

Fitch Ratings

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BY ELECTRONIC MAIL

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Request for comment – Credit Rating
Standardization Study, Release No. 34-63573; File No. 4-622

Dear Ms. Murphy:

Fitch, Inc. (“Fitch”) submits this letter in response to the request of the Securities and Exchange Commission (“the Commission”) for comments in relation to Section 939(h) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Dodd-Frank Act”), requiring the agency to study the feasibility and desirability of standardization among important elements of ratings and terminology as well as requiring more quantitative correspondence between ratings, default probabilities, and expected losses.

More specifically, the Commission is required to study the “*feasibility and desirability of: (A) standardizing credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms; (B) standardizing the market stress conditions under which ratings are evaluated; (C) requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress; and (D) standardizing credit rating terminology across asset classes, so that named ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity.*”

Fitch continues to support the goals of “the Dodd-Frank Act” aimed at increasing transparency in the rating process; fostering greater competition among existing credit rating agencies (CRAs); increasing the demand and opportunity for new CRAs and reducing excessive reliance on ratings by market participants, particularly investors.

However, Fitch believes that the premise of the study referenced runs counter to these goals and in some instances contradicts fundamental principles of NRSRO regulations –

“that the Commission may not regulate either the substance or credit ratings or the procedures and methodologies by which the NRSROs determine credit ratings”.

Standardization potentially impedes two clear initiatives of the Dodd-Frank Act with respect to rating agencies -- fostering greater competition and reducing reliance on ratings. There is no question that markets benefit from a variety of credit opinions including ratings. If multiple competitors are limited to approaching ratings and their varied and dynamic components in predetermined, standardized ways, there will no longer be diverse opinions or numerous firms competing to provide the best insights.

If creation of these standard terms, conditions, and quantitative outcomes were achievable, it seems the surviving providers of those resulting ratings may be relied on more heavily, not less. One might take the view that the outputs were “government approved”. In turn, providing an efficient alternative to robust in house analysis. Users would be at risk of becoming reliant on these outputs in their own evaluation process.

Desirability:

While it may be considered desirable by some market participants to have credit related terminology, approach, and output standardized, that would run counter to feedback Fitch has repeatedly heard from investors. It would also be inconsistent with statements made by interested bodies such as the Financial Services Roundtable ¹.

It seems the strongest arguments for the desirability of standardization would be those calculating regulatory capital. As ratings have been, or are, in the process of being written out of these requirements, it seems those most interested in precise feedback in terms of probability of default (PD) and/or expected loss (EL) for capital calculation purposes will no longer benefit from this type of output.

This also breaks with the fundamental intention of Fitch’s ratings, which are meant to provide a relative rank ordering of risk. Fitch’s views on this topic were updated in a June 21, 2010, report titled, “Ratings Comparability”, a copy of which is attached.

Transparency and ongoing improvements on this front seems to be more desirable than standardization. In retrospect, standardization seems to have played a key role into the excesses (e.g. residential mortgages), which became prevalent leading up to the current crisis. A system that becomes too rigid and precise lays the ground for parties to “optimize” (or “game”) the system. Once this process begins and activity responds to the rewards of efficiency, the framework often begins to deteriorate rapidly. Rather than yielding to the perceived benefits from standardization, greater focus on transparency and elements of comparability will likely yield better long term results.

¹ p. 4 response to request for feedback dated Feb 7, 2011 “..we believe that any effort to change ratings methodologies rather than merely making them more transparent, including by mandating applicable levels of stress, would be inappropriate.”

Feasibility:

Moving away from some of the contradictions standardization seems to introduce by achieving new goals at the expense of others, the feasibility of creating standardization also presents some meaningful challenges in Fitch's view.

Even if standardizing terminology, stress conditions, probability of default, and expected loss is desirable to some parties; the practicalities of achieving such standardization across asset classes and geographies are daunting. Take for example, studies of the Great Depression in the US. While the principal of applying this degree of stress may be beneficial in driving greater comparability across asset classes, standardizing that "case" across regions is very difficult. The reality is there are many different starting points for the key drivers of different economies, including the relative contribution of industrial or governmental influence on the system's production and other important macro factors that are important inputs to create such standardized stresses.

It would likely prove more practical to establish the type of scenario that a given rating should be resilient to and be transparent in sharing how comparability is achieved in different asset classes and regions.

This comparability is likely most feasible on a PD level and, in Fitch's view, difficult to achieve in standardizing the expected loss a security would have across rating categories and sectors.

At high rating levels the probability of default should be very remote, so even if the loss given default is assumed to be high, any expected loss number would be low. Trying to establish a refined estimate of loss at those rating levels is difficult at best. Events that would create a default of AAA ratings should be of such a magnitude that recovery factors such as timing and asset liquidation would also be under severe distress.

