dodd-Frank Act. The approach would provide for enhanced requirements for registration of NRSROs with the SEC, including periodic review of the performance of their credit ratings. For securities and money market instruments to qualify as bank-eligible investments and for capital risk weights of less than 100%, ratings by at least two NRSROs would be required, with the lowest rating to govern.

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[6] In compiling this data, analyst Jason Mendelson employed the following sources: Securities Industry and Financial Markets Association (SIFMA) for outstanding U.S. bond market debt (at 2Q2010); the Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet for Federal Reserve holdings (at 08/25/2010); and SNL DataSource 5.0 for bank and thrift holdings (at 2Q2010). We chose to provide the most recent data available rather than as of a single, earlier date.

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Such an approach would substantially fulfill Congressional intent by increasing competition and supervisory discipline for NRSROs, assuring multiple points of view on the credit of bank-eligible investments. It would also provide a framework with which the fixed-income markets are familiar, with minimal unintended effects on market pricing and liquidity. Finally, it would be compatible with the Basel Accord and remove a significant stumbling block to the ability of the federal banking agencies to work with their foreign counterparts in the implementation of the Basel III capital standards.

Sincerely,

Joseph Longino
Principal

Thomas W. Killian
Principal

cc: The Honorable Timothy F. Geithner
Secretary of the Treasury
U.S. Department of the Treasury