30 September, 2005

BY ELECTRONIC MAIL AND POST

Jose Maria Roldan
Chairman
Andrea Enria
Secretary General
Committee of European Banking Supervisors
Floor 18
Tower 42
25 Old Broad Street
London EC2N 1HQ

Re: *CEBS' Consultation Paper on the recognition of External Credit Assessment Institutions (the "Consultation Paper")*

Dear Messrs Roldan and Enria:

We are writing in response to the Consultation Paper, published by the Committee of European Banking Supervisors ("CEBS") on 29 June, 2005. We welcome CEBS' desire to harmonise, to the greatest extent possible, the recognition process for External Credit Assessment Institutions ("ECAI"s), especially when that process will involve multiple Member States. We agree that there must be consistency in decision-making throughout the EU. We also greatly appreciate CEBS' expressed intent to reduce the administrative burdens on all parties concerned. The existence of any undue burdens would clearly create barriers to entry. We set forth below our comments with respect to the specific questions raised by CEBS (and the corresponding explanatory material) in the Consultation Paper. Please note that we have only commented on those aspects with respect to which we have questions or concerns.

Question 1. If you are an institution or an ECAI, how do you envisage using the proposed recognition process, in particular in cases where applications for the same ECAI are submitted in more than one Member State at the same time?

We expect to apply for recognition as an ECAI in all 25 Member States (subject to the requirements imposed by each individual Member State), and therefore would utilise the joint assessment process.

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Question 2. Do you support the proposed joint assessment process? Does it address the need for efficiency, consistency and reduced administrative burdens in light of the CRD requirement that each competent authority make its own decision (direct or indirect) on eligibility?

We believe that it is of paramount importance that the recognition process is harmonised so as to ensure a consistent outcome in each Member State. This is especially true with respect to an application made in more than one Member State. We agree with the principle that such applications should be processed so as to avoid duplication of effort by all parties, to increase efficiency and to ensure the same outcome in each relevant Member State, although we have some concerns with respect to certain proposals made in the Consultation Paper.

First, we appreciate that the competent authorities of each Member State must ultimately take their own decision with respect to recognition and mapping. However, to ensure the joint process is not undermined, it would be important to ensure that the joint assessment arrived at in each case by the relevant group of competent authorities would, in fact, provide a high degree of certainty as to the outcome at the Member State level.

We note that the competent authorities are given discretion as to whether applicants can be the credit rating agency ("CRA") itself, any of the institutions planning to use the CRA's ratings or either (paragraph 20). We have two observations to make about this approach. First, if an application is made by someone other than the CRA, the CRA should have the ability to decline recognition, and thus stop the process. Second, if the CRA consents to the recognition process going forward, then the CRA should be the entity presenting the information requested by the Common Basis Application Pack – a third party would not necessarily have all the relevant information, or the most up-to-date information with respect to the CRA. Paragraph 24 seems to imply that a third party could supply this information; it is unclear to us how, as a practical matter, that could work.

We very much agree that a standardised package of information should be provided by any CRA seeking recognition as an ECAI. (See below for our specific comments with respect to the proposed Common Basis Application Pack.) However, we note that CEBS mentions in several places that the competent authorities of a Member State may consider other information they consider relevant and/or ask for complementary information and documentation (see, e.g., paragraphs 16, 41, 42, 43, 50, 51 and 52). As this contradicts the principle that all Member States should be looking at essentially the same package of information, we would expect the use of/request for information other than that supplied in the Common Basis Application Pack to be limited. It would be helpful for CEBS to provide some guidance as to when recourse can be had to this additional information. For example, CEBS could provide an indication of what kind of "national specificities" (paragraph 42) could be expected to affect individual regulators' considerations.

With respect to an application in more than one Member State, we have the following concerns. First, there is no specific timetable within which a decision must be taken. We note that the relevant competent authorities must meet to determine the single joint process within a month of receipt of the CRA's application (paragraph 37), but there are no further deadlines established.

We would expect that a decision could be reached within four months of the establishment of the joint process; it would be helpful for CEBS to specify such a timeframe. On a related point, we note that each competent authority can determine how its decision is communicated to the applicant (paragraph 45); we think, to avoid confusion, that if a CRA is seeking recognition from several Member States, the decisions from those Member States should be announced at essentially the same time. Equally, competent authorities for each Member State should announce, wherever possible, the decision for all applicant CRAs simultaneously.

Next, the Consultation Paper states that a " 'process facilitator' will be appointed" to coordinate the other competent authorities and to produce the joint assessment (paragraph 39). We think the existence of a process facilitator will be absolutely necessary in order to ensure efficiency and lack of duplication of work, given the variety of ways in which the joint process could be constructed (see paragraph 38). We are, however, concerned about the basis for determining which competent authority will be the process facilitator. We think the choice should be based on objective criteria that will facilitate the efficiency of the recognition process, such as: the Member State in which the CRA's headquarters or largest office is located; the predominant business language for the CRA; the Member State in which the majority of the CRA's senior management is located (for ease of communication); and the Member State in which the largest amount of the CRA's relevant data is located. In addition, we believe it would be extremely helpful, with respect to the ongoing review of an ECAI, if the same process facilitator were to continue in that role. The Consultation Paper does not specify that the process facilitator will be used for ongoing reviews (both with respect to reported material changes, and the more formal five-yearly reviews) (see paragraphs 61 and 62); we believe that should be clarified.

