MEMORANDUM

To: File

From: Hester Peirce

Re: Proposed Rule: Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations
File No.: S7-04-07

Date: April 20, 2007

On April 20, 2007, Charles D. Brown and J. Douglas Murray of Fitch Ratings and Martin Flumenbaum of Paul, Weiss, Rifkind, Wharton & Garrison LLP met with Commissioner Paul Atkins and his staff to discuss the proposed rule. Specifically, they discussed the issues raised in the attached document.

Attachment

Presentation on Rule 17g-6

Key Message

- Notching is a two pronged issue. Both issues need to be addressed.
- All ratings are comparable.
- The arguments in favor of notching are unfounded.
- SEC should not grant an 85% market share to the two leading rating agencies.
- Bond insurers are impacted by same practices. This needs to be addressed.

Notching is a Two-Pronged Issue

- **First,** Moody's and S&P explicitly require that no less than 80% of the securities in an investment vehicle bear their public rating.
- **Second,** for the portion that they do not publicly rate, Moody's and S&P insist that they "shadow" rate or notch down another NRSRO's public rating by as many as four rating categories.
- Through these two components, Moody's and S&P, either directly or indirectly, create for themselves virtually a 100% market share.
- Rule 17g-6(a)(4) must address both prongs of notching.

Example of Moody’s CDO Rating Requirement

80% of Securities Purchased By a CDO Must Be Rated By Moody’s
20% of a CDO Portfolio is Either Notched or Credit Assessed by Moody’s

	S&P Rated				Fitch Rated		
	AAA	A+ to BBB	Below BBB		AAA	A+ to BBB	Below BBB
Resi A Mortgage	-1	-2	-3		-2	-3	-4
Credit Card	-1	-2	-3		Not eligible for notching		
Healthcare	-1	-2	-3		Not eligible for notching		
HEL Securities	-1	-2	-3		Not eligible for notching		
MH	-1	-2	-3		Not eligible for notching		
Resi B/C Mortgage	-1	-2	-3		Not eligible for notching		
Small Biz Loans	-1	-2	-3		Not eligible for notching		
Student Loans	-1	-2	-3		Not eligible for notching		
Tax Lien Securities	-1	-2	-3		Not eligible for notching		
Franchise Securities	-1	-2	-3		Not eligible for notching		
12b1-fee Securities	-1	-2	-3		Not eligible for notching		
Oil & Gas Securities	-1	-2	-3		Not eligible for notching		
Restaurant & Food Svcs	-1	-2	-3		Not eligible for notching		
Aerospace & Defense	-1	-2	-3		Not eligible for notching		
Auto Securities	-1	-2	-3		Not eligible for notching		
Car Rental Rcvbl Sec	-1	-2	-3		Not eligible for notching		
Recreational Vehicle Sec	-1	-2	-3		Not eligible for notching		
Bank Guaranteed Sec	-1	-2	-3		Not eligible for notching		
Guaranteed Debt Sec	-1	-2	-3		Not eligible for notching		
Insurance Co Sec	-1	-2	-3		Not eligible for notching		
REITs	-1	-2	-3		Not eligible for notching		

Not eligible for notching means Moody’s will shadow rate or credit assess for a fee

Additional NRSROs are not recognized by Moody’s

FitchRatings
KNOW YOUR RISK

Example of S&P CDO Rating Requirement

80% of Securities Purchased By a CDO Must Be Rated By S&P
20% of a CDO Portfolio is Either Notched or Credit Assessed by S&P

	Fitch & Moody's		Fitch or Moody's	
	Inv Grade	Below IG	Inv Grade	Below IG
Consumer ABS	-2	-3	-3	-4
Commercial ABS	-2	-3	-3	-4
MH	-2	-3	-3	-4
CMBS	-2	-3	-3	-4
REITs	-2	-3	-3	-4
RMBS Prime	-2	-3	-3	-4
RMBS Subprime	-2	-3	-3	-4
Specialty Structures (i.e. future flows)	-3	-4	-4	-5
Non-U.S. SF	Not eligible for notching			
Guaranteed Securities	Not eligible for notching			
CDOs of SF and RE	Not eligible for notching			
CDos of TruPS	Not eligible for notching			
CBOs of CDOs	Not eligible for notching			
CLOs of Deistressed Debt	Not eligible for notching			
12b-1 fee securities	Not eligible for notching			
Cat Bonds	Not eligible for notching			
First Loss tranches of any SF	Not eligible for notching			
Synthetics	Not eligible for notching			
Synthetics CBOs	Not eligible for notching			
Combo Securities	Not eligible for notching			
RE-REMICS	Not eligible for notching			
Market Value CDOs	Not eligible for notching			
NIMS	Not eligible for notching			
Any asset class not listed	Not eligible for notching			

Not eligible for notching means S&P will shadow rate or credit assess for a fee

Additional NRSROs are not recognized by S&P

Economic Impact of Notching to the CDO

Rating Categories	Probability of Default *
AAA	.20%
AA	.60%
A	1.5%
BBB	**5.0%**
BB	**20.0%**
B	40.0%
CCC-C	60.0%

Notching a BBB to BB results in:

- Substantially increases capital requirement
- Falsely quadruples probability of default
- Amount of credit enhancement required quadrupled for the same risk
- No CDO manager can afford to buy securities rated by any NRSRO other than Moody's and S&P
- The two prongs of notching ensures Moody's and S&P have 100% of market

