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Submitted by email

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Dear Sir or Madam

RE: DISCUSSION PAPER ON CRA3 IMPLEMENTATION

Nationwide Building Society including its subsidiaries and regional brands ('Nationwide') welcomes the opportunity to respond to the discussion paper (DP) published by the European Securities and Markets Authority (ESMA) on CRA Implementation.

Nationwide is the UK's third largest mortgage lender and second largest high street deposit-taker, with circa. £190 billion in assets. Nationwide is a market leader in providing banking services but we are not a bank – we are a mutual building society – the largest of its kind in the UK. Unlike banks that are run for the benefit of their shareholders and to maximise profit, we are owned by and run for the benefit of our 15 million members – which comprise our retail savings and mortgage customers. As such we are unique in UK retail financial services, providing a mass-market credible alternative to the plc banks and focusing on long-term, transparent customer relationships. Whilst our core business is residential mortgage lending funded by retail deposits, we are a full service personal finance provider, offering current accounts, personal loans, credit cards, investments and insurance. We continue to diversify our product and service proposition – growing our banking market share and exploring ways to bring our brand to new areas.

The principles on which we are run are fundamentally different to those of our plc peers – we exist to deliver value to our member customers and we are accountable to them. There is no divergence between customer and shareholder needs because they are one and the same. Without the need to meet shareholder demand for short-term returns, we are able to optimise profit – rather than maximise profit – to deliver member value over the longer term through improved pricing and market-leading customer service. This results in a lower risk appetite and profile than our peers that has meant we have remained safe and secure throughout the financial crisis with capital and liquidity ratios amongst the highest in our peer group.

A strong building society sector in the UK, led by mass market mutuals such as Nationwide, provides a competitive alternative to the big plc banks for consumers. In the financial year ending 4 April 2013, Nationwide advanced £21.5bn of mortgages, an increase of 17% on the previous year. Our net mortgage lending was up 140% at £6.5bn, equivalent to 108% of total market growth and we provided almost one in five of all first time buyer mortgages, helping 42,000 first time buyers into their first home.

Nationwide is both an investor in and originator of Structured Finance Instruments (SFIs). We target circa 25% of our funding from wholesale markets, meaning that efficient access to secured funding is critical to our lending activities in the real economy. We also maintain a non-core portfolio comprising available for sale assets (approx £4.4bn at year end) as part of our normal treasury operations which includes investments in SFIs. As an issuer, Nationwide has been sponsoring a UK RMBS Master Trust since 2008. Our only motivation in operating this securitisation programme is funding. The programme solely distributes AAA rated securities, and the pool underlying the programme is a random selection of eligible prime UK 1st charge mortgages. All of the economic risk and reward of the programme remains substantially with Nationwide, and we have neither sought nor been granted any regulatory capital relief from the underlying assets which remain on our regulatory balance sheet.

Section II of the DP focuses on article 8b (information on structured finance instruments) of the CRA Regulation. This is the subject of an extensive response from the Association for Financial Markets in Europe (AFME) dated 9 October 2013. We have contributed to that response and do not propose to expand on it in this letter beyond making a few general remarks. Since 2008, the securitisation industry as a whole has made great strides in improving the quantity and quality of the information made available to investors. The information now available for mortgage backed SFIs is quite extensive and compares very favourably with other asset classes and investments e.g. covered bonds. There are now a number of disclosure regimes operating in parallel and Nationwide in common with other originators of SFIs is an active participant in and supporter of a number of initiatives. For example, we now publish loan-level data on a third party provided website to meet Bank of England requirements and via the European Data Warehouse to meet ECB requirements. Nationwide is also a founding and funding member of the Prime Collateralised Securities Initiative. Our overall message with regard to article 8b is that we would recommend that ESMA review the new disclosure regimes that originators now comply with and take these into account when formulating what is permissible for the purposes of satisfying the CRA regulation.

In the attached paper, we wish to provide feedback on section III of the DP which concerns the European Rating Platform. In particular, we have focused on the issue of the specific categories of credit ratings and rating types that CRAs issue or could issue and what might be displayed on the ERP. Internal discussions regarding ratings have lead us to explore the possibilities of seeking simplified ratings for securitisation. As the same concept might prove useful in fulfilling some of the aims of CRA3, we have provided an outline of our thinking in the attached paper.

