

**Submitted Statement of Fitch Ratings
As Delivered By
Keith Buckley, Group Managing Director and John Olert, Group Managing Director
To The
National Association of Insurance Commissioners'
Public Hearing on Credit Rating Agencies
September 24, 2009**

The global capital markets have experienced unprecedented levels of stress and volatility since the beginning of the “credit crisis” in the summer of 2007. As Fitch has noted previously, many factors contributed to the initial credit crisis. These have been broadly analyzed and debated by market participants, the media, and within the policy-making and regulatory communities. Key underlying factors include historically low real interest rates, greater global demand for higher-yielding and relatively riskier assets, significantly higher degrees of systemic leverage, lax underwriting standards in the mortgage origination markets, inadequate discipline in the securitization process, insufficient risk management practices at financial institutions, an outmoded global regulatory framework, and credit ratings in RMBS and CDOs that have not performed as originally intended.

While overall macro-economic conditions remain difficult, it seems the period of most intense market stress has passed. This is due to both a variety of government initiatives here and abroad aimed at restoring financial market stability as well actions taken by companies individually to shore up their balance sheets and reduce risk. Having said that, important sectors in the fixed income markets struggle to re-open, and certain asset classes,

such as commercial mortgage-backed securities, are experiencing greater performance strain on their underlying assets.

During this time, the focus of Fitch Ratings has been on implementing a broad and deep range of initiatives that enhance the reliability and transparency of our rating opinions and related analytics. More specifically, our primary focus is on vigorously reviewing our analytical approaches and changing ratings to reflect the current risk profile of securities we rate. We are releasing our updated ratings and research transparently and publicly and we are communicating directly with the market the latest information and analysis we have.

In parallel, we have been introducing a range of new policies and procedures – and updating existing ones – to reflect the evolving regulatory frameworks within which credit rating agencies operate globally. In each of these areas, we have been as transparent as possible and broadly engaged with a wide range of market participants, including policy makers and regulators. We are happy to expand upon any of these topics in the discussion today.

In the NAIC's invitation to Fitch, it noted it intended to seek testimony from different organizations on three primary subjects:

1. the reliance of insurance regulators on ratings and the difficulties encountered by regulators as a result of this reliance;

2. the performance of the NRSROs in the years leading up to the financial crisis and the reasons for recent rating volatility; and
3. regulatory alternatives to reliance upon NRSROs and recommendations for next steps.

With respect to the first topic, Fitch believes it is more appropriate for market participants, in this case primarily regulators and their regulated entities, to offer their perspective on the advantages and limitations in using the ratings of NRSROs. While Fitch is certainly aware of the ongoing dialogue in the market with respect to such topics – including discussions among the NAIC, the ACLI, rated insurers and other insurance industry participants regarding the use of credits ratings and their impact on capital charges -- we have been focused primarily on initiatives that enhance the reliability and transparency of rating opinions and related research.

In terms of the second topic (recent performance of the ratings of NRSROs), we would offer a number of observations. From the perspective of a credit rating agency, and as Fitch has noted in multiple public forums in the last few years, the credit crisis primarily began with pronounced asset quality deterioration in the U.S. subprime residential mortgage market. As a result, the market prices and credit ratings declined significantly in related RMBS (subprime and Alt-A) and certain CDO securities. A dramatic reduction in the market price for all forms of structured securities followed reflecting, in large part,

concerns that ultimate credit losses would be significantly greater than anticipated in all asset classes.

As time has progressed, the market stresses have become more broad-based – by asset class, institution and geography – and emanate from a global reassessment of the degree of leverage and appropriateness of short-term financing techniques inherent in today’s regulated and unregulated financial companies. Deleveraging is dramatically reducing liquidity and contributing to price volatility – both for individual securities and for the institutions that own or insure them. Credit ratings generally do not address market risk or liquidity, and to the extent that certain market participants may have inappropriately used ratings as a proxy for those variables, the flaws in that approach have become apparent.

In retrospect, too many of our structured finance credit rating opinions have clearly not performed as well as originally intended. We have downgraded significant numbers of structured finance securities due to the performance of underlying assets and structures of the deals, and in many cases by multiple notches or even rating categories. Originally, this affected primarily subprime RMBS and CDOs. It has since also affected Alt-A and even prime RMBS securities. While significant rating actions themselves do not necessarily imply realized losses, in many cases the magnitude of the rating downgrades and the levels of the current ratings do in fact correlate with not only a greater probability of default but also the prospect of significant losses for many low rated securities. Other structured asset classes, such as CMBS and ABS, have been more resilient, but these are also facing real credit headwinds as the macro-economic environment deteriorates. Strains in the

commercial real estate sector may affect the ratings of CMBS – in particular the junior tranches. However, TALF-eligible ABS assets such as credit cards, auto loans and student loans continue to be among the most resilient classes.

Fitch has previously acknowledged that while we were aware of, and believed we accounted for, many various risks posed by subprime mortgages and the rapidly changing underwriting environment in the U.S. housing market in our models and analyses, we did not foresee the magnitude or the velocity of the decline in home prices, nor the dramatic shift in borrower behavior brought on by the changing practices in the market. Nor did we appreciate the extent of dubious mortgage origination practices and fraud – by lenders and borrowers – in the 2005-07 period.