Finally, the issue of the language in which documents will be submitted is touched on in paragraph 48; we do not understand what is meant by the phrase "without prejudice to domestic language requirements". We believe very strongly that a CRA should be allowed to communicate in its predominant business language. Equally, to address concerns regarding the barrier to market entry which a burdensome application or review process could entail, we anticipate that the application process will not require a CRA to translate any of its methodologies, criteria, policies, procedures and other documents into an additional language, and would be grateful for clarification on this point.

Specific Comments on Common Basis Application Pack (Annex 1).

1. Presentation of the ECAI. As stated above, we believe that it is crucial that all CRAs provide essentially the same information. To that end, we are not certain as to why the 10% threshold for share ownership and the 5% threshold for revenues from issuers/subscribers is said to vary depending on the ECAI. It would be helpful to either have a fixed percentage, or an explanation of the reasons for, and amount of, any such variations. Moreover, with respect to the request for information regarding the percentage of revenues received from issuers/subscribers, we would point out that we do not currently track our business in this way, as we do not think such information is relevant to the way in which we manage our business. Indeed, we think it better, from the perspective of managing potential conflicts of interest, that we do not compile this information. If there is a demonstrable need for this

information, we would work with the relevant competent authority to gather the information.

2. Technical criteria laid down in the CRD. We believe the best way to answer this request is to provide copies (ideally electronically or via access to our website) of our criteria/methodologies for the main analytical areas with respect to which we are seeking recognition. A review of these documents by the competent authorities will clearly show the differences among the criteria/methodologies. It would be helpful for CEBS to clarify that our approach would be acceptable.

3. Methodology; 1. Objectivity; paras 2), 3) and 4). We would expect the "high-level" nature of this information to indicate that our existing public disclosure on criteria, rating process and initiation or participation status by issuer would satisfy the requirements of the application process. Specifically on point 4: our methodologies are generally international in scope, and the weighting of rating factors in our analysis may vary from one country to another without there being a formal difference in methodology. We publish separate special reports where underlying data displays differences in quantitative stress levels (e.g., residential mortgage-backed securities) or where qualitative factors have a regional profile (e.g., utility regulation), but the methodology remains broadly consistent.

4. Methodology; 1. Objectivity; para 5). We assume this would be addressed by published transition and default studies; it would be helpful for CEBS to confirm that this is considered a suitable document.

5. Methodology; 2. Independence; para 4). We are happy to certify that our key staff members possess the requisite skill levels, and that we have an extensive training programme for our staff members. We believe that evidence of this is provided in our default studies and transition studies.

6. Methodology; 2. Independence; para 6). We are happy to certify that our remuneration policy does not affect the production of independent and objective ratings. We believe that evidence of this is provided in our default studies and transition studies.

7. Methodology; 3. On-going Review; para 1). We have the following observations with respect to the reference to carrying out rating reviews at least annually. We can demonstrate the regularity of our reviews by reference to our established policies and procedures. Fitch is staffed with the intent and result that its ratings are monitored on a real-time basis. Our analysts, for example, follow a significantly smaller number of credits than is the case for analysts in most commercial banks. This is not to say that the analyst/issuer ratio is an unambiguous indicator of quality, but it does exemplify that our surveillance is designed with continuous monitoring in mind. In addition, we believe that default studies and transition studies are the best way to track the performance of ratings; if ratings were habitually "stale", this would be apparent in

the results of these studies. We currently conduct our default and transition studies on an annual basis.

8. Methodology; 3. On-going Review; para 2). It is unclear what is intended here. The outcome of a review is typically followed by the issuance of a rating action commentary. However, this may not always be the case as rating actions may have occurred before the formal review or may not be necessary post the review depending upon the views of the analytical team following the credit.

9. Methodology; 3. On-going Review; para 4). Given the number of issuers we rate, it would be extremely burdensome to provide this information with respect to each issuer. Instead, we think it would be appropriate for a CRA to provide its policy with respect to participation by issuers.

Question 3. What are your views on the proposed common understanding of the CRD recognition criteria to be implemented by supervisors in determining the eligibility of ECAIs?

We would begin with a basic observation. Ratings should be based on all information available to the CRA and deemed relevant by the CRA.

We very much agree with CEBS' assertion that competent authorities should avoid making judgements as to whether an ECAI's methodologies are objectively correct (paragraph 81). We also strongly endorse the position that the results of default studies and transition studies are good indicators that a CRA's methodologies are objective, rigorous and systematic (paragraph 84). Indeed, we believe that such studies also demonstrate the independence of a CRA's methodologies and the appropriateness of such CRA's ratings reviews, as well as the level of skills and experience of the CRA's analysts.