We would encourage ESMA to follow up on the matters raised in the AFME response and in this letter and would welcome the opportunity to assist you any further on this matter.

Yours faithfully

Andy Townsend
Treasurer

Enclosures/1

ESMA Discussion Paper on CRA3 Implementation: Nationwide Paper on New Rating Types

Introduction

In its discussion paper dated 10/07/13, ESMA invites comments to facilitate the drafting of Regulatory Technical Standards (RTS) pursuant to the CRA Regulation. There are three main sections seeking feedback on:

1. Draft RTS on information on structured finance instruments – Section II
2. Draft RTS on the European Rating Platform – Section III
3. Draft RTS on fees charged by CRAs to their clients – Section IV

Section II relates to disclosure requirements and is the subject of an extensive response from the Association for Financial Markets in Europe (AFME).

This paper focuses on section III which is concerned with achieving the overarching aims of CRA3 through creating RTS for the European Rating Platform.

Executive Summary

- Current market practice in the rating of Structured Finance Instruments (SFIs) employs bundled ratings where the rating of the bonds is linked through complicated criteria to the rating of the counterparty and sovereign.
- The experience of the crisis has exposed the shortcomings of the bundled rating approach in the form of ratings volatility, ratings becoming de-linked from primary credit performance and increased transaction inefficiency.
- This in turn has lead to a situation where investors are already doing the work to look beyond what bundled ratings on SFIs are telling them and often discount counterparty and sovereign side-effects, unbundling these strands in their analysis.
- We propose that ESMA consider publication of “Simple SF Ratings” on the ERP alongside the usual “bundled” ratings for SFIs to introduce the Simple SF Rating as a legitimate option in the market and stimulate market evolution
- Introducing a Simple SF Rating would simply give tangible expression to a thought process that is already happening in practice. By initiating publication of Simple SF Ratings, the ERP could add value by furnishing market participants with an additional tool to shorten the work.
- This would create conditions which could enable the market to adopt Simple SF Ratings in preference to bundled ratings for certain purposes if investors and participants deem this desirable as it provides an additional option which is available to be positively selected by investors or originators via normal market forces
- This would also introduce the Simple SF Rating as an additional option to consider for legislators calibrating regulations which refer to credit elements e.g. capital requirements for SFIs as well as internal credit departments, Central Banks and other market participants.

- This in turn could pave the way to increase simplicity, transparency and consistency in the SFI market, improving the position of investors and stimulating issuance of SFIs, hence contributing to sustainable growth.

Simple SF Ratings – Summary of key points

Features

A Simple SF Rating would:

- use exactly the same methodology as the current bundled ratings product offered by CRAs except that the dependence of the rating on counterparty and sovereign criteria would be removed
- give primary emphasis to the quality of the collateral and the credit enhancement structure which creates the investment's exposure to the collateral
- perform simplified checks regarding other risks i.e. checks that appropriate hedging, liquidity facility, account bank etc are in place but otherwise exclude the effects of the credit ratings of counterparties and the sovereign by assuming they are sufficiently rated
- be assessed on a fixed criteria basis i.e. criteria prevailing at the date the securities were issued and the rating first assigned apply for life
- be published in addition to a normal bundled rating, where adopted by issuers.

Benefits

1. Furthers the aims of CRA3 by: giving investors an additional rating tool, stimulating market evolution and participants' consideration of simplified securitisation rating process, reinforcing competition between CRAs by providing a simpler, primary rating tool which facilitates the assignment of unsolicited credit ratings
2. Promotes simplicity & transparency by giving market participants a simplified rating tool
3. Reduces ratings volatility in SFIs since Simple SF Ratings would follow "true" credit performance
4. Alleviates retrospective rating volatility and unpredictability due to re-ratings solely driven by criteria changes
5. Creates a rating which signals performance of the main credit component underpinning a transaction
6. Reduces ratings-driven sales due to downgrades which are not collateral related
7. Reduces price & mark-to-market volatility
8. Clearly identifies high-quality SFIs, reinforcing this investment in the eyes of investors, thereby encouraging investment in high quality SFIs as a source of funding to the real economy
9. Limits the effect of sovereign contagion via downgrades and ratings caps which can act as a brake on the market in countries such as Portugal Ireland Italy, Spain and Greece as well as new EU entrants

10. If widely adopted as the preferred indicator to bundled ratings, could reduce unnecessary costs in wholesale funding, costly restructurings, amendments and consent solicitations
11. If widely adopted as the preferred indicator to bundled ratings, could lead to removal/simplification of penal counterparty criteria e.g. volatility buffers or cash limits, reducing the need to regularly amend due to assumption that counterparty keeps requisite rating or is replaced by eligible party with requisite rating.