Structured securities are specifically designed for lower-rated, riskier and therefore higher-yielding bonds to absorb losses first. However, radically and rapidly changing markets have led to dramatic rating changes that have affected even highly rated bonds. The worsening economic environment accelerates the deterioration of the underlying assets, and combined with forecasted further economic stress, is consistent with broad-based negative ratings migration. Building complex highly tranced securities on historical default probabilities does not always provide enough cushion for extraordinarily variable economic and asset performance.

Certain structured assets have represented a major portion of asset losses and write-downs. They are one of the original catalysts for today's financial crisis, but that is not a complete

picture. Derivative exposure relating to these and other assets has created major stress. Balance sheet leverage was too high for the volatility we experienced and the ongoing deleveraging process is dramatically pressuring markets and prices. Further, the leverage from synthetic exposures that normally is not transparent became painfully transparent as counterparties lost confidence in each other and required physical collateral to protect positions. Consequently, many global financial institutions have found themselves experiencing material balance sheet stress, severe losses, equity market pressures, and a lack of confidence that has precipitated various government intervention programs here and abroad.

While a credit rating is a forward-looking opinion, one of the primary ways by which we assess the performance of our ratings over time is through the publication of our transition and default studies. In structured finance over the last decade, upgrades actually exceeded downgrades in every year from 1999 forward until 2007. In 2008 the pace of downgrades accelerated, particularly in RMBS and CDOs, as the credit crisis progressed. Even so, 87% of structured securities rated “AAA” at the beginning of 2008 remained “AAA” at year end. However, continued stress on the performance of underlying assets and our evolving perspectives on the fundamental economic drivers have led to significant additional rating actions across global structured finance thus far in 2009, including larger numbers of downgrades to “AAA” securities. Our credit ratings denote probability of default, not expected loss, so a ratings downgrade logically indicates a greater probability of default. A bond that remains rated investment grade reflects our opinion that the odds of default remain low, but further actions into non-investment grade categories increase the

odds of default and with it the probabilities of loss. Such loss estimates can vary widely by asset class, region, structure and collateral, so Fitch has introduced loss severity ratings and recovery ratings in structured finance to provide our perspective on this dynamic as well. That said, we fully recognize that there are a range of material regulatory capital issues, fair value accounting issues, and changes in market price and liquidity that are associated, if not fully correlated, with credit rating actions taken by NRSROs.

Our corporate finance ratings portfolio (financial institutions and non-financial corporates) tells a different story. While the majority of ratings by par value at origination are “AAA” by design within structured finance, it is different in corporate finance. The average financial institutions rating tends to be in the “AA” to “A” categories, while the average non-financial corporate rating tends to be in the “BBB” category. There are a relatively limited number of “AAA” rated issuers. Interestingly, 86% of Fitch’s corporate issuers rated “AAA” at the beginning of 2008 remained “AAA” at year end, and of those, none were downgraded below “AA.” At the same time, the number of downgrades significantly exceeded the number of upgrades in 2008, trends that have continued during the first half of 2009.

Given the above, over the last two years, Fitch has made a broad range of changes and refinements across nearly all dimensions of our company – both at our own initiation and in response to various regulatory changes. Broadly speaking, we have: (1) implemented a series of important analytical refinements and new initiatives; (2) adopted a host of policy, procedure and organizational changes; (3) introduced a number of new or revised tools and

analytical offerings that complement our “traditional” credit ratings; (4) engaged constructively with policy makers and regulators; and (5) continued our active dialogues with market participants who are affected by our actions and interested in our opinions.

At the end of this statement, attached is publication, “Ensuring Reliability and Transparency in the Ratings Process,” which we released in February of this year. It provides a rather comprehensive summary of Fitch’s approach and actions given our overarching objective to enhance the reliability and transparency of our ratings and research and to contribute to the rebuilding of confidence across the global debt capital markets.

Analytically, Fitch has pursued action on many fronts. Philosophically, we have made clear that we need to re-emphasize the “art” of fundamental credit analysis as learned through our experience as an appropriate complement to the “science” of modeling and quantitative analytics. Our rating opinions must be more predictive and our research and analysis must be insightful and forward-looking. Simply put, we must endeavor to provide the market with a clear and balanced opinion about what may happen tomorrow instead of just a review of what happened yesterday. In so doing, our objective is to offer ratings that are more stable and reliable, combined with transparency in our analysis and modeling techniques, so investors and all market participants can understand and use our ratings to supplement their own risk analysis and decision making. This applies to all of our ratings – structured, corporate and public. Importantly, we remain committed to the highest standards of integrity and objectivity in all aspects of our work.

Practically speaking, from 2007 forward we have built significantly more conservatism into our analytical approach as we reassess our current portfolio of ratings or consider ratings on new securities. Specifically, we have conducted extensive rating reviews across most asset classes, revised our ratings where necessary – and in some cases significantly, and updated our criteria and models with new approaches and assumptions. We have also focused on publishing frequent, timely and relevant research on the performance of asset classes and individual issuers.

Fitch has been reviewing and making appropriate changes to policies, procedures, and organizational structures to manage better conflicts of interest and so that Fitch's operations are consistent with the revised rules put forth by global regulators. By way of example, Fitch has implemented an updated and IOSCO-compliant Code of Conduct, and IOSCO itself has noted our conformity with the standards they have set forth. We have already implemented, or are in the process of so doing, a range of policies that will enable compliance with the SEC's recently announced final rules for NRSROs. Organizationally, we have implemented a number of senior management changes. We have created new positions of chief risk officers within each of the rating groups. We have introduced additional measures to ensure the full separation of our rating analysts from any commercial considerations for issuers they cover. In addition, we have created even greater separation of our analytical activities from our commercial activities by moving our complementary products and services into a new entity – Fitch Solutions.

