William J. Harrington
[redacted]

February 2, 2014

VIA ELECTRONIC MAIL

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20002-4224

Dear Ms. Murphy:

I have several questions regarding the Open Meeting that will be held on February 5, 2014 at 3:00 PM by the Securities and Exchange Commission (SEC).

Please treat my inquiries as standing ones or, alternatively, advise that I re-submit my inquiries at regular intervals prior to the Open Meeting.

1. May the public offer views, either in person or remotely via a link?

2. Has subject matter been added, deleted or postponed subsequent to the notice of January 29, 2014? (http://www.sec.gov/news/openmeetings/2014/ssamtg020514.htm)

3. Will securitization swaps, a key component of most cash-flow, asset-backed securities, be examined as the Commission considers whether to adopt rules revising the disclosure, reporting, and offering process for asset-backed securities? In particular, will an issuer be required to disclose the presence of a "flip clause" in a securitization swap, given that such a clause was held to be unenforceable against Lehman Brothers in 2010?

On two separate occasions in 2013, I briefed the SEC on the risks that securitization swaps (and, in particular, flip clauses) posed to investors in asset-backed securities, as well as to the financial system as a whole. On October, 16, 2013, I met with staff from the Office of Credit Ratings and, on November 12, 2013, I met with staff from the Division of Trading and Markets. (http://www.sec.gov/comments/s7-18-11/s71811-76.pdf)

In the latter briefing, I recommended that flip clauses, lynchpins to almost all securitization swaps, be counted prominently among “any other factor or characteristic of the assets that would be material to the likelihood that the issuer of the ABS will pay interest and principal according to its terms and conditions.” When a flip clause is not upheld against an insolvent counterparty, as occurred with respect to Lehman Brothers, an ABS issuer must divert funds that had been earmarked for timely payment of interest and principal towards paying a lump-sum termination amount to the insolvent counterparty, instead.

Fortunately, Lehman Brothers provided very few securitization swaps to issuers of cash-flow, asset-backed securities. AIG, however, provided such swaps to many, many issuers who, but for the 2008 bail-outs, would have been obligated to pay large, lump-sum termination amounts to AIG, rather than pay “interest and principal according to its terms and conditions.”

Sincerely yours,

William J. Harrington

William J. Harrington
[redacted]

September 11, 2013

VIA ELECTRONIC MAIL

Mr. Abe Losice
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20002-4224

Mr. Felix Flinterman
European Securities and Market Authority
CS 60747
103 rue de Grenelle
75345 Paris Cedex 07, France

Dear Messrs. Losice and Flinterman:

This letter follows my June 3, 2013 comment to the Securities and Exchange Commission[1] that mapped inflated ratings of asset-backed securities (ABS) and derivative product companies (DPCs.)

My June 3 comment forms part of the official record of the Credit Rating Roundtable,[2] held May 14, 2103 at SEC headquarters in Washington, D.C., to discuss methods for assigning ABS ratings that mitigate the conflict of interest inherent in the issuer-pay model. Sen. Franken of Minnesota, Sen. Wicker of Mississippi, and Rep. Garrett of New Jersey opened the proceedings, and the five SEC commissioners presided over the day's three panels.

I attended the roundtable as an observer, after having submitted questions for discussion and offering to serve as a panelist. My experience in formulating methodologies to assess derivative risk in ABS and DPCs is singular[3], as is my practice of publicly critiquing committee processes that assign inaccurate ratings. For instance, my Counterproposal to SEC Proposed Rules for

[1] See <http://www.sec.gov/comments/4-661/4661-28.pdf>.
[2] See <http://www.sec.gov/spotlight/credit-ratings-roundtable.shtml>.
[3] Appendix A p. 15 contains an April 10, 2013 article by Structured Credit Investor, a subscription-based website, in which I offer best practices for assessing derivative risk in rating ABS and call for a "Y2K" exercise to assess derivative risk more generally.

Rating Agencies[4] has received ongoing attention since being filed on August 8, 2011 and recently informed lengthy discussion with officials from the state attorneys general of Connecticut, Delaware, and Mississippi.

No options, just securitization swaps?

An issuer of cash flow ABS enters into a derivative contract to mitigate losses to an ABS that may arise if its interest rate, index, or currency appreciates relative to that of an asset pool. Absent a derivative contract, payments to an ABS hinge as much on the relative change in noncredit attributes of an asset pool as on the payment profile of individual assets, although the impact of relative change in noncredit attributes is asymmetrical. Relative depreciation of an asset pool reduces ABS payments by more than a corresponding appreciation increases them.

The vast majority of derivative contracts entered into by ABS issuers are securitization swaps, which are generally costless to enter but costly to exit ahead of schedule when an asset pool has appreciated. A securitization swap fixes all or a part of the noncredit mismatch between ABS and assets at a stable level that does not appreciate or depreciate, making ABS repayment primarily a function of whether individual assets pay in full and according to schedule.

As long as a securitization swap remains intact—i.e., a counterparty remains solvent—depreciation of the asset pool does not decrease payments to ABS (nor does appreciation increase them). However, a securitization swap has termination provisions that activate in the event of counterparty insolvency. These provisions may decrease ABS payments when an asset pool has appreciated, i.e., when ABS payments may have otherwise increased had an issuer never entered into a securitization swap or remained stable had a counterparty not become insolvent.

ABS issuers infrequently buy options, a second type of derivative contract, although an option is costless after purchase and moreover can recoup some, all, or more than its purchase price when an asset pool appreciates irrespective of whether a counterparty has remained solvent. When an asset pool has depreciated, counterparty insolvency will decrease payments to ABS whether an issuer holds an option or is party to a securitization swap.

Rating agencies assign AAA ratings to ABS when an issuer has entered into a securitization swap or bought an option by assuming in each case that a counterparty remains solvent for as long as ABS are outstanding. In rating agency models, a securitization swap or an option always pays out when the noncredit aspects of an asset pool depreciate and a securitization swap never imposes termination losses on ABS when an asset pool appreciates.

[4] See <http://www.sec.gov/comments/s7-18-11/s71811.shtml#comments>.

Bad math: A few trillion ABS are exposed to a handful of irreplaceable counterparties
Insolvency of a single counterparty may simultaneously compromise the ability of many, many ABS issuers to pay many, many more ABS, given that issuers do not reserve against an involuntary loss of a securitization swap. Instead, ABS issuers have long opted for a cut-rate approach that papers over the risk of losing a securitization swap by recycling "replacement provisions" and "flip clauses" into derivative contracts and priorities of payments.

Post-2008 events support the adage that one gets what one pays for—replacement provisions have proved largely ineffectual and flip clauses have not been uniformly upheld worldwide. Even so, ABS issuers balk at drawing the conclusion that they cannot insulate ABS against early termination of securitization swaps by contractual and structural protections alone but must also hold reserves, purchase options, securitize additional assets, issue fewer ABS or accept ABS with lower ratings.

Replacement provisions have long directed a downgraded counterparty to pay a higher-rated one to take over a securitization swap with an ABS issuer, even though the secondary market for replacement by third parties is small and shallow. Moreover, the number of counterparties that serve the primary market of entering into new securitization swaps is dwindling as counterparties retrench along geographical lines. A handful of "too big to fail" (TBTF), government-insured bank subsidiaries[5] serve as counterparties to some $2 trillion of U.S. ABS, and a similar number of TBTF European banks similarly serve Euro 2 trillion of core EU ABS. Peripheral ABS markets in the EU have either a few national counterparties each or none at all.

A flip clause is a fallback against failed replacement that subordinates the obligation of an ABS issuer to pay a termination amount to an insolvent counterparty when an asset pool has appreciated— i.e., to walk away from the securitization swap without making any termination payment at all. Without a flip clause, an ABS issuer cannot justify holding zero reserves against ABS losses that may arise from counterparty insolvency. (With a flip clause, a counterparty cannot justify valuing a securitization swap that is an asset at full mark-to-market, given that receipt of the asset is largely a function of the counterparty's own credit profile rather than that of the ABS issuer.)

