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BY ELECTRONIC MAIL

Ms Ingrid Bonde
Chair
Task Force on Credit Rating Agencies
The Committee of European Securities Regulators (CESR)
11-13 avenue de Friedland
75008 Paris
France

Dear Ms Bonde,

The 2007 CESR Review of Credit Rating Agencies
Questionnaire Regarding the Rating of Structured Finance Instruments

Thank you for inviting Fitch Ratings to respond to the CESR questionnaire regarding the rating of structured finance instruments. We have pleasure in providing our responses below.

Introductory Notes

First, we note that, for the purposes of this questionnaire, CESR has employed a definition of structured finance provided by the Committee on the Global Financial System of the Bank for International Settlements. This states that "...structured finance involves the pooling of assets and subsequent sale to investors of claims on the cash flows backed by these pools..." For clarity, we have included in our response our structured finance business related to the rating of synthetic structured finance transactions as well as cash transactions.

Secondly, we thought it would be helpful to address those areas of the questionnaire that relate to ancillary services with a high-level overview of the services provided by Fitch.

Analytical Services

Fitch's core business is the provision of independent analysis and opinions regarding a variety of risks in the financial markets. Over time, Fitch has also developed, and will continue to develop, new rating scales, surveillance products, research products and other analytical services which are central to our strategy of providing comprehensive, independent risk analysis.

To explain how the traditional analytical services of ratings and scores can continue to grow in a manner consistent with existing analytical products, it is instructive to look at two recent innovations, the Rating Assessment Service and the RAP CD evaluator for Collateralised Debt Obligations ("CDOs").

The Rating Assessment Service offers rated corporate entities the opportunity to receive an indication of what impact a certain set of events would have upon their ratings (e.g. an acquisition or recapitalisation). The assessment is focused on the specific scenario provided by the issuer. The value added thus derives from an independent opinion of the result of a series of actions, rather than an opinion as to their advisability.

RAP CD is an analytical tool which allows users to model the market risk within their CDO portfolio. It generates mark-to-model valuations and allows users to change the parameters affecting their portfolio in order to perform sensitivity tests on that market risk. While RAP CD does not generate any rating or scaled assessment as an output, it provides significant analytical insight for CDO investors.

Ancillary Services

It is important to distinguish between the delivery of an opinion and the provision of advisory services. Fitch's business involves the preparation and dissemination of opinions that assess a variety of risks in the financial markets. While providing an analysis of the relative level of those risks, Fitch's opinions – ratings, assessments, scores or the outputs of analytical models – do not comment on the suitability of any particular type of investment or the appropriate level of risk for any rating user. In preparing its opinions, Fitch is indifferent to the rating or assessment levels achieved, and neither suggests nor cautions against individual 'target' levels of rating or assessment. Consequently, Fitch does not provide advisory or consulting services.

Fitch only offers one service within a rating entity that is ancillary to the generation or dissemination of an opinion. Valuspread is Fitch's Credit Default Swap ("CDS") consensus pricing service, providing end-of-day mid-market spreads on over 2,700 single-name corporate, sovereign and index CDS. A full description of the Valuspread product is provided in Annex 1.

As a purely data-driven service, where external data is synthesised and redistributed, Valuspread does not form part of the analytical business. No rating analysts are involved in the process of providing the end-of-day mid-market spreads, and the sale and distribution of the product is subject to our Firewall Policy. In addition, rating analysts and other departments within Fitch receive Valuspread data in the same format as external subscribers, and do not have access to any of the primary source data supplied in the computation of spreads.

Any other ancillary services are provided by separate companies outside the ratings group, and are also subject to our Firewall Policy. These companies provide training services (under the Fitch Training brand) and risk management software and consulting services (under the Algorithmics brand) to the marketplace in general.

<u>Questionnaire Regarding the Rating of Structured Finance Instruments</u>
<u>A) Questions Addressed to the Credit Rating Agencies</u>

<u>Organisation</u>

1. **What proportion of your total rating revenue comes from structured finance related activity?**

2. Do you offer non rating "ex post" services related to structured finance products (i.e. pricing or valuation models)? If yes, what proportion of your total structured finance derived revenue comes from those ancillary/advisory services?

As mentioned in the introductory notes, Fitch offers no advisory services, and offers only one ancillary service: a CDS consensus pricing service – Valuspread – which is relevant to both structured finance and corporate finance products. While Valuspread is a division within our Derivative Fitch operations, the revenue derived from the sale of this product is not included within our structured finance rating revenues. If we were to include it, it would have represented less than 0.6% of our structured finance rating revenues.