Recent experience also suggests that the market benefits from additional information beyond the core rating. In an effort to meet the evolving needs of investors and increase transparency in the debt capital markets, Fitch has developed and introduced a range of new tools and analytical offerings over the last year or so, such as recovery ratings in structured finance and “RMBS LossMetrics.”

While our own judgment and experience have informed many of the actions we have taken to date, we have also greatly benefited from our regular interaction with market participants globally, and in particular from our dialogue with policy makers and regulators. We recognize the complexity of many of the issues facing the policy makers and regulators with respect to credit ratings. We may occasionally differ in our respective opinions, or disagree with certain characterizations of the quality of our efforts, but we share the same objectives of enhanced stability, greater ratings reliability, and improved confidence in the markets.

Lastly, we have always maintained an open and active dialogue with investors, intermediaries and issuers – and that has not changed despite recent market developments. We host a variety of teleconferences, webcasts, one-on-one meetings and conferences to maintain this dialogue. In addition, we issue commentary, publish special research reports and participate in speaking panels and interviews with media outlets worldwide. Throughout the crisis, Fitch has frequently and proactively reached out to its investor base through these communication channels to provide credit opinions, disseminate information, respond to market inquiries and solicit feedback.

With respect to the third primary topic, Fitch has previously offered its perspective on a number of salient points related to so-called “regulatory alternatives.”

A recurring theme in such regulatory discussions is the management of conflicts of interest. The majority of Fitch’s revenues are fees paid by issuers for assigning and maintaining ratings. This is supplemented by fees paid by a variety of market participants for research subscriptions. The primary benefit of this model is that it enables Fitch to be in a position to offer analytical coverage on every asset class in every capital market – and to make our rating opinions freely available to the market in real-time, thus enabling the market to freely and fully assess the quality of our work. Fitch has long acknowledged the potential conflicts of being an issuer-paid rating agency. Fitch believes that the potential conflicts of interest in the “issuer pays” model have been, and continue to be, effectively managed through a broad range of policies, procedures and organizational structures aimed at reinforcing the objectivity, integrity and independence of its credit ratings, combined with enhanced and ongoing regulatory oversight. In recent months, Fitch has introduced new policies, and revised many existing ones, focused on these issues. No payment model would be completely immune to conflicts of interest, whether from investors, issuers, governments or regulators. An “investor pays” model also contains direct conflicts, given that most major investors have a vested financial interest in the level of ratings and many are rated entities. A move to a complete “investor pays” model, by definition making the ratings a subscription product, could also remove ratings from the public domain. This

would conflict with investor and policymakers' call for ratings to be broadly available, thereby allowing the market to openly judge ratings performance.

More broadly, and stated simply and clearly, Fitch supports fair and balanced oversight and registration of credit rating agencies and believes the market will benefit from globally consistent rules for credit rating agencies that foster transparency, disclosure of ratings and methodologies, and management of conflicts of interest.

Interestingly, the overall dialogue on changes to rating agency regulation continues to follow two primary – and not necessarily consistent – themes. The first is the imposition of additional rules and regulations that are manifested in a range of new or enhanced policies and procedures. This has been the primary thrust of recent SEC rulemaking and of the recently passed EU rules. Fitch is or will be fully compliant with these new rules.

At the same time, a number of commentators – including the NAIC -- have spoken on the topic of the market's perceived over-reliance on credit ratings. To a certain extent, we agree with this premise, in so far as some market participants clearly used ratings as a substitute for – as opposed to a complement to – their own fundamental credit analysis. One proposed remedy for this is to eliminate the use of ratings in regulation or to eliminate the NRSRO concept altogether. While deceptively simple, we believe this proposal warrants several comments. Ratings have been used constructively in many places in regulation, as they are an important common benchmark. From a regulatory point of view, the question of what would be used in place of credit ratings is rarely answered

satisfactorily. Simply having regulators “do it themselves” has a range of practical implications and unintended consequences. As does the notion of allowing regulated financial entities to assess the credit risk of the securities completely on their own without reference to any independent external risk benchmarks. In many cases, if you eliminate the use of “NRSRO” ratings in regulation, company and industry participants will likely develop or maintain their own guidelines and use credit ratings anyway. We believe they will default to the largest “brand name” rating agencies (Moody’s and S&P), which is not a positive if one of your objectives is increasing competition and thereby fostering a better work product. Note that the SEC proposed a variation on this theme in 2008 with respect to money market funds and their use of ratings but chose not to move forward, in part based on significant feedback supporting the use of ratings in money market regulations from the fund industry itself. Some have suggested replacing ratings with market prices for debt – either bond spreads or CDS spreads. While these may reflect the market’s sense of price at a given point, recall from the events of the last two years that not all securities are liquid, that bid-ask spreads can widen materially in times of stress and that market prices by definition are inherently more volatile than a fundamentally driven credit rating. Note also the ongoing debate relative to fair value accounting (and standards of international convergence) and the difficulties of fostering widespread consensus on the key parameters of market prices and when they should or should not be used, let alone the dynamics of procyclicality.

However, if one is serious about eliminating ratings in regulation, we suggest that you transition to elimination over an intermediate time frame with careful consideration of each

regulation, rather than wholesale elimination. Fitch continues to believe that a better solution is continued recognition and oversight of NRSROs with the goal of improving the performance and usefulness of ratings.