Unfortunately for ABS investors (and fortunately for counterparties to securitization swaps), the enforceability of flip clauses is doubtful in many jurisdictions, most notably the United States. On January 25, 2010, the Lehman Brothers bankruptcy court held that, under the U.S.

[5] On August 22, 2013, Moody's excluded TBTF ratings of FDIC-insured bank subsidiaries from a review for possible downgrade of TBTF ratings for bank holding companies. See <https://www.moodys.com/research/Moodys-reviews-US-bank-holding-company-ratings-to-consider-reduced--PR_280779>.

bankruptcy code, a flip clause was not enforceable against an insolvent counterparty.[6]

Replacement dies a second death in jurisdictions that do not uphold flip clauses. A counterparty whose securitization swaps will be made whole upon insolvency is incentivized to avoid incurring replacement losses merely for being downgraded. Moody's speeds rigor mortis along by issuing "no downgrade" letters in response to counterparty proposals to disregard contractual obligations to replace themselves at no cost to ABS issuers.[7]

In the United States, an expanded clearing mandate took effect on June 10, 2013[8] that may permanently lay replacement to rest for interest rate swaps, the most prevalent type of securitization swap used in the U.S. ABS sector. Ostensibly, the clearing mandate covers securitization swaps that reference interest rates; however, in practice, refusal by ABS issuers to post margin or otherwise conform to specifications set by clearing houses means that the swaps won't be cleared.

ABS issuers refuse to post margin because they lack spare margin to post—assets are earmarked solely for ABS when reserves are not held against counterparty insolvency. Replacement provisions and flip clauses are among the terms common to securitization swaps that do not confirm to clearing house specifications.

Securitization swaps that do not adhere to the clearing mandate may be unenforceable should they be repudiated by the party that is out-of-the-money following a counterparty insolvency. Even counterparties that accept repudiation risk in writing new securitization swaps may balk at assuming the same risk in bidding to replace scores of legacy securitization swaps for a third party that has been downgraded. [9]

Bad ABS math based on too-big-to-fail bailouts for flailing counterparties

Investors, finance companies, rating agencies, deal counsel, underwriters, legislators, regulators, and industry lobbyists accommodate issuers in pretending that a securitization swap with replacement provisions and flip clauses confers riskless benefits upon ABS. Prior to the U.S. Clearing mandate, few within the ABS industry pushed issuers to hold reserves, securitize more

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[6] See <http://www.cgsh.com/lehman_bankruptcy_court_holds_cdo_provision_subordinating_swap_termination_payments_to_lehman_is_unenforceable/>.

[7] Appendix B contains an August 2, 2013 article by Structured Credit Investor detailing Moody's issuance of 96 "no downgrade" letters in response to counterparty proposals to unilaterally rewrite contractual obligations to ABS issuers. For instance, Moody's approved a Morgan Stanley proposal to not replace itself as counterparty to seven ABS issuers as described on p. 18.

[8] See <http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/ClearingRequirement/index.htm>.

[9] Appendix B pp. 18-19 discusses challenges to replacement that arise when securitization swaps cannot be cleared.

assets, purchase options, or otherwise come to market with sufficient resources to repay ABS in the event of counterparty insolvency.

The same ABS participants ushered in the 2008 financial catastrophe by assembling deficient asset pools. ABS would have incurred derivatives losses as well had 2008 financial consolidation and bailouts not halted the domino effect of one flailing counterparty taking down a second, then both taking down a third, etc. Fortuitously for cash flow ABS, Lehman Brothers was counterparty to comparatively few securitization swaps[10] (whereas bailed-out AIG remains counterparty to many[11]).

ABS participants depict 2008 outcomes as validation that ABS are sufficiently insulated from involuntary loss of a securitization swap. Accordingly, issuers bring ABS to market with insufficient assets and inflated ratings. Finance companies receive more cash for each loan cleared from their books, investors beat bogeys by more basis points, underwriters and deal vendors such as counsel, accountants, servicers, and rating agencies earn more fees, legislators raise more contributions from the financial industry, and regulators can more easily cast their gaze elsewhere.

In the U.S., the ABS industry pitches the indispensability to housing finance reform of reviving residential mortgage-backed securities (RMBS) and ignores the highly idiosyncratic risks of "balance guarantee" securitization swaps that underpin the whole sector. In Europe, the industry hinges economic revival upon increased securitization of corporate receivables and reduced capital penalties for ABS, glossing over outsized market risk of ubiquitous securitization swaps that hedge depreciation of asset pools attributable to currency mismatches.

For its part, Moody's assigns "rating uplift" of two to three notches to ratings of TBTF banks and DPC affiliates based on the rationale that they will again receive open-ended bailouts if needed. The greatest degree of uplift is assigned to insured bank subsidiaries that house most derivative risk worldwide.[12] In turn, Moody's ABS ratings build from the uplifted TBTF ratings for counterparties rather than the barely-investment-grade "standalone" ratings that exclude government support.

Being downgraded to standalone levels would obligate most counterparties to securitization swaps to attempt to replace themselves simultaneously—i.e., to stop the music and tally

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[10] Where Lehman was counterparty to an ABS issuer (Eurosail) under securitization swaps, ABS incurred significant losses. See <http://www.sidley.com/structured_finance_and_securitisation_update_030911/>.

[11] See pp. 57-59 of my June 3, 2013 comment letter to the SEC, available at <http://www.sec.gov/comments/4-661/4661-28.pdf>.

[12] On August 22, 2013, Moody's excluded TBTF ratings of FDIC-insured bank subsidiaries from a review for possible downgrade of TBTF ratings for bank holding companies. See <https://www.moodys.com/research/Moodys-reviews-US-bank-holding-company-ratings-to-consider-reduced--PR_280779>.

embedded losses in one securitization swap after another. A counterparty will realize losses on the minority of securitization swaps that are replaced (replacement is expensive) and take write-downs on the remaining securitization swaps that cannot be replaced and so are retained by default. (Flip clauses jeopardize mark-to-market assets and obligations to post overcollateralization amounts push mark-to-market liabilities further into the red.)

The reckoning will be magnified for DPCs that are counterparties to ABS issuers and vice versa.[13] When counterparty to one or more securitization swaps, a DPC overstates the adequacy of its capital resources, carries an inflated rating, and presents a credit profile to both ABS issuers and other trading partners alike that is misleadingly strong.

A DPC sizes its capital under the assumption that it will receive almost all mark-to-market assets with ABS issuers, whereas the issuers assume that they will never make such payments and accordingly hold no reserves to do so. With both DPCs and ABS issuers understating the risk of facing each other under securitization swaps so as to operate on the cheap, neither has spare assets to post as collateral, although their high ratings suggest otherwise.

Moody's builds a DPC rating up from the TBTF rating of its parent and not on the standalone resources of the DPC itself. (A standalone DPC is a run-off portfolio of legacy derivative contracts with finite assets, a few employees, and perpetual risk of being downgraded.) Moody's does not independently model securitization swaps and other derivative contracts held by a DPC, but instead relies on the DPC to do so and share its results.

Nor does Moody's aggregate risks for a counterparty with many securitization swaps (DPC, insured bank subsidiary, bank holding company or otherwise), let alone track systemic risks that accumulate across all securitization swaps as a sector. In fact, a Moody's ABS model does not record the counterparty to a securitization swap at all, but merely references a generic placeholder that exchanges payments with an ABS issuer without fail for the life of a securitization swap. In a Moody's model, one counterparty is as good as the next and no counterparty ever defaults.

