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April 7, 2010

BY ELECTRONIC MAIL: baselcommittee@bis.org

Mr. Stefan Walter
Secretary General
Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: ***Strengthening the Resilience of the Banking Sector***
Consultative Document

Dear Mr. Walter,

Fitch Ratings ("Fitch") submits this letter in response to the request for comments of the Basel Committee on Banking Supervision (the "BCBS") on the Consultative Document - Strengthening the Resilience of the Banking Sector (the "Consultative Document") - published on December 17, 2009. Our feedback relates to proposed changes to the existing criteria concerning External Credit Assessment Institution ("ECAI") recognition, as outlined in paragraphs 195-196 of the Consultative Document, and the treatment of unsolicited ratings, as outlined in paragraphs 200-201 of the Consultative Document. Our comments are set forth below.

Amendments to the ECAI Recognition Criteria

We note that the BCBS proposes to expand the ECAI recognition guidelines to incorporate elements of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (the "IOSCO Code"). Fitch considers the IOSCO Code to represent the international best practice standards for our industry and, as such, we welcome this proposal. However, we note that the proposed amendment to the disclosure criteria as drafted in the Consultative Document could be misinterpreted as requiring something different to the IOSCO Code provisions. This proposed amendment states that:

*"**Disclosure**: An ECAI should disclose the following information: its code of conduct; its compensation arrangements with assessed entities; its assessment methodologies, including the definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each assessment category; and the transitions of the assessments, e.g. the likelihood of AA ratings becoming A over time."*

In light of the BCBS's stated intention, we encourage the BCBS to clarify that the reference to disclosure of "compensation arrangements with assessed entities" was intended to capture IOSCO Provisions 2.8 (a) and (b), which state that:

"*A CRA should disclose the general nature of its compensation arrangements with rated entities.*

(a) Where a CRA receives from a rated entity compensation unrelated to its ratings service, such as compensation for consulting services, a CRA should disclose the proportion such non-rating fees constitute against the fees the CRA receives from the entity for ratings services.

(b) *A CRA should disclose if it receives 10 percent or more of its annual revenue from a single issuer, originator, arranger, client or subscriber (including any affiliates of that issuer, originator, arranger, client or subscriber."*

Without such clarification, it is possible that individual bank regulators adopting this amendment into their own ECAI recognition criteria will misunderstand this criterion as suggesting that ECAIs should be required to disclose the rating fees received from each individual issuer.

Fitch would have strong reservations about any proposal that credit rating agencies disclose all of their individual rating fees. While we fully accept that ECAIs should provide information to users of their ratings that will assist those users in assessing whether they believe the ECAI is subject to potential conflicts of interest, a requirement to disclose each individual rating fee would be unduly burdensome to the point of being completely unworkable. We also think that the information will not be of practical value to users of ratings since information relating to fees is only of use if provided in some sort of context. Finally, we believe it would be anti-competitive to require disclosure of fees on an entity-by-entity basis since such information is highly commercially sensitive.

<u>Treatment of Unsolicited Ratings</u>

We note that the BCBS proposes to expand its guidance regarding the recognition on unsolicited ratings to address the concern of some BCBS members that unsolicited ratings assigned by some ECAIs may be of lesser quality than solicited ratings. The proposed guidelines state:

"As a general rule, banks should use solicited ratings from eligible ECAIs. National supervisory authorities may, however, allow banks to use unsolicited ratings in the same way as solicited ratings if they are satisfied that the credit assessments of unsolicited ratings are not inferior in quality to the general quality of solicited ratings. However, there may be the potential for ECAIs to use unsolicited ratings to put pressure on entities to obtain solicited ratings. Such behaviour, when identified, should cause supervisors to consider whether to continue recognising such ECAIs as eligible for capital adequacy purposes."

Fitch has two observations on this provision, both of which relate more to the general concept itself than the nature of the proposed amendments. First, the provision as drafted runs the risk of stigmatizing unsolicited ratings, even in cases when there are no concerns relating to their quality or purpose and, as such, is anti-competitive. Second, the signal provided by the provision is inconsistent with the practices that have actually been adopted in the majority of national bank regulators that have introduced the Standardised Approach under Basel II.

