The Dominion Bond Rating Response to the January 2001 Basle Committee on Banking Supervision Draft

Submitted by:

Walter Schroeder, CFA

(416) 593-5577

May 28, 2001

May 28, 2001

Dear:

Re: Basle Committee on Banking Supervision

DBRS is the fourth largest rating agency globally, with roughly 1,000 companies followed, split evenly between Canada and the rest of the world. DBRS has previously supplied a detailed presentation on the original Basle draft and as such, the following discussion relates to only those specific, additional areas that we wish to address at this time.

Use of External Credit Assessments (ECAI's)
External Credit Assessments, if completed by independent agencies with credibility, are objective, comparable and consistent. We note the Long-term rating Scales Comparison that you have published on April 30, 2001, comparing Standard & Poor's, Moody's, and Fitch IBCA ratings, which are effectively treated as equivalent. In the Canadian market, a substantial number of banks rely on the DBRS ratings. Further, and in structured finance transactions, DBRS ratings are used with Moody's and Standard & Poor ratings and are treated as equivalent by market participants for purpose of investment guidelines, transaction triggers, etc. The ratings are also treated as equivalent by securities administrators. In addition, with the purchase of CBRS by Standard & Poor's, Standard & Poor's ratings are being directly compared with DBRS ratings in the Canadian market. Our own internal analysis has indicated that DBRS ratings, compared to Standard & Poor's and Moody's have been very close and have been over time (for a review, please see the following publications: Richard Cantor, Moody's investors service response to the consultative paper issued by the Basel Committee on Bank Supervision "A new capital adequacy framework" (2001), 25 Journal of Banking and Finance 171 and Richard Cantor and Frank Packer, "The Credit Rating Industry" (1994), FRBNY Quarterly Review 1). In summary, we believe that the DBRS ratings are directly comparable to the ratings of Standard & Poor's, Moody's and Fitch IBCA. Further, and given reliance placed on our ratings, it would be of assistance to banks to publish a comparison of our ratings with the above-mentioned rating agencies. Following from this, we would suggest the following comparison scale:

	DBRS	S&P	Moody's	Fitch IBCA
Rating Scales				
	AAA	AAA	Aaa	AAA
	AA (high)	AA+	Aa1	AA+
	AA	AA	Aa2	AA
	AA (low)	AA-	Aa3	AA-
	A (high)	A+	A1	A+
	A	A	A2	A
	A (low)	A-	A3	A-
	BBB (high)	BBB+	Baa1	BBB+
	BBB	BBB	Baa2	BBB
	BBB (low)	BBB-	Baa3	BBB-
	BB (high)	BB+	Ba1	BB+
	BB	BB	Ba2	BB
	BB (low)	BB-	Ba3	BB-
	B (high)	B+	B1	B+
	B	B	B2	B
	B (low)	B-	B3	B-
	CCC (high)	CCC+	Caa1	CCC+
	CCC	CCC	Caa2	CCC
	CCC (low)	CCC-	Caa3	CCC-
	CC	CC	Ca	CC
	C	C	C	C
	D	D		D

We would be pleased to work with you to provide you the information you need to come to this view. Without your assistance in this matter, and without the ability of banks to compare ratings from agencies other than Standard & Poor's, Moody's and Fitch IBCA, it will be difficult for these other agencies to participate in the ratings market in the future.

<u>Weightings</u>

As discussed in our previous presentation, we continue to have concerns regarding the limited number of rating categories and the weighting differentials between the categories in the new accord. The weightings as proposed will provide limited benefit for Company's receiving a credit rating below A- and with a 150% weighting, any Companies in the B range or worse will have no incentive to become rated. We refer you to our proposal for weightings in our previous submission and continue to believe that no weighting should be over 100% in any category.

<u>Short-Term Ratings</u>

Short-term ratings should be used for instruments with an original term of less than 365 days. The highest two categories in the short term rating scales used by DBRS are R-1 (middle) and R-1 (high), which could be used relative to A-1+ ratings on the short-term scale. For DBRS, these two rating categories normally correspond to entities that are able to achieve AA- or better long-term ratings on their senior debt. Similarly, the R-1 (low) rating is consistent with "A" credits, and could be assigned 50% weighting. All ratings under the R-1, A-1, or P-1 could have 100% weightings, while 20% weightings could be applied to R-1 (middle) and R-1 (high) ratings.

Use of Default Rates

DBRS uses default rates extensively on its structured finance ratings. The data DBRS uses in the structured finance area was obtained from Canada and from the U.S., with adjustments for the Canadian environment (for a description, see the publication, DBRS, CBO/CLO Rating Approach (September 1998)). It was necessary to obtain the statistical data from the U.S., given the lack of data in Canada. In the past 25 years, there were only about 15 investment grade company failures in Canada. This is insufficient to provide for any statistical validation on the basis of Canadian data alone. In addition, another reason DBRS looked outside of Canada for default rates for our ratings is that DBRS rates as many companies outside Canada as inside. Accordingly, we have substantial experience outside of Canada.