By freely drawing on TBTF credit, Moody's committees avoid examining derivative risk in assigning ratings to DPCs, bank holding companies, and insured bank subsidiaries, as well as ABS—i.e., Moody's committees help foment the "unforeseeable" crises that blindside them time and again.[14]

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[13] See p. 16 of my June 3, 2013 comment letter to the SEC, available at <http://www.sec.gov/comments/4-661/4661-28.pdf>.

[14] For example, Moody's senior bank analysts were not aware prior to the collapse of Bear Stearns in 2008 that it would lose $2 billion from its DPC triggering into standalone mode. See pp. 38-39 of my June 3, 2013 comment letter to the SEC, available at <http://www.sec.gov/comments/4-661/4661-28.pdf>.

Breaking bad ABS math apart

An insolvent counterparty will deplete an ABS issuer's cash by either failing to make hedge payments (when an asset pool has depreciated) or claiming a lump-sum termination amount (when an asset pool has appreciated). Additionally, the estate of an insolvent counterparty will saddle an ABS issuer with litigation expenses and lengthy operational uncertainties, e.g., by contesting the validity of securitization swaps that do not conform to local regulations.

An ABS priority of payments locks in ABS losses when cash runs short or assets are written down, and the impact may be magnified in the wake of a major counterparty becoming insolvent. Interest proceeds that have been depleted by a relative depreciation of the asset pool or springing legal fees may divert principal proceeds to pay senior ABS coupons, leaving senior principal outstanding and junior ABS with cashless, in-kind coupons. Funding a termination payment can force an ABS issuer to liquidate assets at fire sale prices (other ABS issuers will be liquidating similar assets for the same reason), eroding support for all tranches irreversibly.

When a securitization swap is in-the-money to an ABS issuer, (i.e., an asset pool has depreciated), the issuer may hold collateral posted by the counterparty prior to its insolvency. However, most ABS issuers can liquidate collateral only for the purpose of applying proceeds to reconstituting a nonperforming securitization swap or instituting a near facsimile, i.e., effecting replacement for themselves. Typically, an issuer may not use proceeds from liquidating collateral to buy additional assets, pay down ABS liabilities, or otherwise dampen the relative depreciation of an asset pool.

Moreover, an ABS issuer with an in-the-money securitization swap may never receive collateral, leaving ABS fully exposed to relative depreciation of an asset pool after a counterparty becomes insolvent. Following an industry-wide downgrade of banks in 2012, counterparties unilaterally deferred posting collateral to ABS issuers or voided the obligation to do so altogether by again obtaining no-downgrade letters from Moody's.[15]

Worst math ever: Derivative methodologies for ABS, banks, and sovereigns don't add up

Moody's, S&P, Fitch, DBRS, Kroll, and others inflate ratings of ABS, banks, and sovereigns in two simple steps.

First, Moody's and its competitors treat a securitization swap as a win-win for both an ABS issuer and a bank counterparty[16] rather than as a win-lose in which one party's gain is the other's loss.

[15] Appendix B, p. 17, details 20 successful proposals by Barclays to defer posting collateral to 38 ABS issuers.

[16] Appendix C, p. 20, contains an August 6, 2013 notice in Structured Credit Investor that Fitch assigns identical ratings to a counterparty position in a currency swap and the corresponding ABS. The rationale that the "key driver for the rating of swap obligations is the rating of the related reference notes" is circular, given that the rating of reference notes relies on counterparty obligations to post collateral, replace, and accept subordination.

Better still would be lose-lose, in which each party's assumptions fall short—ABS incur losses attributable to involuntary loss of a securitization swap, and a counterparty either receives less than its mark-to-market asset or pays more than its mark-to-market liability with an ABS issuer.

Second, rating agencies pencil in open-ended taxpayer support for the TBTF banks that house most derivatives worldwide without correspondingly erasing the same taxpayer support from sovereign ratings.

TBTF ratings distort derivative pricing and incentivize banks and end-users such as ABS issuers to assume more derivative risk than if ratings were assigned using a closed system that exactly offsets derivative credits and debits across sectors. Appendix A of this document details the buyer's remorse driving banks to rewrite securitization swaps unilaterally through no-downgrade letters and therefore avoid the costs of posting collateral to ABS issuers and arranging replacement at no cost to them. Moody's is paid for each no-downgrade letter it issues.

In running with Moody's expectation of open-ended taxpayer support in the event of yet another derivative-based crisis, banks and their counterparties such as ABS issuers perpetuate TBTF and make more bailouts an inevitability. The bilateral nature of a derivative contract eggs both parties on to evermore wishful thinking—witness the initial defenses in the London Whale saga that derivative valuation is an art and not a science. (Cherry-picking is an art?)

At the SEC Roundtable, Moody's and its competitors disavowed all responsibilities with respect to ABS methodologies save making them publicly available on respective websites so that ABS issuers can solicit ratings in an informed manner. No agency maintained that its ABS ratings were accurate over even a short horizon. No panelist—rating agency, SEC, issuer, or investor—mooted linking methodologies for ABS and other sectors in a closed system that tracked securitization swaps and bank holdings of ABS as mitigation for the industry-wide conflict of interest that produces inflated ABS ratings.

Take the worst math ever and double it: Moody's ABS LINKAGE methodology.v2

On July 18, 2013, Moody's issued a comment request, Approach to Assessing Linkage to Swap Counterparties in Cashflow ABS[17] (Version 2), that is designed to prop up ABS ratings worldwide in a perfect demonstration of unchecked conflict of interest within Moody's and the wider ABS industry. Version 2 addresses one topic—Moody's insistence on evaluating securitization swaps as being win-win for ratings of both ABS and counterparties, particularly

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Fitch squares its circularity by defining it away, i.e., carving out impacts from counterparty insolvency from the swap rating.

[17] See <https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF334282>.

counterparties that are DPCs.

Title notwithstanding, Version 2 does not link the 2012 downgrade of TBTF banks[18] to a sector downgrade of ABS attributable to higher risks of involuntarily losing securitization swaps, nor does it link the refusal of banks to post collateral or replace themselves to downgrades of shortchanged ABS.[19] Moreover, Version 2 does not link ratings of TBTF banks to the cost of posting collateral to ABS issuers, obtaining replacement in limited cases, and being subject to flip clauses. Lastly, sovereign ratings are not linked to obligations of TBTF banks under securitization swaps that may lead to new derivative crises and more bailouts.

Moody's issued an almost identical comment request a year earlier (Version 1) that too clearly read as pretext for leaving ABS ratings unchanged in the wake of widespread bank downgrades. Consequently, Version 1 was left in limbo while Moody's regrouped. Version 2 reworks the more transparent nomenclature of Version 1 while fulfilling its mission to preserve Moody's ABS franchise at the expense of accurate ratings for ABS, banks, and sovereign entities.

For example, Version 2 acknowledges ABS linkage to a counterparty at close, scrapping the earlier schema of alternating de-linkage at close morphing into linkage at some later date but preserving the same outcomes. New ABS can be rated Aaa because de-linkage exists at close (Version 1) and the impact of linkage at close is so minute that it adds less than a basis point of risk[20] (Version 2). Similarly, Version 2 sheds the expedient designation of securitization swaps as either plain vanilla or exotic but, like Version 1, it concludes that the vast majority of securitization swaps worldwide can be replaced without interrupting payments to ABS.

Version 2 doesn't explicitly endorse DPCs as counterparties to securitization swaps in the manner of Version 1, but it does so implicitly by not specifying that only fundamental ratings such as those assigned to banks be used to evaluate counterparties.[21] The same Moody's teams assign ratings to both DPCs and collateralized debt obligations, a large ABS sector.