In conclusion, Fitch continues to engage broadly and deeply with important market participants around the globe. We seek to share our latest thinking and also solicit ideas and answer questions. Fitch believes that we have responded in many good and productive ways, and anecdotal feedback from market participants is consistent with that view. That said, while the crisis has eased, we clearly have more to do, but we believe we are on the right path.

Appendix 1: Ensuring Reliability and Transparency in the Ratings Process (February 2009)

[See attached document.]

Ensuring Reliability and Transparency in the Ratings Process

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Related Research

[Fitch Updates Market on Steps to Enhance
Transparency and Restore Confidence,](#)
29 May 2008

Fitch Ratings Update on Key Initiatives

The unprecedented events that have taken place illustrate the sensitivity and interdependence of credit events on the world's financial markets. As market conditions have evolved, Fitch Ratings has taken numerous steps to enhance the quality and transparency of its credit ratings and to help restore confidence to the credit markets. This document provides an update on the range of initiatives that the agency has implemented.

Stephen Joynt, President and CEO of Fitch Ratings, commented on November 12, 2008 that "Fitch recognizes that strengthened market confidence in the opinions of rating agencies is an important aspect of working through these challenging times."

Fitch has focused primarily on ensuring the reliability and transparency of its credit analytics. Fitch conducted extensive rating reviews across asset classes, revised ratings where necessary, and updated criteria and models with new factors and assumptions. Fitch has also focused on publishing frequent, timely and relevant research on the performance of asset classes and individual issuers and has launched new tools and analytics to further enhance transparency.

Fitch has also been working closely with investors, policy makers and regulators on a range of proposed modifications to restore and maintain confidence in the credit markets. Fitch has been reviewing and making appropriate changes to policies, procedures, and organizational structures so that Fitch's operations are consistent with the revised rules put forth by global regulators.

What follows are: (I) a summary of key analytical initiatives; (II) a recap of updated policies, procedures and organizational changes; (III) a description of Fitch's new tools and analytic offerings; and (IV) an overview of Fitch's real-time engagement with the capital markets. This document complements Fitch's May 2008 update on key initiatives, as well as previous public statements to authorities such as the European Commission, US Congress and US SEC.

Fitch will continue to update the market on the measures outlined below and on the progress of its commitments. Updates to policies, processes and the Fitch Code of Conduct are available on Fitch's public web site at www.fitchratings.com.

Fitch Ratings' Key Initiatives

I. Analytical initiatives to enhance transparency and provide the highest quality credit ratings and research:

Fitch has focused on ensuring the reliability and transparency of its credit analytics. Each ratings group has focused on:

- Conducting extensive rating reviews and, where necessary, taking rating actions
- Updating methodologies and models
- Performing deterministic stress analyses
- Publishing extensive timely and relevant research

Examples of key credit initiatives within each rating group are included below.

Structured Finance

- **Developed Structured Finance Ratings Outlooks.** To better signal concerns about potential ratings pressure, Fitch launched Structured Finance Rating Outlooks in June 2007 in Europe, followed by the US in May 2008 and Latin America in January 2009. Rating Outlooks are an early indicator of a potential rating change over the next one- to two-year period. Fitch is the first agency to provide this information.
- **Strengthened Structured Finance Originator Evaluations.** Acknowledging the key role of the originator in influencing the level of risk and expected performance of a transaction, Fitch has strengthened its existing originator evaluation processes globally for structured finance issuers. The evaluation determines Fitch's ability to rate a transaction as well as positive or negative adjustments to the credit enhancement levels based on the originator's operational risks.
- **Proposed Complementary Ratings Scales for Structured Finance.** In an effort to add greater transparency and capture additional risks, Fitch has explored a range of potential complementary rating scales for structured finance securities. Based on market feedback, Fitch is continuing to review the potential for an additional scale on loss given default. Loss Severity Ratings would attempt to quantify the recoveries on a tranche-level basis that a creditor would likely receive in the event of default.

Residential Mortgage Backed Securities (RMBS)

- **Updated US RMBS Criteria and ResiLogic Model.** Fitch completed a full review of its US RMBS rating criteria and announced revisions to ResiLogic, Fitch's mortgage default and loss model for US RMBS prime, Alt-A and subprime transactions, in July 2008. Updated criteria reflect new assumptions for factors such as falling home prices and loan performance, as well as substantial changes in mortgage originations.
- **Incorporated New Procedures for Information on US RMBS Transactions.** In December 2008, Fitch announced new procedures related to US RMBS ratings. These procedures are intended to ensure that Fitch is relying on the most complete and accurate information when assessing the credit worthiness of a US RMBS transaction:

- **Originator Reviews.** Fitch now requires originator reviews, which provide an indication of the risk attributable to an originator's level of risk management and disclosure. Fitch will decline to a rate transaction if the origination practices do not meet the agency's standards.
- **Loan-level Reviews.** Loan-level reviews must be conducted by an independent third-party to better identify poor underwriting practices. Fitch will not rate a transaction if the results of the loan-level review are unacceptable.
- **Representations and Warranties.** Representations and warranties in RMBS transaction documents must meet Fitch's elevated standards. Fitch will not rate a transaction whose representations and warranties are not acceptable.
- **Revised US RMBS Surveillance Criteria.** Revisions have also been made to surveillance criteria. Fitch's methodology for reviewing US prime criteria was published in August 2008, followed by updated criteria for US subprime announced in November 2008 and US Alt-A in December 2008.
- **Published EMEA RMBS Criteria.** Fitch also published its criteria for rating residential mortgage securitizations in EMEA emerging markets (September 2008) and the treatment of Automated Valuation Model (AVM) property valuations for residential mortgages in EMEA (November 2008).

