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THE CLEARING HOUSE
Advancing Payment Solutions Worldwide

September 28, 2004

Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Attention: Jennifer J. Johnson
Secretary

Re: Bank Holding Company Rating System (Docket No. OP-1207)

Ladies and Gentlemen:

The member banks of The Clearing House Association L.L.C.[1] ("The Clearing House") are writing to comment on the notice and request for comment on a proposal by the Board of Governors of the Federal Reserve System (the "Board" or the "Federal Reserve") to adopt a revised bank holding company ("BHC") rating system (the "Proposal"). 69 Fed. Reg. 43996 (July 23, 2004).

The Proposal identifies four key objectives for the new BHC rating system: (i) to elevate the prominence of risk management in order to better align the rating with the supervisory process; (ii) to provide a more comprehensive framework for assessing risk

1 The member banks of The Clearing House are: Bank of America, National Association; The Bank of New York; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, National Association; JPMorgan Chase Bank; LaSalle Bank National Association; U.S. Bank National Association; Wachovia Bank, National Association; and Wells Fargo Bank, National Association.

management; (iii) to define the financial strength components of the rating system to better reflect the structure of the BHC and the impact of the structure on the depository institution subsidiaries; and (iv) to provide a framework for assessing and rating the potential impact of nondepository BHC subsidiaries on the depository institution subsidiaries of the BHC. The Clearing House agrees with the Board that the existing BOPEC/F-M rating system is out-of-date, and we both support the adoption of a new system and generally endorse the objectives outlined in the Proposal. We have, however, a number of concerns and questions relating to implementation of the revised rating system, and would welcome an opportunity to meet with the Board's supervisory staff to discuss these issues.

Our concerns and questions relate to certain specific rating system elements, as well as the level of subjectivity involved in deriving both the composite rating and certain of its components. In addition, we are concerned about the implications of the Proposal for functional regulation, in particular the extent of the Board's deference to the views of the primary federal banking regulator for a BHC's depository institution subsidiaries. We also are concerned about the effect that the new rating system could have on a BHC's status as a financial holding company. These issues and other specific comments are discussed in more detail below.

1. Subjectivity.

A fundamental change in the Proposal is the introduction of a substantially more subjective evaluation by the examiners. For example, the crucial composite (C) rating is not based on an average of its components but "reflects examiner judgement with respect to the relative importance of each of the components". Id. at 43999-44000.

The Clearing House recognizes that the legitimate objectives of the revised rating system require greater subjectivity. We believe, however, that subjectivity runs the risk of introducing less conformity, uniformity and predictability. Accordingly, we offer two recommendations.

- First, we believe that the new rating system should be run in conjunction with the current rating system for at least one, and perhaps two, examination cycles. During these concurrent rating periods, the current rating would govern. This would enable BHCs to adjust to the new system. We note that the Proposal itself refers to the "testing" of the new rating system. Id. at 43998 n.3.

- Second, we believe that there must be a meaningful review process within the Federal Reserve of an examiner's ratings. A meaningful review has two key components: (i) the independence of the review process; and (ii) the clear absence of recrimination for requesting a review.

The Federal Reserve's examination ratings have enormous impact on the future of a BHC, particularly at a time of rapid consolidation. It is essential that a major change in the rating system be implemented carefully and thoughtfully to ensure fairness and accuracy.

2. Specific Rating System Elements.

a. "F" Financial Condition Component

The assessment of a BHC's financial condition would involve a substantial new element -- an analysis of significant differences between the Federal Reserve's own view and the market's view. Although we can understand the desirability of this analysis, we are concerned by certain of its aspects as described in the Proposal.

Our first concern relates to the consideration of equity prices. We believe that equity prices are influenced by factors that have no relationship to financial condition. For example, the very largest BHCs often trade at lower multiples to earnings than other BHCs because they are not viewed as acquisition candidates. As a result, there is no element of optionality that enhances the stock prices of some smaller BHCs. Conversely, some BHCs in a weak financial condition trade at a high price/earnings ratio because their very weakness makes them takeover candidates.

Second, there is the implicit assumption that if the Federal Reserve's view is more negative than the market view, it must be the market that is wrong. We believe that, in such a case, the Federal Reserve should rereview its own assessment.

Third, there is a related assumption that if the Federal Reserve's view is more negative, then the BHC's public disclosures are inadequate or at least suspect. In such a case, the examination staff is instructed to review the BHC's policies, procedures and controls relating to disclosure and, by inference, the disclosure itself. Public disclosure is, however, a complex process, governed by established standards of materiality, subject to review by the Securities and Exchange Commission, and now subject to numerous requirements and penalties under the

Sarbanes-Oxley Act. We believe that the Federal Reserve should engage in a review of disclosure only in exceptional cases.[2]

Fourth, we are concerned that the comparison is a "lose-lose" for the BHC. If the Federal Reserve's assessment is more positive than the market, it appears that the Federal Reserve's rating should be negatively affected by this difference.

Fifth, it is important that the final rating system (or related examiner guidance) provide clear guidance as to the relevance of each of the relevant market indicators to an overall assessment of the market's view of the financial condition of a BHC and to the Federal Reserve's own rating. (This guidance becomes even more imperative if equity prices are a consideration.) For example, if there is a difference between credit spreads and debt ratings, which is more important? Is a Federal Reserve assessment of differences required when there is the equivalent of a single credit grade difference, e.g., AA vs. A, or something more?

b. "C" Capital Adequacy Subcomponent

The F rating is supported by four subcomponents: C (capital), A (asset quality), E (earnings) and L (liquidity). The C subcomponent is intended to reflect the adequacy of a BHC's consolidated capital position from a regulatory perspective and an economic capital perspective. The Proposal indicates, however, that the evaluation of capital adequacy should consider, among other things, the distribution of capital across legal entities. The Clearing House is concerned that this requirement could result in the imposition of *de facto* capital adequacy requirements on

2 For the same reasons, we have concerns about the suggestion that there may be a specific disclosure subcomponent after the Basle II framework has been implemented. See id. at 43998 n.4.

nonbanking subsidiaries of BHCs on a legal entity basis. In addition, the structural differences among large complex BHCs make it extremely difficult to apply a consistent approach to evaluation of capital distribution across legal entities.