For lower rating levels (non investment grade for example) there can be more meaningful estimates of recovery and expected loss for traditional corporate asset classes. Again, trying to create standards of expected loss becomes very difficult as many factors influence motivations and asset values for entities in distress.

Standardization of loss expectations across asset classes is further complicated by the transaction and tranche level mechanics found in structured finance, including the effects of rating to ultimate maturity compared with more definite time frames typically achievable when assessing recovery for corporate asset classes. Fitch also believes that comparability of recovery between corporate sectors and structured finance is not easily achieved.

It is important to recognize that we are sharing our points on feasibility and challenges in getting to expected loss at the security or tranche level at our own expense. It would

likely be beneficial to us to represent that such standardization could be achieved and provided in terms of rating stresses, performance and correlation of PDs and EL. This would suggest a level of expertise and ability that would represent unique offerings. However, the feasibility of doing so is very low. Ratings are intended to be rank orderings and reflect judgment, debate, and the output of a committee process, not precise mathematical equations.

We believe more can be done to better compare terminology and express why we think ratings in different sectors should perform similarly, but the risks faced, terminologies used, and stresses faced will differ by asset class and region making the feasibility of elements to be studied low.


We do not believe these elements are achievable other than within particular asset classes for the PD element or where a sector or asset class is already experiencing distress to generate an informed estimate of EL (so the relative window and related circumstances are more definable). To suggest otherwise, would be at best optimistic and at worst misleading.

Conclusion:

If we are to continue to rebuild confidence, it must be done so with realistic intentions in terms of what is feasible and what is desirable. More dialogue, understanding, and comparisons under normal conditions would be more realistic and useful as an initial approach, rather than trying to standardize approaches so broadly.

Fitch supports the commissions' efforts to enhance transparency, reduce excessive reliance on ratings, and encourage competition. The standardization outlined in the request for comment would be a tremendous undertaking and, more importantly, will not yield the desired results.

Respectfully,



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Special Report

Ratings Comparability

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Related Research

- *Fitch Ratings Global Structured Finance 2009 Transition and Default Study, March 26, 2010*
- *Fitch Ratings International Public Finance 2009 Transition and Default Study, March 26, 2010*
- *Fitch Ratings U.S. Public Finance Transition and Default Study 1999-2009, March 25, 2010*
- *Fitch Ratings Global Corporate Finance 2009 Transition and Default Study, March 18, 2010*

Default Risk Comparability — A Primary Objective of ‘AAA’ Scale Ratings

The widely recognized ‘AAA’ to ‘D’ credit scale, first designed by John Fitch in 1924, is a universally recognized indicator of credit risk. However, in reality, credit risk crosses multiple dimensions — default, loss, liquidity, and others. A rating scale should pick one dimension if it is to give the clearest message. Fitch Ratings’ core aspiration for its international long-term ratings continues to be comparability of default risk across asset classes for like-rated securities.

Fitch also aspires to achieve higher comparability on ratings transition across asset classes. The goal is to replicate the performance of sectors that have demonstrated behavior Fitch would have expected through a cyclical downturn, such as corporates, while making appropriate adjustments in criteria and process to areas that have underperformed.

Lastly, while loss given default (LGD) is also a seemingly desirable component to have imbedded in a long-term rating, Fitch recognizes that differences among sectors and structures make it impractical to aspire to achieve comparability on this element within all its long-term ratings. There are limitations to what ratings can provide and Fitch remains committed to providing transparency on process, criteria, opinions, and data used to establish its ratings. In terms of LGD, Fitch endeavors to provide valuable information on LGD via its recovery and loss severity ratings.

Rank-Ordering — The Benefits of Comparable Ratings

Fitch uses the same rating scale for all of its international ratings, so market participants can compare Fitch’s perspectives on credit risk across sectors and regions. Ratings are designed to provide a rank ordering from those with the least vulnerability to default to those with the most vulnerability.

Fitch, like most who evaluate creditworthiness, must reconcile differences across many sectors, regions, products, and structures. In practice, long-term ratings in different sectors and regions have and will demonstrate varying levels of transition, default, and recovery, depending on the historical period considered or the impact of systemic or idiosyncratic factors on a given rated entity. Nonetheless, the aspiration is for Fitch’s ratings to demonstrate broadly comparable levels of default patterns over long periods.

It is important to note that Fitch offers other bespoke rating scales that do not aspire to achieve such broad comparability. After international long-term ratings, national ratings are the next largest population for Fitch and a good example of debt ratings established relative to a particular country. These ratings typically address the requirements and needs of a specific market and are denoted to reflect that specificity. Money market fund ratings would be another example of ratings that address specific elements and features of that market and are not comparable with traditional long-term ratings. In all, there are at least 10 other types of rating scales Fitch offers to address risks such as servicer, country, asset manager, currency, short-term, volatility, and others with varying levels of granularity below them.