Collateralized Debt Obligations (CDO)

- **Reviewed CDO Rating Methodology.** In November 2007, Fitch announced a full review of its CDO rating methodology and placed a moratorium on new CDO issuance until this review was complete.
- **Revised CDO Rating Criteria.** Following this review, Fitch announced updated global criteria for market value structures (April 2008), corporate CDOs (April 2008), project finance CDOs (August 2008) and structured finance CDOs (December 2008).
 - A review of the impact of Fitch's updated corporate CDO criteria in November 2008 notes the resiliency of ratings under the new criteria and demonstrates that the new criteria effectively highlight industry and/or obligor concentrations and adverse selection.
- **Evaluated Credit Risk Inherent in CPDOs (Constant Proportion Debt Obligations).** In April 2007, Fitch concluded that first generation CPDOs did not merit high investment grade ratings and, as such, did not rate any public CPDO deals.

Commercial Mortgage Backed Securities (CMBS)

- **Conducted Stress Testing.** Fitch conducted extensive stress tests on "at risk" CMBS deals across the US and Europe and then changed rating outlooks and took rating actions where appropriate.
 - Findings from these stress tests were subsequently published to help investors quantify the risks that potential property-specific and macroeconomic stresses may present to ratings (e.g., "Fitch Stress Testing: Expected Losses in US CMBS - 2006 & 2007," dated 31 July 2008).

- **Completed Model Updates.** In January 2008, Fitch announced a number of updates to its multi-borrower rating model.

Asset Backed Securities (ABS)

- **Conducted Stress Testing.** Fitch conducted stress tests on certain key ABS areas (e.g., student loan auction rates) and continues to monitor credit card and auto transactions, with a focus on unemployment levels and the impact of house price declines and energy costs.
- **Reviewed ABCP Programs.** Fitch has reviewed all ABCP program ratings. ABCP programs with exposures to RMBS, CDO and financial guarantors continue to be reviewed on a weekly basis, followed by the publication of Fitch's associated commentary.

Financial Institutions

- **Conducted Portfolio Reviews and Rating Actions.** Considering the evolution of recent market events and their impact on financial institutions, it is important to remember that banking is a confidence-sensitive industry, so a sudden erosion of confidence can overwhelm the fundamentals of an issuer in a short period. Nonetheless, Fitch has focused on providing timely, relevant credit opinions and rating actions in this sector. Apart from emerging markets, negative rating actions have been largely concentrated on complex and wholesale banks and have generally been relatively modest (one to two notches). Most banks remain relatively highly rated ('A' or above), although Fitch expects that ratings pressure will remain in place for a number of developed and emerging market banks throughout 2009.
- **Reviewed Impact of Sovereign Rating Actions on Emerging Market Banks.** Emerging markets have not escaped the financial crisis, and banks in a number of countries have been experiencing liquidity and funding difficulties. Following a review of the sovereign ratings and outlook for 17 major emerging market economies, a large number of actions were taken on the ratings of banks in various countries.
- **Conducted Stress Testing on European Banks.** Given the impact of the economic slowdown in Europe and the number of banks exposed to the mortgage and consumer sectors, Fitch has conducted stress test reviews of banks' mortgage portfolios in the UK, Spain and Ireland.
- **Monitored Liquidity Positions.** Fitch continues to closely monitor the liquidity position of all wholesale banks and those mortgage banks that have been more reliant on securitization and have long-term funding requirements.
- **Published Timely Research on Key Issues.** Fitch published, and continues to publish, updated research and commentary on key issues affecting financial institutions, such as: macroeconomic conditions; consolidation within the industry; government intervention; and liquidity challenges. Research is published by both country/region (e.g., "Japanese Major Banks: Semi-Annual Review and Outlook," dated 9 December 2008) and sector (e.g., "Fitch Sees Elevated Risk of Bank Hybrid Capital Coupon Deferral in 2009," dated 4 February 2009; "Converting to Bank Holding Company Status," dated 21 January 2009; "Bank Ratings, Confidence Sensitivity and Support - Cliffs and Safety Nets," dated 17 October 2008).

- **Reviewed and Published Bank Rating Methodology.** In November 2008, Fitch published its bank rating methodology to provide greater transparency on Fitch's analytical process and ratings rationale.
- **Heightened Surveillance Efforts for Money Market Funds and Closed-End Funds.** As market conditions evolved, Fitch enhanced its surveillance efforts for money market funds and closed-end funds, focusing on liquidity and performance issues, as well as the impact of various government-led initiatives.
- **Revised Closed-End Fund Criteria for Leveraged Loans.** In light of the heightened market price volatility of closed-end funds' portfolio holdings and a broader initiative across Fitch to update its market value criteria, Fitch updated its criteria for rating securities issued by leveraged closed-end funds in December 2008.
- **Proposed Revisions to Global Money Market Fund Rating Criteria.** Fitch recently solicited feedback on proposed changes to its global criteria for rating money market funds. Primarily focusing on "prime" funds, criteria changes include: a more direct recognition of potential institutional support; a closer alignment of portfolio liquidity and the potential for high redemptions in times of stress; the introduction of new diversification guidelines and a Portfolio Credit Factor (PCF) matrix; and a revised ratings scale that adds a MMF subscript and eliminates existing MMF Volatility ratings.
- **Expanded Covered Bonds Group.** Fitch supplemented its widely respected European covered bonds team with additional resources. Additionally, a covered bonds team was established in the US, consistent with government efforts to develop this market. In September 2008 Fitch published a special report providing an introduction to US covered bonds, comparison relative to US RMBS and European covered bonds and discussion of key factors issuers and investors should analyze when considering this sector ("ABCs of US Covered Bonds," dated 3 September 2008).

