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BY ELECTRONIC MAIL

Ms. Danièle Nouy
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Email: BCBS.Capital@bis.org

Re: Third Consultative Package of the New Basel Capital Accord

Dear Ms. Nouy:

Moody's would like to thank the Basel Committee on Banking Supervision (the Committee) for the opportunity to comment on the proposals contained in the third consultative package of the New Basel Capital Accord (the New Accord). The New Accord raises the regulatory use of agency ratings to a new level. We understand the desire of the Committee to employ the opinions of external credit assessment institutions (ECAIs) in determining minimum capital adequacy. As publicly available, independent and reliable opinions of creditworthiness, bond ratings have met capital market needs for nearly a century. As a consequence, it proposes to subject the credit rating industry to greater scrutiny by establishing criteria for rating agency performance and regulatory supervision. To that end, we caution the Committee that its use of ratings may inadvertently fundamentally alter those characteristics of ratings that provide value for supervisory purposes.

Adverse incentives for unrated issuers
Moody's is concerned that the Proposal will encourage many speculative-grade firms with large outstanding liabilities to avoid ratings *in order to* minimize capital charges to lending banks and/or to otherwise avoid public scrutiny.[1]

Under the Standardised Approach, the Committee recommends a risk weight of 100% on unrated claims, versus a 150% risk weight on claims rated B1/B+ or lower. Consistent with the Committee's proposal, we have found that default rates on pools of (mainly unrated) middle market firms are low by capital markets standards. Importantly, however, we believe that this finding relates to the current characteristics of unrated firms versus firms rated speculative-grade, which characteristics Moody's believes may be materially altered by the proposed risk-weight approach. Simply put, Moody's believes that through adverse selection the default characteristics for unrated issuers will rise due to regulatory benefit for avoiding B1/B+ or lower ratings.

The New Accord was motivated in part by a desire to better align bank capital charges to asset risk levels. By providing an incentive to avoid the rating process, the Committee has inadvertently decoupled capital charges from credit risk.

In order to improve market transparency and maximize the calibration of credit risk, we recommend two possible alternatives to the Committee's proposal:

1) Claims on *unrated issuers of public debt* will be assessed a capital charge commensurate with the B1/B+ and below rating category.

2) Claims on large unrated issuers will be assessed a capital charge commensurate with the B1/B+ and below rating category. Issuer size could be established by a threshold for outstanding debt, total assets or revenue.

The objective under either alternative would be to segregate and separately risk-weight firms according to characteristics that approximate the existing market of speculative-grade rated firms versus smaller, generally unrated firms with their different (lower) default probabilities.

Definition and use of unsolicited ratings
The Committee recommends that banks use only *solicited* ratings from eligible ECAIs, with the proviso that supervisors may allow the use of *unsolicited* ratings. Although not defined as such in the New Accord, we recommend that the term *unsolicited* be used to refer to a lack of participation by the issuer in the ratings process. Although Moody's has curtailed its assignment of *unsolicited* ratings in recent years, in the past many firms that did not requested a rating from

[1] Our research database lists 424 corporate issuers that defaulted in total on $68 billion of unrated public bonds and notes since 1990. In an effort to quantify our performance, Moody's routinely publishes detailed studies of global corporate bond default experience. We maintain a database of default events, including dates of default, amount of debt affected and, where applicable, rating histories.

Moody's nevertheless chose to participate in the ratings process.[2] Conversely, some issuers who do request ratings later choose to terminate communications.

It has not been Moody's practice to make rating distinctions on the basis of solicitation, or to track systematically the commercial relationship between itself and rated entities. However, Moody's will indicate in a press release when a newly-rated issuer chooses not to participate in the ratings process.

We recommend that the Committee refine its requirement such that recognized ECAIs disclose to the market those instances where the issuer chooses not to participate in the ratings process. National supervisors can then decide whether or not to use such ratings in the determination of minimum capital levels.

Multiple rating scales

We raise for the Committee's benefit a caveat that many ECAIs publish multiple rating systems, or scales, to meet diverse market needs. Some rating systems, particularly national scale, or domestic market, ratings are designed to rank, on a relative basis, the creditworthiness of issuers and obligations within a particular country. Such ratings are not necessarily comparable to globally-positioned foreign currency or local currency ratings. Their default and loss content may vary considerably, and thus, they may not be suitable for mapping to global standards. We therefore suggest that supervisors specify the ECAI's applicable rating scale when mapping to risk buckets.

Separate risk weights blur meaning

The Committee's proposal to utilize separate risk weightings, under the Standardised Approach, for corporate, sovereign and bank exposures may serve to blur the meaning of agency ratings. The implication is that ECAIs do not consistently rate the credit risk of entities across sectors. Except where there is a stated intention to maintain separate rating systems, rating agencies have every incentive to align the risk content and meaning of their ratings across issuers and obligations.[3] By prescribing different risk weights for equivalent ratings across sectors, the Committee may foster the perception of differences in meaning where none exist. We suggest that the Committee provide a single weighting function for all exposures.

Conclusion

Moody's applauds the Committee's efforts to refine the regulatory basis for minimum bank capital levels. We believe the New Accord will help banks to better measure and manage credit risk, thereby improving the safety and soundness of the global financial system. Credit ratings

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[2] Moreover, an issuer may request a rating for one class of debt obligations and Moody's may decide to rate another class.

[3] Moody's has, for example, acknowledged that its US municipal rating scale is not equivalent to its global, taxable rating scale, in terms of expected risk content. The difference arises from the unique features of the rated municipal bond market, particularly the very small number of defaults.

can play a role in this process, as demonstrated by their ability to meet capital market needs for nearly a century. We thank the Committee for providing an opportunity to respond to its latest proposal and we look forward to contributing to the future success of the Basel process.

Sincerely yours,

Raymond McDaniel
President
Moody's Investors Service