Written Statement for the Hearing Record
by the
FEDERAL DEPOSIT INSURANCE CORPORATION

on

OVERSIGHT OF THE CREDIT RATING AGENCIES POST- DODD-FRANK

Subcommittee on Oversight and Investigations
Committee on Financial Services
Washington, D.C.

July 27, 2011
10:00 a.m.

The Federal Deposit Insurance Corporation appreciates this opportunity to submit a statement for the record for the hearing on "Oversight of the Credit Rating Agencies Post-Dodd-Frank." The Subcommittee has asked for an update on the FDIC's rulemaking to implement the credit rating reforms in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), as well as other rulemakings under Title IX of the Act.

The recent financial crisis highlighted the markets' over-reliance on credit ratings. Banking organizations and other investors suffered significant losses from once highly-rated securities – especially certain structured finance products – which experienced rapid and severe downgrades of their external credit ratings. A major cause of these downgrades was an overly optimistic assessment of risk by Nationally Recognized Statistical Rating Organizations (NRSROs) in their assignments of initial credit ratings for structured products and certain mortgage backed securities. As initial credit ratings migrated lower, credit rating agencies were criticized for possible bias in the structure of the rating process and for the presence of conflicts of interest among credit rating agencies, investors, and issuers. Many investors, including banking organizations, placed undue reliance on external credit ratings by failing 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 (Dodd-Frank Act) requires federal financial regulatory 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, agencies are required to remove such references to or reliance upon credit ratings, and to substitute in their place uniform standards of credit-worthiness.

FDIC actions pursuant to Section 939A of the Dodd-Frank Act

Generally, FDIC regulations reference credit ratings for four purposes. First, credit ratings are used as an input for calculating minimum risk-based capital requirements. Second, credit ratings are incorporated in permissibility standards to determine if investments are appropriate for financial institutions to purchase. Third, banking organization credit ratings have been used as an input to the FDIC's deposit insurance assessment system. Finally, in certain instances credit ratings or the lack of a credit rating are required to be disclosed to customers or other market participants.

Capital Requirements. Under the FDIC's existing risk-based capital guidelines, credit ratings are used to assign a capital charge for securitization exposures, including structured finance products, under the general risk-based capital rules and advanced approaches rules. Under the current rules, the rating of a structured finance product corresponds to a specific risk weight or capital charge that banks may use to determine minimum capital requirements. Additionally, the market risk rule uses credit ratings to assign standardized specific risk add-ons. Eligibility requirements for certain guarantors and collateral also reference credit ratings. Finally, the Basel II and Basel III international agreements rely on credit ratings in certain instances to determine minimum capital requirements.

On August 25, 2010, the FDIC, together with the Federal Reserve Board and the Office of the Comptroller of the Currency, issued the *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). The ANPR solicited comment on various alternative credit-worthiness standards that may be used for risk-based capital purposes. When considering different approaches, the agencies noted that they would evaluate the extent to which any alternative standard of credit-worthiness would: appropriately distinguish the credit risk associated with a particular exposure within an asset class; be sufficiently transparent, unbiased, 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.

The FDIC received 23 comment letters from various sources, including industry associations, banks, and rating agencies. Generally, comments received did not concretely identify or suggest alternative standards of credit-worthiness. Most commenters expressed concern that credit ratings would no longer be permitted as an input into the risk-based capital rules, and argued that credit ratings are valuable tools in evaluating credit risk. Commenters generally argued that alternative standards of credit-worthiness need not only be risk-sensitive, but also internationally consistent to ensure a level playing field across jurisdictions.

On November 10, 2010, the agencies also hosted a roundtable discussion with industry participants and credit assessment experts to discuss alternatives to credit ratings. Roundtable panelists presented their views on factors and methodologies that the agencies should consider in formulating alternative standards of credit-worthiness. While there was no clear solution developed that could meet the agencies' standards for determining risk based capital requirements, panelists' comments generally mirrored those received from the ANPR. Broadly, panelists asserted that in order to be implemented by banking organizations of all sizes and levels of complexity, alternative standards of credit-worthiness need to be simple and risk-sensitive without adding undue burden.

