

ECBC Response to Fitch Ratings' Exposure Draft: Covered Bonds Rating Criteria

Brussels, 28th of July 2016

The European Covered Bond Council (ECBC)¹ represents the covered bond industry, bringing together covered bond issuers, analysts, investment bankers, rating agencies and wide range of interested stakeholders. The ECBC was launched by the European Mortgage Federation (EMF) to promote the interests of covered bond market participants at international level. As of July 2016, the ECBC brings together over 100 members from more than 25 active covered bond jurisdictions representing over 95% of covered bonds outstanding, which were worth nearly 2.5 trillion EUR at the end of 2015.

The ECBC welcomes the opportunity to comment on the Fitch Ratings' Exposure Draft regarding the proposed updates of the covered bond rating criteria and would like to thank Fitch Rating for the ongoing commitment to a constructive dialogue.

The Exposure Draft has been discussed within the ECBC Rating Agency Approaches Working Group and we would like to share the following observations with you.

1. Introduction

Overall, the members of the ECBC Rating Agency Approaches Working Group support Fitch Ratings' efforts to try and make the covered bond rating criteria more transparent and simple to understand as the D-cap approach was sometimes considered as a black box. It also focuses more on ALM risk and not longer treats one factor as the blocking factor that could limit the uplift in rating as constraint via D-cap, even though all other factors would allow for better rating uplift.

However, it seems that the Exposure Draft does not clearly identify what the exact changes are and how the programmes would be impacted. Therefore, there may be the need to further explain this in more detail.

In addition, the members of the ECBC Rating Agency Approaches Working Group acknowledge that a rating agency has to adapt its rating methodology to changes in capital markets and political environment and in this relation, it is understandable that Fitch Ratings would like to keep its methodology up-to-date. However, it appears that, in recent years, Fitch Ratings changed its methodology, or relevant parts of its approach, quite often and the members expressed a preference for more stability going forward.

Another topic, which seems not to have been discussed in detail in the Exposure Draft, is how the foreign exchange (FX) risk and hedging are taken into account.

2. Specific Comments

Question 1: Please provide feedback on the appropriateness of Fitch's proposed change in approach, based on the risk of undercollateralisation, to determine the uplift above the IDR reflecting the favourable bank resolution regime treatment of fully collateralised covered bonds at a point where the issuing bank continues to make covered bond payments.

¹ The European Mortgage Federation - European Covered Bond Council (EMF-ECBC) is registered in the European Institutions' Transparency Register under ID Number 24967486965-09.

The members of the ECBC Rating Agency Approaches Working Group found it difficult to comment on this question, as it is not fully clear from the Exposure Draft how it is exactly treated and the impact on all programmes, especially the integration of the issuer with its parent in the same group in the IDR uplift approach. Therefore, further clarifications in this regard could be helpful.

Question 2: Do you agree that greater uplift for protection in a resolution is warranted for programmes issued by banks whose IDRs are VR-driven than those that are support-driven except for when the issuer is so integrated with the support provider that both entities are likely to be resolved together?

It should not matter, based on the feedback received, if the parent bank's IDR is based on support or VR driven at the point where the issuer is under resolution. There could be numerous options and it seems difficult to predict precisely which approach will be taken.

Question 3: Do you agree that if there is a risk of an issuer liquidation or enforcement of the recourse against the cover pool upon resolution, no IDR uplift should be assigned to a covered bond programme? This would apply to programmes of non-deposit taking, specialised covered bond issuers who are not fully integrated into a parent bank, as well as jurisdictions where resolution legislation exists but where Fitch views that there is a high likelihood that recourse against the cover pool would be enforced upon resolution.

Our interpretation is that this question refers to covered bonds from countries that have not clearly stated that covered bonds are exempt from bail-in. It could be difficult to determine in advance which institution would go into resolution or liquidation. In most covered bond-issuing countries, the importance of covered bonds to the jurisdiction's financial markets is clear via the regulatory focus, while the relevance of the issuer could be considered more important than the degree of integration of an issuing subsidiary and the question, whether the IDR was VR-driven or support-driven.

In other words, it would be useful to clarify whether it is in all cases more likely that covered bonds from a highly integrated issuer, whose parent IDR was VR-driven, will be served out of the parent in resolution compared to covered bonds from a standalone specialised institution, coming from a jurisdiction, where covered bonds are very important for the national economy. It could be also considered that covered bonds issued out of a specialist bank, will probably be less affected by problems at the parent level.

Question 4: Do you believe that Fitch's proposal to determine the payment continuity uplift (once recourse against the cover pool has been enforced), with the focus placed on the liquidity provisions in place, is a fair approach?

Based on the feedback received, Fitch's proposal in that regard seems to be reasonable, given that liquidity risk is the most common constraint on covered bond ratings. However, the switch in focus to liquidity risk may result in less focus on basic principles, especially with regard to alternative management. It seems that extending the length of the liquidity protection period has more impact than shortcomings in the alternative management.

Question 5: Do you agree with the approach to derive the RSL assumptions for government bonds, sub-sovereign assets and residential and commercial real estate mortgage loans?

Based on the feedback received, this approach seems reasonable but more clarification on how the RSL assumptions are derived and how the existence of an active RMBS market in the countries is taken into account could be useful.

Question 6: Do you agree that the severe liquidity squeeze that can affect interbank markets in countries rated in the 'A' and 'BBB' categories is sufficiently addressed in the proposed RSL definition for both public-sector and mortgage cover pools?

Overall, the proposed approach seems reasonable taking into account such factors.

Question 7: Do you agree that the stressed RSL in the high investment-grade rating scenarios can exclude the credit risk premium spread across the assets' weighted average life, which is represented by the stressed credit loss that is taken into account separately in Fitch's cash flows modelling?

This approach seems reasonable as the stresses applied are high enough and in periods of stress the WAL is not the factor that will impact the credit risk premium spread as it is already taken into account in the levels.

Question 8: Do you agree that an extreme spike in spreads can be covered by a fire-sale discount applied on top of the stressed asset price calculating using the applicable RSL?

Based on the feedback received, this proposal seems feasible, but there is the concern that there could be a double penalty by taking high spreads and the fire sale discount on top of it.

Question 9: How do you view Fitch's more loss-driven approach to assessing recoveries given default, considering that a minimum OC of at least 0% will deliver above average recoveries compared with senior unsecured debt, in line with a one-notch recovery uplift?

Based on the feedback received, although the proposed approach seems reasonable, it seems unclear what exactly the changes are compared to the current approach, where a 2 -notch uplift is possible, as the information on the proposed changes regarding the recovery uplift could be viewed as vague. The members of the ECBC Rating Agency Approaches Working Group consider that neither the new approach nor the reasons for the changes are entirely comprehensible. Therefore, additional information in that regard could be helpful.

Question 10: Do you agree with Fitch considering that OC at least equal to the cover pool's stressed credit loss will deliver outstanding recoveries, in line with a two-notch recovery uplift (or three notches if the covered bonds tested rating on a PD basis is non-investment grade)?

Based on the feedback received, the proposed approach seems reasonable, but it seems unclear what exactly the changes are compared to the current approach, where a 2 -notch uplift is possible.