Feasibility

1. Assigning a Simple SF Rating would require little change to CRAs existing processes, since it would involve subtracting elements from CRAs existing analysis rather than re-writing it;
2. In preliminary discussions between the industry via PCS both S&P and Moody's indicated that they were open to providing a form of collateral-only rating which is similar to the Simple SF Rating envisaged.

Paper on New Rating Types: Simple SF Ratings

Introduction

The CRA 3 regulation aims at:

1. improving investors' ability to make informed assessments on the creditworthiness of SFIs by way of sufficient information on those instruments and the assets backing those SFIs.
2. enabling investors to reduce their reliance on external credit ratings
3. reinforcing the competition between CRAs and facilitating the assignment of unsolicited credit ratings.

ESMA will set up a central website called the European Rating Platform (ERP) on which all rating information will be displayed with the aim of helping investors in their decision making, contributing to investor protection and improving the visibility of smaller CRAs.

Simplifying SFI Ratings

We think that one of the best ways to reduce the reliance of investors and indeed the wider market's over-reliance on external credit ratings for SFIs is to reduce the complexity of rating criteria. We acknowledge that ESMA and other European authorities are not currently in a position to prescribe rating criteria or legislate for specific changes to rating criteria. Aside from the technical challenges involved, it is probably not appropriate to impose specific criteria on CRAs as this would be in effect making requirements for how it should do business. However, it should be possible to put forward via RTS options that will give market participants the room to move toward simpler criteria if this is desirable. In absence of a fundamental simplification in the nature of SFI ratings we think that the goals of improving transparency and stimulating greater competition in the market may be difficult to achieve.

Bundled ratings

At present, the rating given to securities in a securitisation is a "bundled" rating which takes into account the effect of various counterparties' credit quality on the credit standing of the securities as well as that of the sovereign. The problem with this approach is that it bundles the credit effects of several elements in with the quality of the collateral supporting the SFIs and the credit support provided by the deal structure[1]. The bundled approach typically introduces complicated rules into the transaction about how the securities rating is linked to the credit quality of e.g. the account bank and the swap counterparty and sets complicated and costly rules and

[1] The credit enhancement supporting the structure and the soundness of the legal arrangements that enable the SFIs to be paid from the collateral cashflows, can be viewed as forming part of the collateral side of the structure.

documentary requirements that need to be followed in order to achieve that rating. These counterparty requirements are determined by a separate regime of complicated counterparty criteria. Each rating agency has its own unique criteria in this area and this criteria is subject to change at any time.

As a result, either 1) a change in the credit status of any one counterparty or 2) a unilateral change in the counterparty criteria by a given rating agency can cause the rating of an SFI to change. This can take place even though the quality of the main credit exposure underlying the transaction has not changed. This can lead to disproportionate effects in a stressed environment e.g. forced sales. The original purpose of counterparty criteria was to protect the credit quality of the SFT securities by ensuring that the counterparties to the transactions met a certain credit standing. In practice, as the financial crisis evolved, it has become increasingly apparent that bundled ratings can produce unforeseen and unsatisfactory results. The value of investors knowing the rating and the credit standing of each of the counterparties connected to the transaction is clear. If all cash in a transaction is channelled via an unrated offshore bank this is relevant information. Yet this is information that an investor is a) already aware of and b) well-placed to assess independently, in conjunction with other relevant considerations. By contrast, the value of a bundled rating and the abstruse criteria that go with it is open to question. In the context of SFTs, by far the most obvious way to simplify the ratings is to reduce the importance of or remove some of the elements which comprise bundled ratings.

Counterparty driven downgrades

Investors' experience of counterparty driven downgrades during the crisis illustrates the disadvantages of bundled ratings.As the crisis unfolded, many financial institutions were downgraded as their credit standing deteriorated. Securitisations where the underlying cashflows come from the originator's consumer customers - e.g. mortgage securitisations - are often set up so that the originator remains in place as the "account bank" for the transaction. This minimises disruption to both the customer and the bank, since the customer usually repays the loan by transferring funds into its account with the originator bank. The same is true of the securitisation "servicing" – the role of managing and collecting cash from customers: this often remains with the originating bank also.

