July 22, 2013

Mr. Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
Constitution Center, (OGC) Eighth Floor
400 Seventh Street SW
Washington, DC 20024

Re: Removal of References to Credit Ratings in Certain Regulations Governing the Federal Home Loan Banks; RIN 2590-AA40

Dear Mr. Pollard:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rule (the "Proposed Rule") of the Federal Housing Finance Agency ("FHFA"). The Proposed Rule would remove references to credit ratings in certain safety and soundness regulations affecting the Federal Home Loan Banks ("Banks"), most importantly the rules governing permissible investments by the Banks. In addition, it would substitute alternative standards of credit-worthiness and require Banks to "apply internal analytic standards and criteria to determine the credit quality of a security or obligation."[2] The FHFA has issued the Proposed Rule in accordance with the requirements of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

INTRODUCTION

Credit ratings have existed for over a century, and they have become an extremely important fixture in our financial markets. They have been widely relied upon not only by investors and other market participants, but also by regulators, and they became embedded in our federal regulations as shorthand standards of credit-worthiness. As stated in the Dodd-Frank Act, "credit rating agencies are central to capital formation, investor confidence, and the efficient performance of the United States economy."[3]

Although serving as important tools in our financial markets, credit ratings have also contributed to some of our most spectacular financial crises, including the collapse of

1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.
2 Release at 30,784.
3 Dodd-Frank Act § 931(1).

Enron and the more recent financial crash and Great Recession that began in 2008. For years, the ratings industry has been riddled with conflicts of interest and anti-competitive behaviors. The issuer-pay model is the most problematic characteristic of the industry. A compensation system where the issuers competitively bid to be paid for their ratings of debt securities creates an inherent conflict of interest that perpetually threatens the accuracy and objectivity of credit ratings.

Establishing an effective regulatory regime for credit rating agencies has proven to be a long, slow, and challenging process, one that has not kept pace with the power of credit ratings to profoundly affect our markets. The process has been marked by long periods of study and evaluation, followed by congressional enactments and waves of rulemaking activity. The Dodd-Frank Act represents the latest attempt to reform the credit ratings industry, while at the same time reducing reliance on ratings and promoting independent credit analysis and due diligence.

Indeed, the importance of reducing this reliance and requiring alternative analytic standards and criteria to determine the credit quality of a security or obligation has been made abundantly clear from recent lawsuits filed against the credit rating agencies. In an ongoing civil case brought by the U.S. Department of Justice against Standard & Poor's in February 2013,[4] the rating agency has audaciously defended itself by arguing that it was unreasonable for investors to rely on its previous assertions about its objectivity, independence, and integrity in its ratings process.[5] S&P thus has claimed that people should know that its ratings are not objective or data-based.

But, the sole purpose of credit ratings used by investors, issuers, regulators, and legislators is to provide objective, data-based information that people and institutions can rely upon to assess credit risk—if this is not the case, the ratings are at best worthless, or worse, misleading. They certainly should not serve as a measure of credit-worthiness in any regulatory framework, as Congress correctly concluded in Section 939A of the Dodd-Frank Act.

THE DODD-FRANK ACT

The Dodd-Frank Act represents a congressional attempt to institute regulatory measures that will finally and effectively address the decades-old challenges posed by credit ratings. In addition to enhancing the regulatory oversight and accountability of credit rating agencies, Section 939A seeks to reduce reliance upon credit ratings by requiring federal agencies to review their regulations, to remove any references to, or requirement of reliance on, credit ratings in those regulations, and to substitute appropriate standards of credit-worthiness in place of credit ratings. The relevant section of the statute provides as follows:

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4 *United States of America v. Mcgraw-Hill Companies Inc. and Standard & Poor's Financial Services LLC*, No. 2:13-cv-779 (C.D. Cal. Feb. 4, 2013).

5 Edvard Pettersson, *S&P Raises Puffery Defense Against U.S. Ratings Case*, BLOOMBERG, July 8, 2013, *available at* http://www.bloomberg.com/news/2013-07-08/s-p-to-argue-puffery-defense-in-first-courtroom-test.html.