One of the issues that concerns us is the requirement that rating agencies statistically validate their rating scales. Apart from Standard & Poor's and Moody's, and given their long-established presence in the U.S. market (which is the only market with good information on bond performance), other agencies will have difficulty in directly correlating their ratings with default rates, as requested. Further, and even when Standard & Poor's and Moody's provide new ratings, they are nonetheless providing opinions of credit quality. They are not providing statistical statements of default probability. Over time, however, these opinions have been found to be correlated with an average default probability. They have been able to provide this correspondence since they have had ratings going back over decades, matched against an excellent historical record of bond performance history. This experience is unique to the U.S. market. In short, for rating agencies to provide this type of data, they will have to have a large number of ratings in a market over a period of decades before similar statements can be made. Without more, this provides a huge advantage to Standard & Poor's and Moody's and disadvantages other rating agencies accordingly.

On a similar note, we note that, in essence, there are similar requirements under the internal ratings based (IRB) approach. We are skeptical that the banks have sufficient data to use this approach. Implicitly, the Committee seems to recognize this difficulty by allowing banks to use data from numerous sources, subject to issues of comparability of the data and the bank's portfolio. A similar approach could be considered for rating agencies. To the degree that the Committee believes that a rating opinion from Standard & Poor's or Moody's correlates with a default probability, one solution may be to compare the ratings of these agencies with other agencies. If the other agencies provide comparable ratings, by implication, their ratings should correspond to the same approximate default probabilities. As previously noted, our past work in this area indicates that DBRS ratings have been very close to ratings supplied by Standard & Poor's and Moody's.

As an additional suggestion, it may be sensible to look at the use of a broader default scale rather than just the local Canadian scale (or home country scale). This would help to harmonize rating agency scales, and minimize national differences with respect to default performance.

Selection of ECAI

A central body from the BIS should select eligible ECAI's, based on advice from the National Supervisors in the home country. This will make the criteria more consistent. Otherwise, it would require the ECAI's to visit over 100 countries and make the same presentations. There is also the concern that for the smaller ECAIs, many national regulators will be unfamiliar and, accordingly, the difficulty of the qualification procedure will increase. Conversely, and for the larger ECAIs, and given greater familiarity with them, they may not face the same difficulties in dealing with individual, national regulators.

Unsolicited Ratings

New rating agencies will have difficulty getting started without doing unsolicited ratings or at least doing benchmark reports. These ratings are not done by new ECAI's to put pressure on entities to obtain solicited ratings, but to start up operations or to gain exposure to new markets. Today, DBRS has a general policy to stay out of

unsolicited ratings if at all possible, but DBRS started by doing over 100 unsolicited ratings. Despite present opinions with respect to our involvement in unsolicited ratings, DBRS would never have been created, had it not been able to do unsolicited ratings at the start.

Multiple Assessments

The criteria for establishing weightings when multiple assessments are made (take the top two ratings, and chase the higher one of the two) are good, and will encourage new rating agencies being formed locally. The more opinions that exist on a company, the better, and will dilute the power that any one rating agency has.

Comments on Securitizations

There are several comments on securitizations which should be made.

First, in terms of liquidity facilities, the Canadian market has consistently used liquidity facilities which do not take on any credit risk. The operation of Canadian liquidity facilities has been consistent with OSFI's B-5 guideline. In view of the absence of credit risk in Canadian liquidity facilities, and the very different operation of liquidity facilities in the U.S. market, it is appropriate that Canadian facilities retain a 0% conversion factor. Certainly, in the future, if liquidity facilities in the U.S. market are constructed and operate as they do in Canada, similar treatment should be accorded. However, at the present, it is unfair for U.S. market participants to claim that they are being treated unfairly, compared to Canada. U.S. market participants, for quite some time, have benefited from liquidity lines that have carried credit risk. Given the operation of the Canadian market, we feel that securitizations can work properly with pure liquidity lines. Transactions can be adjusted, and credit enhancement can be added, to deal with liquidity concerns.

We are concerned with the treatment of the issue of "reputational" or "moral" risk for banks which securitize. Although we understand the concern surrounding implicit recourse, there is a danger in penalizing a bank too heavily on this issue. In the Canadian market, there has not been a case of implicit recourse. Further, transactions are structured so that this is avoided. It would be unhealthy for the securitzation market and for the banks to rely on implicit recourse. Having said this, and at some point in the future, there may be a situation where implicit recourse arises. We would be concerned if, on a cost-benefit analysis, the bank could not provide implicit recourse. From a financing point of view, implicit recourse may not change the risk of the bank, but in terms of the long-term financing benefits and reputation, it may be an important for the bank to provide some implicit recourse. Given the concern that regulators have concerning the possible abuse of implicit recourse, we believe that a bank should report any situation of this nature to the regulator, and that the bank should lose any capital treatment benefits for that particular transaction. Beyond this point, however, we are concerned that further penalties may be counterproductive in the long run.

These are the main comments that DBRS has with respect to the revised proposal. Should there be any further questions, please feel free to contact me.

Yours truly,

Walter J. Schroeder, CFA
President
WJS/pav