Chairman Remarks
Credit Ratings ANPR
August 10, 2010

This ANPR is the first rulemaking required by the Dodd-Frank Wall Street Reform and Consumer Protection Act that this Board will have acted on. And for good reason.

Every study of the root causes of the financial crisis highlights the role of credit ratings as a key contributing factor to the problems the led to virtual collapse of the financial sector.

Issuers created and successfully marketed complex transactions that lacked economic substance.

Investors bought these toxic assets in the hundreds of billions without performing their own analysis because they carried a AAA—the same rating assigned to debt back by the full faith and credit of the US government.

Ratings agencies were able to assign such absurdly high ratings because they relied on untested econometric models and overly optimistic assumptions.

The results were devastating. Once losses exceeded expectations, the securities unraveled and investors and the issuing banks and securities firms lost billions.

So it was no surprise that as part of the regulatory reform package, Congress established provisions to address the breakdown in the credit ratings process. Section 939A of the Dodd-Frank Act requires all federal agencies to review their regulations that reference or require the use of credit ratings and remove those references.

This action by Congress was understandable in light of the failings in the credit ratings process, at least for structured finance.

I believe that investors—including banks—relied too heavily upon ratings as a substitute for due diligence, and that this outsourcing of the risk assessment contributed to the problems that we are now dealing with.

However, I also believe that the task of replacing credit ratings with a better substitute will not be simple. The agencies have used ratings beyond capital, in fact, examiners have used ratings for decades to determine whether or not to criticize corporate securities held in bank investment portfolios. And though ratings should never be exclusively relied upon in assessing risk, they have proven to be somewhat more effective with their traditional role of evaluating corporate debt.

I think that we will also find that some of the more likely replacements — credit spreads, internal models, supervisor-determined risk buckets-- are far from perfect. Further, we are going to need to balance the benefits of alternative approaches with the burdens associated with implementation.

That is why I strongly support the issuance of this ANPR as the vehicle for beginning this important—but challenging process.

This ANPR puts forth numerous alternatives to credit ratings. However, any substitute to credit ratings is going to need to pass some tests before I can get fully comfortable, such as whether the alternatives:

- adequately capture the risks associated with a particular exposure;
- are sufficiently transparent
- ensure comparability in capital requirements across banks for similar asset types;
- 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

Most important, I want to make sure the alternatives foster prudent risk management. The problem we had here was a failure of investors to do their own homework. Ratings work best when they are but one of many factors in the investment decision making process. Alternatives that provide incentives for banks to more fully understand the full spectrum of risks present in an investment should be encouraged.

In closing, I want to reiterate my support for this ANPR. The agencies have a challenging task ahead, and I am pleased with the fast quick response from all of our staff in getting this ANPR completed expeditiously.

I would also like to remind everyone that the agencies are very close to finalizing a Standardized Approach NPR and Market Risk NPR. Both of these NPRs significantly improve our existing rules. However, they do include the use of ratings. Therefore, we thought it best to put these two NPRs on hold until we gather more information on alternatives. These two NPRs should benefit greatly from whatever information we gather through ANPR we are considering today.

Thank you.

Last Updated 8/10/2010