> (a) AGENCY REVIEW.—Not later than 1 year after the date of the enactment of this subtitle, each Federal agency shall, to the extent applicable, 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.
>
> (b) MODIFICATIONS REQUIRED.—Each such agency shall modify any such regulations identified by the review conducted under subsection (a) **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 making such determination, such agencies shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness.

The congressional determination to reduce reliance on credit ratings is justified on several grounds. First, the reliability of credit ratings is inherently suspect. Regardless of how much regulation is brought to bear on the credit rating agencies, the quality of their ratings will remain subject to question due to the conflicts of interest they face.

Second, regulatory reliance upon credit ratings heightens systemic risk. Incorporating ratings into regulatory standards inevitably magnifies the impact of erroneous or fraudulent ratings, since market participants subject to those regulatory standards broadly rely on the same flawed ratings.

Finally, the use of credit ratings as regulatory benchmarks undermines independent and thorough credit analysis and due diligence by market participants. The incorporation of credit ratings into statutory and regulatory provisions is perceived as a governmental endorsement or seal of approval. This, in turn, induces an excessive reliance and a sense among market participants that independent credit analysis and due diligence are unnecessary.

SUMMARY OF COMMENTS

The Proposed Rule is a commendable effort to implement Section 939A. In conjunction with the Release, it appropriately and effectively addresses—with certain exceptions discussed below—the key challenges that the FHFA must meet. However, to fully comply with the requirements of Section 939A, the Proposed Rule should incorporate the following changes:

- The alternative standards of credit-worthiness are reasonable, but the list of relevant factors should be extended and the consideration of those factors should be mandatory, not discretionary.
- The Proposed Rule should clarify and further limit the extent to which Banks may continue to rely on credit ratings.
- The Proposed Rule and the Release appropriately emphasize the importance of documenting any credit analysis, but they should also ensure that the documented credit analysis reflects no reliance on credit ratings.

COMMENTS

The alternative standards of credit-worthiness are reasonable, but the list of relevant factors should be extended and the consideration of those factors should be mandatory, not discretionary.

The core challenge facing all agencies subject to Section 939A is to establish alternative "standards of credit-worthiness" that are appropriate substitutes for credit ratings. Eliminating regulatory reliance upon credit ratings without providing adequate alternatives will only undermine effective regulation of our financial markets and put investors at greater risk, not less. To protect the public, the standards must be strong; to prevent evasion by market participants and to allow effective oversight by regulators, they must also be clear and concrete.

The Proposed Rule sets forth alternative standards of credit-worthiness that are reasonably concrete. They define "investment quality" to mean that:

(1) There is adequate financial backing so that full and timely payment of principal and interest on such security or obligation is expected; and

(2) There is minimal risk that timely payment of principal or interest would not occur because of adverse changes in economic and financial conditions during the projected life of the security or obligation.

However, to ensure that the alternative standards of credit-worthiness fulfill their intended purpose, two changes in the Proposed Rule are necessary. First, the list of factors to be considered in arriving at the foregoing credit risk determination should be more comprehensive. The Proposed Rule mentions at least one factor—"sources for repayment on the security or obligation"—that Banks must consider when evaluating credit-worthiness. But more should be included. The Release correctly and appropriately lists a host of additional factors that Banks may consider in the process. This list should be incorporated into the Proposed Rule. It includes the following factors:

> Internal or external credit risk assessments, including scenario analysis; security or asset-class related research; credit analysis of cash flow and debt service projections; credit spreads for like financial instruments; loss distributions, default rates, and other statistics; relevant market data, for example, bid-ask spreads, most recent sales price, and historical price volatility, trading volume, implied market rating, and size, depth, and concentration level of the market for the investment; local and regional economic conditions; legal or other contractual implications to credit and repayment risk; underwriting, performance measures and triggers; and other financial instrument covenants and considerations.

Second, the Proposed Rule should **require** Banks to consider all of the listed factors, as appropriate given the security or obligation under consideration, rather than allowing that consideration to be **discretionary**. With these two changes, the alternative standards of credit-worthiness will provide sufficient guidance to Banks and regulators alike.