3. Please describe any specificities of the way you determine your fees for the rating of structured finance products as compared to the fees charged in corporate ratings.

Fees for corporate ratings and structured finance ratings are charged on a similar basis. The fees charged for corporate ratings can be structured in a variety of ways, typically involving:

- a fixed-rate recurring base fee for an issuer rating;
- a once-only transaction fee based on a percentage (typically several hundredths of one per cent – that is, basis points) of the nominal value of a debt issue which may be subject to a cap in a given year for a single issuer; or
- a combination of the two (i.e. a recurring or once-only fee that covers both issuer and issue ratings).

Given that in structured finance we rate the issuance, rather than the issuer, fees are based on a subset of the above approach. Fees are determined by multiplying a specified number of basis points by the transaction size, subject to a floor (for small transactions) and a cap (for large transactions). The number of basis points is set by reference to a fee schedule which reflects the relative complexity of different asset classes and fees are uniformly charged across asset types. In many cases we also charge surveillance fees, either on an upfront or ongoing basis, to cover the cost of monitoring the structured finance transactions over time. In all cases, as with our corporate ratings, our fees are not contingent on the level of any rating issued or the success of the issue.

We would, though, point out two differences between fee arrangements for corporate ratings and structured finance ratings. First, we typically charge additional fees, post-closing of a structured finance transaction, if amendments and/or changes are made to or affect the rated securities which require us to undertake additional analysis. Secondly, we may specify that a break-up fee is payable upon the decision that the issuance or sale of the structured finance securities to be rated will not proceed, or that a rating from Fitch is no longer requested, to compensate for the work already carried out.

4. How are the fees you charge for any "ex post" ancillary/advisory activities determined – are they determined separately from fees relating to the actual rating?

Given that Valuspread is not part of our ratings services, the fees for Valuspread are determined completely separately from any rating fee. Valuspread fees are based on the number of CDS names that a subscriber wants priced on a daily basis, subject to a volume discount. All subscriptions, including those charged to entities that have received a Fitch rating, are based on the same fee schedule.

5. How is staff remuneration determined for structured finance ratings analysts? Is this different from staff that work on related ancillary/advisory services?

As documented in the Fitch Ratings Code of Conduct (Provision 2.13), no Fitch analyst, including any analyst working in any structured finance group, is compensated or evaluated on the basis of the amount of revenue that Fitch derives from issuers or securities that the analyst rates, or with which the analyst regularly interacts. Instead, all analytical staff are assessed and rewarded based on their analytical performance and on the overall financial performance of Fitch. Remuneration is set by reference to performance against objectives that are set at the beginning and, where appropriate, revised during the middle of each year.

Valuspread development and maintenance staff are also assessed and rewarded based on their performance, and on the overall financial performance of Fitch. Their remuneration is also set by reference to performance against objectives that are set at the beginning and, where appropriate, revised during the middle of each year.

The only Fitch employees for whom pay levels are directly linked to revenues are some members of our subscriptions sales teams, which are subject to our Firewall Policy. These staff members are responsible for the marketing of subscriptions to both our research reports and related products, such as Valuspread.

Rating process

6. Is the organisation of the rating process similar for corporate and for structured products? If not, please explain the differences.

The rating process is similar for corporate and structured finance ratings. In both cases, ratings are assigned and reviewed in accordance with the Fitch Ratings Code of Conduct by a rating committee, and the rating analysis and rating decision are based on an analysis of all information known to Fitch and believed by Fitch to be relevant to such analysis and rating decision, according to Fitch's established criteria and methodologies. The Code of Conduct establishes a common basis for all core aspects of the rating process, covering matters such as the analytical team, the rating committee composition, internal and issuer/arranger appeals, issuer/arranger review of our rating commentaries, the dissemination of all rating actions on public ratings and file maintenance and record keeping requirements.

However, due to the iterative nature of the structured finance rating process, and the fact that the structure of the transaction itself is typically not finalised when a rating is first requested – indeed, we are often asked to review several alternative transaction structures that an arranger is considering – it can take longer for the final rating of a structured finance transaction to be determined. Thus, there may be a need for more regular interaction with external parties than is the case with an established public finance or corporate finance entity, as the structured finance transaction is still under formation. In addition, much of the information we review is not publicly available.

7. Which parties does your firm liaise with directly as part of the rating process? Are there clear policies governing how this relationship is conducted?

The principal contacts at the initial stages of the rating process are with the originator, the issuer and/or the arranger. Fitch will also receive information and documentation from the transaction lawyers. These parties will typically provide an overview of the transaction and the originator, as well as a detailed term sheet setting out the main features of the legal and financial structure. The arranger often acts as the conduit between Fitch and the originator for information on the underlying assets and their historic performance. It may also act as a conduit for outside opinions from other experts, such as accountants where relevant.

