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July 31, 2003

Mr. Jaime Caruana, Chairman
Basel Committee on Banking Supervision
Bank for International Settlements
2 Centralbahnplatz
CH-4002 Basel, Switzerland

Dear Chairman Caruana:

Attached is a detailed comment letter on the requirements set forth in the Basel Committee on Banking Supervision's (the Committee) third consultative package of the New Basel Accord for recognizing external credit assessment institutions (ECAI) and using external credit assessments. While the recognition and operational requirements seek to be fair and balanced, Fitch notes that two aspects of the rules as they are currently written are anti-competitive.

Fitch would like to draw your and the Committee's attention to a provision (525d) pertaining to the operational requirements for using external ratings in the securitization framework. Specifically, the provision does not permit a bank to use one ECAI's ratings for one or more tranches and another ECAI's ratings for other tranches within the same securitization. The intent of the provision seems to be aimed at guarding against the potential for "cherry-picking" more favorable ratings on tranches within a securitization structure. However, it is inconsistent with established market practice, where issuers commonly engage different rating organizations to rate different positions within the same securitization structure and are provided with ratings that meaningfully, reliably and consistently differentiate the relative risk of each of the positions within a securitization structure. Fitch notes that this industry practice is captured in the default and migration statistics for structured ratings and that these statistics have performed better than the statistics for corporate ratings which are being relied on by the Committee in evaluating rating agency performance.

Fitch believes that imposing such a condition is anti-competitive and will have the effect of perpetuating Standard & Poor's and Moody's monopoly positions and extending their dominance to structured finance, an otherwise relatively competitive market, by essentially forcing every position within a securitization structure to carry a Standard & Poor's or Moody's rating. In addition, this will have the impact of thwarting innovation in the ratings arena and squeezing out competition, something which runs counter to the market's desire and demand for more information and ratings approaches.

Fitch would also like to draw your and the Committee's attention to Annex 2 which proposes parameters for supervisors to use in evaluating the performance of rating organizations. The annex states that the proposed parameters are based on data from "major international rating agencies," but the proposed rates and levels in the tables are broken out only by Standard & Poor's and Moody's assessment categories. Fitch has spent more than a decade of effort, undertaken multiple mergers and invested millions of dollars to become a global rating agency that is represented in all major jurisdictions throughout the world and has published over 10 years of historical default and transition performance statistics for both corporate and structured finance ratings. We believe that Fitch should also be listed in the tables as well as any other internationally-recognized rating organizations. Singling out the names of Standard & Poor's and Moody's confers an unfair competitive advantage which perpetuates their monopoly position in the ratings industry.

Fitch believes that it is important that regulation affecting rating organizations promote a fair, level and competitive playing field and urges the Committee to address the points discussed above. We would be very happy to discuss this matter as well as our more detailed comments, which are attached, with the Committee or the subgroup responsible for working on the ECAI criteria.

Sincerely,

/s/ Stephen W. Joynt

Stephen W. Joynt
President and CEO

Attachment

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Subject: Fitch Ratings' Comments on the ECAI Criteria and Operational Requirements in the Securitization Framework for using External Ratings

Provided below are Fitch Ratings' (Fitch) comments on the requirements set forth in the Basel Committee on Banking Supervision's (the Committee) third consultative package (CP3) of the New Basel Accord regarding the recognition of external ratings assessment institutions (ECAIs) and external ratings assessments (ECAs) and the operational requirements for using ECAs in the securitization framework.

Recognition Criteria

In general, Fitch thinks that the six eligibility criteria (objectivity, independence, international access/transparency, disclosure, resources and credibility) set forth by the Committee are appropriate as broad principles for the recognition of ECAIs. Fitch particularly welcomes the requirement contained within the Committee's disclosure criterion requiring that rating organizations disclose, among other things, their performance statistics. In our view, publication by rating organizations of actual default rates experienced in rating categories and transition studies showing the actual movement of ratings over time is critical to allowing an evaluation by the market, investors and supervisors of the individual rating organization's performance and the predictive quality of the ratings that are being relied upon by banks in determining their regulatory capital. Fitch believes that regular and periodic disclosure will promote transparency with respect to the performance of the external ratings that are being relied upon by banks.