The Proposed Rule should clarify and further limit the extent to which Banks may continue to rely on credit ratings.

The Release is largely correct in its discussion of the limited role that credit ratings may continue to play in a Bank's credit analysis, but it does not go far enough in limiting that role.

The Release states that the proposed definition of "investment quality" would not "prevent a Bank from using NRSRO ratings or other third party analytics in its credit determination so long as the Bank **does not rely principally** on such rating or third party analysis."[6] The Release further explains that "FHFA expects that such determination will be driven **primarily** by the Bank's own internal analysis of market and other external data and relevant financial information."[7]

These comments in the Release are largely, but not completely, consistent with the language and intent of the Dodd-Frank Act. The Dodd-Frank Act expressly requires not only that the agencies remove references to credit ratings from their regulations, but that they also "**substitute** in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate . . . ." The clear intent of this language is that market participants must apply **new** standards of credit-worthiness that the agencies substitute for credit ratings. Allowing market participants to continue to rely on credit ratings, even to a limited degree as they make credit risk determinations, would conflict with this mandate.

[6] Release at 30,787 (emphasis added).
[7] *Id.* (emphasis added).

Allowing any continued reliance on credit ratings also undermines one of the core objectives of Section 939A of the Dodd-Frank Act. Simply removing references to credit ratings from the regulations helps accomplish one goal of the statute, which is to eliminate the governmental imprimatur on credit ratings. But Congress also sought to promote another policy objective, namely reducing reliance on credit ratings and encouraging independent due diligence and credit analysis. It therefore required agencies to establish new standards that market participants would have to apply in making independent judgments about credit-worthiness. Establishing such new standards, while at the same time allowing market participants to continue their traditional reliance on credit ratings, would not fully accomplish this second Congressional objective of promoting independent credit analysis.

The Release is correct in suggesting that it may not be possible or even desirable to prohibit Banks from **considering** credit ratings as they conduct their own credit analysis. For example, a significant discrepancy between a Bank's credit analysis and the applicable credit rating might serve as a useful signal to the Bank that anomalies or flaws may exist in their own credit analysis. This would presumably have the positive effect of causing a Bank to reexamine its credit analysis and make necessary corrections.

However, the Proposed Rule must make clear that Banks **may not rely** on credit ratings, and that credit risk determinations under the new standards must be justifiable **entirely on the basis of those new standards,** without regard to credit ratings.

The Proposed Rule and the Release appropriately emphasize the importance of documenting any credit analysis, but they should also ensure that credit analysis reflects no reliance on credit ratings.

The Proposed Rule makes expressly clear that credit determinations must be "based on documented analysis." In addition, the Release repeatedly and correctly highlights the importance of documentation in the process:

> FHFA emphasizes that under the proposed definition a Bank must document its analysis as to the credit quality of a particular instrument so FHFA would be able to review these decisions as part of its supervisory and examination process and thereby help ensure consistency and rigor in the analysis across all Banks.

In accordance with the comments above, the Proposed Rule should also require the documentation of the credit analysis to disclose what role, if any, credit ratings played in the analysis. In addition, the Proposed Rule should require the documentation to demonstrate that, while a credit rating may have been considered in the process, any credit determination is justifiable without any reliance on a credit rating.

These enhancements to the recordkeeping requirements are necessary for two reasons. They will help ensure that each Bank applies the new standards of credit-worthiness correctly and without regard to credit ratings. In addition, they will promote accountability by enabling regulators to determine whether a market participant has properly fulfilled its duty to conduct credit risk analysis in accordance with the new standards mandated under the Dodd-Frank Act. Both of these goals are important elements in the effort to reform the way credit ratings are used in our financial system.

CONCLUSION

We commend the FHFA for its Proposed Rule on the removal of references to credit ratings in certain of its Bank regulations. The changes recommended above will help ensure that the Proposed Rule more completely fulfills the letter and the spirit of the Dodd-Frank Act.

Sincerely,

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