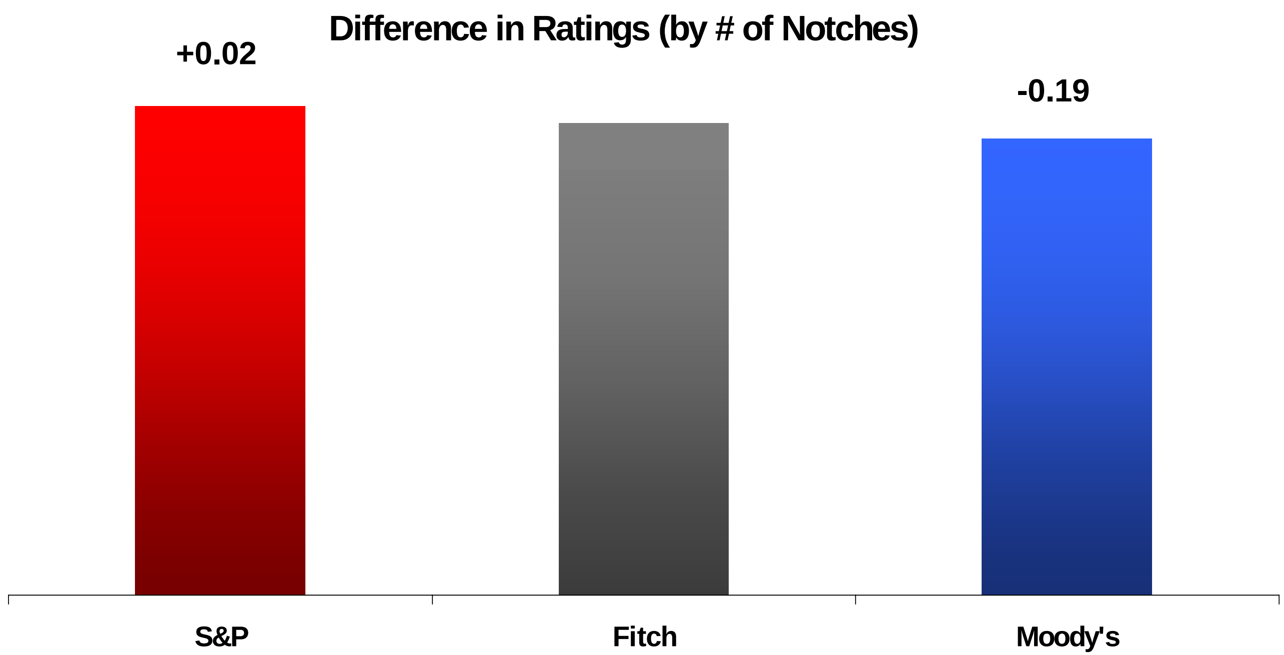
10 year cumulative

Composite S&P, Moody's, Fitch

Rating Comparability

Market Reality: Fitch's Ratings are in the Middle Between S&P and Moody's

- 94.3% of S&P/Fitch ratings the same or within one notch.
- 92.3% of Moody's/Fitch ratings the same or within one notch.



"Average Rating Gap Ranges from 0.01 of a Notch to 0.45 of a Notch on Jointly Rated RMBS, CMBS, ABS and CDOs"

Source: Moody's March 2007 Special Report "Comparing Ratings on Jointly-Rated U.S. Structured Finance Securities"

Moody's Own Study: Ratings Are Comparable

Moody's Notching Practices Not Analytically Supported

Moody's Comparability Study versus Moody's Notching Policies

Moody's Rating	Average Notch Gap w/S&P	Notching Req for S&P Rated Collateral	Average Gap w/Fitch	Notching Req for Fitch Rated Collateral
Aaa	0.03	-1	0.05	-2
Aa	(0.16)	-1	(0.36)	-2
A	(0.40)	-2	(0.50)	-3
Baa	(0.45)	-2	(0.51)	-3
Ba	(0.55)	-3	(0.80)	-4
B	(0.49)	-3	(0.56)	-4
Caa-Below	(2.16)	-3	(0.17)	-4

Sources: Moody's Report: Comparing Ratings on Jointly-Rated US Structured Finance Securities, (2007 Update),Notching requirements from an ABS CDO

S&P: No Published Comparability Study

S&P Notching Practices Not Analytically Support

Fitch Comparability Study versus S&P Notching Policies

S&P Rating	Average Notch Gap w/Fitch	Average Notch Gap w/Moody's	Notch Req for Fitch *and* Moody's Rated Collateral	Notch Req for Fitch *or* Moody's Rated Collateral
AAA	(0.05)	(0.03)	-2	-3
AA	0.06	0.24	-2	-3
A	0.09	0.45	-2	-3
BBB	0.12	0.42	-2	-3
BB	0.35	0.63	-3	-4
B	0.60	1.30	-3	-4
CCC-below	0.93	(0.20)	-3	-4

Sources: Fitch Report: US Structured Finance Rating Comparability Survey, Notching requirements from an ABS CDO

Market Reality: Fitch's Ratings Perform as Well as S&P and Moody's Ratings

Average Annual Default Rates - Fitch, Moody's, S&P

	Corporate Finance			Structured Finance		
	Fitch (1990-2006)	**Moody's** (1983 - 2006)	**S&P** (1981-2006)	**Fitch** (1991-2005)	**Moody's*** (1993 - 2005)	**S&P** (1978-2005)
%						
AAA	0.00%	0.00%	0.00%	0.02%	0.02%	0.00%
AA	0.00%	0.01%	0.01%	0.07%	0.18%	0.00%
A	0.03%	0.02%	0.06%	0.11%	0.24%	0.07%
BBB	0.26%	0.21%	0.24%	0.41%	1.19%	0.21%
BB	1.24%	1.27%	1.07%	1.13%	3.79%	0.68%
B	1.47%	5.26%	4.99%	3.11%	5.94%	2.44%
CCC**	22.93%	17.14%	26.29%	24.87%	25.73%	20.25%

** Moody's rates are impairment rates which include both defaults and near defaults. Moody's does not publish standalone default rates however defaults make up the bulk of the stated impairment rates.*

*** Moody's global corporate 'CCC' default rate excludes 'CC' or lower rated issuers. Fitch and S&P rates at this level span 'CCC' to 'C' issuers.*
Sources : Fitch Ratings, Moody's Investors Service, Standard & Poor's

Correlation Between Rating Agencies Is Extremely High: 97%-98%

RATINGS CORRELATIONS	FITCH	S&P	MOODY'S
FITCH	1	0.977618	0.968459
S&P	0.977618	1	0.973503
MOODY'S	0.968459	0.973503	1

***BASED ON 53,459 RATED STRUCTURED FINANCE AND CORPORATE RATED BONDS**

Market Already Acknowledges Ratings Comparability

Major fixed income index providers use the middle or the average of Fitch, Moody's and S&P's ratings in their indices:

- Lehman
- Merrill Lynch
- Banc of America Securities
- Credit Suisse
- iBoxx

FitchRatings
KNOW YOUR RISK

Why notching is a problem for the market
Credit Markets – A New Paradigm

Traditional Money Managers

Corporate Bonds

Structured Finance Securities

Insurance Companies
Unrated Money Market Funds
Mutual Funds
Pension Funds

Investment guidelines: Set by regulatory authority (e.g. SEC, NAIC), or determined by the investor.