Version 2 has removed contact analysts who are trained in U.S. law, listing just a single author trained in U.K. law, but it is nonetheless proposed for worldwide application both in domiciles that enforce flip clauses (the U.K.) and domiciles that do not (the United States). Moreover, both versions take a legalistic approach rather than a common-sense one with respect to event risk that

[18] But for TBTF, bank downgrades would have averaged five notches rather than two. See <https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_143246>.
[19] See Appendix B, p. 17.
[20] An additional basis point of risk knocks a rating of AAA down to AA.
[21] Moody's classifies DPC ratings as structured finance instruments rather than fundamental ratings owing to the limited capacities of a standalone DPC after severing from a TBTF sponsor. A standalone DPC becomes a run-off portfolio of legacy derivatives contracts with, at most, a few employees and finite assets.

can lead to involuntary losses of many securitization swaps that reduce payments to many ABS at once.

Neither version addresses the risks to ABS ratings or the financial system as a whole when too few counterparties provide too many securitization swaps to too many ABS issuers. Both versions enable ABS issuers to ply ABS with derivative risk by referencing inflated TBTF ratings for bank counterparties rather than much lower standalone ratings.

Given its mission, Version 2 cannot be entirely scrubbed of self-defeating contradictions. In fact, the summary introduces both a circular assessment of why the ABS sector does not face counterparty risk, followed almost immediately by an about-face that downgrades of ABS will track counterparty downgrades. Previously, Moody's previously did not downgrade ABS, which corroborates Moody's assessment that ABS will not incur losses under securitization swaps (circular reasoning) and downgrades will exceed several notches for ABS with exposures to lower-rated counterparties (downgrades are coming).[22] Moody's announcements in 2012 and 2013 regarding securitization swaps tell the same story—legacy ABS will be downgraded as counterparties are downgraded, but new ABS will still be rated Aaa.[23]

Version 2 lays bare Moody's method for glossing over event risk arising under a securitization swap when assigning a public rating of Aaa to a new ABS—Moody's maintains a second rating that reflects an in-house, partial evaluation of an ABS in the presence a securitization swap.[24] The in-house rating incorporates selected outcomes that may decrease ABS payments after a counterparty has become insolvent (e.g., "loss of hedging" when an asset pool has depreciated), but ignores others (e.g., a flip clause may not be enforceable when an asset pool has appreciated).[25]

Moody's in-house rating of an ABS signals (albeit weakly) to Moody's committees and no one else that the presence of a securitization swap may decrease payments to an ABS. By keeping an in-house set of ABS ratings when a securitization swap is present, Moody's can assign a public rating of Aaa to a new ABS (an in-house rating of weak Aaa maps to a public rating of Aaa) and issue a no-downgrade letter in response to a counterparty proposal to not post collateral (Moody's compliance department does not direct committees to downgrade a public rating in conjunction with the downgrade of a corresponding in-house rating).

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[22] See pp. 1-2 <https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF334282>.
[23] See Appendix B, p. 18.
[24] See pp. 9-10 (Step 4 Tables) of Moody's comment request, Approach to Assessing Linkage to Swap Counterparties in Cashflow ABS, available at <https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF334282>.
[25] Even on an in-house basis, Moody's cannot come clean regarding the event risk embedded into an ABS when a securitization swap is present.

With downgraded counterparties balking at posting collateral, fail-safe replacement a pipe dream, unenforceable flip clauses an embarrassment to U.S. attorneys, and a couple of clapped-out DPCs being trotted out to save the day, the worldwide ABS sector should be downgraded to single-A or lower. Instead, Version 2 guts replacement provisions and treats flip clauses as universally enforceable in order to continue awarding Aaa ratings to ABS.

Antidote to bad speech (and worst math ever) is more good speech

Version 2 sets a deadline for responses of August 31, 2013, which mirrors the Version 1 comment period of July 2 to August 31, 2012. Having coauthored the methodology under review (the 2006 Hedge Framework), its two comment requests in 2005, and a predecessor framework in 2002,[26] I responded to Version 1, point by point.[27] You each were sent a copy of my response to Version 1, as were analysts with oversight for securitization swaps at Standard & Poor's (S&P), Fitch Ratings (Fitch), Kroll Bond Ratings (Kroll), and DBRS.

The number of rating agency analysts who can critically assess either securitization swaps or DPCs is small, and the overlap between the two groups (i.e., analysts who can critically assess both securitization swaps and DPCs in tandem) is smaller still. Smaller yet is the subset of analysts who can critically assess both securitization swaps and DPCs in tandem and do so publicly. (Moody's and other rating agencies restrict public freedom of speech by analysts as a condition of employment.) Whether the subset of analysts who can assess securitization swaps and DPCs in tandem and do so publicly comprises seven analysts or three or just one, the subset contains me.

Competing rating agencies continue their long-standing practice of using almost interchangeable methodologies to model payments to ABS from asset pools and under securitization swaps. For instance, Fitch issued a comment request in 2012 that presaged Moody's Version 1 by similarly diluting the analogous Fitch methodology for securitization swaps and likewise concluding that their presence did not preclude assigning a AAA rating to an ABS.[28] I responded to the Fitch comment request point by point with distribution to you, your colleagues, Moody's, S&P, Kroll, and DBRS. S&P joined the pack by watering down its methodology for securitization swaps in 2012—I submitted a critique to S&P as well.[29]

[26] See pp. 34-37 of my June 3, 2013 comment letter to the SEC, available at <http://www.sec.gov/comments/4-661/4661-28.pdf>.
[27] Ibid. (p. 100).
[28] See <http://www.bloomberg.com/news/2012-05-23/fitch-wavers-over-plans-to-relax-banks-derivatives-rules.html>.
[29] See pp. 94-99 of my June 3, 2013 comment letter to the SEC, available at <http://www.sec.gov/comments/4-661/4661-28.pdf>.

Along the same lines, Moody's, Fitch, and S&P resuscitated DPC methodologies in 2012[30] while Kroll and DBRS assigned top ratings to ABS with securitization swaps provided by DPCs without even bothering to develop DPC methodologies.[31] On October 5, 2012, "Moody's Approach to Rating Derivative Product Companies"[32] (Moody's 2012 DPC Update) was released without a preceding comment request. Accordingly, I instituted one, submitting a comment to Moody's with distribution once more to you, your colleagues, S&P, Fitch, Kroll, and DBRS.[33]

Commenting on Moody's 2012 DPC Update was easy, given that I wrote many of its sections in 2009-10 while employed by Moody's. From 1999 to 2010, I spearheaded Moody's analysis for the DPC sector as a whole and led analysis of individual DPCs sponsored by Merrill Lynch, Lehman Brothers, Nomura, JPMorgan Chase, Bear Stearns, and Morgan Stanley. From the beginning of my tenure I bucked the trend of moving with the rating agency herd and instead advised Moody's committees and DPCs alike of the challenges for DPCs in providing securitization swaps and undertaking other new businesses.

In 2008-09, I led an overhaul of DPC ratings in response to sector deficiencies that surfaced in 2008 with respect to a Bear Stearns DPC and that proved fatal later that year for two Lehman Brothers DPCs.[34] In 2009, the DPC team issued a DPC comment request and a methodology update (subsequently replaced by Moody's 2012 Update) and downgraded DPCs in three steps, the first two of which were concurrent with respective publications of the comment request and methodology update.[35] In contrast, S&P and Fitch either kept ratings of DPCs largely unchanged at AAA or withdrew the DPC ratings altogether.[36]

The 2009 downgrades of the DPC sector occurred while one of the DPCs, Merrill Lynch Derivative Products AG (MLDP), was negotiating with AIG to guarantee its payment obligations under securitization swaps with 50+ issuers of CDOs and other ABS. The securitization swaps were in-the-money assets that AIG had been at risk of losing since its own 2008 downgrade had activated obligations to replace (which had proved impossible) or obtain a guarantee.

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[30] See pp. 87-93 of my June 3, 2013 comment letter to the SEC, available at <http://www.sec.gov/comments/4-661/4661-28.pdf>.