The World Evolves — So Must Fitch’s Approach to Achieving Comparability

While striving to provide comparability is not a new ambition for Fitch, aspiration must be backed by concrete actions. The changes Fitch has introduced since the beginning of the credit crisis have included groupwide organizational, structural, criteria, and procedural initiatives. All are designed to strengthen the culture of independence, timeliness, and insightfulness that underpins Fitch’s ratings and research. These enhancements have improved how criteria is reviewed and approved, the process and comprehensiveness of committees, and the transparency with which Fitch shares information that supports the opinions it provides.

In the remainder of this report, comparability in relation to recent events and the core meaning of ratings are discussed, and greater detail is provided regarding Fitch’s aspirations for comparability.

Background

This special report is intended to clarify Fitch’s goals with respect to the comparability of ratings across corporate finance, structured finance, and other ratings sectors, including sovereigns and U.S. municipal debt.

There were clearly other alternatives as to how Fitch might approach what continues to be a challenging endeavor. Fitch has contemplated alternatives in a variety of formats, encouraging divergent opinions and approaches on this topic while incorporating interaction and feedback from external constituents. After much debate, comparability remains a key objective for Fitch.

The timing of this report also follows a ratings recalibration initiative for U.S. municipal debt and heightened market interest in recent rating activity with respect to sovereign ratings, including questions as to how sovereign ratings should compare to corporate ratings. The report also coincides with regulatory requirements that Fitch and other rating agencies will be required to add designations to their structured finance ratings. The EU regulation requires rating agencies to add symbology to denote the ratings of structured finance instruments.

Fitch recognizes that there are many ways to measure what is meant by the word “comparable.” For sake of clarity, Fitch’s goals of ratings comparability are as follows:

- Fitch’s first and primary goal is that over the longer term, default rates will be broadly similar for like-rated securities across all asset classes.
- As a secondary goal, Fitch aspires to greater comparability of ratings transition/volatility across asset classes, especially at the highest end of the rating scale. In this context, one of Fitch’s key goals in recent years has been to reduce the higher levels of ratings transition experienced in several structured finance asset classes, especially for ‘AAA’ rated securities.
- While consistent from a default perspective, Fitch does not aspire to have LGD (i.e. recovery) rates will be comparable across all asset classes for given ratings levels. Issuer default ratings (IDRs) of corporate entities are established on a default risk basis and corporate securities ratings are typically notched from the IDR based on expectations in relation to average recoveries. This approach works very well in communicating relative credit risk within each asset class and Fitch does not see value in changing this purposeful difference in ratings methodology. In contrast, tranches of structured finance transactions are rated on a default risk basis, reflecting the fact each tranche is designed to achieve a different level of exposure

to default should assets in a pool deteriorate. The analysis Fitch has performed in evaluating LGD for securities across the rating spectrum in structured finance has made it clear that the design and complexity of these securities, particularly amortization and diversion features, introduce significant challenges to this type of analysis.

- Fitch believes it could be more helpful by offering greater transparency into loss expectations through separate scales such as its recovery and loss severity ratings.

Fitch is not using this required designation for structured finance ratings to indicate that its goal is for future default rates of structured finance securities to materially differ from those of like-rated corporate securities. The 'sf' symbol will only indicate that the security is a structured finance instrument and will not reflect any other change to the meaning or definitions of Fitch's ratings.

Credit Ratings and Default Risk

By definition, a credit rating is a forward-looking opinion of relative credit risk. A common approach for measuring the performance of ratings over time is through transition and default studies, which measure migration and default patterns over various historical periods.

Overreliance on models and/or underappreciation of changes in the environment or data used in their creation can produce outputs that in hindsight appear too finely cut to offer the comparability Fitch aspires to provide. That false sense of security offered by this level of precision was a significant factor in underestimating the risk that has befallen some asset classes

Fitch has cautioned against the simple extrapolation of past performance of ratings into the future. In other words, a sector or issuer that has demonstrated a no- or low-default history or limited negative ratings migration is not immune from the possibility of prospective worsening in credit risk, nor is it guaranteed a given rating level going forward based solely on past performance. However, such studies can be instructive in considering the distribution of ratings and comparability of ratings across Fitch's rated portfolio.

Importantly, the assignment of ratings and the process to develop and approve the criteria on which they are based have become more involved and often address a wide range of inputs that are considered in the process. While models can be powerful and valuable consideration in the process, the reality is there are often qualitative considerations that are equally if not more important. As such, Fitch is focused on ensuring that the ratings assigned to a particular instrument are consistent with the broader definitions and not just a mathematical output. Overreliance on models and/or underappreciation of changes in the environment or data used in their creation can produce outputs that in hindsight appear too finely cut to offer the comparability Fitch aspires to provide. That false sense of security offered by this level of precision was a significant factor in underestimating the risk that has befallen some asset classes.