When institutions were downgraded during the crisis, this created a situation where the criteria required the account bank and/or servicer to be replaced because they no longer met the counterparty requirements, unless noteholders approved otherwise. In practice, investors often voted to retain the originator bank in place as the account bank because they were best placed to collect funds from their own customers, notwithstanding their deteriorated rating. Where the account bank/servicer was downgraded, investors were required to make their own assessment of the linkage between the SFIs and the counterparty and weigh the relative importance of the rating downgrade against the practical consideration of who was best placed to get their money back.

Thus when the scenarios that the counterparty criteria where designed to mitigate materialised, investors had to rely on their own judgement and were effectively required to unpack bundled ratings as part of their analysis. Investors were required to first determine which element was of primary importance and would typically prioritise the collateral and the nature of their investment in that collateral. Investors would then have to form an independent view of the credit status of that primary credit, using amongst other things, CRAs press releases to work out if the downgraded bundled rating was implying a fundamental deterioriation in the collateral.

Costly rating driven restructurings

The disadvantages of bundled ratings and at times arbitrary nature of rating agency counterparty criteria is also illustrated by the industry restructurings of 2011 and the evolution of S&P's criteria that year. In December 2010, S&P changed its existing counterparty criteria 1) introducing conservative limits affecting how cash is permitted to be held in transactions and 2) requiring additional cash to be posted to cover the costs associated with a potential default of the swap counterparty. In many cases, implementing new restrictive criteria which were not in existence at the time the deals were structured and established would have made the transactions inefficient and many market participants chose to remove S&P from existing and new transactions as a result.[2]

In the case of master trust mortgage securitisations in the UK, which were responsible for the majority of securitised mortgage funding in the UK at that time, in order maintain the current S&P ratings, many originators were forced to restructure their programmes in costly projects that spanned many months culminating in investors being required to vote on the amendments proposed. In Nationwide's case the intial changes required large cash balances of approx £500mn to be exported to another institution until the restructures were completed.

Having observed the consequences and reception of its criteria change, S&P then modified its criteria again in May 2012, in part mitigating some of the effects of the initial changes.

Alternative approach to rating SFIs

In our view, an alternative to bundled ratings should be possible and we think that it would benefit the SFI market to explore such alternatives. Our views are developed further below.

Q21: Particularly for users of ratings: Taking into consideration the rating classification described above, could you suggest (including a detailed reason):

a. other rating types not captured in the above categorisation;
b. which rating categories or rating components should ERP cover;
c. other actions or events affecting the ratings, that should be published on the ERP.

[2] While on the face of it this might look like a healthy example of market forces at work, the reality is that this left market participants and investors even more dependent on the remaining two leading agencies, Moody's and Fitch.

In relation to a and b above, we think the ERP should publish Simple SF Ratings for SFIs.

Simple SF Ratings: features

Naturally, the exact specifications of a Simple SF Rating would be the subject of further work, but in our view a Simple SF Rating should comprise the following features:

1. The review process for assigning a Simple SF Rating would be the same as that of a bundled rating with the key difference that the dependency on a) counterparty ratings and b) sovereign ratings would be removed.
2. This would enable the Simple SF Rating to give primary focus to the quality of the collateral underlying the SFIs and the credit enhancement and structure which creates that investment's exposure to the collateral[3]. It would thus better isolate the primary credit feature of the transaction, indicating its credit quality.
3. Aside from the simplified approach to counterparty and sovereign effects, a Simple SF Rating would take into account all of the issues that the CRAs normally take into account when assigning a bundled ratings i.e. the way the CRA reviews the collateral, credit enhancement, legal framework and other structural features would remain the same.
4. The interest rate and currency risks that would normally be managed via hedging would not be entirely ignored: the assigning CRA would still check whether the risks were hedged and that the issuer was required to maintain a hedge in place. The same would apply for other forms of structural support liquidity facilities, bank accounts etc. i.e. the CRA would confirm that the primary risk was addressed structurally, however the secondary credit risk of the counterparty would be excluded.
5. To remove counterparty and sovereign credit effects, the CRA would assume that the credit rating of the counterparty was at an adequate level to support the collateral rating and assume that any replacement counterpart met the same requirement.