Indices: Utilize ratings from Fitch, Moody's and, S&P to determine investment eligibility (general rule is to utilize lower of 2 ratings or middle of 3 ratings)

Results: Portfolio Manager chooses the investment

Rated Investment Vehicles

Corporate Bonds

Structured Finance Securities

ABCP Conduits	**Rated Money Market Funds**
SIV	**Synthetics**
CDO	**CDO Squared**
Financial Guarantors	**Credit DPCs**
	SIV-lites

Issue Rated Securities

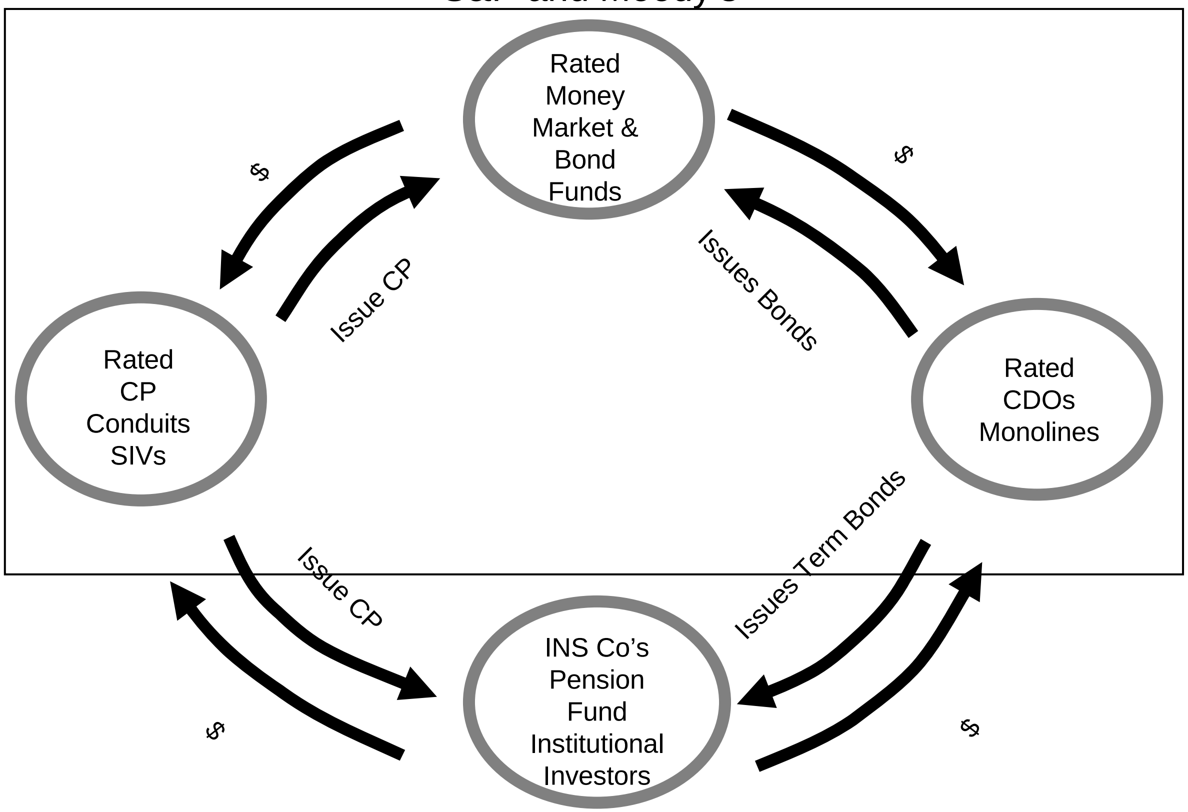
Investment guidelines: Set by Moody's and S&P. Moody's and S&P indirectly require 100% of investments rated by that rating agency

Result: Moody's and S&P determine investments. Therefore stifling competition.

Notching is a Circular Problem

NRSRO Requirements Drive Rating Selection, Not Investors

Investment Guidelines set by S&P and Moody's



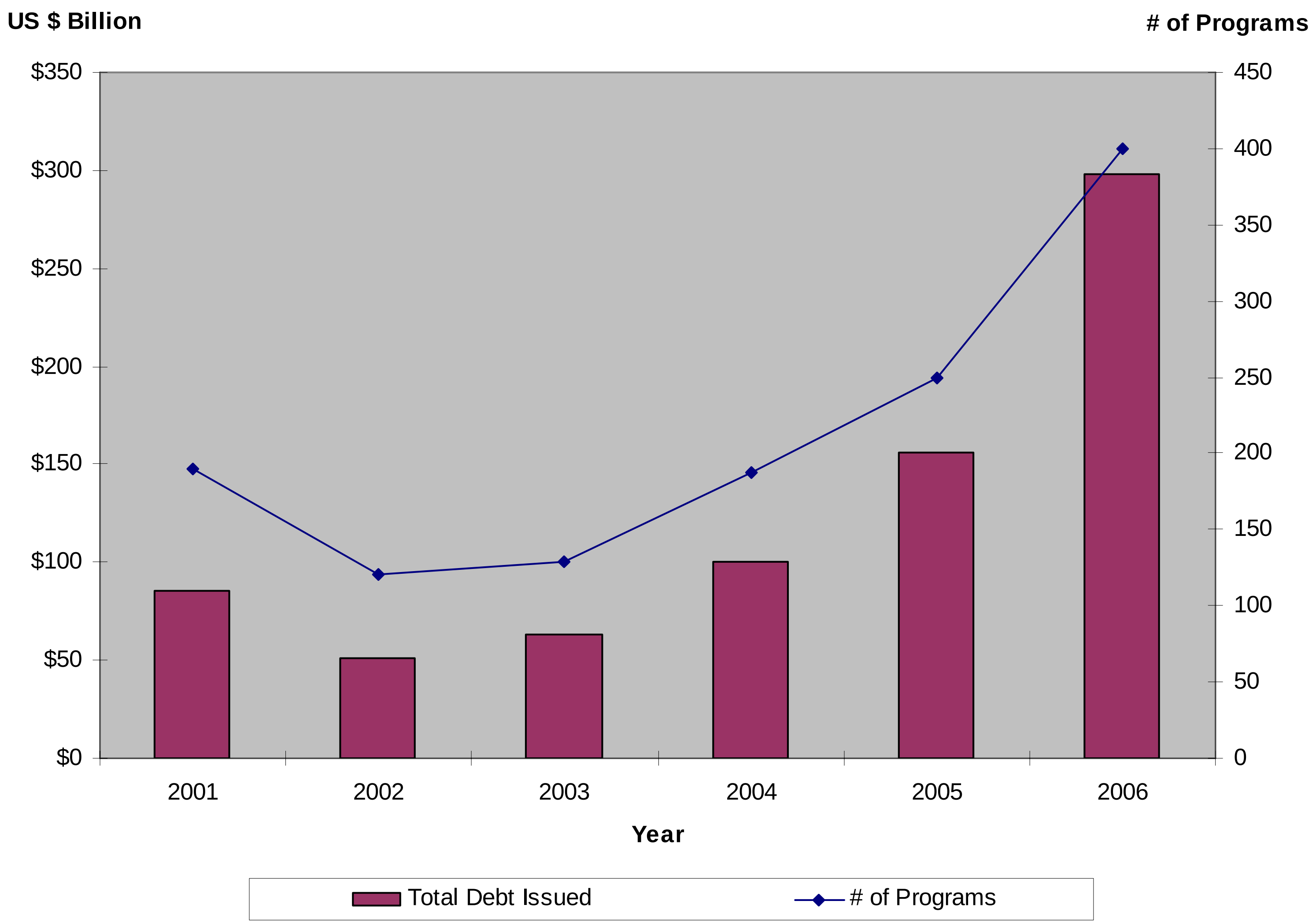
Investment Guidelines set by S&P and Moody's