Annex 2

Annex 2 in CP3 sets forth guidance to supervisors for mapping external ratings to risk-weighting buckets and provides parameters for evaluating the performance of rating organizations. In this regard, it is proposed that supervisors: (1) compare the rating organization's ten-year average of three-year cumulative default rates (CDRs) associated with each rating grade against a long-run "reference" rate, which has been derived by the Committee from the twenty-year average of the major international rating agencies' three-year CDRs; and (2) evaluate the rating organization's two most recent three-year CDRs for each rating grade against "monitoring" and "trigger" supervisory benchmark levels, which have been derived by the Committee from the 99.0th and 99.9th percentile confidence interval, respectively, using a monte-carlo simulation model that relies on publicly available historical default data from the major international rating agencies. While Fitch welcomes the evaluation of rating agency performance statistics, Fitch has a number of comments and recommendations with respect to the proposed parameters that are discussed below.

Update data underlying reference rates and benchmark rates: The long-run and benchmark CDR levels presented in Tables 2 and 3 are based on historical rates from major international rating agencies. However, there does not appear to be a mechanism built into the guidance to require that they be updated over time. More than likely, the reference statistics presented in Annex 2 run just through year-end 2000 or, possibly 2001, which means that they either miss all or a good part of the recent increase in corporate defaults.

Fitch notes that default statistics associated with rating categories are neither static nor absolute measures of risk. Rather, they have the potential to change over time and should be seen as relative indicators of risk. For example, default levels for each rating category tend to rise during recessionary periods. In addition, structural changes in the economy or specific business sectors have the potential to impact default levels over a sustained period of time. While the absolute default levels have the potential to shift over time in any rating system, the performance of the rating categories vis-à-vis one another in a sound rating system should preserve the relative ranking of risk; that is, default levels should be lowest for the rating category representing the best creditworthiness and highest for the category representing the worst creditworthiness.

In view of the above, Fitch believes it is therefore important that the reference and benchmark comparison rates not remain fixed in time, but rather that they be updated annually to include the most recent history possible. While the inclusion of the most recent annual rates is unlikely to change the long-run historical average of three-year CDRs significantly in the short-term, reflecting the potential changes in volatility around three-year CDRs is important when setting benchmark levels. Over the long-term, historical long-run rates may also be affected depending on the magnitude of change in recent data points and the weight given to the more recent default data in the data series.

Caution when drawing inferences: A point of caution is necessary when comparing a rating organization's two most recent three-year CDRs to the three-year CDR "monitoring" and "trigger" supervisory benchmark levels established through monte-carlo simulation using many years of past historical data. Even when the most recent year's default statistics are included in the model to estimate the benchmark levels, the comparison of a particular rating agency's last two years of three-year CDRs to the benchmarks is not an apples-to-apples comparison, in that the benchmark levels do not solely represent the last two years of performance. This can be important, particularly if the rating agency's two most recent three-year CDR averages have increased and exceed one or both of the benchmark levels due to sustained recession.

When a rating organization exceeds one or more of the benchmark levels, Fitch therefore proposes that the supervisor should also evaluate the organization's break in performance against a composite average, which reflects the collective experience by rating organizations active in the market, for the same period, i.e., the two most recent three-year CDRs. Fitch believes that such a comparison would be helpful in detecting whether there has been an overall rise in default levels or whether the increase is specific to the particular rating agency.

While footnote 152 contemplates that higher default experience could result from a "temporary or exogenous shock," Fitch believe that it is important that supervisors be extra vigilant when evaluating the causes and not de-list rating organizations that are making appropriate credit assessments during a prolonged recessionary period.

Inclusion and Transparency in the tables listing supervisory reference rates and benchmark levels: Annex 2 states that the long-run reference rates and benchmark levels are based on data from the "major international rating agencies", but presents the proposed rates and levels in Tables 2 and 3 broken out only by Standard & Poor's (S&P) and Moody's assessment categories. Fitch has spent more than a decade of effort, undertaken multiple mergers and invested millions of dollars to become a global rating agency that is represented in all major jurisdictions throughout the world, and has published over 10 years of historical default and transition performance statistics for both corporate and structured finance ratings. Fitch believes that the data underlying the proposed supervisory figures should be drawn from all internationally-recognized rating agencies that have published sufficient data and that there should be transparency with respect to the sources from which the data was drawn and the years covered. We therefore recommend that Fitch's name and rating nomenclature, as well as that of any other internationally-recognized rating agency that has published sufficient data, be listed in the tables. Singling out S&P's and Moody's names in the tables confers an unfair competitive advantage which perpetuates their monopoly position in the ratings industry.