Where relevant, Fitch will meet the originator to conduct an on-site servicer review, the purpose of which is to understand the asset origination process, the way the assets are administered and what steps are undertaken in the event of non-performance (e.g. of individual loans within a consumer loan portfolio). This also represents an opportunity for Fitch to resolve any outstanding questions about the data that it has already received. Following this review any further questions on the origination, underwriting or administration process are addressed directly to the originator or via the arrangers.

Fitch's own lawyers (internal or external) may discuss legal and structural aspects of the transaction with transaction counsel, to better understand the transaction and whether and how legal risks relevant to our credit analysis have been mitigated. However, in all cases, these reviews are not designed to supplant or replace the legal analysis performed by transaction counsel, and are instead undertaken simply to understand the legal analysis provided by transaction counsel. In cases where Fitch receives reports and information from other external advisors or experts, such as auditors, actuaries and consultants, we may also discuss these reports and information with such third parties to understand their impact on our credit analysis.

Please note that Fitch does not audit or verify the truth or accuracy of any information provided or available to it, and that Fitch has not undertaken any obligation to audit or verify such information or to perform any other kind of investigative diligence into the accuracy or completeness of such information.

Clear guidance on how these relationships should be conducted is provided within our Code of Conduct and related policies.

8. What information about the remuneration for providing the rating is provided to the various parties to the deal?

The fee letter, covering the specifics of the remuneration for a particular transaction, is typically signed with the issuer or, in cases where the issuer does not yet exist (e.g. a bankruptcy remote SPV that has yet to be created), with the arranger. Fitch does not request that this information is either shared or withheld from any other party to the transaction and, as such, we generally do not know whether the specifics of the rating fee are shared with other parties. However, as a general principle, we have disclosed, and it is widely understood within the market place, that Fitch has an "issuer pays" business model. This is part of the standard disclosure language that is included in our reports, including presale reports which, along with our Rating Action Commentaries, are a major method of communicating our opinions on specific transactions to investors.

9. Please describe any specificity regarding your policy of publication of ratings in the structured finance segment.

Our policy with regard to the dissemination of all public structured finance ratings is the same as that covering the dissemination of all public corporate finance ratings. This policy is contained within Section 2.5 of our Code of Conduct. In short, we publish all public ratings, and related actions and opinions, including the rating history and any withdrawal of a rating, free of charge on a non-selective basis on our free public website, www.fitchratings.com.

Simultaneously with the publication of any initial public rating or any subsequent rating action, it is our policy to distribute an appropriate announcement of the rating action along with a Rating Action Commentary, which outlines the elements that the rating committee found key to the rating action, both via our public website and via the appropriate wire and other media services.

As outlined in Section 2.3 of our Code of Conduct, to the extent reasonably feasible and appropriate, prior to issuing or revising a rating, Fitch provides the issuer with advance notification of all rating actions and a copy of the commentary to be published with respect to such action. Fitch provides such notification and related commentary solely to allow the issuer to check for factual accuracy or the presence of non-public information. However, as noted in Section 2.5 of our Code of Conduct, Fitch always retains full editorial control over all rating actions, related commentaries and all other published materials. This control extends to when, and whether, Fitch shall take, or publish, any rating action.

Rating methodologies

10. How do you adapt your methodologies to market developments? Have you changed them recently? How do you apply the changes to the surveillance of rated transactions?

Individual criteria reports, which set out the framework for rating transactions in different asset classes, are reviewed regularly and updated as necessary. Updates may be necessary to reflect changes in market practices regarding the origination of assets, to reflect Fitch's revised views on the risks inherent in an asset class or simply to implement a new, more sophisticated, rating methodology.

Existing transactions are reviewed according to the criteria under which they were originally rated. Thus, only in very rare circumstances will a change in criteria, by itself, change a rating. Emphasis is generally placed on seasoning and performance trends, such as delinquency, loss, and prepayment rates as determinants of rating changes. However, in cases where a significant departure from the original expectations occurs, the transaction may be reviewed in accordance with new criteria.

In addition, in a number of areas, screening algorithms are used to monitor large volumes of performance data and prioritise transactions for further review. These surveillance screening algorithms are updated to reflect new criteria. Reflecting the importance to market participants of avoiding unnecessary rating volatility, if a deal is identified for a possible downgrade based on a conservative criteria change, but performance of the transaction is strong, the rating may well remain unchanged. Similarly, if the transaction is flagged for an upgrade but performance indicates a negative trend, the rating may well be left unchanged.