Insurance

- **Conducted Stress Tests.** Over the course of the past year, Fitch has focused on stress testing insurers' investment and liquidity exposures, focusing on capital levels as well as the impact of possible government support.
- **Continued Ongoing Sector Reviews.** Fitch conducted ongoing insurance sector reviews with a focus on the expected impact of realized and unrealized investment losses on insurers' capital levels and profitability. As a result of this analysis, Fitch placed all insurance sectors globally on Negative Outlook in October 2008. Further rating outlook rationale by sector is provided in recently published 2009 sector outlooks, and Fitch continues to actively screen the entities it covers.
- **Published Special Reports on Key Issues.** As market conditions have unfolded, Fitch has also focused on providing timely commentary on key topics affecting the insurance industry. Examples include: "US Mortgage Insurers - 2008 Review and 2009 Outlook (Continued Losses and Capital Demands)," dated 13 January 2009; "Presentation: How Credit/Market Crisis Impacts Life Company Ratings," dated 18 November 2008; and "Property/Casualty Insurer Asset Risk (Growing Investment Loss Concerns)," dated 4 November 2008.

- **Enhanced Rating Methodology for Health Insurers.** In December 2008, Fitch announced an enhancement to the methodology it uses to measure financial leverage of US Health Insurers, placing greater emphasis on various cash flow measures and less emphasis on balance sheet ratios.
- **Completed Targeted Review of Bond Insurers.** Fitch announced a formal review of all 'AAA' rated bond insurers in November 2007, with a special focus on portfolios of structured finance collateralized debt obligations (SF CDOs) that contain subprime collateral. At the conclusion of this analysis, several insurers were identified as having material capital shortfalls relative to Fitch's 'AAA' standards and three downgrades took place – the first among the industry. In February 2008, Fitch launched a second phase of analysis due to the speed and magnitude at which the US real estate market continued to deteriorate. This phase included not only an updated capital analysis, but also close scrutiny of the escalation of expected losses and expected future claim payments, and resulted in additional market-leading rating actions.

Corporates

- **Conducted Portfolio Reviews.** Fitch has focused on providing timely credit opinions and rating actions that reflect the severity of market conditions. Fitch continues to actively monitor rated entities, assessing both ongoing factors, such as capital management, and emerging factors, such as new terms in loan agreements that banks are now requiring of corporate borrowers. Fitch is also in the process of reviewing distressed debt exchange and recovery ratings in light of the robust data coming in during this economic environment.
- **Produced Special Reports on Key Issues.** Fitch issued hundreds of special reports over the course of the past year, commenting frequently on key performance issues across Corporate Finance, Global Infrastructure and Project Finance, Global Power and Leveraged Finance. Reflecting the wide range of published research, examples of 2008 special report topics ranged from Fitch's analytical approach to liquidity and bank agreements given the impact of the credit crunch ("Corporate Liquidity: Bank Agreements and Refinancing Risk," dated 22 August 2008) to niche sector- and regional-specific analysis (e.g., "Infrastructure Finance in India: Lessons from the Front Line," dated 25 November 2008).
- **Published Criteria.** Fitch also published criteria pieces throughout the course of the year to communicate key characteristics taken into account when rating specific sectors (e.g., "Rating Food Companies," dated 5 November 2008; "Rating European Telecoms," dated 20 August 2008) and/or to reflect recent criteria updates (e.g., "Equity Credit for Hybrids and Other Capital Securities," dated 25 June 2008).
- **Published Revised Sector Outlooks.** Additionally, Fitch published revised sector outlooks reflecting updated expectations for credit performance given recent market events.

Sovereigns

- **Published Relevant Research on Sovereign Creditworthiness and Ratings.** The intensification of the global financial crisis has prompted much more extensive government and central bank intervention and financial support to stabilize domestic banking systems. The size of contingent liabilities for governments and the fiscal cost of such

interventions resulted in market and media commentary on the risks to sovereign credit worthiness and ratings. In addition to affirming 'AAA' ratings as appropriate, a vital pillar of maintaining confidence in ratings has been the publication of insightful and accessible research. As such, Fitch has focused on producing key research pieces in support of 'AAA' ratings. For example: "Finance Sector Support and the US's 'AAA' Rating," dated 3 October 2008; "Sovereign Implications of the Financial Crisis," dated 8 October 2008; "Sovereign Implications of European Bank Bailouts," dated 29 October 2008.

- **Conducted Review of Emerging Markets Sovereigns.** In November 2008, Fitch assessed from a sovereign credit perspective the vulnerability of major investment-grade emerging market economies to various negative external shocks and their capacity to absorb them. The sovereign ratings of 13 major emerging market economies were affirmed, four were downgraded and the rating outlooks on seven were revised to Stable or Negative.
- **Worked with Financial Institutions Group to Assess Guaranteed Bank Debt.** The Sovereign and International Public Finance Groups have been actively working with the Financial Institutions Group on the assignment of ratings to new bank debt guaranteed by sovereign governments, notably in the UK and France.

