

**DEPARTMENT OF THE TREASURY**  
**Office of the Comptroller of the Currency**  
**12 CFR Part 3**  
**Docket ID: OCC-2010-0016**  
**RIN 1557-AD35**

**FEDERAL RESERVE SYSTEM**  
**12 CFR Parts 208 and 225**  
**Regulations H and Y; Docket No. R-1391**  
**RIN 7100-AD53**

**FEDERAL DEPOSIT INSURANCE CORPORATION**  
**12 CFR Part 325**  
**RIN 3064-AD62**

**DEPARTMENT OF THE TREASURY**  
**Office of Thrift Supervision**  
**12 CFR Part 567**  
**Docket ID: OTS-2010-0027**  
**RIN 1550-AC43**

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

**AGENCIES:** Office of the Comptroller of the Currency (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision (OTS).

**ACTION:** Joint Advance Notice of Proposed Rulemaking.

**SUMMARY:** The regulations of the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS) (collectively, the agencies) include various references to and requirements based on the use of credit ratings issued by nationally recognized statistical rating organizations (NRSROs). Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), enacted on July 21, 2010, requires the agencies to review their regulations that (1) require the use of an assessment of credit-worthiness of a security or money market instrument and (2) make reference to, or have requirements regarding, credit ratings. The agencies must then modify their regulations to remove any reference to, or requirements of reliance on, credit ratings in such regulations and substitute in their place other standards of credit-worthiness that the agencies determine to be appropriate for such regulations.

This advanced notice of proposed rulemaking (ANPR) describes the areas in the agencies' risk-based capital standards and Basel changes that could affect those standards

that make reference to credit ratings and requests comment on potential alternatives to the use of credit ratings.

**DATES:** Comments on this ANPR must be received by [INSERT DATE 60 DAYS AFTER FEDERAL REGISTER PUBLICATION].

**ADDRESSES:** Comments should be directed to:

**OCC:** Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by e-mail, if possible. Please use the title “Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Regulatory Capital Guidelines of the Federal Banking Agencies” to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- **Federal eRulemaking Portal – “Regulations.gov”:** Go to <http://www.regulations.gov>, under the “More Search Options” tab click next to the “Advanced Docket Search” option where indicated, select “Comptroller of the Currency” from the agency drop-down menu, then click “Submit.” In the “Docket ID” column, select OCC-2010-0016 to submit or view public comments and to view supporting and related materials for this notice of proposed rulemaking. The “How to Use This Site” link on the Regulations.gov home page provides information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.
- **E-mail:** [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).
- **Mail:** Office of the Comptroller of the Currency, 250 E Street, SW, Mail Stop 1-5, Washington, DC 20219.
- **Fax:** (202) 874-4448.
- **Hand Delivery/Courier:** 250 E Street, SW, Attn: Public Information Room, Mail Stop 1-5, Washington, DC 20219.

*Instructions:* You must include “OCC” as the agency name and “Docket Number OCC-2010-0016” in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, e-mail addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this [insert type of rulemaking action] by any of the following methods:

- **Viewing Comments Electronically:** Go to <http://www.regulations.gov>, under the “More Search Options” tab click next to the “Advanced Document Search” option where indicated, select “Comptroller of the Currency” from the agency drop-down

menu, then click “Submit.” In the “Docket ID” column, select “OCC-2010-0016” to view public comments for this rulemaking action.

- **Viewing Comments Personally:** You may personally inspect and photocopy comments at the OCC’s Public Information Room, 250 E Street, SW, Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874-5043. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.
- **Docket:** You may also view or request available background documents and project summaries using the methods described above.

**Board:** You may submit comments, identified by Docket No. R-1391, by any of the following methods:

- **Agency Web Site:** <http://www.federalreserve.gov> Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- **Federal eRulemaking Portal:** <http://www.regulations.gov> Follow the instructions for submitting comments.
- **E-mail:** [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.
- **FAX:** (202) 452-3819 or (202) 452-3102.
- **Mail:** Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20<sup>th</sup> Street and Constitution Avenue, NW, Washington, DC 20551.

All public comments are available from the Board’s Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in Room MP-500 of the Board’s Martin Building (20<sup>th</sup> and C Street, NW) between 9:00 a.m. and 5:00 p.m. on weekdays.

**FDIC:** You may submit comments on the ANPR, by any of the following methods:

- **Agency Web Site:** <http://www.FDIC.gov/regulations/laws/federal/notices.html>. Follow instructions for submitting comments on the Agency Web Site.
- **E-mail:** [Comments@FDIC.gov](mailto:Comments@FDIC.gov). Include RIN # on the subject line of the message.
- **Mail:** Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429.
- **Hand Delivery:** Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

**Instructions:** All comments received will be posted generally without change to <http://www.fdic.gov/regulations/laws/federal/propose.html>, including any personal information provided.

