

Special Report

The Role of Support and Joint
Probability Analysis in Bank
Ratings
Outcome of Consultation

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■ Executive Summary & Conclusions

On 31 May 2006 Fitch published a consultation paper “The Role of Support and Joint Probability Analysis in Bank Ratings” inviting feedback from the market during a consultation period that closed on 30 June 2006. This paper presents the results of that consultation, leading to the following conclusions:

1. Although Fitch recognises the conceptual validity behind joint probability analysis, it also recognises the severe practical limitations, and, on this basis, Fitch has rejected the adoption of a JPD model methodology for assigning its bank ratings.
2. Fitch will continue to base its bank ratings on its current judgement based methodology, utilising the widest possible range of input variables, some of which are more easily quantifiable than others. Where models can assist this process they will be utilised.
3. Fitch will continue to research and publish material related to the role of external support in bank ratings, and will continue to provide the market with the explicit Support and Individual ratings with which it has become familiar. Specifically, Support Ratings will continue to set rating floors for bank LT IDRs.
4. Fitch will continue to evaluate whether external support is sufficiently factored into its ratings in the light of inter alia potential changes to supporter behaviour, fixed income market practice and expectations, and the availability of empirical data.
5. On the latter point, Fitch is committed to providing the markets with bank specific failure and default rates in order to facilitate transparency in this discussion.

■ Scope of Consultation

The consultation document was published on Fitch's public web-site on 31 May 2006. To date it has been downloaded in excess of 300 times. Additionally the report was sent electronically to, and opened by, a further 470 contacts.

Fitch presented on the report at its Global Banking Conference in Paris, Milan, Zurich, London, Singapore, Seoul, Tokyo and New York which had a total of 664 attendees. The New York conference was web-cast and viewed by a further 227 participants. The paper was also presented at conferences in Hong Kong and Taipei to a further 200 attendees.

In addition to the conferences face-to face meetings were undertaken with c30 capital markets participants in the UK, the Netherlands, Germany and Spain. These included investors, investment bankers (sell-side analysts, ratings advisors, and debt-capital markets), and bank counterparty risk managers from a range of major European and US owned institutions. Dialogue has also been undertaken with a number of US domiciled investors both specifically in the context of the current consultation paper and in the context Fitch's Bank Systemic Risk product.

Scope of the Feedback

The bulk of the feedback was verbal in the context of the Global Banking Conference and face-to face meetings. There were, however, a limited number of written submissions.

Although most respondents recognised the conceptual validity of joint probability analysis, the overwhelming bulk of the feedback was negative with regard to a potential implementation of a joint probability model for deriving bank credit ratings given the reservations set out below:

Opposition largely fell into two categories; theoretical considerations and practical considerations

Theoretical arguments

- There is insufficient empirical data on which to make model assumptions
- The model, particularly at the higher investment grade ratings, is very sensitive to small changes in input values
- Correlation values cannot be substantiated
- Given the above, the appearance of greater rating precision is in reality "spurious accuracy" (in the words of one major UK investor).

Practical arguments

- The market would not welcome the increased level of ratings volatility that it was felt a model approach would entail
- If model-driven upgrades resulted in ratings compression either at AAA or at lower country ceilings, it was felt that ratings would become significantly less useful as measures of relative credit risk
- The vast majority of respondents felt that banks are currently fairly rated, and would not welcome technically-driven upgrades
- Several respondents indicated that, considering where we are perceived to be in the credit cycle (i.e. conditions are as benign as they are likely to get, and the next significant move is likely to involve a deterioration in credit quality), any technically driven raising of ratings would convey a misleading message.

Recognition of the Role of Support...

Despite the negative reaction to a JPD model based approach, all respondents recognised that external support plays a very real role in the banking industry and that this fact distinguishes the banking industry from most, if not all, corporate sectors. Equally respondents acknowledged the contribution that Fitch has made to this debate through its long-standing publication of bank Support ratings, and through the publication of research on this topic. (A full list of Fitch publications relevant to the subject of external bank support is given in Appendix 1) Indeed many respondents were keener to discuss fundamental support issues rather than the intricacies of a model. Such questions included the potential support from a national government for an internationally operating bank, and the role of the European Commission in allowing/preventing bank rescues within the European Union. These are both issues that Fitch has addressed at various junctures, including in the September 2002 publication: "Bank Support in the Developed World."

...but little consensus on how to factor it in

Although there was near universal recognition of the role of external support, there was less consensus on how this should be factored into bank credit ratings in the absence of a pure JPD model approach. A number of respondents favoured excluding support altogether with ratings reflecting only intrinsic risk. It was felt that this best reflected the price volatility risk that they were exposed to, with actual default risk, given the rarity of default events (at least in the developed world) being a minor consideration.

Others, however, felt that if ratings are to express real default risk, then external support has to be factored in, although there was little clarity or agreement as to exactly how, or to what extent, this should be done.

Fitch's commitment to provide research and data

Nevertheless, there was broad support for, and satisfaction with, Fitch's current system of Individual ratings, Support ratings and support-derived rating floors for bank IDRs. Fitch will,

therefore, continue to provide the market with in-depth analysis and commentary on the role of support in bank ratings and will continue to evaluate whether the current rating approach best suits the needs of the credit markets in the light of *inter alia* potential changes to supporter behaviour, fixed income market practice and expectations, and the availability of empirical data. On the latter point, Fitch is committed to providing the markets with bank specific failure and default rates in order to facilitate transparency in this discussion.

■ Appendix 1: Bank Support Publications

Methodology	
Bank Rating Methodology	25 May 2004
Launch of Fitch's Bank Support Rating Methodology	July 22, 2003
Methodology for Assigning Ratings to European Banking Structures Backed by Mutual Support Mechanisms	21 October 2004
Support Ratings and the Rating of Bank Hybrid Capital and Preferred Stock	27 July 2005
Rating banking subsidiaries in investment grade countries of non-investment grade parent Banks	13 July 2001
Regional or Country Specific Comments	
Bank Support in the Developed World	30 September 2002
Review of Bank Support in the GCC	27 May 2004
Bank Support in Japan	15 March 2004
The New Zealand Banking System – An Overview Of Structure and Support	23 December 2003
Understanding U.S. Bank Failures	December 9, 1999
The EU and the Evolution of the European Banking Market	28 February 2005
Landesbanks: Yesterday, Today, Tomorrow	24 June 2004
The EU and German Landesbanks – Showdown or anti-climax?	28 September 2000
Statistical Studies	
Bank Support in the Developed World	30 September 2002
Fitch Bank Failures Study 1990 – 2003	31 March 2005
Related Material	
Assessing Bank Systemic Risk: A New Product	26 July 2005
Bank Systemic Risk Report	26 July 2005 & 22 February 2006

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