Public Finance

- **Evaluated and Proposed a Recalibration of the Municipal Rating Scale.** After an extensive review, in July 2008 Fitch proposed a recalibration of its municipal ratings to denote a comparable level of credit risk relative to its international ratings scale for corporate, sovereign and other entities. Given continued market turmoil, Fitch decided to defer its final determination on municipal recalibration, which will be revisited in first-quarter 2009.

In addition to the examples above, each of the rating groups has completed 2009 sector rating outlooks, which provide analysis on trends and issues from both industry and credit rating perspectives. These are available on Fitch's public web site under Outlook Reports for 2009.

II. Updated policies, procedures and organizational changes to ensure the integrity of the ratings process and manage potential conflicts of interest:

In addition to the analytical initiatives within each of the rating groups, Fitch has also taken actions at the corporate level to further reinforce the objectivity and integrity of its ratings.

Updated Policies and Procedures

Fitch has reviewed all existing practices and is in the process of implementing appropriate changes to policies, procedures and internal controls. Changes recently introduced include:

- **Revised Code of Conduct.** Fitch recently revised its Code of Conduct to conform to changes made to the IOSCO code published in May 2008. Fitch's updated Code of Conduct reflects both the spirit and the letter of the IOSCO code and continues to focus on four key areas: (1) the quality and integrity of the ratings process; (2) independence and avoidance of conflicts of interest; (3) responsibilities to the investing public and issuers; and (4) disclosure of the code and communication

with market participants. It also states clearly what Fitch expects of issuers in the rating process.

- **Updated Policy on Fee Negotiations.** Fitch updated its policy regarding fee negotiations to ensure a clearer separation between analytical and business development activities. The policy affirms and provides further guidance on: (1) who may conduct fee negotiations; (2) the internal dissemination of, and access to, fee information; (3) analyst and business development interactions with issuers, intermediaries and investors; and (4) participation at conference and business networking events.
- **Published Statement on the Definition of Ancillary Business.** In order to clarify what is and is not included in Fitch's core business offerings, Fitch has published its definition of an "ancillary business," which is any business other than providing independent analysis and rating opinions regarding a variety of risks in the financial markets. Any ancillary business within the Fitch Group of companies is provided by separate companies outside the ratings group or by separate divisions, all of which are subject to Fitch's Firewall Policy.

In the coming months, additional changes will be incorporated into Fitch's policies such as: Confidentiality, Conflicts of Interest and Securities Trading; File Maintenance and Record Keeping; and Firewall.

Furthermore, Fitch intends to implement additional measures consistent with final rules expected from worldwide regulators.

- Fitch is supportive of the US SEC's regulatory changes that improve ratings quality, increase disclosure and transparency, and address potential conflicts of interest among the credit rating agencies.
- Fitch is also supportive of the efforts of the European Union to introduce a regulatory framework with a consistent rating agency registration and surveillance process. While Fitch will continue to search for common ground on a few key provisions in the proposals, the agency will engage in a balanced and constructive way with the European Commission, the European Council and the European Parliament as the approval process moves forward.
- Fitch is working closely with legislative and regulatory bodies in other regions as they establish new guidelines and regulations.

Long-Standing Practices to Manage Conflicts of Interest

In addition to the policy and procedural changes noted above, Fitch continues to maintain established practices to manage potential conflicts of interest. For example:

- Business development is separated from credit analysis to keep each group focused on its core task.
- Individuals involved in the assignment of credit ratings do not participate in any fee discussions with issuers or arrangers.
- No analyst or group of analysts is compensated on the revenues related to their credit analysis.
- Ratings are determined using a committee structure, not by a single analyst. These committees include independent members who do not participate in recommending the rating to the committee.

- All ratings criteria are reviewed by cross-group committees that include independent members drawn from the senior analytical staff.

Organizational Updates

Fitch has also made organizational changes that enhance the independence and analytical oversight of the rating agency. These changes better align Fitch resources with current market conditions and associated initiatives:

- **Launched Fitch Solutions.** In January 2008, Fitch Group created a new division, Fitch Solutions, which is managed separately from Fitch Ratings. Fitch Solutions reinforces the independence of the rating agency and creates a more focused grouping of products and services. The division includes all non-ratings products and services, product development and product sales, as well as Fitch's training business. The creation of Fitch Solutions allows for even clearer separation of non-ratings products and services from the rating agency. Following the creation of Fitch Solutions, Fitch Group now has three separately managed divisions: Fitch Ratings, Fitch Solutions and Algorithmics.
- **Introduced Group Credit/Risk Officers.** Group Credit Officer and Portfolio Risk Officer roles have been added to the Corporates/Financial Institutions, Public Finance and Structured Finance areas. The roles were added to bring enhanced analytical oversight, experience and training to the analytical groups. The Credit and Risk Officers focus on criteria updates, model reviews and important thematic research. They also work with each group to identify important trends and to ensure that Fitch's analytical process is both rigorous and balanced.
- **Ensured Appropriate Staffing Levels.** Fitch conducted a review of its staffing throughout the course of the year and, where necessary, took actions to ensure the most appropriate level of resources with the skill sets and expertise required under current market conditions and expected analytical needs.
- **Increased Structured Finance Surveillance Resources.** Fitch has focused on ensuring the appropriate resourcing and independence of analytical resources dedicated solely to surveillance work on individual Fitch-rated structured finance transactions. Surveillance teams have been enhanced with more senior resources, and staff has been increased. Surveillance teams are focused on monitoring the effects of recent market dynamics and publishing the most timely and relevant ratings and research.
- **Enhanced Training Initiatives.** Fitch has continued its commitment to learning and development, increasing both the number and types of courses offered – ranging from mandatory compliance training to technical and analytical topics.