**OTS:** You may submit comments, identified by OTS-2010-0027, by any of the following methods:

- **Federal eRulemaking Portal:** “Regulations.gov”: Go to <http://www.regulations.gov> and follow the instructions for submitting comments.
- **Mail:** Regulation Comments, Chief Counsel’s Office, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552, Attention: OTS-2010-0027.
- **Facsimile:** (202) 906-6518.
- **Hand Delivery/Courier:** Guard’s Desk, East Lobby Entrance, 1700 G Street, NW, from 9 a.m. to 4 p.m. on business days, Attention: Regulation Comments, Chief Counsel’s Office, Attention: OTS-2010-0027.
- **Instructions:** All submissions received must include the agency name and docket number for this rulemaking. All comments received will be posted without change, including any personal information provided. Comments, including attachments and other supporting materials received are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.
- **Viewing Comments Electronically:** Go to <http://www.regulations.gov> and follow the instructions for reading comments.
- **Viewing Comments On-Site:** You may inspect comments at the Public Reading Room, 1700 G Street, NW, by appointment. To make an appointment for access, call (202) 906-5922, send an e-mail to [public.info@ots.treas.gov](mailto:public.info@ots.treas.gov), or send a facsimile transmission to (202) 906-6518. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days between 10 a.m. and 4 p.m. In most cases, appointments will be available the next business day following the date we receive a request.

**FOR FURTHER INFORMATION CONTACT:**

OCC: Mark Ginsberg, Risk Expert, Capital Policy Division, (202) 874-5070; or Carl Kaminski, Senior Attorney, Legislative and Regulatory Activities Division, (202) 874-5090, Office of the Comptroller of the Currency, 250 E. Street, SW, Washington, DC 20219.

Board: Thomas Boemio, Senior Project Manager, (202) 452-2982; William Treacy, Advisor, (202) 452-3859, Christopher Powell, Financial Analyst, (202) 912-4353, Division of Banking Supervision and Regulation; or Benjamin McDonough, Counsel, (202) 452-2036, or April Snyder, Counsel, (202) 452-3099; Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551.

FDIC: Bobby Bean, Chief, (202) 898-6705; Ryan Billingsley, Senior Policy Analyst, (202) 898-3797, Policy Section, Division of Supervision and Consumer Protection; or Mark Handzlik, Counsel, (202) 898-3990, or Michael B. Phillips, Counsel, (202) 898-3581, Supervision and Legislation Branch, Legal Division, Federal Deposit Insurance Corporation, 550 17<sup>th</sup> Street, NW, Washington, DC 20429.

OTS: Sonja White, Director, Capital Policy, (202) 906-7857, Teresa A. Scott, Senior Policy Analyst, Capital Policy, (202) 906-6478, or Marvin Shaw, Senior Attorney, Regulations and Legislation Division, (202) 906-6639, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552.

## I. BACKGROUND

The agencies' regulations and capital standards include various references to and regulatory requirements based on the use of credit ratings issued by NRSROs.<sup>1</sup> Section 939A of the Act requires each Federal agency to review "(1) any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and (2) any references to or requirements in such regulations regarding credit ratings."<sup>2</sup> Each Federal agency must then "modify any such regulations identified by the review ... to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations." In developing substitute standards of credit-worthiness, an agency "shall seek to establish, to the extent feasible, uniform standards of credit-worthiness" for use by the agency, taking into account the entities it regulates that would be subject to such standards.<sup>3</sup>

Through this advanced notice of proposed rulemaking (ANPR), the agencies are seeking to gather information as they begin to work toward revising their regulations and capital standards to comply with the Act. This ANPR describes the areas in the agencies' general risk-based capital rules,<sup>4</sup> market risk rules,<sup>5</sup> and advanced approaches rules<sup>6</sup> (collectively, the risk-based capital standards) where the agencies rely on credit ratings, as well as the Basel Committee on Banking Supervision's (Basel Committee) recent amendments to the Basel Accord.<sup>7</sup> The ANPR requests comment on potential alternatives to the use of credit ratings.<sup>8</sup>

## II. Risk-Based Capital Standards

In June 2009, the agencies, as part of the international Joint Forum Working Group on Risk Assessment and Capital, participated in a stocktaking exercise to identify

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<sup>1</sup>A nationally recognized statistical rating organization (NRSRO) is an entity registered with the U.S. Securities and Exchange Commission (SEC) as an NRSRO under section 15E of the Securities Exchange Act of 1934. See 15 U.S.C. 78o-7, as implemented by 17 CFR 240.17g-1. On September 29, 2006, the President signed the Credit Rating Agency Reform Act of 2006 ("Reform Act") (Pub. L. 109-291) into law. The Reform Act requires a credit rating agency that wants to represent itself as an NRSRO to register with the SEC.

<sup>2</sup> Pub. L. No. 111-203, 124 Stat. 1376, section 939A (July 21, 2010). Although the agencies have conducted a broad review of their risk-based capital regulations to identify all references to credit ratings and consider alternatives, the agencies note that section 939A of the Dodd-Frank Act limits the required review of agency regulations to those pertaining to a credit-worthiness assessment of a security or money market instrument.