Fitch remains extremely concerned at any provision that proposes, as a starting point, to segregate ratings based purely upon their commercial status. We believe that such an approach has negative implications for the independence of rating agencies, and is likely to have a negative impact on competition within the market for ratings. In response to the introduction of Basel II in a number of countries, we published the attached report "Unsolicited Ratings and Basel II" in August 2006 to outline our concerns and to address the five most common misconceptions regarding agency-initiated ratings. In particular, we highlighted that unsolicited ratings are a way for smaller rating agencies to expand their coverage and compete with the two dominant global agencies. In addition, certainly in the case of Fitch, the rating process and the methodologies applied to the assignment of unsolicited ratings are no different from those applied to solicited ratings. Moreover, Fitch will not assign or maintain any ratings, solicited or otherwise, unless it has sufficient information to do so.

Within our 2006 report, we also listed three direct and very real threats to the independence of the ratings used by financial institutions that are inherent in any proposal that starts from a position of segregating ratings on non-analytical grounds. We strongly encourage the BCBS members to review this report and consider the merits of our arguments.

Fitch understands the concern that the BCBS may have with regard to certain unsolicited ratings. However, we believe that these concerns could be addressed, and the same broad outcome achieved, without stigmatising unsolicited ratings simply by reworking the provision as outlined in the paragraph below. This would allow supervisors to choose not to recognise the unsolicited ratings of a given credit rating agency where genuine concerns exist, but would not send a signal that unsolicited ratings, as a general rule, are all substandard, or in some way different from solicited ratings, which seems to be the starting point of the current provision.

"As a general rule, banks may use both solicited and unsolicited ratings from eligible ECAIs. National supervisory authorities may, however, prohibit the use of unsolicited ratings if they are not satisfied that the credit assessments of unsolicited ratings are of the same quality as the general quality of solicited ratings. In cases where supervisors have reason to believe that an ECAI has used unsolicited ratings to put pressure on entities to obtain solicited ratings, they should consider whether to continue recognising such ECAIs as eligible for capital adequacy purposes."

We note that such an approach would be consistent with the position adopted by the majority of national bank regulators that have introduced the Standardised Approach of Basel II, under which ratings produced by recognised ECAIs are employed for capital calculations, in their local markets. Indeed, of the 60 jurisdictions where Fitch has received ECAI recognition, only one third have decided to disallow the use of unsolicited ratings on an indiscriminate basis.

I hope you find our comments constructive, and that you will give them due consideration. Please do not hesitate to contact me in London on +44 20 7417 6341, sharon.raj@fitchratings.com should you wish to discuss this matter further.

Yours sincerely,

Sharon Raj
Regional Compliance Officer – Europe, Middle East, Africa and Asia
Fitch Ratings

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KNOW YOUR RISK

Unsolicited Ratings and Basel II

August 2006

- Unsolicited ratings are a fundamental element in the independence of rating opinions.
- Excluding unsolicited ratings from use for regulatory capital purposes erects substantial barriers to entry in the rating industry.
- Omission of unsolicited ratings distorts rating portfolios, with a bias that will likely understate credit risk.

The Use of Unsolicited Ratings Under Basel II

Credit ratings issued by the global rating agencies today are typically initiated by the entities being rated. Under certain circumstances, a rating agency may also assign ratings at its own initiative (i.e. without the rated entity's request), or continue to rate an entity once an entity has ceased a mandated relationship with the agency. The public debate regarding the use of 'unsolicited' ratings has become of interest to bank supervisors given the work currently being undertaken globally to translate the provisions of the Basel II framework into local capital adequacy directives.

In the many years in which credit ratings have been used within safety and soundness provisions, no major regulator has chosen to use the nature of the commercial relationship between issuer and agency as a qualifier to the rating's usage. Paragraph 108 of the Basel II accord has set a global precedent in raising the option to supervisors of differentiating between solicited and unsolicited ratings.