III. New tools and analytic offerings to provide investors with additional information and insight:

In an effort to meet the evolving needs of investors and increase transparency in the debt capital markets, Fitch Ratings has developed new tools and analytical offerings throughout the course of the year. Examples include:

- **ResiEMEA.** Released in February 2008, ResiEMEA is an analytical model for the risk assessment of residential mortgage loans in accordance with Fitch Ratings' RMBS criteria. ResiEMEA helps determine expected default probability, loss severity and recovery on a loan-by-loan basis

for transactions.

- **RMBS Loss Metrics.** In December 2008, Fitch announced the launch of RMBS Loss Metrics, an enhanced surveillance offering comprised of key loss and performance metrics across the universe of approximately 40,000 US RMBS bonds rated by Fitch.
- **EMEA CMBS Surveillance Reporting.** Fitch Ratings also launched enhanced surveillance reporting for EMEA CMBS in December 2008. Surveillance pages on the Fitch Research web site now provide advanced EMEA CMBS performance metrics and analysis in a standardized form.
- **Projected Loss Analysis.** As an additional supplement to Fitch's Structured Finance CDO surveillance, in August 2008, Fitch introduced asset-level projected loss analysis (PLA) – a new analysis that builds off of Fitch's RMBS mortgage loss assumptions to estimate the impact to structured finance CDOs.
- **SMART for Covered Bonds.** Fitch Ratings introduced a new surveillance and research service for the covered bonds market called SMART (Surveillance, Metrics, Analytics, Research and Tools) for Covered Bonds in March 2008. The product provides investors with periodic data on cover pools and information about discrepancies in maturity, interest rate and currency between cover pools and corresponding covered bonds. Fitch is the first credit rating agency to have developed this type of service for this sector.
- **Fitch Ratings Web Site.** Beginning in January 2008, Fitch has made updates to its web site to better meet the needs of issuers and investors. In particular, Fitch integrated cutting-edge search and information access capabilities, redesigned market sector and market focus pages, and updated tools and features so that users can more easily access Fitch's research, data and content.

Fitch Solutions has also developed tools and analytics for further transparency in the market. For example:

- **Liquidity Measures.** In December 2008, liquidity scores and percentile rankings for widely traded credit derivative assets were introduced to help banks identify their exposure to the most liquid and least liquid assets and strengthen their liquidity risk management procedures.
- **Fitch Risk and Performance Platform.** In June 2008, a new platform was launched that provides market-based credit risk analytics, credit default swap pricing and fundamental ratings content. The platform incorporates new tools for quickly reviewing credit performance within a user's portfolio.
- **Portsmouth Financial Systems.** In May 2008, Fitch Solutions announced that it had partnered with Portsmouth Financial Systems (PFS), a next generation provider of structured finance analytics, to provide a comprehensive suite of data, analytics and cashflow solutions for the global structured finance market. In January 2009, an early access program was introduced for Fitch Deal View, a desktop product developed in conjunction with PFS that provides detailed collateral analysis, public and legible waterfall models, loan-level prepayment and default modelling, and scenario analysis for mortgage-backed securities.

IV. Real-time engagement, reflecting Fitch's ongoing commitment to maintaining an active dialogue with market participants:

Fitch has always maintained an open and active dialogue with investors, intermediaries and issuers. Fitch hosts a variety of teleconferences, webcasts, one-on-one meetings and conferences to maintain this dialogue. For example, in 2008, Fitch's Global Structured Finance group held over 1,700 meetings and hosted over 40 conferences with nearly 3,500 participants. To gain additional feedback, Fitch also established an Investor Advisory Council in both the US and Europe.

In addition, Fitch issues commentary, publishes special research reports and participates in speaking panels and interviews with media outlets worldwide. In 2008, Fitch frequently and proactively reached out to its investor base through these communication channels to provide credit opinions, disseminate information, respond to market inquiries and solicit feedback.

Fitch has also been actively engaged in dialogues with policymakers, regulatory bodies and other market participants on both ratings-specific topics and market-wide initiatives. This includes global entities, such as the Bank for International Settlements (BIS), as well as regional authorities. For example, in the US Fitch has maintained constructive dialogues with Congressional staff, the Treasury Department, the Federal Reserve and the SEC, among others. In Europe, Fitch has remained in close contact with pan-European bodies such as CESR and the European Commission, as well as country-specific authorities such as the UK's FSA and France's AMF. Similarly, Fitch has maintained active dialogues with international regulatory authorities and policymakers as they continue to evolve their regulatory regimes.

Fitch is encouraged that, in most cases, the policymaking community's response to current events has recognized the importance of preserving the independence and flexibility of credit opinions. Fitch will continue to work with relevant regulatory agencies to implement any final rules set forth.

Next Steps

Restoring confidence in rating agencies is an important step to stabilizing the debt capital markets. As such, Fitch will remain focused on, and committed to, providing the highest quality ratings and research. This will include: continuing to update its criteria; taking rating actions where appropriate; publishing timely research and credit opinions; introducing new tools for the investor community; and implementing policies and procedures to comply with regulatory requirements.

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