Factor migration into performance evaluation: While Annex 2 provides guidance for assessing the performance of rating organizations with respect to default statistics, it is silent on the dimension of migration experience. Fitch believes that a review of ratings migration should also be conducted by supervisors to ensure that the organization's ratings are relatively stable over time. Since the volatility of the migration statistics is greater than default statistics, Fitch thinks that it is more difficult to establish benchmarks with respect to migration. However, as part of a qualitative review, Fitch thinks that would be instructive for supervisors to compare the organization's migration performance a long-run average as a basis for identifying extreme outliers and engaging in dialogue as to the factors driving the results. In addition, a review of migration statistics would be beneficial when evaluating newer entrants into the rating industry. In this regard, it takes many years of history to develop meaningful default statistics, whereas transition figures that give insight into a rating agency's performance can be developed over shorter periods of time.

Calculation of individual rating organization default statistics: Annex 2 may lead to confusion as to the calculation method for computing rating organization CDRs. As discussed in an earlier Fitch commentary on Basel II *(see Fitch Research on Basel II: Refinements to the Framework, February 6, 2003, available on Fitch's website at www.fitchratings.com)*, paragraph 3 states that supervisors should evaluate the CDRs associated with all "issues" and throughout the document it is unclear whether weighted average or average is meant when referring to CDRs. Fitch notes that it is industry convention to calculate default statistics based on the number of company defaults (i.e. by issuer) as opposed to the number of bond defaults (issues). In addition, it is industry convention to use weighted averages when calculating default statistics as opposed to simple averages in order to correctly emphasize the years with the greater number of rating observations. When comparing default performance across rating organizations and to supervisory reference rates and benchmark levels, Fitch believes that it is important that a consistent calculation method be used and that this method should be based upon industry convention which has been analytically-proven and has historical depth. Accordingly, Fitch recommends that the Committee clarify the language around these points.

Operational Requirements for using External Ratings in the Securitization Framework

Fitch is troubled by paragraph 525(d) in the securitization framework, which does not permit a bank to use one ECAI's ratings for one or more tranches and another ECAI's ratings for other positions within the same securitization structure. Fitch notes that the imposition of this condition is inconsistent with established market practice, where issuers commonly engage different rating agencies to rate different positions within the same securitization structure and receive ratings that meaningfully, soundly and consistently differentiate the relative risk of each of the positions within a securitization structure. In addition, this industry practice is captured in the default and migration statistics for structured ratings and these statistics have performed better than the statistics for corporate ratings which are relied on in Annex 2 for evaluating the performance of rating agencies.

Fitch believes that imposing such a condition is anti-competitive and will have the effect of perpetuating Moody's and S&P's monopoly positions and extending their dominance to structured finance, an otherwise relatively competitive market, by essentially forcing every position within a securitization structure to carry an S&P or Moody's rating. In addition, this will have the impact of thwarting innovation in the ratings arena and squeezing out competition, something which runs counter to the market's desire and demand for more information and ratings approaches.

While the likely reasons for proposing condition 525(d) in Basel II were to ensure that the ratings assigned to tranches in a particular securitization structure measure the relative risk of each position vis-a-vis one another in a consistent manner and that banks do not employ different rating agencies to obtain a more favorable rating for a particular tranche than would otherwise have been assigned (or, in other words, engage in the so-called practice of cherry-picking), Fitch believes that Basel II can easily address these points through provisions that are not anti-competitive. Namely, by requiring eligible rating organizations to publish the default and transition statistics associated with their structured ratings on a regular basis and mandating that supervisors review and evaluate these performance statistics.