[31] This is surprising, given that Mr. Dan Curry, President of DBRS Inc., rated DPCs while working at Moody's from 1985 to 2007. (See p. 30 of my June 3, 2013 comment letter to the SEC available at <http://www.sec.gov/comments/4-661/4661-28.pdf>.) Jerome Fons, Executive Vice President of Kroll, worked at Moody's from 1990 to 2007 and participated in meetings where I discussed the impact of securitization swaps and general derivative risk for ratings of both ABS and fundamental companies.

[32] See <https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF293573>.

[33] See p. 16 of my June 3, 2013 comment letter to the SEC, available at <http://www.sec.gov/comments/4-661/4661-28.pdf>.

[34] See pp. 38-44 of my June 3, 2013 comment letter to the SEC, available at <http://www.sec.gov/comments/4-661/4661-28.pdf>.

[35] Ibid. (pp. 45 and 48-67).

[36] Ibid. (pp. 46-47).

In the absence of replacement, obtaining a guarantee (the last resort for AIG) had been made more expensive and time consuming by the MLDP downgrades. AIG complained and Moody's compliance department tried unsuccessfully to invalidate the downgrades on two occasions. After the July downgrade, the compliance department directed an entirely new committee to review MLDP from scratch—the second committee deliberated for a month before voting the same downgrade. In the wake of the third and final downgrade in December, I waived away attempts by the compliance department to revisit MLDP again.[37]

In my view, a senior vice president is obligated to preserve the analytical integrity of committees and methodologies when management acts to placate large counterparties.[38] In 2005, my colleagues and I issued two comment requests with respect to the work-in-progress that became the 2006 Hedge Framework, in part to retain provisions that protected ABS ratings when lower-rated counterparties entered into securitization swaps. We also wished to lay out provisions clearly so that all parties interested in securitization swaps—ABS issuers, underwriters, counterparties, investors, and Moody's own analysts—could accurately assess costs and not claim at a later date to have been blindsided. (After voting to approve the 2006 Hedge Framework, one Moody's manager unwittingly validated the team's efforts by bemoaning that Lehman Brothers would not be able to provide securitization swaps.)

Sometimes, saying nothing is saying something

Clearing houses are rejecting securitization swaps without comment. The CFTC has refrained from issuing a "no action" letter that exempts securitization swaps from the expanded clearing mandate for interest rate swaps. Spokespeople for rating agencies, ABS issuers, and counterparties do not trumpet recent successes in replacing downgraded counterparties with third-party entities. U.S. attorneys are not going on record in support of flip clauses. Moody's has not announced a review of TBTF with respect to the FDIC-insured bank subsidiaries that house 90% of U.S. derivatives. Moody's, S&P, Fitch, Kroll, and DBRS do not critique each other's assessments of securitization swaps.

The best time for bad news is ASAP

The finance industry takes great pride in operating a ruthlessly efficient market that sets rational prices by continuously scouring the world for information. Linkages abound (the evolution of the Arab Spring simultaneously ties to commodity prices, Fed policy, U.S. economic growth, employment, consumer spending, auto production, and prices of debt backed by auto

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[37] See pp. 57-59 of my June 3, 2013 comment letter to the SEC, available at <http://www.sec.gov/comments/4-661/4661-28.pdf>.

[38] Also, in my view, a Moody's analyst should propose that a committee issue a no-downgrade letter only when the expected loss of an ABS (i.e., the risk of nonpayment) will remain stable or improve with implementation of a proposal. (Moody's compliance department allows committees to issue no-downgrade letters so long as the public rating of an ABS is not impacted by implementation of a proposal, even if the in-house rating and expected loss deteriorate as a result.)

receivables) and are continually reexamined to discern new patterns that are reflected back to the world through real-time pricing.

Pricing financial instruments is not akin to effecting social change, which requires years, decades, centuries, or even millennia as individual emotions coalesce into group consensus.

So here goes, once again. Most issuers of securitized debt (backed by auto loans, commercial mortgages, corporate debt, credit cards, entertainment royalties, equipment leases, legal settlements, residential mortgages, student loans, utility charges, or other assets) cannot repay the debt with a certainty commensurate to its rating.

Issuers choose not to hold reserves, buy options, or securitize more assets so as to dampen ABS losses arising from a relative depreciation of securitized assets, attributable to relative changes in interest rates, indices, currencies, or other noncredit variables. A securitization swap dampens ABS losses from depreciating assets for as long as a counterparty remains solvent, but it also introduces new sources of ABS losses (e.g., an issuer paying a termination amount involuntarily and being tied up in litigation with the estate of an insolvent counterparty).

TBTF encourages ABS issuers and TBTF counterparties to underestimate the likelihood of counterparty insolvency and so underprice securitization swaps. In turn, ABS issuers offer generous terms for industry and consumers to finance new borrowing that overstates true demand for securitized assets. Borrowers pay artificially low fixed rates (the market demands floating-rate paper), access artificially high credit lines in their own currency (the market demands another currency), and obtain prepay options that are otherwise unobtainable (the market prefers bullet maturities).

More financial crises may be unavoidable, but their frequency and intensity are a function not of arbitrary forces but rather of decisions made today and repeated tomorrow with respect to pricing securitization swaps, overextending credit, securitizing assets, and issuing ABS with too few resources and inflated ratings.

Sincerely yours,

William J. Harrington

Appendix A - Ratings differentiation

Structured Credit Investor - 10 April 2013

Call for improved assessment of derivatives risk

'Too big to fail' is emerging as a mainstream concern and with it come calls for the assessment of derivatives risk to be improved. For securitisation investors, better differentiation of risk in credit ratings is being put forward as one solution.

In a hypothetical scenario, where the securitisation industry could start over with regards to ratings frameworks, ex-Moody's svp William Harrington believes that ratings should be capped at single-A for deals that contain derivative hedges. At present, senior ratings don't distinguish between transactions that have a derivative at the top of the waterfall and ones that don't, even though downgrade risk is significantly higher for the former.

"Ratings caps would facilitate a more rational investment landscape that enables asset managers to look at their overall portfolio and identify which other factors - not just credit risk in the underlying - they might be sensitive to," he argues. "They could then hedge out their currency risk, for instance, on an exchange or leave the transaction unhedged and be compensated for associated risk. It would engender a better understanding of performance."

Harrington says that better differentiation of risk in ratings would create a clearer alignment of investment objectives across the spectrum from conservative institutional investors to risk-savvy sophisticated investors. He suggests that three distinct investment profiles could be targeted in this way: investors who would like to eliminate derivatives risk entirely; investors who can accept index/exchange risk but don't want derivatives risk; and investors seeking exposure to both index/exchange risk and derivative risks.

At issue is the limited number of ratings categories for structured finance, which means that hundreds of different outcomes converge on only 19 different ratings. "Different types of risks can be borne in securitisations and at present there is no way of distinguishing them. If variegated risks are reflected appropriately in a rating, it's then up to the investor which ones they can bear. A better way to gauge these risks would be to, say, designate them on a scale of one to a hundred," suggests Harrington.

This would also lessen the 'cliff effect' observable in current ratings approaches, whereby the minimal difference in expected loss between triple-A, double-A and single-A means that mild losses can move sharply down the capital structure.

Another issue that needs to be remedied, according to Harrington, is that information - such as differing underwriting standards, as well as nuances between asset classes and derivative type and counterparty - isn't typically disclosed to the end-users of ratings. Doing so would help investors and regulators gain a more granular sense of the risk involved.

"Publishing the vote tally in ratings committees would also help investors form opinions about contentious decisions, as well as follow rating patterns over time," he adds.

Harrington expects the drive towards central clearing of OTC positions will mean that derivatives return to their original function as hedging instruments. It may also force asset managers to scrutinise their derivatives documentation in more detail, thereby shedding light on how confirms are changing over time, for example.

"The broader issue is that assessment of derivatives risk needs to be improved," he observes. "It is analogous to the Y2K systems overhaul in that asset managers should be undertaking as much due diligence on derivatives risk as they do on credit risk. They now have two hedging options - via futures exchanges and OTC clearing."