We also think that ideally, a Simple SF Rating should represent the rating as of the date of issuance and should be assigned on fixed criteria basis i.e. every time it is periodically reported in future, the deal rating should continue to apply the same rating methodology that was in force at the date the SFIs were first issued to investors and the rating first assigned. The rationale for this is explained further below.

Simple SF Ratings: benefits

In principle, we think that Simple SF Ratings could offer the following advantages. Naturally, to view some of these advantages we have to imagine a world in which a) the industry has worked together with CRAs to agree the details about what form

[3] This necessarily takes into account the soundness of the legal and operational structure which creates the investment: its credit enhancement, cashflows etc.

Simple SF Ratings should take and b) Simple SF Ratings gain acceptance amongst the investor community as the primary indicator of SFI credit quality.

Furthering the aims of CRA3

We consider that the existence of a Simple SF Rating for SFIs could lead to a number of benefits as it would:

1. improve investors' ability to make informed assessments on the creditworthiness of SFIs by giving them an additional rating tool;
2. open up the way for investors and originators to choose to create and invest in simplified securitisation structures where, as an alternative to relying on bundled ratings, the investor uses the Simple SF Rating in conjunction with existing public information (including counterparty's ratings) to make informed assessments of creditworthiness of SFIs;
3. reinforce competition between CRAs and facilitate the assignment of unsolicited credit ratings, by providing a simpler, primary rating tool which new and/or unassigned CRAs could offer instead of or in addition to complicated bundled ratings. This could reduce the time to market for new CRAs as well as expanding the range of options on which existing CRAs can compete for business.

Promoting simplicity & transparency

We think that publication of Simple SF Ratings could also promote simplicity, transparency and standardisation in the SFI market. By increasing and diversifying the number of options available to market participants, the presence of an additional rating type like Simple SF Ratings via the ERP could help stimulate positive change by equipping market participants with more options to explore and adopt in the course of their usual market behaviour. The presence of Simple SF Ratings on the ERP could facilitate dialogue between originators and investors about the possibility of simplified structures and alternative rating types.

Reducing rating volatility in SFIs.

During the crisis, many European SFIs were downgraded due to the downgrades of the relevant swap counterparties that provided the swaps on the transaction. As an investor in SFIs as part of its Treasury operations, Nationwide observed multiple downgrades resulting purely from swap counterparty issues, which were later followed in some cases by upgrades. Whenever counterparty downgrades occurred an exercise was required to determine whether the downgrade was a "true" downgrade that signalled a deterioration in collateral that threatened prospects of being repaid and thus required action in the form of disposal, impairments etc or whether the downgrade reflected the secondary elements of a change in the credit status of the counterparty. Additionally, where counterparty downgrades breached the hard-coded limits required to maintain the bundled ratings, Nationwide often participated in investor meetings where investors were required to vote on whether to keep the downgraded counterparty in place and lower the rating limit. Nationwide alongside other investors would make an independent assessment of the situation weighing the swap provider/originators credit standing and commitment to the programme against the costs of replacing the counterparty. At Nationwide, we do not recall participating in a single vote where investors chose to force the replacement of the downgraded swap counterparty with a new counterparty with the required ratings. In addition, we cannot recall Nationwide taking any action by way of disposal following downgrades associated with counterparty risk.

The rating volatility created by bundled ratings with hard coded rating criteria has a number of practical consequences. Investors whose investment criteria include minimum ratings (e.g. a AAA fund) may be forced to sell on a downgrade crystallising a loss, notwithstanding that the performance of the underlying assets might not have merited it. For bank investors downgrades can result in higher capital being required to be held against the SFI exposures even though the quality of the underlying collateral has not changed.

Reducing "retrospective" volatility due to unilateral criteria changes

Rating downgrades can also be driven by changes to rating criteria, either in the counterparty criteria and collateral criteria or by changes in credit conditions.