Investment Guidelines set by S&P and Moody's

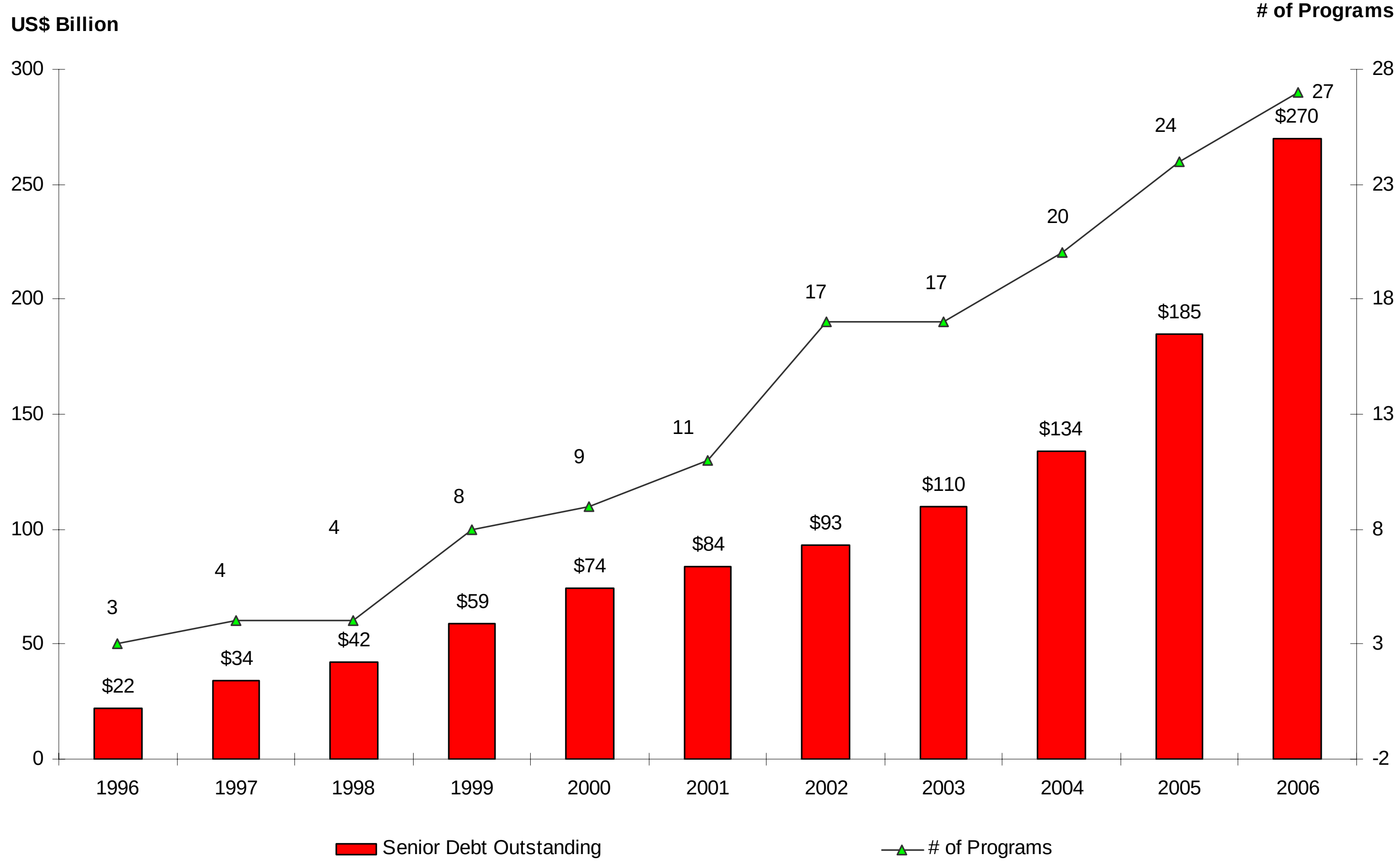
Investment Guidelines Determined by Investors

When given a choice, the market is moving to pick any two NRSROs, or two of three

Growth of CDO's



Growth of Structured Investment Vehicles (SIV's)



The Arguments in Favor of Notching Are Unfounded

- "How can we rely on someone else's opinion, or a new NRSRO?"
- "Tail risk is a false issue."
- "How do you protect against the rogue CRA."
- "If we don't rate an asset, it is because of rating shopping."
- "One bad rating can blow up a deal."
- "Our ratings are different than other ratings."
- "There needs to be a study to determine notching is 'unfair, coercive or abusive'."
- "Accepting another opinion could violate securities law."
- The arguments are designed to create fear and confusion in the marketplace.
- There are no better arguments because there is no empirical evidence to justify notching.

"How Can We Rely On Someone Else's Opinion?"