<sup>3</sup> Id.

<sup>4</sup> See 12 CFR Part 3, Appendix A (OCC); 12 CFR parts 208 and 225, Appendix A (Board); 12 CFR part 325, Appendix A (FDIC); 12 CFR part 567, subpart B (OTS).

<sup>5</sup> See 12 CFR Part 3, Appendix B (OCC); 12 CFR parts 208 and 225, Appendix E (Board); 12 CFR part 325, Appendix C (FDIC); OTS does not have a market risk rule.

<sup>6</sup> See 12 CFR Part 3, Appendix C (OCC); 12 CFR part 208, Appendix F and 12 CFR part 225, Appendix G (Board); 12 CFR part 325, Appendix D (FDIC); 12 CFR part 567, Appendix C (OTS).

<sup>7</sup> See "International Convergence of Capital Measurement and Capital Standards, a Revised Framework, Comprehensive Version," the Basel Committee on Banking Supervision, June 2006. The full text is available on the Bank for International Settlement's website, <http://www.bis.org/publ/bcbs128.htm>.

<sup>8</sup> The OCC is planning to issue a similar advance notice of proposed rulemaking addressing alternatives to the use of external credit ratings in the regulations of the OCC.

the use of credit ratings in relevant statutes, regulations, policies and guidance.<sup>9</sup> The agencies have identified multiple regulations that must be brought into compliance with Section 939A of the Act. Included among these regulations are the agencies' risk-based capital standards.

The agencies' risk-based capital standards reference credit ratings issued by NRSROs (credit ratings) in four general areas: (1) the assignment of risk weights to securitization exposures under the general risk-based capital rules and advanced approaches rules;<sup>10</sup> (2) the assignment of risk weights to claims on, or guaranteed by, qualifying securities firms under the general risk-based capital rules;<sup>11</sup> (3) the assignment of certain standardized specific risk add-ons under the agencies' market risk rule;<sup>12</sup> and (4) the determination of eligibility of certain guarantors and collateral for purposes of the credit risk mitigation framework under the advanced approaches rules.<sup>13</sup> In 2008, the agencies issued a notice of proposed rulemaking<sup>14</sup> that sought comment on implementation in the United States of certain aspects of the standardized approach in the Basel Accord. The Basel standardized approach for credit risk (Basel standardized approach) relies extensively on credit ratings to assign risk weights to various exposures. (Throughout the rest of this ANPR, references to the Basel standardized approach are references to the Basel Accord rather than the 2008 proposal.)

In 2009, the Basel Committee published the following documents that were designed to strengthen the risk-based capital framework in the Basel Accord: *Revisions to the Basel II Market Risk Framework* (Revisions Document); *Enhancements to the Basel II Framework* (Enhancements Document); and *Strengthening the Resilience of the Banking Sector*.<sup>15</sup> In the Enhancements Document, the Basel Committee introduced operational criteria to require banking organizations<sup>16</sup> to undertake independent analyses of the credit-worthiness of their securitization exposures.<sup>17</sup> Implementation in the United

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<sup>9</sup> See, "Stocktaking on the use of credit ratings", The Joint Forum. The full text is available on the Bank for International Settlement's website, <http://www.bis.org/publ/joint22.htm>.

<sup>10</sup> See 12 CFR part 3, Appendices A and C (OCC); 12 CFR part 208, Appendices A and F and 12 CFR part 225, Appendices A and G (Board); 12 CFR part 325, Appendix A and 12 CFR part 325 Appendix D (FDIC); 12 CFR part 567, subpart B and Appendix C (OTS).

<sup>11</sup> See 12 CFR part 3, Appendix A, section 3(a)(2)(xiii) (OCC); 12 CFR parts 208 and 225, Appendix A, § III.C.2 (Board); 12 CFR part 325, Appendix A, § II.C. (FDIC); 12 CFR 567.6 (OTS).

<sup>12</sup> See 12 CFR part 3, Appendix B, section 5 (OCC); 12 CFR parts 208 and 225, Appendix E, section 5 (Board); 12 CFR part 325, Appendix C, section 5 (FDIC); OTS does not have a market risk rule.

<sup>13</sup> See the definition of "eligible double default guarantor," "eligible securitization guarantor," and "financial collateral" in the agencies advanced approaches rules. 12 CFR part 3, Appendix C, section 2 (OCC); 12 CFR part 208, Appendix F § 2 and 12 CFR part 225, Appendix G § 2 (Board); 12 CFR part 325, Appendix D § 2 (FDIC); 12 CFR part 567, Appendix C, section 2 (OTS).

<sup>14</sup> 73 Fed. Reg. 43982.

<sup>15</sup> See "Revisions to the Basel II Market Risk Framework" (July, 2009, Basel Committee); "Guidelines for Computing Capital for Incremental Risk in the Trading Book" (July, 2005, joint publication of the Basel Committee and International Organization for Securities Commissioners); "Enhancements to the Basel II Framework" (July, 2009, Basel Committee); and "Strengthening the Resilience of the Banking Sector" (December, 2009, Basel Committee).

