Federal Advisory Council

On February 3, 2012, the Federal Advisory Council met with the Board of Governors to discuss the Board's proposed rulemaking concerning alternatives to the use of credit ratings to determine certain capital requirements under the market risk capital rules (Docket No R-1401). The Council provided written views, which are provided below.

Regulatory Measures of Creditworthiness

The federal banking agencies have proposed some alternative standards of creditworthiness to be used in place of credit ratings to determine the capital requirements for certain debt and securitization positions covered by the market risk capital rules. What is the Council's view of this proposal?

- The Council supports the banking agencies' overall goal of strengthening the regulatory capital framework and reducing the degree to which regulatory risk weights or capital charges are determined solely on the basis of credit ratings. The members also recognize the challenges associated with developing alternatives for the use of credit ratings in the capital rules and elsewhere.
- However, the Council believes that significant adjustments to the proposal are needed to ensure that any alternatives to credit ratings properly reflect the risk of exposures and the differences in risk among exposures both across and within asset classes. Moreover, we believe that the agencies should take the time necessary to ensure that the proposed alternatives are properly structured and calibrated. This is especially true since the agencies have indicated that the alternatives developed as part of the market-risk rulemaking will be applied to the banking book as well. Given the importance and complexity of the proposal, the agencies also should consider extending the comment period.
- The Council strongly believes that any alternatives developed for regulatory capital purposes and implemented in the United States must be risk sensitive. That is, within and across classes of exposures, the amount of required regulatory capital should accurately reflect differences in relative risk. Otherwise, the capital rules may unintentionally create incentives for banking organizations to hold *riskier* assets, much as the very broad risk-weighting categories in the original Basel I capital rules provided incentives for banks to purchase the riskier assets within these broad risk-weighting categories.
- The Council recognizes that appropriately risk-sensitive rules may result in adjustments – both upwards and downwards – to the risk weights for

particular exposures or types of exposures. Nevertheless, the Council believes that risk-sensitive capital rules are the best way to protect the safety and soundness of banking organizations, prevent systemic risks that can arise from distorted incentives, and deter regulatory arbitrage.

- The following highlights some of the most important concerns of Council members with the proposal:

Securitization exposures. Several aspects of the proposed Simplified Supervisory Framework Approach ("SSFA") weaken the SSFA's ability to accurately distinguish between the risk of different securitizations and tranches.

- For example, K_G, which is used to calibrate the capital charge, does not sufficiently take into account the difference in quality among different pools of assets in the same asset class. Moreover, it is unclear from the proposal whether or how credit enhancements, like overcollateralization and funded reserves, may be taken into account in assessing the risk of a securitization position.
- The proposed supervisory floor, moreover, would assign the same risk weight to all tranches above K_G once cumulative losses exceed K_G, regardless of the seniority or "thickness" of the tranche, both of which bear importantly on the probability and severity of potential losses on the position held. Further, the sizable "steps" in the floor overstate the incremental increases in risk, particularly with respect to more senior tranches, as cumulative losses begin to exceed K_G. These very large steps likely will have substantial procyclical effects as cumulative losses approach these breakpoints and do not recognize that risk decreases for many positions as the securitizations mature.
- Applying the capital charge to the par value or acquisition cost of a securitization, rather than to its carrying value, also will result in a regulatory capital "double hit" for those exposures' losses, which flow through earnings or regulatory capital.
- It is not clear how revolving securitization structures and FFELP student loans would be treated under the proposal.

Exposures to sovereign debt, banking organizations, and public-sector entities.

- Under the proposal, the OECD Country Risk Classification ("CRC") would be used to determine the risk weighting for sovereign debt positions. In addition, the risk weight for banking organization and public-sector entity (such as state and local governments) exposures would be based on the CRC assigned to the country where the banking organization or public-sector entity ("PSE") is chartered or incorporated.

- CRCs, however, may not accurately measure sovereign credit risk. For example, the OECD methodology for assigning CRCs are focused on transfer and convertibility risk and on the potential for force majeure events (e.g. war, expropriation) to disrupt the payment on obligations. Moreover, all OECD-member sovereigns that are a "high-income country" are assigned the most favorable classification even though there may be important gradations of risk among these countries.
- The proposal also does not appear to adequately recognize that the risk profile of banks and PSEs within a particular country, and the different classes of debt issued by these entities, can vary significantly. For example, the proposal would assign the same risk weight to the senior and subordinated debt issued by a banking organization, despite the higher risk posed by subordinated debt.

Public company exposures. Under the standard approach, all exposures to public companies would receive a uniform 100% risk weight. Preliminary analysis by one large institution suggests that the alternative indicator-based approach would result in exposures to many investment-grade corporate issuers being assigned the same risk weight as exposures to non-investment-grade issuers. Moreover, neither approach takes into account potential differences in the level of seniority or collateral support among the debt issues of a particular issuer. Accordingly, the proposal unintentionally creates incentives for banking organizations to invest in riskier, rather than safer, corporate debt.