The Truth: NRSROs Rely on Other Opinions All the Time

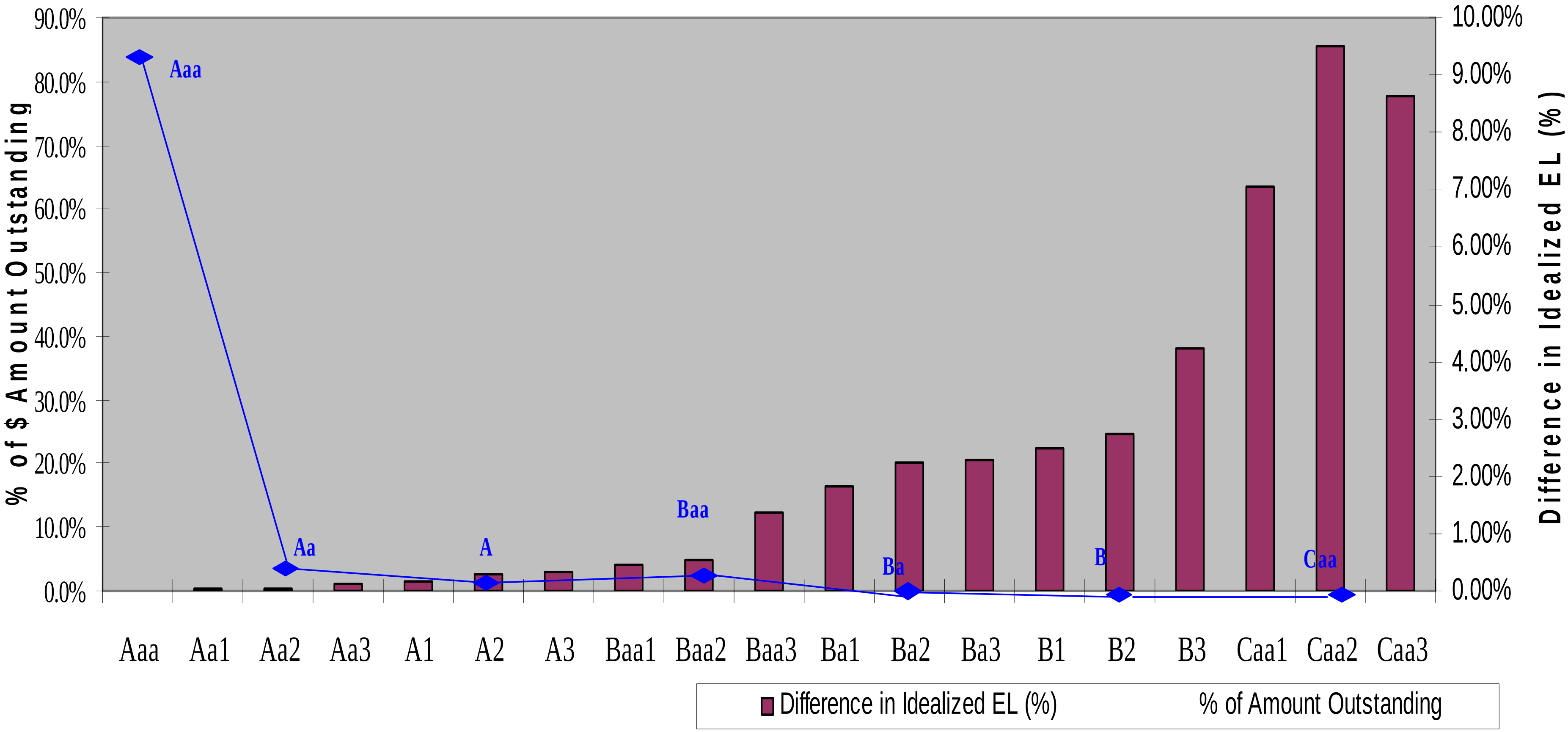
NRSROs Currently Rely on:

- Internal bank ratings
- Accountant opinions
- Legal opinions
- Company projections
- Actuarial opinions
- Appraisal Firms

“Tail Risk” is a False Issue

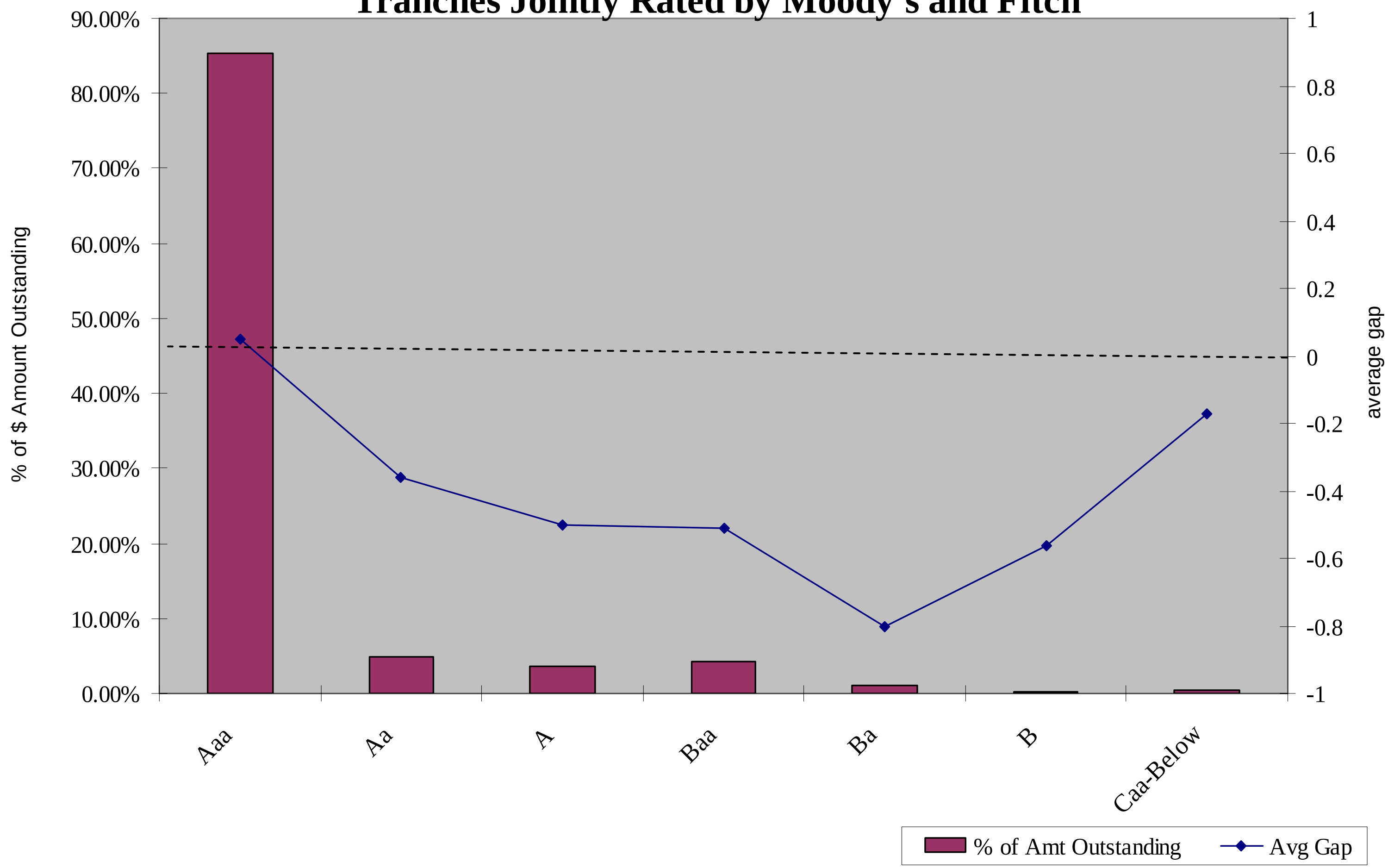
- Moody’s and S&P sometimes justify their practices by pointing to limited occurrences where there are wide rating differences. This is a false argument.
- The observations of significant rating differences are almost always in deep speculative grade securities that compromise extremely small portions of an investment vehicle’s portfolio.
- The size and diversity of the total universe of rated bonds, the small number of deeply speculative bonds and the random distribution of bond ratings means that these differences have no practical impact on the creditworthiness of investment vehicles.
- The reality is that over 90% of all ratings in any combination are the same or within one notch.