Regarding the issue of consistency, Fitch notes that, even when rating only a single tranche in a particular securitization structure, it is necessary to evaluate the collateral and structural elements of the underlying pool in coming up with the required enhancement for the particular tranche being rated. While the methodologies for rating differ across the major rating agencies, statistics show that the assessments of risk levels are consistent across the major rating agencies.

In this regard, Fitch compared ratings in the U.S. structured finance markets issued by Fitch, S&P, and Moody's during 2001 and published its findings in a report in June 2002 *(see Fitch Research, Structured Finance Ratings: Similar at Issuance and Over Time, June 27, 2002, available on Fitch's website at www.fitchratings.com).* The study reviewed 6,100 rated bonds from 993 transactions. The report concludes that identical ratings are issued from any two of the three rating agencies in 95% of all instances. Furthermore, when a tranche had different ratings, the difference was only one notch 85% of the time. That study was built upon research that Fitch has released on the transition of ratings for structured securities during the past ten years *(see Fitch Research, Structured Finance Rating Transition Study, May 8, 2002, available on Fitch's website at www.fitchratings.com).* A comparison of the movement of ratings with the transition studies of S&P and Moody's structured ratings also showed no meaningful broad distinctions. This information reinforces our view that the vast majority of ratings can be considered fungible when rating structured bonds.

In terms of quelling the potential for cherry-picking ratings, Fitch believes that an evaluation of default and performance statistics for structured ratings will show whether a rating organization is issuing overly favorable ratings. Moreover, it is important to note that it is not in the long-term interest of a major rating organization to issue lenient ratings. The credibility of a rating organization lies in its ability to accurately assess credit risk in the overwhelming majority of cases. To the extent that a rating organization's credit ratings are not reliable indicators for assessing the likelihood that a security will default, the market will simply stop relying on them. The regular publication and review of performance statistics helps to facilitate such market-discipline and provides a meaningful check on whether a particular rating organization's credit ratings are understating risk. In our view, this, in combination with regulation that sets high standards for ECAI recognition, address the concern regarding the potential for cherry-picking, without the negative anti-competitive effects which would result from imposing 525(d).

Harmonization of Recognition Criteria Across Supervisory Bodies

Through the years, external ratings have been increasingly used in safety and soundness and eligible investment regulations for banks, insurance companies and other financial institutions. When external ratings are included in prudential regulation, Fitch believes that it is important to set standards for recognition which ensure that rating organizations possess the competence necessary to develop accurate and reliable rating systems and demonstrate reliable performance over time. While Fitch agrees with the need to set high standards for recognition, we note that, in addition to the Committee, a number of other supervisory bodies are currently reviewing standards that affect the recognition of rating organizations. For example, the International Organization of Securities Commissioners (IOSCO) is presently developing key principles with respect to recognition and oversight of rating agencies and the Financial Stability Forum is considering on its agenda issues affecting the regulation of credit rating agencies. In addition, through the Basel II process, bank supervisory agencies throughout the world will be issuing their own implementing regulations with respect to ECAI recognition. Furthermore, securities commissioners in various countries are also in the process of re-thinking their recognition criteria. For example, the U.S. Securities Exchange Commission recently published a concept release, which, among other things, covers the question of recognition criteria.

With so many supervisory and regulatory bodies and major international committees working on the topic of recognition criteria and rules for rating organization, the potential is great for many additional and conflicting layers of regulation to be imposed on rating organizations, which significantly increase the cost of compliance and raise barriers to entry. Fitch believes that it is imperative that recognition criteria and regulations affecting rating agencies not be developed in isolation and encourages the Committee to continue to seek to harmonize the proposed criteria to the greatest extent possible with the other international committees, as well as ensure that the implementation by national bank supervisors of the criteria and performance parameters area as consistent as possible across the Basel member countries.

Conclusion

Fitch appreciates the opportunity to comment on the proposed recognition criteria for ECAIs and operational requirements for ECAs set forth in CP3 and believes that it is important that regulation affecting rating organizations advance financial system safety and soundness while at the same time promote a fair, level and competitive playing field. We would like to thank the Committee in advance for considering our comments and suggestions. We would be very happy to discuss the above points further with the subgroup responsible for working on the ECAI criteria and provide any default or migration performance data that the Committee might find helpful in evaluating rating agency performance.

Stephen W. Joynt
President and CEO

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