

ECBC Response to Fitch Ratings Request for Comment

“Rating Impact of Rating Agency Removal”

Brussels, 22 May 2015

The European Covered Bond Council (ECBC)¹ represents the covered bond industry, bringing together covered bond issuers, analysts, investment bankers, rating agencies and a 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 May 2015, the ECBC brings together over 100 members from more than 25 active covered bond jurisdictions representing over 95% of the EUR 2.6 trillion outstanding covered bonds.

The ECBC welcomes the opportunity to respond to the Request for Comment on “Rating Impact of Rating Agency Removal” launched by Fitch Ratings (Fitch) on 13 April 2015. The ECBC would also like to thank Fitch for their ongoing commitment to a constructive dialogue and would be more than willing to discuss this topic in more detail in the future if Fitch wishes to do so.

1. Introduction

The ECBC understands that the current Request for Comment serves the purpose of collecting feedback from market participants as to whether the introduction of Rating Agency Removal Language (RRL) should limit achievable ratings.

Once the RRL is applied, the issuer or sponsor has the power to remove a given rating agency, together with any related references included in the contractual provisions, provided that at least two other rating agencies are retained. This essentially provides the issuer or sponsor with the power to remove contractual obligations related to particular rating agencies from the legal documentation.

Following on from this, and considering the degree of impact of the proposed rating approach, the ECBC consulted with the members of the ECBC Rating Agency Approaches Working Group in order to collect their views on the matter.

2. General Comments

In general, upon a removal of a rating agency, any contractual provisions consistent with that agency's rating criteria are automatically removed from the related legal documentation. Essentially, as a result of this, the issuer or sponsor is provided with the option to remove contractual obligations that it considers to be related to the rating agency that has been taken out.

However, based on the exact wording that RRL uses together with the specificities of the particular transaction or programme, it may not always be evident that a particular provision has been removed.

3. Specific Comments

As outlined in Fitch's Request for Comment on the “Rating Impact of Rating Agency Removal”, the RRL is present in a limited number of structured finance transactions and covered bond programmes that are

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

being rated by this rating agency. Nevertheless, there is the possibility that new issuance from these programmes would be subject to the rating limitations that the RRL presents. Following on from this, Fitch asked a number of questions, to which the ECBC provides industry-specific feedback below.

Do respondents agree that RRL provides the issuer or sponsor with an option to avoid rating-related contractual obligations by removing a rating agency from a transaction, rather than complying with those contractual obligations, and that rating agency removal is more likely than in programmes or transactions where investor consent is required, when investors may not agree to such a change in all circumstances? If not, please explain your rationale.

The comments that the ECBC received from its members outline the understanding that the RRL may provide issuers with the option to avoid rating related contractual obligations. However, even without the RRL, the past years have proven that issuers have ample room to amend programme documentation without explicit investor consent, sometimes accepting higher over-collateralisation requirements. Generally, issuers will have their programmes rated by at least one rating agency, and in most cases more than one, as investors require at least one public rating and various regulations do still refer to ratings (ECB repo, LCR, CRR, Solvency II, etc.).

If yes, do respondents agree:

That the risk of rating migration for programmes or transactions containing RRL is greater than that for those that do not and that the difference in risk is significant enough for Fitch to factor this into its rating analysis by capping ratings? If not, please explain your rationale.

The risk of rating migration for programmes or transactions with RRL is not necessarily higher. This is the case due to the fact that for a given investor, the question whether a covered bond is rated is probably more relevant than the question by which rating agency or agencies it is rated. Hence, differences in rating agency related contractual obligations are probably of less relevance than whether a particular programme has the minimum required number of ratings and rating levels. Also, in legal documentation with the RRL, where one out of three rating agencies and its related contractual obligations are removed, it does not necessarily have consequences for the remaining second best or first best rating of a covered bond. Furthermore, Fitch investor survey published earlier this year shows that 66% of the investors only require covered bonds to be rated by one rating agency, while 32% of the investors require ratings by two rating agencies and 6% do not need a rating.

Therefore, we neither think it is needed nor significant enough to factor this into Fitch rating analysis and cap the rating as a result. Fitch should only indicate in its publications if certain wording and RRL are in line or not with the standard criteria and if there is a risk that the rating may be removed. Issuers will want to have some flexibility to decide themselves going forward which rater they want to have rating their programme and this may change over time (although very rare). Changes in rating agencies have mostly been driven by sudden changes in criteria of the rating agencies themselves (for example, Moody's in Denmark and Standard & Poor's changes in counterparty criteria).

With adopting a rating approach based on an assessment of the practical ability and likelihood of RRL being exercised in the determination of whether the rating will be capped? If not, please explain your rationale.

It could be considered that there are no strong arguments to include this rating agency removal risk explicitly in the rating approach. Ratings should be rather based upon to what extent the issuer currently meets all requirements deemed relevant by the rating agency to support the current covered bond rating. If any, it could be made more explicit in general to what extent there is room to weaken structural

provisions, i.e. what provisions could potentially be weakened without the investor's consent and under what circumstances.

Alternatively, do respondents think the risk of rating volatility resulting from the presence of a RRL clause is not material enough to be reflected in ratings and could be sufficiently addressed by disclosure of the risk in Fitch's rating communications (which might include rating sensitivity analysis regarding the exercise of RRL)? If so, please explain your rationale.

It could be said indeed that the presence of an RRL clause, does not, by itself, seem to be material enough to be reflected in ratings. Nevertheless, it could provide added value, if the presence of this risk is disclosed by Fitch, potentially supported by an analysis of the circumstances under which rating agency removal is more likely to occur. Furthermore, if Fitch, as a rating agency, is being removed from a covered bond programme, Fitch may also consider to publish in its announcement of such a removal a list of the contractual requirements that may potentially be weakened or removed from the programme documentation by the issuer as a consequence thereof, or outline if the rating by Fitch would have been affected if not withdrawn.