For example, on 12 April 2011 S&P placed the ratings of 2005 structured finance securities in 975 transactions on CreditWatch negative. The move followed S&P's assessment of counterparty risks and the deterioration in creditworthiness of some financial institutions. This amounted to 30% of outstanding Europe, Middle East and Africa structured finance transactions that they rated. A further 225 transactions would have been affected had "credible action plans" not been submitted regarding steps to mitigate the rating actions. According to S&P 1090 ratings in 511 transactions were subsequently lowered by an average of 2.9 notches. Downgrades were concentrated toward the top of transaction capital structures, especially among tranches previously rated in the 'AAA' and 'AA' categories.[4] At this time Paragon was a programme that Nationwide had been investing in and notes which were previously AAA in Paragon 7, 8, and 13 were all downgraded.

Changes CRAs make to collateral rating criteria can also drive ratings downgrades. The crisis caused the CRAs to revisit their ratings approach to different types of collateral and produce new more conservative criteria for collateral. For example a mortgage securitisation that achieved a AAA rating when it was issued in 2006 may not have achieved it if it were issued using the new revised criteria. Once the new rating agency criteria were published however, that mortgage securitisation would face having to make amendments to the structure or be downgraded.[5]

It seems inappropriate that a SFI may be issued one day with a AAA rating and be downgraded the next month if the rating agency changes its criteria even though there has been no change to the collateral or deal structure. The absence of a link between a SFI rating on the one hand and the original date that rating was issued and in particular the criteria prevailing at the time on which that rating was based seems to be unsatisfactory and encourage confusion about what a rating actually signifies.

[4] 2010 Counterparty Criteria—What Happened Next For Global Structured Finance Ratings?, Standard & Poors, July 2011.

[5] E.g. see http://www.housingwire.com/articles/fitch-places-rmbs-deals-ratings-watch.

If a sub-prime security was issued with a AAA rating and sold to investors on that basis, it seems to be of limited value to permit that security to be downgraded to junk status some years later when that rating agency's criteria changes. Downgrades due to collateral performance would of course continue to be a take place when relevant. But to mix downgrades which are solely due to changed criteria with downgrades due to collateral performance, mixes the causal factors which contribute to the rating, creating ambiguity about what the revised rating is telling users. This mixing makes a given rating harder to read, reducing transparency. Thus in practice, investors in SFIs have to do additional work to interpret and assess every downgrade. Additionally, changes of rating criteria occur at the relevant CRA's discretion and are thus unpredictable.

In addition to reducing transparency, predictability and stability of ratings, this also reduces the ability of investors to assess the true value of the original rating that was in place when the investment was made. By extension it also reduces accountability of rating agencies and hence the ability for new entrants to compete. For this reason, it makes sense that Simple SF Ratings should be assigned on a fixed criteria basis i.e. the criteria that were in force at the date the SFI was issued and the rating first applied. The Simple SF Rating would only change in future if serious collateral or structural issues materialised in the course of the transactions life which meant that when using the original rating criteria, the original rating was no longer accurate and had to be downgraded.

Signalling "true" collateral performance

The volatility and unpredictability of bundled ratings means that they can move out of step with the true performance of the main credit component of the relevant SFIs: the underlying assets and the structure which creates the investment. Senior European high quality SFIs have proven to be reliable investments throughout the crisis and have demonstrated solid performance with zero losses – see Appendix 1. Yet the volatility of the bundled ratings assigned to these investments over the same period actually masks this exemplary performance. Publication of Simple SF Ratings would redress the balance by making quality deal structures with high quality and well performing collateral clearly visible.

Reinforcement and encouragement of high quality securitisation

By providing a clear sign of collateral quality, publication of Simple SF Ratings would also clearly identify high-quality SFIs and reinforce this investment in the eyes of investors, thereby encouraging investment in high quality SFIs as a source of funding to the real economy. At present, the continued existence of high quality securitisation in Europe as a key source of funding is under threat largely due to the damage to the reputation of European securitisations caused by the poor performance of US sub-prime securitisation products. This has affected the reputation of European SFIs in the eyes of regulators, policy makers and investors and in turn created further obstacles to revival. Yet as mentioned above, this tarnished reputation does not reflect the true performance of European SFIs. Prior to the financial crisis, European securitisation provided around €450bn to the European economy. Following the crisis the market has shrunk to €85bn placed with investors last year[6]. At the recent AFME Conference "Financing Growth: Capital Markets, Investment and the Economy", it was common ground amongst regulators, central bankers and investors alike that the revival of European securitisation is critical for restoring sustainable wholesale funding and promoting growth in the European economy. The introduction of Simple SF Ratings could help restore the reputation of European SFIs, promoting confidence and inward investment into Europe.

