MEMORANDUM

April 28, 2010

To: File No. S7-08-10

From: Gena Lai
Office of Commissioner Troy A. Paredes

Re: Asset-Backed Securities

On April 27, 2010, Commissioner Troy A. Paredes, with Gena Lai, Counsel to the Commissioner, met with Jerry del Missier, President, and Patrick Durkin, Managing Director, of Barclays. The participants discussed the Commission's proposed rulemaking concerning the regulation of asset-backed securities. Written comments are included with this memorandum.

Areas for Improvement in Financial Reform
(April 2010)

We support the Administration and Senate Banking Committee as they look to create strong and consistent capital requirements, enact rigorous oversight to protect consumers and the markets, and end "too big to fail."

Oversight is critical to protecting consumers, investors, and the integrity of the markets overall and we strongly support steps the Obama Administration and Congress have taken to develop strong and consistent consumer protections and consolidating oversight and authority. We support a well designed "systemic risk oversight authority" with the capacity and expertise to monitor risk and work with regulators to manage and tighten controls on firms that pose a risk to the financial system. Globally, we believe there must be a level playing field where capital requirements are consistent and coordinated across all markets so financial players cannot go to where regulations are the weakest. We support regulation that brings complete transparency and regulatory reporting of every derivative transaction, everywhere in the world. We support the clearing and trading of standardized derivatives, which is how the vast majority of derivatives should and will be traded. And customized transactions that cannot be cleared or exchanged traded, must be immediately reported to regulators, to ensure an accurate view of the market. Finally, no bank should be "too big to fail." If a bank fails, no taxpayer money should be used to resolve that bank's operations or its obligations, and any money that has already been committed should be repaid.

It is important to our economy that financial reform be completed this year. The Senate bill goes a long way to achieving this. There are areas where improvements still can be made to promote economic growth while ensuring the highest levels of transparency and regulatory oversight.

Below is a summary of these three areas – the 5% securitization hold, derivatives reform, and the Volcker Rule – where improvements may be made to promote lending and job creation while ensuring the safety and soundness of the financial system.

The 5% Securitization Hold

The securitization market provides an important mechanism for investors to fund consumer lending through asset-backed securities ("ABS") and mortgage-based securities ("MBS"). If the regulations require lenders and securitizers to retain excessive amounts of a loan and underwriting, securitization markets may be seriously damaged. The securitization markets redistribute and recycle credit risk so banks and other lenders (e.g., mortgage loan providers, auto finance companies, credit card issuers, and student loan providers, etc.) may extend more credit at a lower cost. If risk retention were to be applied to all ABS and MBS asset classes, with approximately $12 trillion outstanding, a 5% securitization hold means that banks, originators, sponsors and other lenders active in securitization may be required to hold an additional $600 billion (5% of $12 trillion) of equity capital. Lenders would likely be forced to respond to the 5% hold by significantly reducing or eliminating their securitization activity, a development that could lead to an increase in interest rates charged by lenders on consumer loans and a significant decrease in consumer lending generally.

Given the importance of the securitization markets to lending as well as economic and job growth, here are a few improvements to the existing proposals in the following areas:

- Since originators make the loan and evaluate the borrower's credit, the goal of managing risk is more effectively achieved by shifting most of the hold to originators.
- It is imperative that lending and borrowing standards are tightened since the primary evaluation of a borrower's credit occurs at origination.
- To improve the quality of pooled and securitized loans, originators should hold loans until a credit history is established (approximately one year).
- Before a specific level of a hold is implemented (like 5%), it is important for both asset- and mortgage-backed markets that a careful analysis be conducted by regulators to determine the negative impact of various hold levels and structures on lending and the economy.

Derivatives Reform

Globally coordinated regulation that brings transparency and regulatory reporting of derivative transactions is important. While clearing and reporting of standardized derivatives would cover the vast majority of derivatives, there are customized transactions that cannot be cleared. These should be reported to regulators in a timely manner to ensure that they have an accurate view of the market.