Fitch remains extremely concerned at any proposal to segregate ratings based upon their commercial status, or any other non-analytical grounds, and the implications of this proposal for the independence of the ratings used by financial institutions. Exclusion of unsolicited ratings will also have a systemically negative impact on the number of rating opinions in the marketplace. In this document, we have addressed the five most common misconceptions regarding agency-initiated ratings ("AIRs"), the most commonly understood form of unsolicited ratings. We have also listed three direct and very real threats to the independence of the ratings used by financial institutions that would be inherent in any proposal to segregate ratings on non-analytical grounds.

We have also highlighted on page 10 one pragmatic approach, already proposed in draft language by some European regulators, which would permit the use of unsolicited ratings on a conditional basis. This case-by-case approach would allow regulators to address genuine concerns that may arise regarding inappropriate behaviour by individual rating agencies, without adopting an indiscriminate ban.

Misconceptions Surrounding Agency-Initiated Ratings

Misconception #1

"There is a qualitative difference between agency-initiated ratings and other ratings."

Fitch's AIRs are maintained to the same standards for analysis and information as other ratings.

Fitch applies the same standards to ratings irrespective of commercial or participation status, including those ratings which it establishes and maintains on an agency-initiated basis. There is no difference in the relevant rating committee, rating appeal, rating dissemination or rating performance procedures employed by Fitch based on the commercial or participation status of a rating.

All of our ratings are assigned and maintained subject to thresholds of available information from all sources. If there is insufficient information to sustain appropriate coverage for an issuer or a transaction, Fitch **will not assign ratings**, or, if ratings have already been assigned, **Fitch will withdraw those ratings**. As discussed in more detail below, solicitation status is a purely commercial issue, and is not a proxy for the level or quality of information received from an issuer. Fitch has in the past refused to assign ratings solicited by certain issuers, and has also withdrawn ratings solicited by certain issuers, where our threshold for information was not met.

Any analytical opinion given by Fitch which is **not** comparable with that of a published rating for any reason (for example, conditional or 'shadow' opinions used primarily to assess the underlying assets in a large-pool collateralised debt obligation) is communicated by using a modified or entirely separate scale, disclosed as such on the definitions section of Fitch's website.

Misconception #2

"If an issuer does not request the ratings, the agency lacks sufficient information."

Neither commercial status nor participation status reflect absolute information levels.

Solicitation status is not a proxy for absolute information levels. Neither is the current level of direct participation by the issuer. The primary source of information behind ratings remains the public information disclosed by the issuer, including its audited financial statements, strategic objectives, and investor presentations. Other information reviewed includes peer group data, sector and regulatory analyses, and forward-looking assumptions on the issuer or its industry.

Issuers assigned AIRs by Fitch will typically be significant issuers in the capital markets of developed countries, who consequently have significant disclosure obligations towards their investors. It would be of concern if the public disclosure of a major capital markets issuer were so constrained that, at a minimum, a trained rating agency analyst specialised in their sector, with access to significant market intelligence from the rest of their portfolio, were not able to reach a rating judgement. Where the information level is nonetheless so constrained, and in the absence of direct participation by the issuer to raise available information to an acceptable level, Fitch will, as noted above, withdraw the rating.

Direct participation can naturally add information to the process, and more than half of our agency-initiated traditional ratings are currently participative. The level of direct participation itself, however, varies between all issuers, and varies for each individual issuer over time. This variation occurs whether the rating is solicited or unsolicited. Information flow may dip or lapse entirely (for example at a time of financial stress for the rated entity).

Issuers about to embark upon a corporate merger or acquisition may choose to inform the rating agencies in advance, or they may choose not to. Initiation status is not an accurate predictor of advance notification. An issuer which has mandated Fitch to rate its obligations may choose not to notify the agency in advance of a particular corporate action. At the same time, an issuer whose ratings were initiated by Fitch may choose to provide us with advance notice of a proposed bid as part of their participation in the rating process.

Information levels generally show a stronger relationship to geography than to solicitation or participation status. Public information for some entities in high-disclosure jurisdictions who do not directly participate in the rating process will substantially exceed the sum of public and non-public information for other issuers in low-disclosure jurisdictions who do participate in the rating process.

Misconception #3

"AIRs are assigned to exert undue commercial pressure on the rated issuer to pay a fee."

Fitch's AIRs are not entered into as a predatory practice.