Default experience over time will continue to be the primary measurement of how effective the ratings have rank-ordered credit quality. What period that evaluation encompasses is of great importance, as the period in and of itself can lead to overconfidence, depending on macroeconomic conditions in which the entities or transactions being assessed have been exposed. Variation in actual default statistics across industries within a given sector, such as corporates, has been the case repeatedly through recent and historical cycles. While cumulative default statistics are a common gauge of performance, this crisis has reinforced attention on what type of stress should different ratings be expected to withstand with no or limited impact. If one focused exclusively on cumulative default statistics prior to this crisis, a number of sectors may have appeared to be overly conservative after extended periods of benign conditions, resulting in very low comparative defaults and high levels of upgrades as these transactions amortized or experienced rapid prepayments. Similarly, there were market commentators that often suggested banks were overcapitalized and called for

capital to be returned to shareholders, leading up to this crisis. Thus, default experience over time needs to be viewed in context of the environment and events that were encountered to make period-based cumulative default comparisons useful.

Ratings Transition

Another method of evaluating comparability beyond core default statistics would include the pace and magnitude of ratings transition, or, in other words, the frequency and severity by which ratings change. While not a factor explicitly incorporated into rating definitions, migration of ratings has been a much discussed topic through the current crisis. Again, this is particularly useful when assessed relative to cyclical stress or macroeconomic pressures. Fitch produces global annual transition and default studies for its ratings based on its 'AAA' to 'D' scale.

Two areas of note on both default and transition metrics would be U.S. RMBS and global CDOs. These classes have not performed as Fitch would expect, particularly for the most highly rated instruments. Market participants have made it clear that not only do they expect Fitch's ratings to have similar default statistics, they also expect that transition rates should be as comparable as possible. To Fitch, that means its highest ratings should experience default at very low levels, with the expectation that any rating activity would be in relation to the macro pressures faced. For example, while a Great Depression type scenario (which for the U.S. would mean unemployment in the mid-20% range and negative GDP for multiyear period) might yield movement across many rating categories, Fitch's highest ratings categories — particularly for long-dated transactions — should be sufficiently protected against this type of event. Contrast that with an environment where unemployment is at 10% and GDP has turned negative, resulting in cyclical increases in default and delinquencies — this should result in little rating activity particularly at levels above 'A'.

The revamped criteria for CDOs represent a good example of where shortcomings in the performance of investment-grade synthetics and structured finance CDOs have been acknowledged and a number of factors introduced (including key stress tests) to support the expectation that these ratings in the future may withstand significantly greater stress; thus, should deterioration of underlying collateral materialize, ratings migration would be much more comparable to the historical ratings migration of other sectors.

As noted, Fitch's secondary goal with respect to ratings comparability is to achieve greater comparability of transition rates among asset classes, especially at the highest end of the rating scale. Stated another way, a key goal is to reduce mult notch and multicategory downgrade risk for 'AAA' and 'AA' rated structured finance securities in the future and to bring these transition rates more in line with corporate levels.

However, Fitch does not expect or aspire for ratings transition rates to be as comparable as default rates. Transition rates can be influenced by many factors across sectors, ranging from the timing and/or magnitude of parental or government support in some to structural protections or features in others. In cases where structural features are central to the instrument, the rate and direction of transition could accelerate or be tempered, depending on the severity of the stress faced as well as a securities ranking in the transaction.

Loss Given Default and Expected Loss

In rating corporate entities and their securities, Fitch assigns an IDR to the corporate entity, which is primarily driven by expectations for default risk. In rating the various secured, unsecured, and hybrid/preferred securities of corporate issuers, Fitch employs

notching guidelines that consider how structural features could affect performance relative to average recoveries.

There have also been calls from several market participants over the years for ratings to explicitly incorporate LGD. While LGD analysis is useful, Fitch is not convinced that it should be incorporated beyond the broad notching guidelines it utilizes for its corporate ratings. The same average assumptions would be inappropriate for areas such as structured finance given the complexity of those securities and resultant distinction that introduces in trying to establish definitive estimates of loss.

In addition, the incorporation of LGD would make it difficult to distinguish between defaulted and performing securities as some level of recoveries would nearly always be achievable. In the most extreme case, a defaulted security rated 'AAA' could still be rated 'AAA' provided recoveries were expected to be 100% as expected loss would be zero. Instead, in Fitch's view, ratings comparability and information regarding LGD is best accomplished by unbundling these components where possible. Fitch's approach has been to either incorporate LGD into ratings in a general sense within notching guidelines or to address the expected loss component of LGD via complementary rating scales, such as recovery and loss severity ratings that can be viewed alongside its credit ratings. This transparency helps minimize the risk of giving a misplaced impression of mathematical precision that, in turn, could provide users with an inappropriate sense of confidence relative to estimates of loss.

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