<sup>16</sup> For simplicity, and unless otherwise indicated, this ANPR uses the term "banking organization" to include banks, savings associations, and bank holding companies.

<sup>17</sup> These operational criteria would require a bank to have a comprehensive understanding of the risk characteristics of its individual securitization exposures; be able to access performance information on the underlying pools on an on-going basis in a timely manner; and have a thorough understanding of all structural features of a securitization transaction. Enhancements Document, paragraphs 565(i)-(iv).

States of the changes to the Basel Accord contained in the Revisions Document would be significantly affected by the need for the agencies to comply with section 939A of the Act.

The table below provides an overview of where credit ratings are referenced and used as the basis for a capital requirement along two dimensions of exposure category and capital framework.

Exposure Category	General risk-based capital rules	Advanced approaches rules	Market risk rules	Basel standardized approach	Basel market risk framework (Revisions Document)
Sovereign			X	X	X
Public Sector Entity			X	X	X
Bank				X	X
Corporate	X		X	X	X
Securitization	X	X	X	X	X
Credit Risk Mitigation	X	X		X	

### III. Request for Comment

This ANPR seeks comment on standards of credit-worthiness other than credit ratings that may be used for purposes of the risk-based capital standards. The various alternative approaches in this ANPR may present challenges of feasibility in varying degrees. The agencies would appreciate commenters' views on the feasibility of implementing the suggestions for alternative approaches in this ANPR and any methodologies that commenters may provide.

#### a. Credit-worthiness Standards

Section 939A of the Act requires the agencies to establish, to the extent feasible, uniform standards of credit-worthiness to replace references to, or requirements of reliance on, credit ratings for purposes of the agencies' regulations. The agencies are therefore considering alternative credit-worthiness standards, including those currently in use in the agencies' regulations, supervisory guidance, and market practices. The agencies recognize that any measure of credit-worthiness will involve a tradeoff among the principles listed below. For example, a more refined differentiation of risk might be achievable only at the expense of greater implementation burden. In evaluating any standard of credit-worthiness for purposes of determining risk-based capital requirements, the agencies will, to the extent practicable and consistent with the other objectives, consider whether the standard would:

- 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.

Question 1: The agencies seek comment on the principles that should guide the formulation of credit-worthiness standards. Do the principles provided above capture the appropriate elements of sound credit-worthiness standards? How could the principles be strengthened?

**b. Possible alternatives to credit ratings in the risk-based capital standards**

The agencies' existing risk-based capital standards include a range of approaches to differentiating credit risk. At one end of the spectrum, the agencies' general risk-based capital rules provide a relatively simple approach to measuring and differentiating risk based on the use of broad risk buckets. This approach requires all corporate exposures, for example, to receive the same risk weight, regardless of the variation in risks that exist across corporate exposures. At the other end of the spectrum, the agencies' advanced approaches rules require a banking organization to make its own assessment of the credit risk of a corporate exposure, subject to a number of agency-prescribed standards. This assessment is then used as an input into a supervisory formula to calculate minimum risk-based capital requirements. The agencies' rules also incorporate other methods for assessing risk-based capital requirements, including the use of NRSRO ratings.

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 developing 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. The approaches also include developing broad qualitative and quantitative 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. These general approaches present certain advantages and disadvantages. In considering these approaches, the agencies will evaluate the extent to which the alternatives meet the principles described above.

Risk Weights Based on Exposure Category: One way to eliminate references to credit ratings in the risk-based capital standards would be for the agencies to delete all of the sections in their risk-based capital regulations that refer to credit ratings and retain the remainder of the general risk-based capital rules. Under this approach, all non-securitization exposures generally would receive a 100 percent risk-weight unless otherwise specified. For example, certain sovereign and bank exposures would be assigned a zero percent or a 20 percent risk weight, respectively. Alternatively, the agencies could revise the risk-weight categories for exposures by considering the type of obligor, for example, sovereign, bank, public sector entity (PSE),<sup>18</sup> as well as considering other criteria, such as the characteristics of the exposure, which could increase the risk sensitivity of the risk-based capital requirements by providing a wider range of risk-weight categories.

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 by the agencies for various

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<sup>18</sup> A PSE exposure is an exposure to a state, local authority, or other government subdivision below the sovereign entity level.



exposure categories. Such standards would be based on broad credit-worthiness metrics. For instance, exposures could be assigned a risk weight based on certain market-based measures, such as credit spreads; obligor-specific financial data, such as debt-to-equity ratios; or other sound underwriting criteria. Alternatively, banking organizations could assign exposures to one of a limited number of risk weight categories based on an assessment of the exposure's probability of default or expected loss.

As part of an exposure-specific approach, the agencies are considering whether banking organizations should be permitted to contract with third-party service providers to obtain quantitative data, such as probabilities of default, as part of their process for making credit-worthiness determinations and assigning risk weights. While this method could increase risk sensitivity, consistent application across exposure categories and across banking organizations could be more difficult to achieve.