We have some additional specific observations. Paragraph 75 makes reference to "evidence that the methodology has produced accurate credit assessments in the past". We would note that ratings are opinions, and as such are not demonstrably "accurate" or "inaccurate".

We think it would be helpful for CEBS to clarify that ratings assessment activities – that is, providing feedback to an issuer of the potential impact on its rating given a set of hypothetical circumstances – are part of a CRA's core rating activities and would not be considered to be an ancillary service.

An additional point of clarification arises with respect to paragraph 92.d. – the final sentence could be read to imply that issuers will always participate in the ratings process. Given that issuers face no legal obligation to continue participation in ratings which they have requested, and that CRAs may also issue unsolicited ratings, it is possible, in such situations, that there is no issuer participation. We therefore believe this reference to frequent contacts with rated companies should be qualified to state only that the ECAIs "have enough resources to permit frequent contacts with the rated companies."

Paragraph 96 sets forth a requirement that each ECAI demonstrate that each rating is reviewed at least annually (regardless of whether a review has been conducted in the interim with respect to a significant event). We would point out that ratings (other than those designated as point-in-time) should be under continuous surveillance. See our response to a similar requirement set forth in the Common Basis Application Pack (item 7 above).

Paragraph 98 requires that we provide at least one year of default and transition studies for each market segment in which we wish to apply for recognition – structured finance, public finance and commercial entities (corporates and FIs). As we have commented in previous responses, the default history for public finance securities is modest. The three major international rating agencies each publish ratings performance statistics for the sovereign entities that they rate. In looking at these studies, it is clear that, due to small sample sizes, there is a large degree of rating volatility present in each of the samples. For example, in 1998 a total of just two Fitch rated sovereign defaults led to a default rate for the year of 3.64% -- on the surface a relatively high level but due overwhelmingly to the small sample which consisted of 55 rated sovereigns. The two defaults in 1998 therefore had a significantly disproportionate impact on the default rate. In contrast, for each of the years 1994 through 1997, and in 2000, there were no sovereign defaults, resulting in annual default rates of 0%. As recently as 2003, Fitch's universe of sovereign ratings totalled just 80 – again pointing to considerable sample size issues. Our understanding is that the other major rating agencies also have a limited number of sovereign ratings which again can create significant distortions in the published default and migration rates. With respect to public-sector finance, such as municipal securities, we note that this is largely a feature of the U.S. market. In Europe, although some municipalities have ratings, the overall population is again extremely small.

Therefore, while the proposed process gives scope for the statistical issues associated with public finance to be addressed qualitatively (under Paragraph 143.c among others), we recommend again that default and transition studies be requested only for the corporate and structured finance sectors, where statistically meaningful data is available.

Question 4. What are your views on the proposed approach for implementing the mapping process?

Question 5. Do you support the proposal that the "mapping" of credit assessments to risk weights should also be addressed under the joint process set out in Part 1 for applications made in more than one Member State?

We support the proposal that "mapping" also be subject to a joint process. In response to Paragraphs 136-137, we would expect competent authorities to bear in mind the volatility of default rates over cycles and across sectors, with the result that anchoring external, ordinally based credit ratings to any cardinal scale, however broadly constructed the "monitoring" and "trigger" levels may be, will face limitations. Paragraph 136 repeats the (asymmetric) presumption that higher observed CDRs would be presumed to be due to weaker assessment standards or miscalculations unless the agency could demonstrate otherwise. Fitch would disagree with this presumption but nonetheless acknowledges the supervisor-level discretion in

the consideration of trigger events granted within the proposed framework, and expects that this will be applied on a consistent and informed basis.

Question 6. Do you think that the concept of loss, rather than default probability alone, is the appropriate key parameter for mapping securitisation credit assessments? If not, what should be the appropriate parameter? How should it be measured statistically? To what extent do the same considerations apply for CIU credit assessments?

Fitch believes that default probability is the most appropriate uniform measure upon which to compare and map securitisation assessments on a consistent basis. While the determination of default or impairment rates in structured finance presents its own complexities, the available data sources are deeper and more reliable than is the case for loss rates. Transaction or instrument ratings for both corporate and structured finance include varying degrees of loss severity within them across the rating scale, but the primary driver of each rating remains the default risk.

On managed funds, given that default is an inapplicable concept for the managed fund itself, the "AAA"-scale credit ratings which we assign to funds do not map entirely to our debt ratings, including the debt ratings of bonds issued by those managed funds. However, following discussions with the CEBS working party, we understand that you would wish to apply ratings to CIUs on a "look-through" basis under Article 87 of the Capital Requirements Directive. As our managed fund ratings address the weighted average default risk of the fund, they may be considered suitable for this purpose, provided the distinction between these ratings and our instrument ratings assigned to the fund's issued bonds is properly understood. We can arrange a meeting to discuss these ratings in considerably more detail if appropriate.

Thank you for the opportunity to be a part of this extremely important process. Please call me at your convenience at +44 20 7417 4228 with any questions that you have about our comments or to discuss this matter further.

Sincerely yours,

Paul Taylor
Group Managing Director
Fitch Ratings