% of Amount Outstanding Tranches vs. Difference in Idealized EL Values



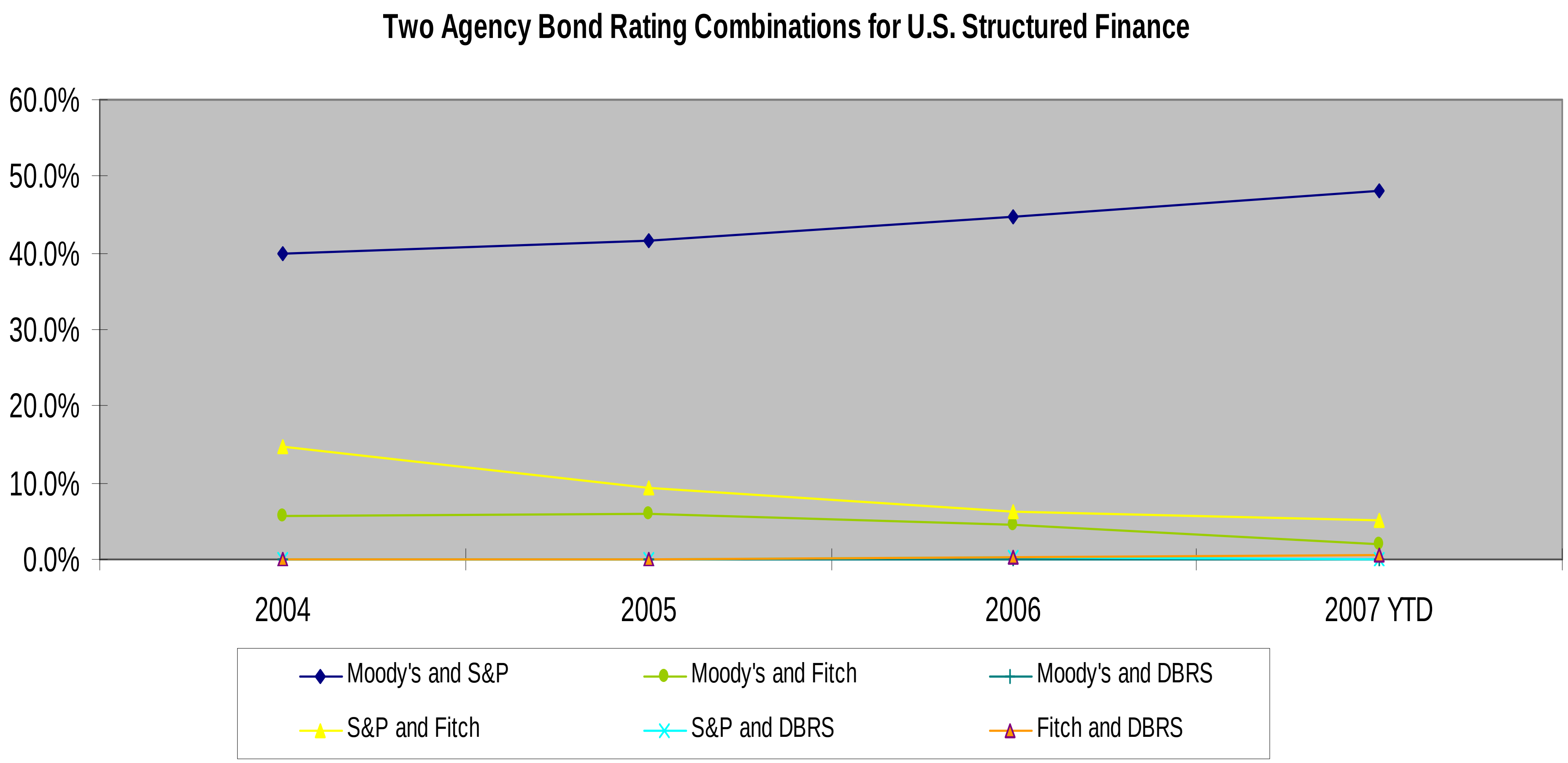
Source: Moody's, "Comparing Ratings on Jointly-Rated U.S. Structured Finance Securities (2007 Update)"; Standard & Poor's, a Division of The McGraw-Hill Companies, Inc.

% of $ Amount Outstanding by Rating vs. Average Gap of SF Tranches Jointly Rated by Moody's and Fitch



Source: Moody's, "Comparing Ratings on Jointly-Rated U.S. Structured Finance Securities (2007 Update)"; Standard & Poor's, a Division of The McGraw-Hill Companies, Inc.

“How do you protect against the rogue start up CRA?”



Note: A.M. Best has not participated in the Structured Finance market

There are many reasons besides rating shopping for an issuer to select one NRSRO over another.

- CRAs compete on an array of services such as:
  - Responsiveness
  - Open and transparent rating criteria and process
  - Quality and timely pre-sale research reports
  - Surveillance
  - Price

"One Bad Rating Can Blow Up a Deal."

The Reality is That It Can't.

- Structured Vehicles are large, well-diversified portfolios.
- No investment makes up more than a few percent of any portfolio.
- The premise of well-designed structured vehicles is that one exposure cannot result in losses to the holders of highly-rated securities.
- Transactions with higher concentration limits have greater credit protection.
- Systemic risks are far greater than the risk of default of a single bond:
  - The concentration of rating agencies.
  - The risk of changes to rating agency criteria and models.
  - Extraneous financial events.

"Our Ratings Are Different than Other Ratings."

The Reality of Differences in Definitions and Methodology

- All credit ratings address the risk of loss due to a debtor's non-payment.
- Definitional differerences are distinctions without a difference.
- Methodology differences exist, but are limited by available technology and data:
  - Everyone uses the same statistcial methods.
  - Everyone looks at the same data.
- If the methodologies are so different, why are the ratings so similar?
  - Comparability studies
  - Default Rates

"There Needs to be a Study to Determine Notching is 'Unfair, Coercive or Abusive'."