3. Composite Rating.

The Proposal indicates that each BHC will receive a composite rating reflecting the overall assessment of the BHC based on the quality and effectiveness of consolidated risk management, the BHC's consolidated financial strength, and the impact of the parent company and nondepository subsidiaries on the subsidiary depository institution(s), as well as the subsidiary depository institution(s) itself. The C rating is not intended to be based on a simple average of the R, F, I and (D) components, but, as mentioned, "reflects examiner judgment with respect to the relative importance of each of the components to the overall safety and soundness of the institution's operations". The Clearing House would be very interested in discussing with the Board's supervisory staff how this examiner judgment will be applied in deriving the composite rating. We are concerned about consistency in approach and in application of examiner judgment.

4. Functional Regulation.

a. Depository Institution Subsidiaries

The Proposal recognizes the role of the primary federal bank regulators of the BHC's depository institution subsidiaries. In certain instances, however, the Proposal instructs examiners to substitute the Federal Reserve's judgment for that of the primary regulator. We are concerned that this could undermine the role of the primary regulators.

The examiners are instructed to refer to the CAMEL composite rating assigned by the institution's primary bank regulator, but the Proposal goes on to state:

> If in the process of analyzing the financial condition and risk management programs of the consolidated organization, a major difference of opinion relative to the safety and soundness of the depository institution emerges between the Federal Reserve and the depository institution's primary regulator, then the (D) rating *should reflect the Federal Reserve's evaluation.*

Id. at 44005 (emphasis added).

This reference to an automatic override of the primary regulator's evaluation can be read to suggest that Federal Reserve examiners should often conduct an independent examination of the depository institution. We do not believe that such an approach is consistent with the basic federal bank regulatory scheme.

Moreover, the ability of the Federal Reserve examiners to override the primary regulator's composite rating could have a serious negative impact on the relationship between the primary regulator and its regulated institution. The primary regulator has the deepest knowledge of the depository institution, which is acquired over a substantial period of time and often with continuous on-site examination staff, and its views should be given great deference. We respectfully suggest that it would be very rare for the Federal Reserve to be in a position to dispute the views of the primary regulator, and we think it should be made clear to examiners that this could occur only in exceptional circumstances.

b. Nonbank Subsidiaries

The I component of the rating involves a more in-depth review of the BHC's nonbank subsidiaries. Although the Proposal indicates that it is not the objective of the Federal Reserve to extend bank-like supervision to nondepository entities, the level of review is clearly heightened, covering such areas as strategic considerations, operational considerations, legal and reputational considerations, concentration considerations, capital distributions, intra-group exposures and parent company cash flow and leverage. Does the Federal Reserve intend to conduct an independent examination of entities regulated by other governmental authorities (SEC and state insurance commissioners) and, if so, how will differences be reconciled? Furthermore, the Proposal does not address how the Federal Reserve will reconcile differences with non-U.S. regulators that have regulatory responsibility for foreign nonbank subsidiaries of BHCs.

5. Financial Holding Company Status.

Another issue posed by the potential rereview of the primary regulator's rating is the effect on determining continued financial holding company ("FHC") status. If the Federal Reserve disagrees with the composite CAMEL rating of 1 or 2 of a depository institution subsidiary of a BHC that has elected FHC status, and assigns a (D) rating of "3" or below, it is not clear what effect that rating would have on the BHC's status as an FHC. A BHC that fails to be "well-managed" is required to execute an agreement with the Board to bring the BHC into compliance within a specified period of time, during which the BHC's activities may be severely limited. The well-managed standard is based, however, on the CAMEL rating assigned by the depository institution subsidiary's primary regulator. If the Federal Reserve assigns a composite rating of "3" or below, would this subject an FHC to similar requirements and limitations irrespective of a well-managed determination by the primary regulator?

6. Other Matters.

a. Confidentiality

The Proposal should confirm that all ratings will continue to remain confidential.

b. D Rating

It is not clear how the D rating actually fits into the Composite rating. We note, for example, that the Proposal relates to "three essential components" of the composite rating, which do not include D. Id. at 43997.

c. Legal Entities

The Proposal seems to place emphasis on individual legal entities. In contrast, lines of businesses have previously been the principal point of review. Clarification would be helpful.

d. Relationship to Section 404 of Sarbanes-Oxley

We recommend that the Proposal note that a rating less than the highest rating in any particular category does not suggest a significant control deficiency within the meaning of Section 404 of Sarbanes-Oxley.

e. Scale

Unlike all other components and subcomponents, risk management subcomponents are rated on a three-level scale rather than a five-level scale. We believe that there will be resultant uncertainty as to how to mesh the two different scales, and we recommend that the risk management subcomponents also be evaluated on a five-level scale.

f. <u>Duplication</u>

There appears to be some duplication in the assessment of risk management, as it is both an independent component (R) and an element of the financial condition component (F).

* * *

As requested above, The Clearing House member banks would greatly appreciate an opportunity to discuss these and other related issues with the Board's supervisory staff. Please feel free to call Norman R. Nelson of The Clearing House at (212) 612-9205.

Very truly yours,