Alternatively, 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 requirement for individual securities.<sup>19</sup> One potential drawback of this approach is excessive reliance on a single third-party assessment of risk.

Regardless of the approach used, the agencies would establish strict quantitative and qualitative criteria to ensure that the methodology employed is consistent with safe and sound banking practices.

Question 2: What are the advantages and disadvantages for each of these general approaches? What, if any, combination of the approaches would appropriately reflect exposure categories and the sophistication of individual banking organizations? What other approaches do commenters believe would meet the agencies' suggested criteria for a credit-worthiness standard? If increasing reliance is placed on banking organizations to assign risk weights for credit exposures using the types of approaches described above, how would the agencies ensure consistency of capital treatment for similar exposures? How could the use of third-party providers be implemented to ensure quality, transparency, and consistency?

### **c. Exposure-specific options for measuring credit-worthiness**

The broad approaches discussed above could be applied in various ways across the agencies risk-based capital rules as well as existing exposure categories. While the range of approaches is potentially applicable to all exposure categories, the sections below provide a more detailed discussion of how the approaches might be implemented by exposure categories.

#### **i. Sovereign Exposures**

The agencies' general risk-based capital rules risk weight exposures to sovereign entities based on membership in the Organization for Economic Cooperation and Development (OECD).<sup>20</sup> However, under the Basel standardized approach, a banking

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<sup>19</sup> See <http://www.naic.org/rmbs/index.htm#background>.

<sup>20</sup> 12 CFR part 3, Appendix A, section 3(a) (OCC); 12 CFR parts 208 and 225, Appendix A, § III.C (Board); 12 CFR. part 325, Appendix A, § II.C. (FDIC); 12 CFR 567.6 (OTS). The OECD-based group of countries comprises all full members of the OECD, as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements to Borrow. The list of OECD countries is available on the OECD web site at [www.oecd.org](http://www.oecd.org).

organization would assign a risk weight to a sovereign exposure based on the external credit rating of the sovereign by a credit rating agency.<sup>21</sup> The current market risk rule and the Basel modified market risk framework also make use of ratings for sovereign exposures.

There are several alternative methodologies that could be used to risk weight sovereign exposures that have different implications for risk sensitivity. One option would be to assign risk weights for sovereign exposures based on whether the sovereign is a member of an organization other than the OECD, such as the G-20 or the Basel Committee on Banking Supervision, or whether it participates in the International Monetary Fund (IMF) New Arrangements to Borrow. This type of approach would be operationally simple, but would not recognize differences in credit-worthiness among the individual member nations within an organization. An additional degree of risk sensitivity could be incorporated into this approach by adding additional criteria beyond membership in a given organization. For instance, a higher risk weight could be assigned to an exposure to a sovereign entity if it had restructured its debt within a specified period of time or if its credit-worthiness deteriorated based on some market indicator (for example, credit spreads).

The agencies could also consider incorporating into standards of credit-worthiness country risk classifications generated by the OECD, the World Bank, or a similar organization. This approach could assign risk weights according to the relative credit risk of each risk classification or designation. Under such an approach, exposures to sovereigns classified as having lower credit risk would receive lower risk weights, and exposures classified as higher risk would receive higher risk weights.

A third option would be to differentiate the credit risk of sovereign exposures based on certain key financial and economic indicators. For example, risk weights could be assigned based on one or more ratios such as gross debt per capita, real gross domestic product growth rate, or government debt and foreign reserves. Such a treatment would require the agencies to select specific ratios and acceptable data sources, for example, from the IMF or the OECD.

Question 3: What are the advantages and disadvantages of these alternative methods? How can the agencies ensure consistent and transparent implementation? Should the agencies consider other international organizations? Which financial and economic indicators should the agencies consider? What are the implications or potential unintended consequences? Are there other methods for assessing risk-based capital requirements for sovereign exposures that would meet the principles described in section III? Commenters are asked to provide quantitative as well as qualitative support and/or analysis for proposed alternative methods.

**ii. Public Sector Entity (PSE) exposures**

The agencies' general risk-based capital rules assign risk weights to PSE exposures based on the repayment source for the exposure (for example, whether the exposure is a general obligation, revenue, or industrial revenue bond) and membership of the PSE's sovereign government in the OECD.<sup>22</sup> Under the Basel standardized approach, PSE exposures would be risk weighted based on the credit rating of the exposure or the

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<sup>21</sup> Basel Accord, Paragraphs 53-56.

<sup>22</sup> See 12 CFR parts 208 and 225, Appendix A, § III.C (Board); 12 CFR part 325, Appendix A, § II.C (FDIC); 12 CFR 567.6 (OTS).

risk weight of the sovereign.<sup>23</sup> The current market risk rule and the Basel modified market risk framework also make use of credit ratings for PSE exposures.

One approach would be to continue to use the general risk-based capital rules' treatment of differentiating the risk of PSEs based on the type of exposure, the sovereign of incorporation, and by how revenues are collected for the PSE exposure.