There is some concern that the Senate's exemptions for commercial end-users have become so restrictive that many important financing and hedging transactions for companies will not happen or will only be available at a prohibitive cost. The Senate's bill effectively requires end-users, irrespective of their systemic significance, to clear and exchange-trade almost all structured derivatives transactions. This would require commercial end-users to post collateral. The costs of posting cash collateral for margin and immediate price discovery on an exchange will make many transactions uneconomical, deprive companies of needed capital, and would likely discourage risk management by end-users. This could also lead to derivative markets moving off-shore, making effective regulation even more difficult.

As an example, one of the largest developers of wind energy in the country used structured over-the-counter (OTC) derivatives to monetize and hedge future, unpredictable energy prices. Without access to OTC derivatives, this company would not have been able to hedge its risks which would not have allowed it to fund billions of dollars of investments in alternative energy production.

In the oil and gas sector, many domestic independent companies use the derivatives markets by selling forward future production to generate capital for exploration and development. These companies do not have the liquidity to post cash collateral. If they do not have access to the OTC derivatives markets, it is estimated that tens of billions of dollars of financing would not be available, resulting in a negative impact on domestic energy production and independence.

Lastly, the current legislation does not adequately address an effective global framework, which is necessary to ensure a level playing field around the world so markets do not move overseas. Here are some improvements to the Bill:

- To encourage the effective management of risk by commercial end-users, there should be exemptions from the mandatory clearing and exchange trading requirements for transactions entered into by commercial end-users.

- To provide greater transparency, the legislation should require that all transactions be reported in a timely manner to regulators just as they would if the transaction had been cleared and exchange traded.
- Similar to the House Bill, the Senate legislation should provide the regulators with broad exemption authority to deal with any unforeseen effects that such far reaching legislation may have.

Limits on Private Equity, Hedge Funds, and Proprietary Trading (Volcker Rule)

When it comes to managing risk, regulating with capital – particularly with international coordination – would be more effective than limiting these activities. Strict limits on principal and proprietary trading regulations would have a negative impact on customer business and put the US at a disadvantage in providing the most liquid, efficient, and low-cost markets in the world. To improve the current legislation, proprietary trading should be specifically defined as trading activities that are set up with segregated capital and separate teams of people who have no interaction with customer businesses.

Businesses, consumers, and the economy will all benefit from modernizing our financial regulatory system to better protect consumers, investors, and the markets as a whole. Improving the current Senate legislation in terms of the 5% securitization hold, derivatives reform, and the appropriate use of capital will much better achieve the critical objectives of increasing the safety of the financial system and enabling banks to foster economic growth.

Safeguarding Consumer Lending and Improving Securitization Markets

The securitization market provides an important mechanism for investors to fund consumer lending through asset-backed securities ("ABS"). We believe proposed legislation and rules will have a material adverse impact on consumer credit, job growth, and our economy. Most significantly, under the Dodd bill and the SEC Regulation AB reform proposal, the entity that initiates an asset-backed securities transaction by selling or transferring assets to an issuer of ABS will be required to retain a significant risk position although these entities already hold significant "skin in the game" in typical securitization transactions. Proposed legislation to mandate risk retention may impede a recovery of the securitization markets if the type, level or duration of risk retention is too onerous for market participants.

Risk Retention Issues

- Which asset classes will have risk retention requirements (e.g., auto, credit card, mortgages, etc.)?
- How is the proposed 5% risk retention calculated (e.g., does excess spread count in the retention calculation)?
- Is risk retention "vertical" or "horizontal"?
- How long should risk be retained?
- Will the risk be held by the originator or the depositor/sponsor?

ABS Markets

Generally speaking, there are two forms of ABS:

Agented ABS: initiated when an originator or sponsor (the "Company") transfers loans to a bankruptcy-remote entity (a special purpose vehicle, or "SPV") that issues securities. Typically, the Company or an affiliate would continue to service the loans. The Company is advised by an investment bank (the "Agent") that structures the ABS and then markets and sells securities to third party investors. In Agented ABS, the investment bank acts as an *agent* (i.e., earning a fee to advise the Company and structure/distribute securities on the Company's behalf). Typically, the underlying assets stay on the Company's balance sheet and are subject to the economic performance of the collateral. Agented ABS is prevalent in the non-mortgage consumer loan market.