Finally, event risk should be explicitly modelled by rating agencies, according to Harrington. This would include monitoring how many deals a counterparty is exposed to or whether any counterparty has an oversized exposure to a certain sector.

"There should be an upfront linkage between the ratings of a counterparty and the potential for flip clauses to be triggered," he concludes. "Ultimately, securitisations should be modelled according to whether they are fully hedged, partially hedged or unhedged. An overlay pertaining to where flip clauses are enforceable can be added where necessary."

Appendix B - Counterparty conundrums

Structured Credit Investor - 2 August 2013

Investors, issuers adapting to swap-related dilemmas

Given the difficulty of replacing counterparties and expense of posting collateral for cashflow securitisations, high volumes of swap-related rating agency confirmations look set to continue, potentially eroding investor protections in their wake. At the same time, investor acceptance of AA/A rated senior paper is growing, together with appetite for deals without embedded derivatives risk.

Peter Nowell, head of ABS trading at BNP Paribas, says that the Eurosail-UK 2007-3BL case (SCI 10 May) prompted a great deal of scrutiny around derivatives risk in European cashflow securitisations. Equally, rating agencies have become very conservative in their treatment of derivatives, requiring downgraded swap counterparties to post additional collateral.

"The average bank rating is single-A, which is close to the rating agency threshold. **Only a few players with the requisite ratings remain, so counterparty functions are increasingly difficult to replace.** For deals with sovereign caps, there is little point in replacing a downgraded counterparty anyway because the transaction is highly unlikely to return to being rated triple-A," Nowell notes.

He adds: "Given that it's becoming more expensive for banks to act as swap counterparties, transactions are emerging in Europe that don't have derivatives embedded, such as fixed-rate auto ABS. **Similarly, because cross-currency swaps are prohibitively expensive, dollar-denominated issuance is drying up."**

Adding to the difficulty of acting as a swap counterparty is the fact that rating agencies have a different approach to counterparty risk, if they have one at all. Nowell suggests that - with the EU encouraging more rating agencies to enter the market - if the established agencies are seen as overly restrictive regarding derivatives risk, it could encourage issuers to mandate the newer entrants instead.

Moody's recently published a request for comment that replaces its initial July 2012 RFC on assessing the linkage to swap counterparties in cashflow securitisations (SCI 23 July 2013). No substantive changes have been made to the original approach, albeit there is no longer a distinction between swap counterparty 'linkage' and 'delinkage' (see separate box).

Nevertheless, research undertaken by ex-Moody's svp William Harrington shows that the agency has issued 96 rating agency confirmations (RACs) covering 177 ABS transactions between the release of the two documents**. For at least 78 of the RACs, the swap counterparty successfully petitioned Moody's to be allowed to amend an existing derivative contract with an ABS transaction so as to avoid posting collateral and/or finding a replacement counterparty.**

The RACs were issued to 25 swap counterparties: 20 to Barclays; 12 to RBS; seven RACs each to BNP Paribas, UBS and Morgan Stanley; five RACs each to Banco Santander and Natixis; four RACs each to Deutsche Bank and Bank of America Merrill Lynch; three RACs each to JPMorgan and UniCredit; two RACs each to Banca IMI, SG, Credit Agricole, Goldman Sachs and DZ Bank; and one RAC each to Banca Intesa, Standard Bank of South Africa, Banque AIG, Merrill Lynch Derivative Products, National Bank of Greece, Erste Abwicklungsanstalt, Capital Home Loans, Bankia and Intesa Sanpaolo.

Harrington suggests that such actions by Moody's are essentially "giving swap providers a free pass to unilaterally write-off long-standing contractual obligations without obtaining consent of ABS noteholders or providing consideration in the form of alternative protections or compensation". He points to 20 near-identical RACs covering 38 ABS transactions that were obtained by Barclays so as to avoid posting collateral, despite having been downgraded to A2 in June 2012.

Given the go-ahead by Moody's RACs, Barclays lowered collateral triggers in these transactions to below A2, effectively one or more full rating notches lower. Harrington cites a RAC issued by Moody's with respect to Hercules (Eclipse 2006-4) as an example.

Moreover, 14 of the Barclays RACs covering 29 ABS transactions contained the caveat that a downgrade of affected ABS may follow the implementation of the swap comment request. One example of this is a RAC issued with respect to Sherwood Castle Funding 2006-1. Interestingly, Moody's also assigned new Aaa ratings in April to Permanent Master Issuer series 2013-1 with a similar caveat - that a downgrade may follow the implementation of the swap comment request.

The seven RACs provided to Morgan Stanley, meanwhile, were related to seven ABS transactions. Harrington notes that in each case Baa1-rated Morgan Stanley was obliged to find a replacement counterparty for a deep-in-the-money swap but instead retained the swap on its own book, leaving the ABS exposed to making a termination payment in the event of a Morgan Stanley insolvency. A RAC in respect of Broadgate Financing is one example here.

He adds that other noteworthy Moody's RACs have been issued for: Felsina Funding (where the swap counterparty - Banca IMI - unilaterally removed the swap triggers from the swap agreement); Claris Finance, Marche Mutui and BCC Mortgages (where the swap counterparty - SG - failed to post collateral, with the caveat that a downgrade may follow completion of the RFC); and 16 RESI and RESIX transactions issued from 2003 to 2006 (where the swap counterparty - Bank of America - took no actions following its downgrade of June 2012).

Meanwhile, Fitch and S&P also continue to issue RACs, covering all asset classes and jurisdictions. Over the last year, for example, these have involved structural/waterfall changes, account additions/removals, counterparty changes and changes to credit support.

Neither is Moody's the only rating agency that assumes zero risk interest rate, currency and basis derivatives when assigning new triple-A ratings. "The other rating agencies have already diluted their swap methodologies in order to kick the can down the road rather than address rating implications for ABS," Harrington explains.

He says that the key sticking point in rating methodologies is the 'too big to fail' assumption with respect both to swap providers and structured finance transactions that is used explicitly by Moody's and implicitly by other agencies. "At present, Moody's senior unsecured ratings of swap providers are typically rated two to three notches above 'standalone' ratings on the explicit assumption that they will receive government support. DPC ratings are also based on this assumption."

Harrington explains that ABS ratings also embed 'too big to fail' assumptions via 'linkage' to a swap provider. "For the vast majority of new ratings, Moody's and competitors assign an expected loss of zero to a derivative contract and assume that a swap provider will never default and leave an ABS either unhedged or owing a termination payment. For remaining ABS ratings, the swap provider's own 'too big to fail' rating often serves as a basis for capping linked ABS ratings. Hypothetically, if a failed bank isn't bailed out, the rug could be pulled out from under this assumption - with many ABS being impacted at once."

Assessing derivatives risk in securitisation structures could therefore present an opportunity for a second generation of evaluators. "Given that hedges are assumed to remain intact through the life of a transaction, valuations that take counterparty risk into account were historically never modelled. Breaking out asset risk and servicer risk are commonplace in the valuations process, but questioning assumptions regarding derivative risk has only recently emerged. Concentration risk of the swap provider, flip clauses and event risk are the main areas that valuations providers should consider in this regard," Harrington says.

Adding to concerns about securitisation swaps is the apparent failure of the industry (so far) to secure regulatory confirmation that the instruments can't be cleared, which leaves an open question as to the swap's enforceability. Together with rating agency swap linkage requirements, this may potentially drive some dealers to stop writing swaps for securitisations, according to Harrington.

"**It's still early days, but it's possible that some players will become more selective about their ABS counterparties or won't write a contract without hitting all of the compliance checks.** It depends on a dealer's franchise value of writing securitisation swaps," he observes.

He adds: "In particular, the already moribund 'replacement' market may shrivel further. Taking compliance risk for the sake of new business is one thing; doing so for a portfolio of legacy swaps with an impaired or defunct swap provider is quite another."