Alternatively, the agencies could provide some incremental risk sensitivity by differentiating revenue bond issuers by type of service or business. As with sovereign exposures, risk weighting could be based on several financial and economic measures. For example, the agencies could assign risk weights based on one or more ratios, such as a relevant debt service obligation to cash flow ratio (for example, debt to revenue), and/or debt to market value of certain assets (for example, real estate). The agencies also could incorporate credit spreads to help differentiate credit risk among PSE exposures. Other options include permitting banking organizations to assign risk weights to PSE exposures based on the applicable risk weight of the sovereign of incorporation, or using data obtained from qualified third parties to inform credit-worthiness assessments based upon a set of objective criteria established by the agencies.

Question 4: What are the advantages and disadvantages of these alternative methods for calculating risk-based capital requirements for PSE exposures? How can the agencies ensure consistent and transparent implementation? Which services and businesses, or financial and economic measures, should the agencies consider? What are the implications or potential for unintended consequences? Are there other methods for assessing risk-based capital for PSE exposures in a relatively risk sensitive manner that would meet the principles described in section III? Commenters are asked to provide quantitative as well as qualitative support and/or analysis for proposed alternative methods.

### **iii. Bank exposures**

The agencies' general risk-based capital rules generally assign a 20 percent risk weight to exposures to U.S. depository institutions and foreign banks.<sup>24</sup> Long-term exposures to banks not incorporated in OECD countries are assigned a 100 percent risk weight. Under the Basel standardized approach, bank exposures would be risk weighted based either on the risk weight of the sovereign or the credit rating of the exposure.<sup>25</sup> The market risk rule and the Basel modified market risk framework also use ratings for bank exposures.

One option for risk weighting bank exposures is to continue to use the general risk-based capital treatment, which bases the risk weight for bank exposures on whether the sovereign where the bank is incorporated is a member of the OECD. Another method for risk weighting bank exposures could be based on several financial measures and market indicators. For example, the agencies could assign risk weights based on one or more ratios such as funding (for example, core deposits to total liabilities) and/or credit quality (for example, non-performing items to total assets). This method also could be supplemented for banks with publicly traded securities with market-based information

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<sup>23</sup> Basel Accord, paragraphs 57-58.

<sup>24</sup> See 12 CFR parts 208 and 225, Appendix A, § III.C (Board) ; 12 CFR part 325, Appendix A, § II.C (FDIC); 12 CFR 567.6 (OTS).

<sup>25</sup> Basel Accord, paragraphs 60-64.

such as a banking organization's unsecured bond spreads over comparable Treasury securities.

Question 5: What are the advantages and disadvantages of these alternative methods for calculating risk-based capital requirements for bank exposures? How can the agencies ensure consistent and transparent implementation? Which financial and market indicators should the agencies consider? What are the implications or potential for unintended consequences? Are there other methods for assessing risk-based capital for bank exposures in a relatively risk sensitive manner that would meet the principles described in section III? Commenters are asked to provide quantitative as well as qualitative support and/or analysis for proposed alternative methods.

#### **iv. Corporate Exposures**

Under the agencies' general risk-based capital rules, corporate exposures generally<sup>26</sup> receive a risk weight of 100 percent,<sup>27</sup> whereas under the Basel standardized approach, banking organizations would be allowed to use credit ratings to assign risk weights to corporate exposures.<sup>28</sup> The current market risk rule and the Basel modified market risk framework also use credit ratings for corporate exposures.

One option for risk weighting corporate exposures would be to continue to use the treatment provided in the general risk-based capital rules and require banking organizations to risk weight all corporate exposures at 100 percent. Another method would be to differentiate the credit risk of corporate exposures based on financial and economic measures appropriate to the borrower. For example, the agencies could allow banking organizations to assign risk weights based on balance sheet or cash flow ratios, such as current assets to current liabilities, debt to equity, or some form of debt service to cash flow ratio (for example, current interest and maturities to current cash flow from operations). Alternatively, some corporate exposures for publicly traded firms could be risk weighted on the basis of market-based measures, such as credit spreads, equity-price implied default probability, and measures of capital adequacy and liquidity.

Finally, the agencies could allow banking organizations to assign risk weights based upon a more flexible set of objective criteria that the agencies would establish by rule. As a part of their process for making credit-worthiness determinations and assigning risk weights, banking organizations would be allowed to consider external data, including credit analyses (but not credit ratings) provided by third parties, that met standards established by the agencies.

Question 6: What are the advantages and disadvantages of these alternative methods? What are the implications or potential for unintended consequences? If all banking organizations are allowed to calculate their own capital requirements for corporate exposures, how can the agencies ensure consistent and transparent implementation (for example, where there may be material differences in how financial statements are typically presented or differences in chosen financial ratios)? What different approaches or other financial or market criteria would commenters recommend? Are there other methods for assessing risk-based capital for corporate exposures in a

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<sup>26</sup> Certain claims on, or claims guaranteed by, qualifying securities firms may receive a 20 percent risk weight.