Whole Loan ABS: one or more originators will sell loans to a buyer, often an investment bank. The investment bank or an affiliated depositor (collectively, the "sponsor")[1] aggregates loans and transfers these loans to an SPV that issues securities backed by the loans. The investment bank's underwriting team will market and sell securities to investors. In Whole Loan ABS, the investment bank acts in a *principal* capacity (generally holding equity) and the originator has disposed of all of the risk and reward relating to the loans. Whole loan ABS is prevalent in the mortgage markets (in past years approximately 70% of mortgage securitization was completed in whole loan form) although mortgage securitization can be completed in agented or whole loan form.

Consequently, risk retention would have a greater impact in the Whole Loan ABS context where an investment bank is the sponsor, depositor, and underwriter of the ABS. Furthermore, since whole loan ABS is more prevalent in mortgage markets, the proposals would have a more negative effect on mortgage markets. However, if onerous interpretations of certain details of the proposals are finalized (e.g., vertical as opposed to horizontal retention) then the legislation and rules will harm all securitization markets.

---

[1] Under Item 1102 of Regulation AB, "sponsor" means the person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.

Higher Costs to Market Participants Equal Higher Costs for the Consumer

If the regulations alter market-dictated risk retention such that an originator/sponsor is required to retain risk above and beyond what it typically retains, the securitization markets may be damaged. The securitization markets redistribute and recycle credit risk so banks and other lenders (e.g., mortgage loan providers, auto finance companies, credit card issuers, and student loan providers, etc.) may extend more credit at a lower cost. If risk retention were to have been applied to all ABS asset classes, with approximately $12 trillion of ABS outstanding, a 5% securitization hold would have meant that banks, originators, sponsors and other lenders active in securitization may be required to hold an additional $600 billion[2] (5% of $12 trillion) of equity capital. **Lenders would likely be forced to respond to the 5% vertical hold prescribed by the SEC by significantly reducing or eliminating their securitization activity, a development that could lead to an increase in interest rates charged by lenders on consumer loans and a significant decrease in consumer lending generally.**

For example, in a recent (November 2009) Agented ABS transaction, Ford Credit Auto Owner Trust 2009-E issued and sold to investors $1.58 billion of ABS backed by $1.85 billion of auto loans transferred to the trust by the originator, Ford Motor Credit. The $270 million difference (representing a hold greater than 5% of the deal) between the collateral balance and ABS issued (known as "overcollateralization") and certain notes in the capital structure were retained by Ford Motor Credit. Ford Motor Credit acts as servicer for the transaction (for which it receives a servicing fee) and receives the excess spread from the transaction (the extent by which interest collections on the collateral exceed expenses of the SPV). In this example as in many Agented ABS deals, Ford Motor Credit already holds a "horizontal" or "first-loss" exposure in the form of excess spread, the retained overcollateralization and notes which represent greater "skin in the game" than the proposed 5% securitization hold.

A 5% Securitization Hold will be Onerous for Bank Lenders

In Whole Loan ABS transactions, bank securitizers would be subject to 5% risk retention. If banks are required to hold 5% of each transaction on their balance sheets, funding costs would increase, causing banks to lend at higher interest rates to borrowers. For example, suppose in a Whole Loan ABS transaction, a bank securitizes $20 billion of ABS per year. The 5% securitization hold on its balance sheet would "trap" $1 billion of Tier 1 capital for the firm, assuming the retained equity interest would be a direct Tier 1 capital deduction, as it is today. This capital could have been used elsewhere to extend credit for consumers, help grow the economy and create jobs, as well as generate returns for shareholders. According to our calculations, this $1 billion in "trapped" capital equates to an increase in the cost of lending of 2 to 5 percentage points. In essence, consumers would fund the cost increases associated with a 5% securitization hold.[3] In addition, this example does not consider the multiplier effects of this inefficient use of capital. When a bank holds this capital in reserve, it limits its ability to offer the capital in additional loans. The originator should share the securitization hold with the bank securitizer.