At present, only three major swap dealers in the US, one DPC affiliate, a few major European banks and a small number of smaller European banks write new securitisation swaps - and only a handful of these also 'replace' existing securitisation swaps. "Given the concentration by asset class and geographical region, the impact of one provider failing has the potential to impact the entire ABS market," Harrington continues.

Meanwhile, investors are increasingly comfortable with owning downgraded senior tranches with the correct subordination and structure, according to Nowell. "Many legacy European ABS bonds are no longer triple-A rated due to sovereign caps. We've seen many familiar bonds being downgraded, yet still performing well."

In order to access this opportunity and not have to rely on the moribund new issue market, he suggests that the investment guidelines for many European ABS investors will have been relaxed. "Many accounts still want to purchase what are perceived to be safe assets like Granite senior RMBS bonds, which are now split AAA/A rated. In contrast, Asian investors are typically more cautious and still only buy triple-A rated European bonds with Moody's and S&P ratings."

With respect to the primary market, Nowell cites the recently-priced Berica PMI as an example of how investors are increasingly willing to look at new issues that don't carry triple-A ratings. Rated by Fitch and DBRS, the transaction is the first publicly placed Italian SME ABS since 2005. The double-A plus class A1X tranche was upsized to €980m and priced at 240bp over three-month Euribor, having been 1.3 times covered. **CS**

Counterparty criteria explained
Moody's latest RFC on its approach to assessing swap counterparty linkage is substantially the same as last July's proposal (SCI 3 July 2012), but with a few important refinements. The agency is seeking to create a more comprehensive framework and reduce the instances where a case-by-case analysis is necessary (which was common in the first iteration).

The approach also moves away from the current delinkage framework, which consists of a rigid set of criteria regarding rating triggers and collateral formulas. "If these criteria were met, no further modelling of counterparty exposure was required, which is relatively straightforward where banks are highly rated," explains Edward Manchester, svp at Moody's. "But counterparties are finding it more difficult to sign up to these triggers now. Market experience has also showed that these triggers don't necessarily work."

The idea is to replace these rigid criteria with a framework that quantifies the rating impact of linkage, taking into account any enhancements that will absorb or mitigate swap-related losses. Quantifying the impact of the hedge by referencing multiple factors allows for a more flexible and sophisticated approach, according to Manchester.

"The approach allows one to dig deeper and derive the incremental expected loss relating to swap linkage. We add this to the expected loss of the deal and map the result to our rating scale," he explains.

He adds: "The incremental expected loss relating to swap linkage depends on both the probability of becoming unhedged and the expected severity of loss resulting from becoming unhedged. The probability of becoming unhedged primarily depends on the rating of the counterparty, as well as the applicable rating trigger levels and how the relevant remedial actions - such as collateral posting requirements - are defined."

Severity of loss largely depends on the type of swap. Basis swaps typically have a lower severity than cross-currency swaps, for example. Credit enhancement also reduces the impact of losing a hedge.

Finally, the rating of a tranche is relevant: the higher the rating, the more sensitive it is to linkage, given that there is little tolerance for incremental loss.

Moody's notes that swap counterparty exposure has not resulted in significant losses to structured finance investors and has rarely resulted in negative rating actions. For most swaps entered into since the publication of its framework for delinking swap counterparty risks, transaction parties have included robust provisions that significantly mitigate counterparty credit risk, the agency says. Rating triggers have typically been set in the single-A range, with downgraded counterparties committed to take remedial action, such as posting collateral or transferring their obligations to higher-rated replacements.

Appendix C - Currency swap criteria updated

Structured Credit Investor - 6 August 6 2013

Fitch has updated its criteria for rating currency swap obligations of an SPV in structured finance transactions and covered bond programmes. The updated criteria are not expected to result in rating actions.

The key driver for the rating of swap obligations is the rating of the related reference notes. SPV obligations to swap counterparty and noteholders should and usually rank pari passu.

Fitch also expects the currency swap to have terms and conditions that are no more onerous than those of the related notes. The agency will review the swap documentation to identify circumstances in which a termination payment may become payable by the SPV.

Termination payments that become due as the result of non-performance by the swap counterparty itself or a non-credit event are not addressed by the rating analysis, however. Any other events giving rise to a potential termination payment will be identified and analysed within the scope of the rating, Fitch says.

Any change to the rating of the corresponding notes will likely lead to an equal change in the rating of the SPV's currency swap obligations. The rating sensitivity will be driven primarily by the rating analysis applicable to the corresponding notes.

The rating of the SPV's currency swap obligations will be withdrawn if the currency swap agreement is terminated due to non-performance by the swap counterparty or a non-credit related event.

No CFTC relief for swap providers that fail to comply with CFTC regulations regarding legacy securitization swaps

CFTC Briefing by William J. Harrington
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WJH Publications on Securitization Swaps & Derivative Product Companies

"Guidelines for CDO Hedge Counterparties" (Moody's, 2002)

"Capping Hedge Termination Payments in Moody's Rated Structured Notes Following Default of Underlying Debt Instrument" (Moody's, 2004)

"Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions" (Moody's, 2006)

"Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (Moody's, 2009)

"ABS Losses Attributable to Securitization Swaps" (WJH Letter to SEC and ESMA, 2013)

Summary – No CFTC relief for swap providers that fail to comply with CFTC regulations regarding legacy securitization swaps

Primary Rational – Relief will frustrate the three purposes of the CFTC clearing mandate: 1) reducing risk to the American public; 2) increasing transparency in the derivatives marketplace; and 3) improving derivative pricing.

Big Picture – A securitization swap is much less effective than a cleared swap (or a non-cleared swap with two-way collateral posting) in mitigating counterparty exposure for either a swap provider or an ABS issuer.

Although both an ABS issuer and a swap provider are linked until maturity of a securitization swap, neither holds reserves against the other's non-performance. Moreover, a swap provider does not reserve against its own insolvency, a risk posed by a "flip clause" in the ABS priority of payments.

A flip clause, a linchpin of securitization swaps since their inception, encourages an ABS issuer and a swap provider to ignore insolvency risk altogether by masking unresolved issues of law, risk management, and governance. The 2008 bail-outs propped up providers of securitization swaps, such as AIG, and in so doing left flip clauses dormant (and other deficiencies of securitization swaps unexamined). In the absence of bail-outs, ABS losses and downgrades would have been worse.

A swap provider incorrectly treats a securitization swap as plain-vanilla, i.e., as having a robust secondary market and minimal counterparty exposure, and marks-to-market accordingly. (The assessment of minimal exposure to an ABS issuer is validated by reference to the rating of senior ABS, which represents circular reasoning, given that the ABS rating itself rests on a bedrock assumption that the ABS are not exposed to insolvency of a swap provider.) No counterweight offsets the optimistic mark-to-market of a securitization swap by a provider; an ABS issuer doesn't mark a securitization swap to-market at all.

Summary – No CFTC relief for swap providers that fail to comply with CFTC regulations regarding legacy securitization swaps (continued)

Secondary Rationale – Swap providers don't need CFTC relief to novate legacy securitization swaps that fail to comply with CFTC regulations. (The clearing mandate itself states that interest rate swaps that are not accepted by clearing houses won't be cleared, or words to that effect.)

Big Picture – A shortage of highly-rated, third-party swap providers willing to accept novation of legacy securitization swaps (replacement), not the clearing mandate, impedes downgraded providers. As example, downgraded swap providers have novated some legacy securitization swaps to BONY Mellon without either clearing the swaps or obtaining CFTC relief.

Simply put, replacement has proven to be a pipedream, rather than a market reality. After being downgraded in 2008, AIG was unable to replace some 75 securitization swaps that were deep-in-the-money assets with CDO/ABS issuers. As a (poor) alternative to replacing itself, AIG spent two years obtaining a limited guarantee that leaves the CDO/ABS issuers exposed to flip clause risk in the event of AIG insolvency.