Limiting sovereign contagion

In addition to counterparty downgrades, one problem affecting the revival of high quality securitisation in Europe has been the issue of sovereign ratings downgrades especially in periphery member states. In bundled ratings, lowered sovereign ratings can result in a ceiling on the rating that a high quality SFI can achieve – with underlying assets that might normally have achieved a AAA rating being limited to a lower rating because of the complicated linkage between the sovereign and the transaction. In addition to introducing ratings caps, as with counterparty contagion, sovereign contagion can induce a high quality SFIs that might have been AAA one day to become downgraded on another day even though there has been no change to the quality of the main substance of the transaction. Downgrades and ratings ceilings can in turn discourage investment in such SFIs and act as a brake on the market in countries such as Portugal, Ireland, Italy, Spain, and Greece as well as new EU entrants.

Removing unnecessary transaction costs

If Simple SF Ratings ultimately gain acceptance amongst investors as the primary rating indicator in preference to bundled ratings, this could remove a layer of unnecessary costs from the system. We have referred above to restructurings and amendments of SFI transactions where the driver was idiosyncratic criteria changes. Such restructurings and amendments are typically large projects which involve the deal trustee, multiple transaction parties as well as legal and investment bank advisers with the costs running to hundreds of thousands or even millions of pounds. These costs often are recovered from the structure itself via the transaction "waterfall" and deplete the funds that ultimately provide credit protection to investors. Where the costs are absorbed in part or in whole by the originator as junior noteholder or arranger, they represent an increase in the cost of wholesale funding that may ultimately be passed on to consumers. When noteholder votes are required, the costs are dramatically increased due to the protracted noteholder consent solicitation process required which entails additional logistical challenges e.g. the appointment of a tabulation agent is often required to distribute information and co-ordinate the noteholder voting processes. In this respect, it is not an exaggeration to say that the idiosyncrasies of and unilateral changes to CRAs' rating methodologies has created an industry in itself.

[6] Association of Financial Markets Europe.

Enabling "Simple hedging"

One of the key advantages of Simple SF Ratings could be to remove penal counterparty rating criteria and enable originators and arrangers to create structures which employ "simple hedging" as opposed to the complicated arrangements which are required by current rating criteria. By removing considerations that make wholesale funding transactions inefficient and costly for financial institutions, Simple SF Ratings could reinforce SFIs as a sustainable source of funding, paving the way to increased lending to the real economy.

Naturally significant work is required to establish the details of what "simple hedging" entails. However, in principle, if a Simple SF Rating involves checking that hedging is in place and then assumes that the counterparty and replacement counterparty are of adequate credit quality, it is possible to simplify the terms on which SFI hedging is made. For instance, structures could return to the simpler collateral margining that existed prior to complicated criteria changes. Adopting simple hedging would encourage greater disclosure about swap terms and encourage investors to pay closer attention to the detail of the exact terms of the swaps, something which in theory they are able to do already but which in practice is burdensome and fraught with difficulty because of the complicated nature of the documentation and swap criteria, which differs for each agency. Moreover, if Simple SF Ratings encourage transactions where the hedging is struck on simplified, more standardised terms, this would actually enhance the protection to the SFIs by making the derivatives easier to replace in a default scenario.

Reducing ratings driven sales and systemic instability

Ratings downgrades of SFIs can also lead to losses arising from forced sales, the depletion of bank capital and a ripple effect throughout the system as the impact of these events is passed on to other market users, governments and consumers. Rating downgrades can thus accelerate or exacerbate negative outcomes arising from stresses which appear in the economy. Five years on from the crisis, one of the negative outcomes that persists is the reduced market for securitisation in Europe, with central banks providing some of the funding that would have been provided by securitisation. While the disadvantages of bundled ratings are clearly not the cause of reduced levels of securitisation in Europe, they arguably contributed to its contraction as well as prevent bundled ratings from encouraging its revival.

