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Statement of the Shadow Financial Regulatory Committee

On

The Use of Private Credit Ratings for Determining Capital Requirements for Securitizations

In November 1997, the Federal Financial Institutions Examination Council (FFIEC) released for comment a proposal to use private agencies' credit ratings to set capital requirements for securitizated loans. The Committee opposes linking capital requirements to ratings. As the Committee has noted (Statement No. 81, February 1992), micromanagement of capital standards by setting arbitrary rules for measuring risk, or by passing the buck of risk measurement to ratings agencies, is no substitute for a regulatory process that encourages banks and bank debtholders to measure risk exposures properly by forcing them to bear the consequences of underestimating risk. The FFIEC proposal represents another example of dysfunctional regulatory micromanagement.

The use of private ratings to measure credit risk for purposes of establishing banks' capital requirements is fraught with potential for abuse. Ratings traditionally have been issued as a service to investors. Consequently, private ratings agencies that overestimate a security's credit quality place their reputations at risk with investors. Thus private agencies' ratings are often reliable indicators of credit risk. But, when ratings are rendered to and paid for by bankers only for regulatory purposes, there is a risk that the ratings agencies will engage in a "race to the bottom," competing for fees earned for overestimating the credit quality of issuers.

The problem arises because ratings are used to reduce the capital ratios required of institutions that enjoy the protection of government safety nets. Potential abuse is greatest in closely held, non-publicly traded securitizations, where the penalties imposed by outside investors on ratings agencies that exaggerate credit quality would be negligible. Under the proposal, the benefits to originators from obtaining exaggerated ratings are large. For example, in some cases an exaggeration that elevates AA securities to AAA, and BB securities to BBB, would result in a near halving of currently required capital.

Other approaches to linking asset risk and bank capital are superior to the FFIEC proposal. Those alternatives include reliance on market discipline to encourage appropriate combinations of capital and asset risk by insured institutions (e.g., subordinated debt requirements).