11. Do you consider that the track record of your ratings of structured finance products supports the appropriateness of your models?

Yes. We believe that the track record of Fitch's global structured finance ratings supports the appropriateness of our models. In particular, Fitch's global structured finance ratings demonstrate a strong relationship with default experience. Over the 15 year period ending in 2005, the average annual default rate across Fitch-rated investment grade structured bonds was 0.13% while the default rate on speculative grade structured bonds was 3.4%. Fitch's historic structured default rates show a strong relationship to ratings over both annual and multi-year periods with the frequency of default increasing with each movement down the rating scale, especially when moving from investment grade to non-investment grade.

Furthermore, additional tests of the appropriateness of Fitch's structured finance ratings using Gini coefficients which, in simple terms, measure the ability of ratings to rank order default risk, also show that the performance of Fitch's structured finance ratings has been robust over one and multiple year horizons. Fitch's Gini coefficients over one-, three- and five-year periods are 0.88, 0.77 and 0.71, respectively. For perspective, if ratings perfectly rank ordered default risk, all defaults would carry the very lowest rating designation and the resulting Gini coefficient would be 1. The appropriateness of ratings is therefore measured by the proximity of the Gini coefficient to one.

Beyond default risk, Fitch's global structured finance ratings have also exhibited a high level of stability. Approximately 86% of Fitch's structured finance ratings, on average, remained the same year over year during the period 1991-2006.

12. To what extent can another rating agency's underlying ratings be incorporated into a structured finance rating by your firm? Are they treated in the same way as your own underlying ratings? Are there any risks emerging from the use of another agency's ratings?

In certain circumstances, primarily in the analysis of large, diversified pools, Fitch accepts opinions issued by established agencies with respect to individual assets within the pool. Fitch accepts such opinions based on its assessment of the comparability of Fitch's rating scale and the other agencies' rating scales, including empirical research on default rates and rating transitions indicating that the ratings assigned by the three leading global agencies are highly comparable.

Where individual assets included in a pool are not rated by Fitch but are dually rated by Moody's and Standard & Poor's, and one rating is lower than another, Fitch relies on the lower of the two ratings. In the event that an asset is singly rated by Moody's or Standard & Poor's, Fitch typically accepts the single rating.

<u>On-going surveillance of the transactions</u>

13. How do you monitor rated structured products? What are the main inputs into your review process?

The Fitch surveillance process is split into two parts:

a. Ongoing review of monthly/quarterly information by the performance analyst; and
b. A full review by a rating committee periodically, the frequency of which depends on the results of the ongoing review process under (a).

In terms of the ongoing review for structured finance transactions, Fitch receives performance data on key parameters (such as data on delinquencies and defaults) in a format determined at the close of the transaction, and reviews these against base case forecasts, which are based on historic performance. For each of the key parameters, Fitch sets 'soft triggers' – essentially internal markers which, if exceeded, trigger a need for further action. In some cases, Fitch uses defined algorithms to screen transaction performance and highlight performance trends. The calculations carried out compare the credit enhancement we would expect to see, given the rating levels, with the credit enhancement that actually exists.

For other products, the review process is automated such that changes in the quality of the underlying portfolio or any counterparty to the transaction is flagged, with a report highlighting the magnitude of the credit change produced soon after the data is received.

In all cases where the screening techniques employed by the individual analytical groups indicate that internal markers have been exceeded, or other issues raised, follow-up discussions are held with the relevant parties to the transaction to determine whether any action is being taken to address the situation. As indicated above, these transactions are also reviewed by a formal rating committee in a timely manner.

14. Is there any difference between corporate credit ratings and structured finance ratings in terms of the frequency (i.e. happen more often) and magnitude (i.e. are larger) of rating amendments?

In general, rating activity across Fitch-rated global corporate and structured finance issues has been fairly similar. Over the period 1991-2006, an average of 86% of Fitch structured and 79% of Fitch corporate ratings have remained the same year over year. However, rating changes across structured finance as a whole have been skewed to the upside while rating migration has on average been more evenly distributed across Fitch's universe of global corporate ratings. The share of ratings upgraded and downgraded has averaged 10% and 4%, respectively across the universe of Fitch-rated global structured finance issues, while the share of Fitch corporate ratings upgraded and downgraded in any year has averaged 10% and 11% respectively.

Differences in the upgrade to downgrade ratio are related both to the structural features of certain structured finance transactions, as well as to cyclical and macro economic factors. For example, the decline in interest rates over the past decade contributed to exceptionally strong performance in the commercial mortgage sector and subsequently high upgrade rates in CMBS structured finance while, in contrast, lower interest rates encouraged corporate borrowers to operate with more leverage, leading to an excess of downgrades over upgrades.