Sales can be "forced" upon an investor where an investor's investment mandate is tied to certain rating thresholds and the SFI loses that rating. In addition, firms that apply the Foundational IRB approach like Nationwide, can be driven to making sales where they might otherwise would not. For example, Nationwide has in the past invested in US student loan SFIs. When a split rating arose where the SFI was AAA with one agency and B with another, application of the Foundation IRB as required for capital purposes resulted in Nationwide having to set the capital requirement according to the second highest rating, in this case B. As this resulted in a large increase in capital required, it became more economical to sell the SFI at a loss, rather than hold it. This is also despite the fact that the internal assessment of the credit risk might be better than the second highest rating suggests. The presence of additional Simple SF Ratings for ABS might provide options for regulators that could prevent or mitigate this outcome if Simple SF Ratings are ultimately recognised and taken into account for capital purposes.

Reducing price and mark-to-market volatility

Rating downgrades can give rise to price fluctuations affecting the mark-to-market value at which a firm holds an SFI. We expect that this price volatility can have a significant impact on firms using mark-to-market accounting. At Nationwide accounting treatment due to be come into force shortly will mean that price volatility in SFIs could have a significant effect the group’s profit and loss statement. We thus welcome any initiative that mitigates or reduces price volatility.

Feasibility in practice

One argument in favour of publication of Simple SF Ratings is its feasibility: it is something that ratings agencies largely already do. Arriving at assessment of the credit quality of the collateral and the credit structure support the SFIs is something a rating agency must do in the course of assign a bundled rating. Publishing Simple SF Ratings simply aims at requiring CRAs to articulate on paper what is already largely an unspoken part of the process.

We envisage that one form a Simple SF Rating could take is that of a rating with assumptions. The principle behind such a rating is that rating agency would be asked to confirm the ratings of a SFI assuming that the rating of the transaction counterparties and sovereign meets the requisite ratings requirements. “Requisite ratings requirements” in this context refers to the rating level and documentary requirements that enable the SFI to achieve the highest rating that can be achieved given the collateral and structure. The exact detail and wording of this would of course require further work, but it is worth noting that in preliminary discussions with SFI initiative Prime Collateralised Securities both S&P and Moody’s indicated that they were open to providing a form of collateral-only rating which is similar in concept to the Simple SF Rating discussed here.

Once the definition of a Simple SF Rating is settled, we envisage that it would be a fairly simple exercise to incorporate the additional rating confirmation in the transaction process. Originators could ask CRAs to provide a Simple SF Rating alongside the usual bundled rating when issuing the rating letter and presale report for given SFIs.

Conclusion

We regard the publication of Simple SF Ratings alongside the usual bundled ratings would provide a second, simple alternative credit indicator that market participants could refer to in order to assess the creditworthiness of SFIs and make appropriate decisions in times of stress. Publication of such ratings would be the first step to simplifying rating agency criteria and stimulating market scrutiny and debate about the relative value of different types of rating and how these should be used in making investment and credit decisions. As this entails the publication of something which is largely already done in addition to existing ratings, we see this step as offering greater potential benefits than costs.

We would encourage ESMA to consult market participants further on this specialised sub-topic, including seeking the views of some of the specialist ABS research departments in the investment banking community on the behaviour of SFI ratings during the crisis as well as the views of other market participants on publishing a form of simplified rating for SFIs.

Appendix 1: Credit Performance Statistics

Default rates from Mid-2007 to end 2012

	Original Issuance (EUR billion)	Default Rate (%)
Europe		
Total PCS eligible asset classes	**959.9**	**0.10**
Credit Cards	33.2	0.00
RMBS	755.7	0.08
Other consumer ABS	68.0	0.13
SMEs	103.0	0.23
Only senior tranches to be PCS labelled, the default rate for which is zero, like Covered Bonds		
Total Non-PCS eligible asset classes	**734.2**	**5.07**
Leveraged loan CLOs	71.3	0.10
Other ABS	71.0	0.16
Corporate Securitisations	67.7	0.33
Synthetic Corporate CDOs	254.3	2.47
CMBS	163.2	8.67
Other CDOs	77.8	6.33
CDOs of ABS	28.9	39.64
Total European securitisation issuances	**1,694.1**	**2.25**
Covered Bonds	**1,085.0**	**0.00**
Total European issuances	**2,779.0**	**1.37**
Select US asset classes		
Credit cards	295.4	0.04
Autos	215.1	0.04
Student loans	266.8	0.28
RMBS	3,254.9	18.79

Source: Standard & Poor's

Provided by Prime Collateralised Securities

http://pcsmarket.org/credit-performance-stats/