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BY ELECTRONIC MAIL

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Mr. Dan Daveline (ddaveline@naic.org)  
National Association of Insurance Commissioners  
48 Wall Street, 6th Floor  
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Re: Comments on Draft Report to Financial Condition Committee

Gentlemen:

In December, the National Association of Insurance Commissioners (NAIC) released an exposure draft report from its Rating Agency Working Group to its Financial Condition Committee on the general topic of "Evaluating the Risks Associated with NAIC Reliance on NRSRO Credit Ratings." Fitch Ratings is pleased to offer its perspective on the draft report.

In Fitch's view, the draft report does not reflect a balanced assessment of the advantages and limitations of credit ratings in general nor the specific analytical offerings from Fitch. Rather, the report focuses only on what the NAIC believes to be the "problems inherent" in ratings and "reasons for recent rating shortcomings." The report seems to reflect a pre-determined outcome, thereby making it difficult for Fitch to offer valuable commentary on the substance or recommendations of the report. We would, however, like to offer a few observations for your consideration.

Fitch's Interactions with the NAIC

During the course of 2009, as the NAIC conducted what it describes as a "comprehensive evaluation of state insurance regulatory use of credit ratings," Fitch has endeavored to provide our perspective to the NAIC on the key topics of discussion. Senior members of Fitch's Structured Finance ratings groups met with the NAIC on several occasions over the past 18 months both at the NAIC's request and at Fitch's initiative to describe and demonstrate the variety of tools we offer that could be helpful in the NAIC's analysis. In addition, in May we responded to the NAIC's questionnaire by completing the survey and providing significant

additional documentation. Moreover, two of our senior managers participated in the NAIC's public hearing on the role of rating agencies in state insurance regulation. We followed that up with an additional written communication reflecting our views on the key topics that were discussed or left unaddressed (or inadequately addressed) at that forum. A copy of the prepared statement and follow-up letter are attached for reference.

### *Fitch Enhancement Initiatives*

Since the onset of the credit crisis in the fall of 2007, Fitch has introduced a range of new and revised policies and procedures designed to enhance the reliability and transparency of our ratings and our rating processes. Many of these have been launched at our initiative, while others are reflective of the increased regulatory oversight regimes that credit rating agencies now operate under in all of the world's capital markets. These include substantial revisions to ratings criteria, a re-assessment of the role of quantitative models in the structured finance rating process, ongoing reviews of portfolios of ratings, the publication of large amounts of issuer-specific and thematic research, and the introduction of new or enhanced tools and analytics designed to help market participants enhance their understanding of risk. Additional detail on our specific initiatives can be found on our website at [www.fitchratings.com](http://www.fitchratings.com).

### *Regulation of Rating Agencies*

Here in the U.S., the S.E.C. continues to consider new or re-proposed rules as additions to the significant additional rule-making on which it has already acted. And the U.S. Congress continues to debate and advance legislation that builds upon the 2006 act and expands the regulation of credit rating agencies. It is reasonable to believe a final bill will be enacted in the first half of 2010. Fitch has consistently advocated for a globally consistent approach to the regulation of credit rating agencies, and believes that here in the U.S., at least, these are the two bodies most appropriate for determining any such rules and regulations for rating agencies.

### *"Severity of Loss" in Ratings*

Based on the nature of questioning at the public hearing, as well as comments in your exposure draft, Fitch is concerned that the NAIC may misunderstand certain key definitional aspects of our ratings, and in doing so may be coming to inappropriate conclusions as to the veracity of our ratings. We would like to add clarity around this issue, which seems to center on the question of how "loss severity" is captured in ratings. We note this was a key focus when the NAIC considered how to address the impact of downgraded RMBS securities on Risk Based Capital (RBC) results.

According to the NAIC, one of the "problems" of credit ratings is that they "do not take into account the severity of default." For years, Fitch has been clear that our credit ratings reflect our opinion of creditworthiness, and by that we do primarily refer to the probability of default. We believe that is and has been well understood by the market, and that such a definition has served the market well.

Moreover, to supplement its historic focus on probability of default, Fitch introduced recovery ratings, first in corporate finance and more recently in structured finance – the only agency to do so. These metrics provide our view as to both the probability of default and the loss given default (conversely recovery). Currently, Fitch has Recovery Ratings outstanding on over 21,000 securities – more than 18,000 on RMBS bonds alone which is the focus of the NAIC’s efforts.

Fitch has made note of such offerings to the NAIC on multiple occasions and we are surprised that our recovery ratings still do not merit any mention in the draft report. We are even more surprised that the NAIC’s erroneous belief that such tools do not exist is used as an example of another “problem” with credit ratings, when in fact Fitch’s introduction of such new tools to measure credit risks has been helpful for the market.

#### *RMBS Exercise and RBC Formula*

While we believe the NAIC should be free to use ratings, or not use ratings, as part of its regulation of insurance companies (and in its RBC formula), we are concerned by the rationale supporting the NAIC’s recent decision to move away from ratings for RMBS securities.

First, we believe that a sizable part of the “problem” related to RMBS described by the NAIC was not rooted strictly in ratings, but was also related to the RBC formula, which was not designed to capture “loss severity” differences among different types of distressed securities. This issue with the RBC formula became pronounced when many RMBS securities came under pressure last year. Fitch believes that if the NAIC wished to retain its ratings-based RBC formula for RMBS securities it could, in fact, do so in a fairly straight-forward and cost-effective manner by adjusting the formula to reflect the kind of the loss severity metrics that we noted above (i.e., recovery ratings).

Second, the NAIC report also notes the conflicts of interest that arise from the issuer-pays model. Fitch has long acknowledged the potential conflicts that exist and believes them to be managed appropriately through the breadth of policies and procedures we have put in place. The report states, “where issuers pay for AROs for rating services, these competitive pressures may be at odds with prudential supervisory considerations.” However, the NAIC’s most recent effort to address such perceived issues involves engaging a “third-party financial modeler” to develop modeled prices for 20,000 RMBS securities that can be mapped to the corresponding NAIC Designation. This process is estimated by the NAIC to cost \$4.6 million, with such costs being “allocated” back to the insurance companies. In this case, the regulated entity is effectively paying for its assessment, which is not a meaningfully different conflict from the one the NAIC believes to be so problematic for rating agencies.

Fitch’s credit rating opinions reflect our view as to the relative creditworthiness of a given security or issuer. We make no distinctions in our definitions based on who is using the ratings or for what purposes. Said differently, our ratings distill our forward-looking opinions on

a variety of risk factors into a common and easily understood risk metric. As such they are broadly used by investors, issuers, intermediaries and regulators alike. But they are expressly not designed to effect a pre-determined regulatory outcome, such as “free[ing] up capital,” one of the four stated results of the NAIC’s recent proposal regarding RMBS in insurers’ portfolios.

*Conclusion*

In closing, Fitch believes that its rating opinions offer the market a credible set of independent benchmarks for gauging creditworthiness across all asset classes and regions. We have made significant enhancements to the reliability and transparency of our efforts over the last few years. We have made a good faith effort to be responsive to the questions and concerns raised by the NAIC during its review. Finally, we remain willing to work constructively with the NAIC should it choose to continue to incorporate ratings from NRSROs in all or part of its prudential supervisory capacities.

Very truly yours,



Charles D. Brown  
General Counsel

Attachments