With respect to the magnitude of rating changes, there have been more instances of multi-notch rating changes in structured relative to corporate finance. This can be attributed to the nature of structured transactions, which typically involve fixed pools of assets whose performance expectations once realised are less fluid than corporate transactions and therefore rating changes due to improving or deteriorating credit quality have a higher propensity to be multi-notch. In contrast, a company under duress typically has greater latitude in dealing with its circumstances, for example by seeking additional funding or selling non-core assets. This type of flexibility contributes to more gradated rating changes on the corporate side than on the structured side.

15. Is the internal process for amending a structured finance rating similar to the one for amending a corporate rating?

As indicated in our response to question 6, the rating process is similar for corporate and structured finance ratings, whether for the initial issuance of the rating or any subsequent modifications.

16. Do you think that the iterative process inherent in rating structured finance transactions may involve additional conflicts of interest compared to those arising in corporate ratings? If yes, how your firm is organised and what additional measures do you have in place to manage those potential conflicts?

As discussed above in our response to question 6, we follow the same rating process when rating structured finance transactions as we do when rating corporate entities. We recognise that there is typically more interaction with the relevant parties in the former case, however we do not believe that this additional contact results in additional conflicts of interest.

While the rating process in structured finance is an iterative one, Fitch does not itself structure transactions. Arrangers/originators choose the assets that are to be securitised, and models published by Fitch to make its methodologies transparent are also sometimes used by arrangers/originators in their initial review of the assets that they wish to include in a transaction. The decision of which assets to allocate, and which ratings to target, nonetheless remains entirely that of the arranger or originator. The rating committee will not propose alternative assets to include in a transaction, suggest alternative rating levels that may be targeted, or develop alternative legal structures that could be applied.

In the surveillance process, while transactions may incorporate a rating confirmation feature, this does not constitute an endorsement by the agency of any change that may occur in the transaction. As such, Fitch does not ‘require’, ‘approve’, or ‘endorse’ issuer behaviour. This reflects the nature of the particular role filled by rating agencies. Any rating review is simply an observation of relative creditworthiness, and Fitch is indifferent to the level of any rating assigned. Indeed, our fee letters specify that fees are payable regardless of the ratings actually issued by Fitch. Additionally, if the deal is ultimately not rated by Fitch, our fee letter may specify that a ‘break-up fee’ is payable to ensure that Fitch is compensated for the analytical work it has performed.

As with corporate ratings, the committee process is designed to ensure that a transaction has been broadly reviewed. The full rating committee will itself have the opportunity to identify what it sees as the key risks and ascertain whether the structure has adequately eliminated or mitigated these.

17. Do you perceive any potential conflicts of interest between the structured rating activity and any ancillary/advisory service mentioned in question 2?

We do not perceive any conflicts of interest between Valuspread and our structured finance rating activity. Valuspread simply acts as a conduit for market information, as discussed in our description of ancillary services above.

I hope that this information will be useful to you and your colleagues on the CESR Task Force. If you would like any further clarification, please do not hesitate to contact me on +44 20 7417 4362, richard.hunter@fitchratings.com, or my colleague Sharon Raj on +44 207 417 6341, sharon.raj@fitchratings.com.

Yours sincerely,

Richard Hunter
Managing Director
Regional Credit Officer for Europe,
Middle East, Africa and Asia

ANNEX 1

VALUSPREAD

Valuspread is Fitch's CDS consensus pricing service, providing end-of-day mid-market spreads on over 2,700 single-name corporate, sovereign and index CDS. Spreads are calculated as arithmetic averages of contributions received from approximately 20 of the major market makers operating around the globe. Daily files are provided to Fitch via a range of electronic formats, whereupon they are subjected to a series of rule-based data-cleansing algorithms that check the data for items such as stale pricing, flat curves and outliers. Information is received on c.10,000 individual credits as defined by legal name, currency, seniority and ISDA document clauses. Core information is provided where matches on credits are available from at least three separate contributors. Data is provided, where available, across a full maturity spectrum ranging from 6 months to 50 years.

Contributors receive information on a "give-and-get" basis. That is, they will receive back spread information on the credits for which they have submitted a price. Investors and other third-parties may subscribe to the service and receive aggregated information on the full range of available credits through a range of electronic formats (including a Web Service) also on a daily basis, available from 0800 London time. Additionally, interested parties may also obtain a subscription to Fitch's historical database of CDS spreads going back to 1999.