For Fitch, the strategic reason for assigning agency-initiated ratings has been to build our coverage and provide a genuine alternative choice for investors in the rating market. This was a response to widespread investor feedback throughout the 1990s, which indicated that investors valued the research provided by Fitch's predecessor agencies, but that coverage levels made institutional usage problematic. As we have increased our reach, investors themselves have conveyed the message to potential rated entities that they value the Fitch opinion. This has occurred both during direct conversations between investors and issuers, and through decisions such as our inclusion in global bond indices, at the request of investors. By visibly increasing the value of our ratings, we believe that future potentially rated entities are more likely to include Fitch in their rating plans.

The decision of entities initially rated at Fitch's initiative to enter a solicited relationship typically occurs over an extended period, as the value of the Fitch rating is demonstrated to the issuer. As a typical example, investor guidelines or individual requests from syndicate desks and other advisers may encourage the subjects of agency-initiated ratings over time to ask Fitch to assign ratings to specific instruments or additional parts of their business.

As far as the quality and relative level of ratings is concerned, if investors and other users did not regard our agency-initiated ratings as being of an acceptable quality and comparable to other ratings outstanding, then demand would not rise for our ratings, and the commercial strategy behind agency-initiated ratings outlined above would fail. Equally, if the market perceived the ratings as biased in any commercially-motivated way, then any program of agency-initiated ratings would again become self-defeating.

Misconception #4

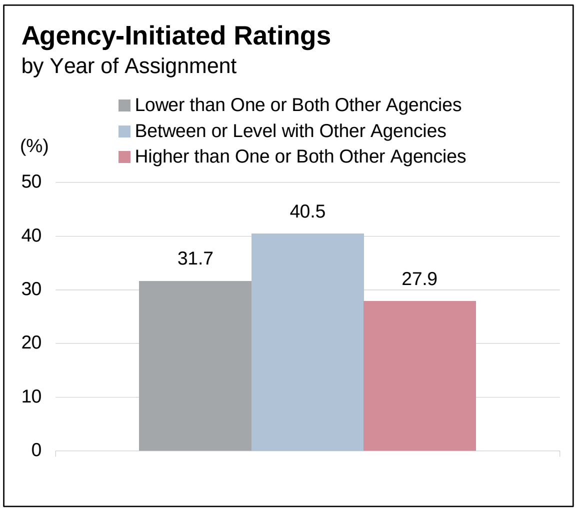
"AIRs are 'pitched low' to encourage rated issuers to mandate the rating agency."

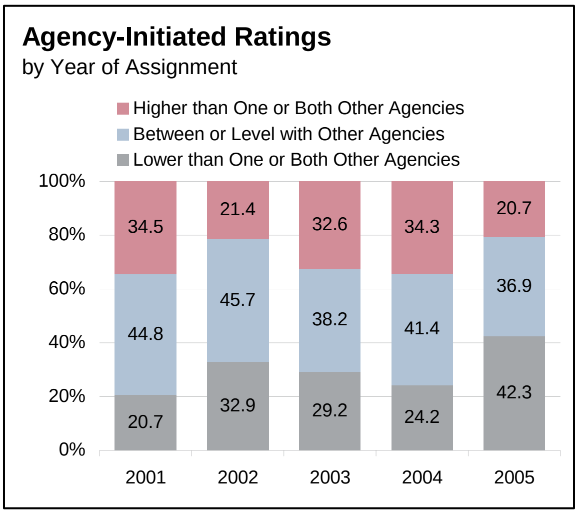
The level of AIRs assigned by Fitch is comparable to that of other published opinions.

For this document, Fitch has examined the relative level of AIRs by comparing the level of ratings initiated by Fitch with the level of ratings for the same issuers assigned by the other two global rating agencies. The analysis compared the level of AIRs as at December 31st in the year of assignment against the comparable ratings outstanding from one or both other agencies. On this basis, from the inception of the formal Fitch-initiated rating program beginning in 2001 until Dec. 31, 2005, **28%** of ratings were assigned at a level higher than one or both other agencies, **40%** were at the same level or between the other agencies, and **32%** were at a level lower than one or both other agencies.