<sup>27</sup> 12 CFR parts 208 and 225, Appendix A, § III.C (Board) ; 12 CFR part 325, Appendix A, § II.C (FDIC); 12 CFR 567.6(a)(1)(iv) (OTS).

<sup>28</sup> Basel Accord, paragraphs 66-68.

relatively risk sensitive manner that would meet the principles described in section III? Commenters are asked to provide quantitative, as well as qualitative, support and/or analysis for proposed alternative methods.

**v. Securitization Exposures**

Under the agencies' general risk-based capital rules, a banking organization may use credit ratings to assign risk weights to certain securitization exposures.<sup>29</sup> Generally, when a banking organization cannot, or chooses not to use the ratings-based approach, it must either "gross-up" the exposure or hold dollar-for-dollar capital against the exposure. These latter methods are designed to capture the risk of unrated or low rated exposures that typically are subordinate in the capital structure of a securitization. Under the advanced approaches rules and the Basel standardized approach, a banking organization is required to use a ratings-based approach when available to assign risk weights to traditional and synthetic securitization exposures.<sup>30</sup> Both the advanced approaches rules and the Basel standardized approach also provide alternative approaches for determining the capital requirements for exposures that do not qualify for the ratings-based approach. The market risk rule and the Basel modified market risk framework also use credit ratings for securitization exposures.

Prior to the implementation of the recourse, direct credit substitutes, residual interests and mortgage- and asset-backed securities rule in 2001 (recourse rule),<sup>31</sup> the agencies' general risk-based capital rules did not rely on credit ratings to determine risk weights for securitization exposures. In addition to establishing a risk-weighting framework based on credit ratings, the recourse rule established an alternative risk-weighting framework for certain securitization exposures (a gross-up treatment reflecting the risk of more subordinated tranches of securitizations). The agencies could apply the risk-based capital rules in effect prior to the implementation of the recourse rule, which would eliminate all references to credit ratings. This would result in all securitization exposures receiving the same risk weight regardless of the amount of subordination in the securitization structure. Alternatively, the agencies could:

- Require that banks apply the aforementioned "gross-up" treatment under which a bank must maintain capital against its securitization exposure, as well as against all more senior exposures that the bank's exposure supports in the structure. The grossed-up exposure would then be assigned to the risk weight appropriate to the underlying securitized exposures.
- Differentiate the credit risk of the "grossed-up" securitization exposure based on financial and structural parameters of the underlying or reference pool of instruments, as well as the exposure itself. For example, risk weights could be assigned based on the securitization transaction's overcollateralization ratio, interest coverage ratio, or priority in the cash flow waterfall.
- Assign the most senior securitization exposure in a transaction a risk weight based

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<sup>29</sup> 12 CFR part 3, Appendix A, section 4 (OCC); 12 CFR parts 208 and 225, Appendix A, §III.B.3.c and (Board); 12 CFR part 325, Appendix A, § II.B.5 (FDIC); 12 CFR parts 567, subpart B (OTS).

<sup>30</sup> Basel Accord, Paragraph 567 (Basel standardized approach) and 12 CFR part 3, Appendix C, section 43(b) (OCC); 12 CFR part 208, Appendix F § 43(b) and 12 CFR part 225, Appendix G § 43(b) (Board); 12 CFR part 325, Appendix D, § 43(b) (advanced approaches rule) (FDIC); 12 CFR part 567, Appendix C, section 43(b) (OTS).

<sup>31</sup> 66 FR 59617 (November 29, 2001).

on the underlying exposure type and the aggregate amount of subordination that provides credit enhancement to the exposure. For example, the greater the amount of subordination, the lower the risk weight to which the senior exposure would be assigned. However, this approach would only apply to the senior-most tranche and would not distinguish between exposures with significant credit support and those where the support had been reduced or eliminated by losses.

- Adopt the Basel Committee’s approach to calculating capital requirements for securitization exposures that is based on the level of subordination and the type of underlying exposures in the Revisions Document. The approach would use a “concentration ratio” to set the minimum risk-based capital requirements for securitization positions. The concentration ratio is equal to the sum of the notional amounts of all the tranches divided by the sum of the notional amounts of the tranches junior to or *pari passu* with the tranche in which the position is held including that tranche itself. The capital requirement is 8 percent of the weighted-average risk weight that would be applied to the underlying securitized exposures multiplied by the concentration ratio. If the concentration ratio is 12.5 or higher, the position would be deducted from capital. Under this approach, the capital requirement would be no less than that which would result from a direct exposure to the underlying assets.
- Design a risk-weighting approach based on a supervisory formula. Building on the capital requirements of the underlying exposures, the agencies could recognize multiple sources of risk related to securitizations and impose provisions that limit some forms of arbitrage. Under the advanced approaches rules, for example, banking organizations are allowed to use the supervisory formula approach (SFA) to calculate minimum regulatory capital requirements for certain securitization exposures.<sup>32</sup> This approach uses exposure-specific inputs, including the capital requirement of the underlying exposures as if held directly by the banking organization. The inputs required for calculating the capital requirement of the underlying exposures are not always available for investing banking organizations. Nevertheless, the agencies could develop a simplified version of the SFA that could be applied by all banking organizations. Depending upon the parameters used in the SFA, this approach could increase risk sensitivity, as well as potentially increasing transparency in the securitization market.

