

ECBC Response to ESMA Call for Evidence

“Competition, Choice and Conflicts of Interest in the Credit Rating Industry”

Brussels, 30 March 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 March 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 Call for Evidence on “Competition, Choice and Conflicts of Interest in the Credit Rating Industry” launched by the European Securities and Markets Authority (ESMA) on 3 February 2015. The ECBC would also like to thank the ESMA 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 the ESMA wishes to do so.

1. Introduction

The ECBC understands that the current Call for Evidence serves the purpose of collecting feedback from market participants with regard to the functioning of the credit rating industry, as well as the market developments concerning structured finance instruments as required by Regulation 1060/2009 with regard to credit rating agencies (CRA Regulation) as amended since 2011. As a matter of background information, the CRA Regulation has the primary purpose of enhancing the integrity, transparency, responsibility, good governance and independence of credit rating activities in order to promote a higher quality of credit ratings, as well as higher levels of investor protection, whilst simultaneously stimulating competition between the various CRAs.

Following on from this, the various sections of the Call for Evidence were discussed with the members of the ECBC Rating Agencies Approaches Working Group and the feedback received from them is included in the paragraphs following next in the paper hereby. More specifically, and after having examined the subject matter of all the six sections of the Call for Evidence, the ECBC would like to focus its comments on one of them, namely Section 4 “Questions for corporate and sovereign issuers”. Essentially, the ECBC discusses two key points in its response, being i) the extension of disclosure requirements to other asset classes than securitisations (Questions 19-20) and ii) the extension of mandatory rotation of CRAs to other asset classes than re-securitisations (Question 23).

2. General Comments

Firstly, it should be noted that issuers of covered bonds both at national and international levels usually obtain at least one credit rating but often even two or three. The majority of banks that have covered

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

bond programmes also issue other capital instruments like senior unsecured bonds at national and international level. Moreover, they may also act as investors in bonds using credit ratings as one of the parameters for their investment decisions. Therefore, the investments of these banks vary from a pure national investment strategy to an international diversified investment horizon.

As far as due diligence practices and the use of credit ratings are concerned, decisions are made on the basis of an internal analysis (and for many banks on the basis of an internal rating as well). External ratings are nevertheless regularly used to make plausibility checks and for comparison purposes. More specifically and with regard to the assessment of the quality of credit ratings, issuers usually use the rating reports of the CRAs and their own rating reviews which are based on official sources such as annual report, budgets, plans, etc. Besides that, ratings are important as they are referred to in various regulatory texts, e.g. in the liquidity coverage requirement (LCR) or in Basel Committee publications, and can determine the capital weights and LCR levels for example.

3. Specific Comments²

Question 19: Please explain whether you would welcome an obligation for issuers to disclose details of the credit quality and preference of other financial credit products in addition to those foreseen by Article 8b of the CRA Regulation, giving reasons for your answer. If so, please explain to which products this obligation should be extended. (page 12)

The feedback received from ECBC members indicates that there is no need to extend the obligation to other financial credit products in addition to all those specified in the abovementioned legal provision. In fact, this subject is either already dealt with in other regulations or is currently being discussed, for instance, with regard to simple, standardised and transparent securitisations and a potential harmonisation of covered bonds. Given the aim to reduce the reliance on external ratings, transparency requirements should not be part of the CRA Regulation.

Additionally there is not much clarity with regard to how and if the disclosure requirements will be used by investors. Due to the fact that covered bonds are first of all bank bonds, where investors have a dual recourse claim, the benefit of an extension are not expected to compensate for the potential additional costs.

Another important aspect to point out relates to the issue of loan-by-loan information, which is not necessarily more helpful for investors than stratified data especially for large granular cover pools. In spite of the potential technical possibility to carry it out, the data are hard to analyse for investors given the size of cover pools as some of them might exceed 600,000 loans. In particular, covered bonds differ from securitisation as the cover pools are dynamic and evolve over time. In addition to the challenges that analysis such large datasets if loan by loan were to be expanded to other asset classes, providing loan-by-loan information could also pose a problem of data comparability between two analysed periods given the dynamic nature of the cover pool.