This annual trend also follows an intuitive path. The relative level was marginally more positive in 2001, 2003 and 2004 (i.e. more ratings were assigned at a higher relative level), in a generally improving economic climate, where a 'fresh look' might reflect stronger financial or operational performance than those captured in existing ratings from other agencies. There was a marginal negative bias in assignments in 2002, due to the weakness of the credit cycle, and again in 2005, due to an expansion of Fitch's ratings in sectors where the agency takes a more conservative view.

There is no institutional bias that would favour a lower rating based on commercial grounds. All ratings, whatever their commercial status, are reviewed through the same committee process. This includes access by the rated entity to the analysts and to an appeal process where appropriate.





Corporate and public finance ratings of comparable type measured at December 31st in the year of assignment. No Fitch-initiated ratings are assigned in structured finance. Includes all Fitch-initiated long-term issuer/senior unsecured debt or traditional insurer financial strength ratings assigned during 2001-2005, where comparable ratings were available from one or both of Moody's Investor Service and Standard & Poor's Rating Services.

Source: Fitch, Moody's Investor Services, Standard and Poor's Rating Services, Bloomberg, LLP

Misconception #5

"Rating agencies identify AIRs, so the agencies must regard them as different."

Disclosure of AIR status by Fitch has been made at the request of third parties, and does not represent a "qualification" of the rating judgement.

Fitch has designed its disclosure of AIRs to meet the requests of a number of external parties. In no way does the designation of a rating as an AIR reflect a "qualification" of the rating judgement. Initiation status is not discussed at the rating committee and is not a factor considered in the rating judgement. For there to be any distinction would in fact represent an inappropriate differentiation of our opinions based upon our commercial relationship with an issuer. The equal treatment of ratings within Fitch's portfolio, irrespective of commercial considerations, extends to their treatment as one single portfolio in default and transition studies and in the presentation of rating performance statistics.

Fitch currently discloses solicitation status in its initial press release, via its website and via its Ratings Desk for individual issuers. Participation status is disclosed on each press release and via the Ratings Desk for individual users. Fitch will take into consideration the potential for such disclosure to be misinterpreted in its ongoing review of disclosure practices.

As noted above, any analytical opinion given by Fitch which is **not** comparable with that of a published rating for any reason, and therefore qualified on an analytical basis, is communicated using a modified or entirely separate scale. These are clearly demarcated, and distinct from the ratings noted in equivalency tables developed for each rating agency as part of the Basel II process. For example, conditional or 'shadow' opinions, used primarily to assess the underlying assets in a large-pool collateralised debt obligation, are modified with an "(s)" or "*" suffix.

Dangers of Inconsistent Treatment of Ratings by Regulators and Supervisors

Unsolicited ratings are a fundamental element in the independence of rating opinions.

Any systematic step to qualify ratings based on their commercial status or any proxy measures of participation level will ultimately allow issuers to unilaterally suppress agency opinions with which the issuers themselves do not happen to agree.

This ability would effectively negate the editorial control of the respective rating agencies over their own opinions. Segregation or qualification of agency-initiated or non-participative ratings is thus a direct threat to the ability of agencies to provide genuinely independent ratings to all users.

Excluding unsolicited ratings from use for regulatory capital purposes erects substantial barriers to entry in the rating industry.

The work of a rating agency requires the agency to establish a track record which demonstrates the value of its opinions to rating users. This track record is a prerequisite for many issuers in deciding which agencies to mandate to provide ratings. This leads to a circular proposition – to be mandated by issuers, the agency needs to demonstrate a track record of assigning ratings, which it will not be mandated to provide until it can demonstrate a track record of assigning ratings.

In practice, the only way for new entrants to enter the marketplace as a full-service traditional rating agency is through the responsible use of agency-initiated ratings. Even an agency with the global reach and coverage that Fitch now enjoys is required to selectively add agency-initiated ratings on an ongoing basis to serve its investor base. Segregation or exclusion of agency-initiated ratings will substantially hamper the entry of any new player. This runs directly counter to the expressed market (and regulatory) desire for a broader range of independent opinions.

Omission of unsolicited ratings distorts rating portfolios, with a bias that understates credit risk.