Question 7: What are the advantages and disadvantages of these approaches for calculating risk-based capital requirements for securitization exposures? How can the agencies ensure consistent and transparent implementation? Which parameters or measures of subordination and structure should the agencies consider? What are the implications or potential for unintended consequences? How can the agencies ensure that an alternative approach meets the criteria for a credit-worthiness standard? What other approaches or specific financial and structural parameters that would be appropriate standards of credit-worthiness for securitization exposures? Commenters are asked to provide quantitative as well as qualitative support and/or analysis for proposed alternative methods.

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<sup>32</sup> 12 CFR part 3, Appendix C § 45 (OCC); 12 CFR part 208, Appendix F § 45 and 12 CFR part 225, Appendix G § 45 (Board); 12 CFR part 325, Appendix D, § 45 (FDIC); 12 CFR part 567, Appendix C, section 45 (OTS).

**vi. Guarantees and Collateral**

The agencies' general risk-based capital rules generally limit the recognition of third-party guarantees to those provided by central governments, U.S. government agencies, banks, state and local governments of OECD countries, qualifying securities firms, and multilateral lending institutions and regional development banks. The general risk-based capital rules recognize collateral in the form of cash, securities issued or guaranteed by OECD central governments, securities issued by U.S. government agencies or U.S. government-sponsored agencies, and securities issued by multilateral lending institutions and regional development banks.<sup>33</sup>

Under the Basel standardized approach, guarantor eligibility is based on the credit rating of the guarantor's unsecured long-term debt security without credit enhancement that has a long-term external credit rating.<sup>34</sup> In addition, financial collateral includes, among other things, long-term debt securities that have an external credit rating of one category below investment grade or higher and short-term debt securities that have an external credit rating of at least investment grade.<sup>35</sup>

The advanced approaches rules recognize the risk reducing effects of financial collateral and guarantees.<sup>36</sup> Eligible financial collateral includes long-term debt securities that have a credit rating of one category below investment grade or higher and short-term debt securities that have a credit rating of at least investment grade.<sup>37</sup> Guarantors eligible for double default treatment include those entities that a banking organization assigns a probability of default equal to or lower than the probability of default associated with a long-term credit rating in the third-highest investment grade category.<sup>38</sup>

One option would be to expand the use of the recognition of collateral and guarantees as provided in the general risk-based capital rules, that is, by substituting the risk weight appropriate to the guarantor or collateral for that of the exposure. This approach would have to be modified to exclude mention of external credit ratings for certain securities firms. The agencies could also incorporate into the recognition of collateral and guarantees some of the credit-worthiness standards discussed above for sovereign, PSE, bank, and corporate exposures.

Question 8: What are the advantages and disadvantages of the alternative approaches? What are the implications or potential for unintended consequences? Are there other approaches that would more appropriately capture the risk-mitigating effects of collateral and/or guarantees without adding undue cost or burden? Commenters are asked to provide quantitative as well as qualitative supporting data and/or analysis for proposed alternative methods.

**d. Burden**

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<sup>33</sup> See 12 CFR part 3, Appendix A (OCC), 12 CFR parts 208 and 225, Appendix A, III.B (Board); 12 CFR part 325, Appendix A, § II.B.2 (FDIC); 12 CFR 567.6 (OTS).

<sup>34</sup> Basel Accord, paragraph 195.

<sup>35</sup> Id. at paragraph 145.

<sup>36</sup> 12 CFR part 3, Appendix C, sections 33 and 34 (OCC); 12 CFR part 208, Appendix F §§ 34 and 35 and 12 CFR part 225, Appendix G §§ 34 and 35 (Board); 12 CFR part 325, Appendix D, §§ 34 & 35 (FDIC); 12 CFR part 567, Appendix C, sections 34-35 (OTS).

<sup>37</sup> Id.

<sup>38</sup> Id. at § 2 (OCC), (FDIC).

The agencies recognize that any measure of credit-worthiness will involve a tradeoff among the objectives discussed in this ANPR. As previously noted, the agencies recognize that a more refined differentiation of credit-worthiness may be achievable only at the expense of greater implementation burden. The agencies seek comment on the costs and burden that various alternative standards might entail. In particular, the agencies are interested in whether the development of alternatives to the use of credit ratings would involve, in most circumstances, cost considerations greater than those under the current regulations.

Question 9: What burden might arise from the implementation of alternative methods of measuring credit-worthiness at banking organizations of varying size and complexity? Commenters are asked to provide quantitative as well as qualitative support for their burden estimates. In addition to the cost burden, the agencies seek comment on the feasibility of implementing various alternatives, particularly for community and mid-sized banks.