This significant adverse effect on Whole Loan ABS will have a dramatic impact on the mortgage markets. Given its breadth and size, the mortgage market should have a functioning Agented and Whole Loan ABS

---

[2] This figure assumes that originators, sponsors, and other lenders do not typically retain any risk in securitization transactions.

[3] Assumptions: If a firm holds a $1 billion above average risk tranche and market returns are 25% on this tranche, the firm would make $250 million. This $1 billion tranche is a direct deduction from Tier 1 capital, which is the most punitive capital treatment. As such, this $1 billion equity tranche is equivalent to $12.5 billion of risk weighted assets (RWA) given a key capital ratio target of 8% ($1 billion / 8% = $12.5 billion). The $12.5 billion of risk weighted assets has a return (RoRWA) of 2% ($250 million / $12.5 billion = 2%), while the firm's target average return on risk weighted assets is 5-10%. Therefore, the net opportunity cost of holding this capital is 3-8% RoRWAs, or $375 million to $1 billion. For the firm to be able to continue in this business, the overall rate charged to consumers would increase by approximately 200bps to 500bps.

market in order to deliver mortgages to consumers at an attractive cost. The proposals requiring risk retention will have a crippling effect on the mortgage ABS market further impeding the recovery of the market and will have a negative impact on economic growth.

Potential Improvements to Securitization

As described above, "ruptures" in the chain fracture the risk distribution process and penalize consumers. We support reform and want to create the proper mechanisms for robust and safe securitization markets. If the goal is to align incentives and give all stakeholders "skin in the game," the following policies would improve the markets:

- Effectively Applying a Securitization Hold: If the securitization hold is too large, it will have a chilling effect on the securitization markets. In many cases, because originators make the loan and evaluate the credit of the borrower, the goal of placing incentives on appropriate market participants is more effectively achieved by shifting all or most of the hold to originators, whether the ABS is completed in Agented or Whole Loan form. If originators are required to retain risk in a securitization, they will have an incentive to ensure sound credit quality when making lending decisions. The absolute level of the securitization hold and where it is held should be determined through a careful analysis by the prudential regulator.

- Improved Origination Standards: Since the primary evaluation of a borrower's credit occurs at origination, it is imperative that lending and borrowing standards are tightened. Loose lending standards were a major contributing factor over the past four years in the ruptures in the loan and securitization markets. Regulatory oversight of origination standards is critical to accomplishing this.

- Rating Agency Reform: In order to have properly functioning securitization markets, rating agencies must have regulatory oversight and operations and incentives must be improved and reformed. It is clear that the ratings were neither consistent nor reliable. Of the approximately $2 trillion in non-agency securitizations from 2006 to 2007, 75% were originally rated AAA. Today, less than 10% are still rated AAA, while the rest have been downgraded. Over 70% have been downgraded to BBB or below. Given the importance of reliable credit ratings for investor confidence and the inflated ratings that were applied to these securities, it is imperative to have reliable, consistent credit ratings for the proper functioning of a healthy securitization market.

- Defer Payments Based on Performance: Presently, in the mortgage Whole Loan ABS space, originators may be able to transfer all the risk to investors and receive an upfront fee for originating the loan (i.e., the difference between their cost to originate and the sale price). If payments were distributed over time and paid out along the various tranches based on collateral performance, originators would effectively serve as lenders to consumers and investors in a securitization.

- Defer Securitization: Instituting an "early pay default" hold on securitizations until payment history is established will improve the quality of pooled and securitized loans. Since originators evaluate a consumer's credit, they could be required to hold their originated loans for a period of time before the loans can be sold into securitizations. Regulators should have the flexibility to adjust this period of time, depending on economic conditions.

In sum, the alignment of incentives is crucial to functioning securitization markets – but it should be executed as a reward for performance, not punitive steps that could meaningfully shrink the securitization markets and consumer lending. In our global economy, securitization extends credit to consumers and all parts of the market are interconnected. A rupture in any one part of this chain will cascade through the markets negatively affecting redistribution of credit risk and tightening credit, which will damage the economy and lead to a substantial loss of jobs.