It should also be noted that the covered bond industry has made substantial efforts to increase transparency through the Covered Bond Label initiative. This initiative, undertaken by the issuer community, was based on an intense and constructive dialogue with the investor community, major national and European authorities, as well as the main law firms active in the covered bond arena who have supported and followed the creation of the Covered Bond Label Foundation and its website. In its

² Please note that the comments provided in this chapter refer to Section 4 of the ESMA's Call for Evidence.

essence, the Covered Bond Label aims at providing in one place detailed covered bond market data, comparable cover pool information and legislative details on the various national legal frameworks designed to protect bondholders.

This transparency tool presents very detailed asset and liability information and facilitates the investors' due diligence when comparing different issuer models, products in different markets and national supervision. This initiative provides a framework for more harmonised and transparent disclosure of cover pool data. Moreover, it has delivered to investors enhanced information disclosures, allowing them to better and more easily assess the cover pools.

Therefore, for all the above mentioned reasons, our feedback would be that article 8b should not be extended in its application to covered bonds.

Question 20: Please provide an estimate of the likely costs to your business of complying with Article 8b as currently formulated, and in the event that it were to be extended to the other instruments listed in your answer to question 19 above. (page 12)

Fulfilling credit rating agencies requirements and complying with all regulatory reporting duties is increasingly burdensome and has already resulted in increased operational and external costs. Based on the loan level data foreseen in the ESMA's draft RTS from June 2014, these costs would increase dramatically, if they were extended to the extremely large dynamic granular cover pools. As already mentioned, covered bonds are first of all bank bonds and, therefore, given that the investor has a dual recourse claim, the benefit of an extension would not compensate for the additional costs.

Question 23: Please explain whether mandatory rotation should be extended to other asset classes. If so, please:

- (1) list the asset classes to be covered and state the appropriate contract length for each;*
- (2) estimate the cost to your business of complying with the extension to each additional asset covered in your response to question 23(1) above;*
- (3) explain whether, and if so why an obligation should be introduced for CRAs to provide a handover file to the incoming CRA at the end of the maximum contract term. (page 13)*

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As stated in the past, the ECBC does not consider such a requirement to be appropriate or necessary for the covered bond market. First and foremost, further (mandatory) rotation would likely increase uncertainty and rating volatility. This would, however, not be due to the emergence of new credit risk information but rather because of the change in the rating agency. Indeed, the rotation process does not seem to take into account that rating methodologies are sophisticated and that changing from one rating agency to another with a distinct methodology could affect the rating as well purely driven by rotation of the rating agency. This is not in the interest of any market participant.

Furthermore, as a consequence of such imposed changes in the rating agency, the performance measurement of the rating agencies and/or the credit ratings would no longer be possible. The benefit of the central repository to provide historical performance data would be thwarted and the informational value of the planned EURIX rating index would suffer due to the constant change in rating agencies and the associated credit ratings. In addition, the lack of medium/long-term relationship between the credit rating agency and the issuer could potentially damage the quality of the rating as it might not allow agencies to properly understand the issuer and its industry.

Moreover, any potential amendments may have negative consequences for the investors. The latter have a substantial interest in the continuous and consistent credit rating of the issue they intend to invest in. Therefore, frequent rotation of rating agencies counteracts this interest and may keep globally active investors out of the European market, thus resulting in a serious competitive disadvantage for European issuers.

In addition, the rising costs for the issuers as well as the investors should not be underestimated. There is the likelihood that in the future, investors and issuers will repeatedly have to familiarise themselves with new rating methodologies, pay for additional subscriptions and ratings. Analysis of the sometimes complex methods and models requires time and human resources. Nevertheless, investors inevitably must carry out such analysis as ratings represent, although not a sufficient, but no doubt a necessary condition for any investment.

With regard to the assumed conflict of interest, the mandatory rotation of the primary analyst and the Chinese walls between analysts and commercial and business development teams should already address this adequately.

The increasing number of ECAIs can be seen as an indication for increasing competition, even though there is still a way to go. As a result, it could be inferred that there is no need for extending the mandatory rotation to other asset classes, also as rotation may have a negative effect on the quality of ratings, we would suggest the ESMA to investigate further how easy it is for issuers to change rating agency as in some cases it turned out to be almost impossible to have a rating withdrawn in practice.