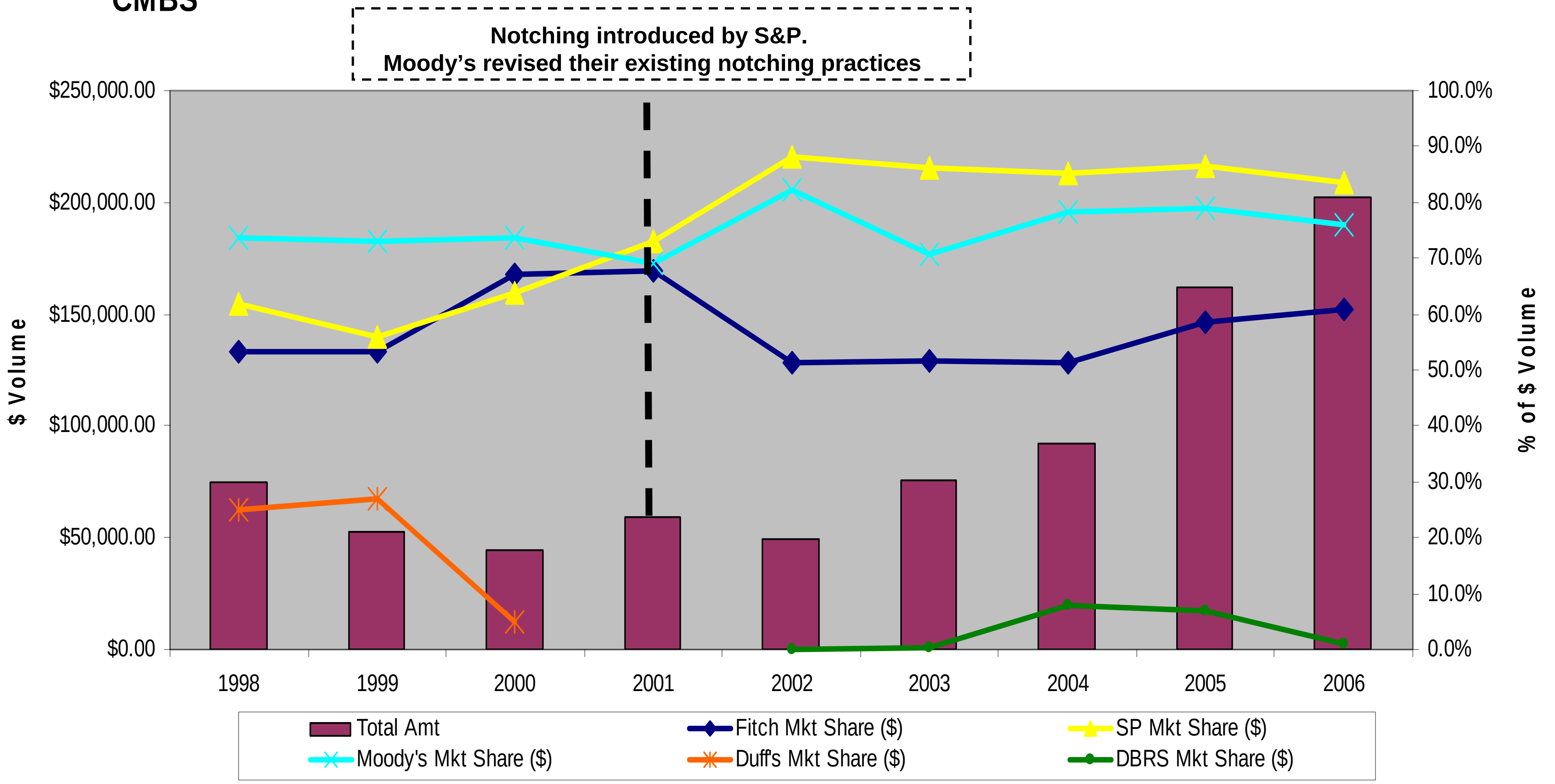
In Fact, There is Ample Evidence to Determine Notching Should Be Prohibited.

- The comment letters filed to date overwhelmingly support the determination that notching is "unfair, coercive and abusive" and should be prohibited.
- Contrary to the assertions of certain NRSROs, Congress did not mandate a study of the issue.
- The SEC has ample evidence before it to determine that notching should be prohibited.
- Studying it is a stall tactic to continue to use anti competitive practices.

Why 66% is the most appropriate threshold?

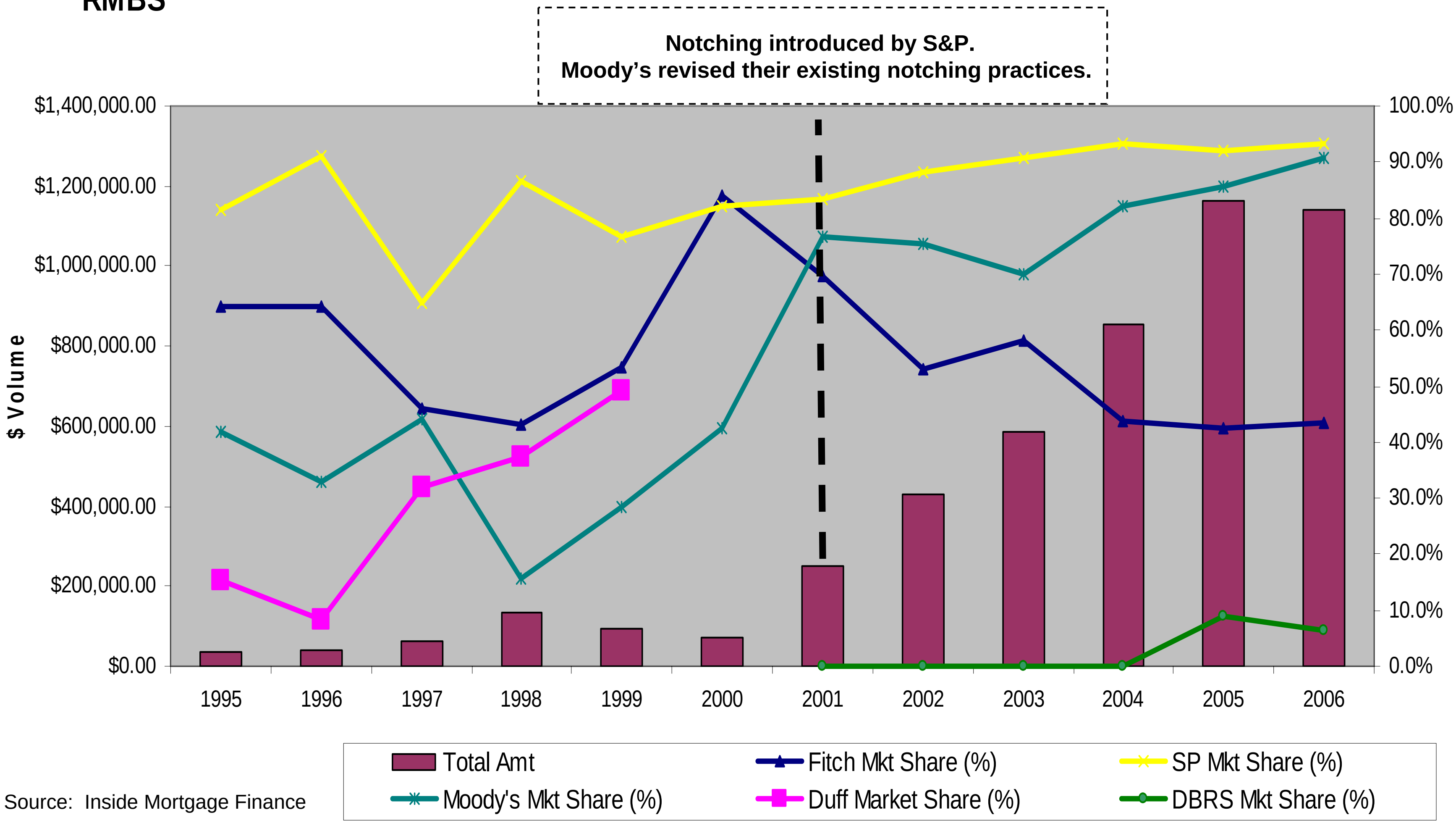
The Anti-Competitive Results of Notching