Identifying suitable alternatives to credit ratings is challenging for a number of reasons and involves a balancing of important policy tradeoffs. Ideally, alternative standards of credit ratings would appropriately distinguish the credit risk of a given exposure. Developing objective and risk-sensitive regulatory credit risk assessments, however, may result in heightened complexity and data requirements for banks. Conversely, using a simple risk-bucket approach may be appropriate for some type of exposures but may not satisfy objectives for risk-sensitivity. Balancing the goals of risk-sensitivity on the one hand, and not placing undue burden on banks on the other, will be important for a successful implementation of Section 939A.

A contrasting approach that would not involve the use of objective formulas or risk buckets would be to allow capital requirements for rated instruments to be set by banks' own estimates of risk. This approach would pose a number of difficult issues. One is that models and risk estimates across banks could differ, resulting in inconsistent capital requirements across institutions. Another issue is that this approach would, in effect, allow banks to set their own capital requirements for the exposures covered by this approach. Over time, this could result in a significant decline in capital requirements and opportunities for banks to engage in capital arbitrage.

Ensuring international consistency has also proved to be challenging. Under international agreements, credit ratings can drive both very high and very low capital requirements. Regulators and banks in other countries are closely monitoring the U.S. regulatory process to see how we will implement these international agreements without using credit ratings.

The FDIC, in conjunction with the other banking agencies, is working to strike an appropriate balance among these potentially competing objectives. Our objective continues to be to seek public comment on concrete proposals to revise our capital regulations to meet the requirements of Section 939A.

We note that Section 939A does not prevent financial institutions from using credit ratings as a means of evaluating the credit risk of exposures as part of their own management of risk. Credit ratings should be supported by an appropriate level of due diligence, but will likely remain a widely accepted, standardized evaluation tool that banks and other market participants will use as part of their efforts to assess the risks of their exposures.

Permissibility Standards. Under the FDIC's permissible investments regulation, banks are generally prohibited from investing in certain types of securities. This regulation makes reference to "investment grade" credit ratings as the criteria for permissible investment activity. The FDIC will modify its permissible investments regulation in conjunction with the other banking agencies to develop uniform standards of credit-worthiness.

Deposit Insurance assessments. The FDIC's deposit insurance assessment rules referenced credit ratings as one of the criteria to stratify the risks posed by financial institutions to the deposit insurance fund. The FDIC has removed the references to credit ratings in this regulation and substituted a scorecard approach that relies on confidential financial and supervisory information. The FDIC approved the final rule making this change on February 7, 2011, and changes were effective on April 1, 2011.

Disclosures. To ensure that purchasers of securities in transactions with FDIC regulated banks are provided adequate information, FDIC regulations require certain disclosures. Included in these disclosures is the requirement for banks to notify customers that a given security is unrated by a NRSRO, if that is the case. This regulation is intended to foster accountability and suitability of the transaction for the customer and is unrelated to the credit-worthiness standard of the underlying security. The FDIC is considering whether the reference to credit ratings in this regulation constitutes a prohibited reference to credit-worthiness that falls under the scope of Section 939A.

<u>Other Dodd-Frank Act Title IX Rulemakings</u>

In addition to Section 939 of the Dodd-Frank Act, the FDIC participated in two other rulemakings pursuant to Title IX. On April 14, 2011, the FDIC issued a NPR titled *Incentive-Based Compensation Arrangements* to implement section 956 of the Dodd-Frank Act. The proposed rule would require the reporting of incentive-based compensation arrangements by certain financial institutions and prohibit incentive-based compensation arrangements that provide excessive compensation. The agencies are now reviewing the comments on that proposed rule. In addition, on April 29, 2011, the FDIC published a NPR titled *Credit Risk Retention* to implement the credit risk retention requirements of section 941 of the Dodd-Frank Act. The proposed rule generally requires the securitizer of asset-backed securities to retain not less than five percent of the credit risk of the assets collateralizing the asset-backed securities unless the assets adhere to defined underwriting standards. The comment period for that proposed regulation ends August 1, 2011.

Conclusion

As required by Section 939A, the FDIC is submitting its report today to Congress describing FDIC regulations that reference credit ratings and the status of efforts to replace such references. Consistent with this testimony, the report will indicate that the work needed to replace credit ratings in most of these regulations is not complete. The FDIC is working with the other federal banking agencies to develop uniform alternative standards of credit-worthiness for capital standards, permissibility, and other purposes.