Portfolios from which unsolicited ratings are removed based on current commercial relationships between agency and issuer will over time display a bias towards ratings set either at the same level or higher than those of existing ratings in the marketplace. Over time, as issuers become aware of the benefits of withdrawing ratings, troubled companies or companies who simply dislike the opinions of a given agency will increasingly remove more conservative ratings by terminating relationships. This will occur irrespective of the quality of the rating opinion expressed. This would significantly limit the utility of such rating portfolios for prudential purposes.

Fitch is not aware of any proposals made by supervisors as to how the impact of such issuer 'self-selection' may be limited, or how banks or their supervisors may adjust for the potentially significant 'positive selection' bias at a portfolio level.

Practical Considerations

There remain practical concerns associated with an indiscriminate exclusion of unsolicited rating usage. The most immediately apparent of these are the problems that banks will encounter in trying to apply a uniform definition of 'unsolicited' in their national and cross-border reporting, given that both regulators and agencies are adopting, and will likely continue to adopt, definitions of unsolicited ratings that vary in material respects.

Fitch provided full details of its own definitions, which conform to the elements of solicitation considered in the IOSCO 'Code of Conduct Fundamentals for Rating Agencies', in its June 2005 publication, "*Rating Initiation & Participation Disclosure*", which is available from our free public website, www.fitchratings.com.

Alternatives to an Indiscriminate Exclusion of Unsolicited Ratings

Fitch is unaware of any compelling rationale which would support an indiscriminate segregation or exclusion of unsolicited ratings. We believe it is inappropriate to link rating usage to the rating's commercial status. We note that a number of regulators have already published language noting unconditional equal treatment of ratings on this basis, examples of which are attached overleaf.

Where valid concerns over a rating agency's practice exist, it would be possible to address those concerns while still avoiding many of the dangers inherent in an indiscriminate exclusion. Overleaf we have reproduced the draft language from one European supervisor proposing a case-by-case assessment of rating agency usage of unsolicited ratings. Where a supervisor believes that they may recognise an agency as an External Credit Assessment Institution ("ECAI") for the purposes of Basel II, and yet still have concerns regarding the agency's unsolicited rating practices, this proposal would allow the supervisor to disallow unsolicited ratings for that agency alone, rather than disallow unsolicited ratings on an indiscriminate basis affecting all agencies.

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Sample Language Proposed in National Implementation of Basel II

Unconditional usage of unsolicited ratings

Netherlands

"Financial enterprises may use 'solicited' and 'unsolicited' credit assessments."

Paragraph 2, Explanatory Memorandum, Part 2: Credit Risk,
Draft Regulation on the Standardised Approach to Credit Risk,
De Nederlandsche Bank N.V., October 2005

Sweden

"The names of the companies whose credit ratings are acceptable for use are outlined in the below table. The table below is applicable to both those external credit ratings which have been published on the initiative of the relevant rating agency, and those external credit ratings which have been published at the request of an issuer or other counterparty."

(Translated from the published Swedish document)
Paragraph 2, Employment of External Ratings in Establishing Risk Weights (Draft Guidance),
Finansinspektionen, May 2006

Conditional usage of unsolicited ratings

United Kingdom

"The FSA's recognition of an ECAI may be limited to its solicited credit assessments. Where this is the case a firm should not use unsolicited assessments. The FSA may indicate[1] that the unsolicited ratings of an eligible ECAI are not to be used for the purposes of BIPRU 3 if those assessments are considered to be inferior in quality to the general quality of solicited assessments or if it considers that the ECAI's strategy in relation to the issuing of unsolicited assessments is founded in the placing of undue pressure on the rated entity to pay for a rating."

Section 3.6.3, BIPRU 3: Standardised Approach to Credit Risk (revised),
Annex 4, PS06/6 - Strengthening Capital Standards 2
Financial Services Authority, August 2006

[1] In section 6.8 of the accompanying PS06/6 feedback document, the UK FSA has stated that it does not propose to exclude unsolicited ratings from the three 'shadow recognised' ECAIs – Fitch Ratings, Moody's Investor Service and Standard and Poor's Rating Service.