CMBS



The Anti-Competitive Results of Notching

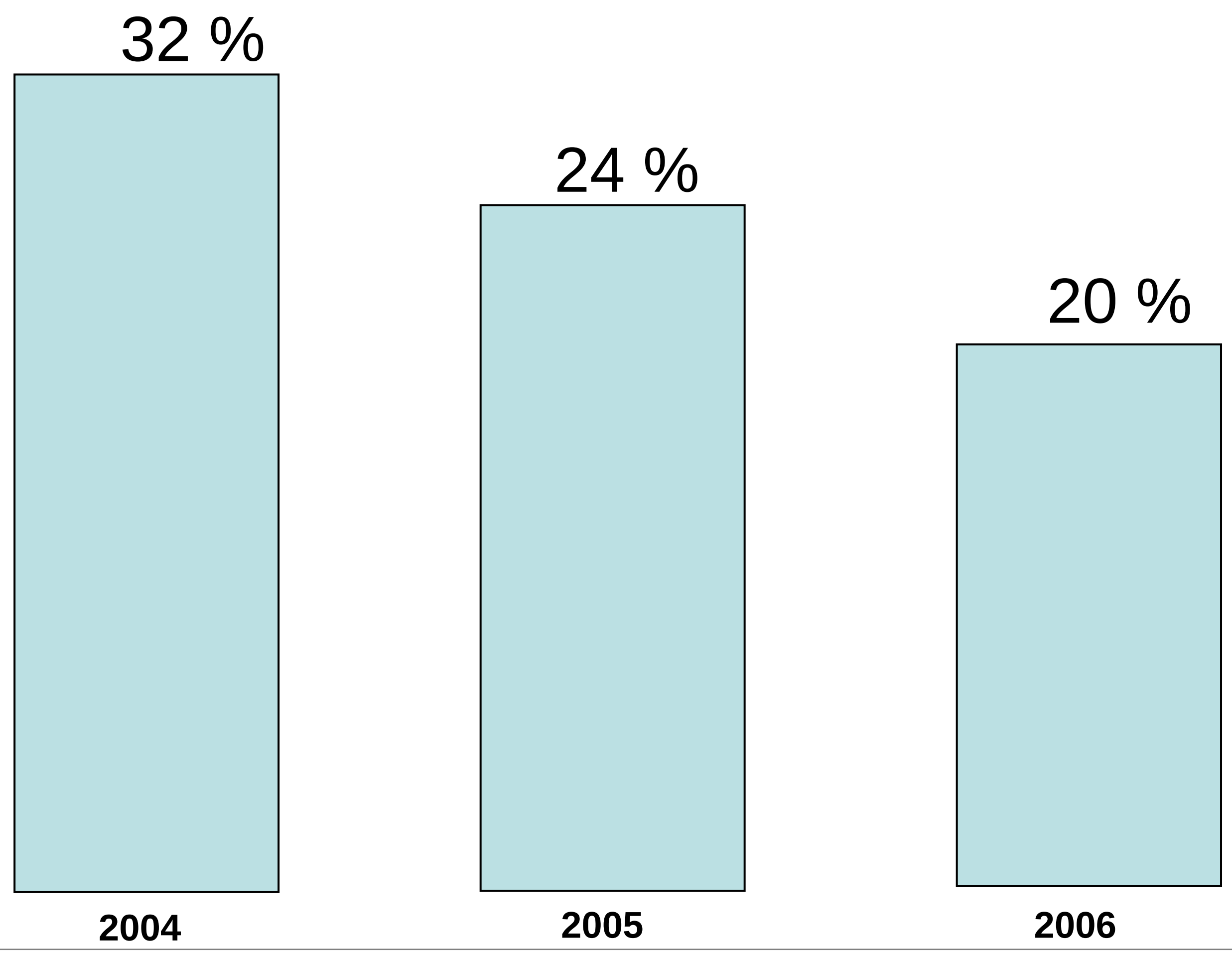
RMBS



Source: Inside Mortgage Finance

Fitch + 1* Rated Bonds in the U.S. SF Markets - More Than 15%

***Bonds Rated By Fitch + Either S&P or Moody's**



Fitch's Proposal:

If an NRSRO has rated 66% of the par value of an asset pool and all the assets are publicly rated by two or more NRSROs.

- The NRSRO is to use one of the two or more public ratings available

If not rated by two or more

- NRSRO may refuse to rate or withdraw its rating on the pool.

Fitch also supports the idea that an NRSRO should be able to walk away and not rate a transaction if they cannot accept another NRSRO's ratings.

If an NRSRO chooses to rate a transaction, however, we believe they must not engage in notching or otherwise insist on their own ratings.

Benefits of Fitch Proposal:

- By using dual-rated assets, it eliminates the risk of unrated or single rated assets by new entrants with limited track records.
- It protects against potentially inaccurate or overly optimistic ratings by allowing the NRSRO rating the pool to choose feely among public ratings on the underlying assets.

Notching Practices Are Also Directed at Bond Insurers

- Capital adequacy models applied by Moody’s and S&P require that transactions insured by a bond insurer be publicly rated by Moody’s and S&P or have a “shadow” rating by Moody's and S&P.
- If an insured transaction is not rated or “shadow” rated by Moody’s and S&P, Moody’s and S&P will “notch” down the rating assigned by another NRSRO.
- This practice is substantially similar to Moody’s and S&P’s practices with respect to CDOs and other investment vehicles.
- This practice creates significant pressure on the bond insurer to:
  - Obtain a rating or “shadow” rating from Moody’s and S&P
  - Pay for ratings on bonds that are otherwise rated by other NRSROs.

Summary

- Notching is a two pronged issue. Both issues need to be addressed.
- Structured Finance ratings are comparable.
- The arguments in favor of notching are unfounded.
- SEC should not grant an 85% market share to the two leading rating agencies.
- Bond insurers are impacted by same practices. This needs to be addressed.