In my October 15, 2013 meeting with the SEC Office of Credit Ratings, the staff corroborated the assessment that basically no replacement providers for legacy securitization swaps existed. (A November 12, 2013 meeting with the SEC Division of Trading and Markets also covered securitization swaps.)

Unable to arrange replacement with third-parties, downgraded providers of securitization swaps are shuffling the swaps in-house to higher-rated affiliates, i.e., FDIC-insured subs and Derivative Product Companies (DPCs), a type of structured finance operating company.

CFTC relief will comfort downgraded swap providers that in-house transfers will be enforceable down the road, but may not help ABS investors. All legacy securitization swaps, whether in-the-money or out of-the-money, expose ABS investors to insolvency of the swaps' providers.

Correspondingly, refusal to grant relief won't harm ABS investors, and may better protect them against provider insolvency, by incentivizing the providers themselves to re-structure legacy securitization swaps.

A downgraded provider has ample room to re-structure a securitization swap under a catch-all provision that allows for "any other remedy that obtains rating agency consent (RAC)." Moreover, a provider faces no looming deadlines after being downgraded that makes restructuring of a securitization swap impracticable; a replacement cure period serves only as a guide and carries no sanctions if breached.

Rating agencies have freely issued RAC (akin to no-action letters) to downgraded swap providers; e.g., Moody's issued 150 RAC letters between 2012-2013 that permissioned providers to defer posting collateral and transferring securitization swaps by lowering rating triggers, or removing them altogether. In some instances, swap providers obtained RAC a year or more after being downgraded. Presumably, swap providers can obtain RAC for proposals of the reverse-type, i.e., those that benefit ABS investors.

Primary Rational in Detail - No CFTC relief for swap providers that fail to comply with CFTC regulations regarding legacy securitization swaps

Relief will frustrate the three purposes of the CFTC clearing mandate: 1) reducing risk to the American public; 2) increasing transparency in the derivatives marketplace; and 3) improving derivative pricing.

1. Relief will not reduce risk to the American public, and may increase it, by grandfathering longstanding practice by ABS issuers not to reserve against counterparty insolvency.
   -- Relief will be construed as a CFTC finding that securitization swaps mitigate bilateral counterparty exposure as effectively as cleared swaps.
   1a. Securitization swaps are an expediency of the ABS industry, not valid market instruments.
   1b. Since the inception of the ABS industry, issuers have largely foregone purchasing options or self-hedging in favor of drafting securitization swaps so as to minimize upfront costs.
   1c. ABS Issuers have also borrowed under securitization swaps. From 2002-2007, 100+ CDO issuers borrowed from a handful of counterparties (chiefly AIG), rather than issue more debt or place more equity.
   1d. Securitization swaps contain Ponzi-like provisions, such as “replacement/guarantee” and “flip clauses” that provide cover for both an ABS issuer and a bank counterparty to treat all receivables, whether scheduled or accelerated, as money-good. As a result, each party to a securitization swap assesses it in a manner that is wildly optimistic taken alone and mutually contradictory taken in tandem. ABS issuers assume that only scheduled payments, and not termination payments, will be exchanged. Bank counterparties mark securitization swaps as plain vanilla swaps that may be liquidated at any time for fair value, i.e., as if ABS issuers will always pay termination amounts in full.
   1e. “Flip clauses” skirt issues of legal enforceability and of governance. Banks sign away 100% of future assets in the event of insolvency by agreeing to “flip clauses” that exempt ABS issuers from paying termination amounts to an insolvent counterparty. ABS issuers increase systemic risk by relying on “flip clauses” that are unenforceable under U.S. law.
   1f. Securitization swaps exempt issuers from posting collateral, even though doing so attaches counterparty risk both to banks and, in boomerang fashion because “flip clauses” are not enforceable under U.S. law, back to ABS investors. In the absence of having posted collateral, an ABS issuer can only fund a termination payment to an insolvent counterparty with funds otherwise earmarked for ABS investors. ABS issuers balk at posting collateral for economic reasons; securitization swaps can be drafted differently to provide for collateral posting by issuers.
   1g. Without collateral, a counterparty must hold an in-the-money securitization swap to maturity in order to be paid in full. Without “replacement,” an ABS issuer will face the same counterparty until maturity of a securitization swap. With a “guarantee,” an ABS issuer is still liable to pay termination amounts owed an insolvent counterparty.

Primary Rational in Detail - No CFTC relief for swap providers that fail to comply with CFTC regulations regarding legacy securitization swaps (continued)

Relief will frustrate the three purposes of the CFTC clearing mandate: 1) reducing risk to the American public; **2) increasing transparency in the derivatives marketplace;** and 3) improving derivative pricing.

2. Relief will not increase transparency in the derivatives marketplace, and may reduce it.
   -- Securitization swaps underpin some $2 trillion of U.S. ABS, but are among the murkiest of derivatives, sustained only through industry dissembling and omerta.
   2a. No regulator worldwide has oversight of securitization swaps – does CFTC want the role?
   2b. Securitization swaps are imploding. Key provisions of securitization swaps that were intended to protect ABS investors from counterparty default either haven't occurred, or have occurred but don't protect ABS investors, or lull ABS investors into ignoring risk of counterparty insolvency. Replacement is not achievable; guarantees don't remove risk of making termination payments; "flip clauses" are both unconscionable and unenforceable; and bank counterparties are obtaining "no-downgrade" letters to avoid posting collateral, replacing themselves, etc.
   2c. Failure of replacement market predates CFTC clearing mandate. A third-party market for replacement that is costless to ABS investors is a construct of the securitization industry that has never materialized, but has kept securitization swaps artificially cheap. Replacement contemplated under requested relief is generally in-house, e.g. to FDIC-insured bank subs or legacy Derivative Product Companies.
   2d(i). Issuers have borrowed under securitization swaps, re-paying counterparties in the form of off-market fixed rates. As example, 100+ CDO issuers borrowed from a handful of counterparties (chiefly AIG) in 2002-2007, in place of issuing more debt or equity.
   2d(ii). A securitization swap is an expediency for the securitization industry -- i.e. issuers, investors, counsel, counterparties, rating agencies, auditors, and regulators – not an organic necessity. From inception, the industry has treated securitization swaps as attaching zero counterparty risk to ABS, so that they may be issued on terms that are identical to ABS that have no need to hedge.
   d2(iii). When a securitization swap is present, ABS issuers receive AAA ratings for seniormost notes without reserving against counterparty non-performance or insolvency. Without a securitization swap, ABS issuers that need to hedge can only receive AAA ratings for seniormost notes by purchasing options or by self-hedging, i.e., purchasing additional assets or reserving additional cash.
   d3. In modeling ABS in the event of counterparty insolvency, agencies model securitization swaps and options similarly. Securitization swap and options that are in-the-money to ABS issuers are modeled as paying according to schedule after counterparty insolvency, while swaps and options that are out-of-the-money never obligate an issuer to pay a termination amount.
   d4. Industry response to the deficiencies of securitization swaps has been to disguise, through diluted methodologies and no-action letters, rather than acknowledge the deficiencies by downgrading senior-most ABS in all sectors.

Primary Rational in Detail - No CFTC relief for swap providers that fail to comply with CFTC regulations regarding legacy securitization swaps (continued)

Relief will frustrate the three purposes of the CFTC clearing mandate: 1) reducing risk to the American public; 2) increasing transparency in the derivatives marketplace; and **3) improving derivative pricing.**

3. Relief will not improve pricing of derivative contracts, and will almost certainly distort pricing of derivative contracts by extending a free pass for providers of securitization swaps and ABS issuers alike to ignore risk of each others' insolvency.
   -- Improved pricing of a securitization swap would reflect the costs of all provisions from the vantage of both a bank counterparty and an issuer of cashflow ABS.

Additional Rationale - No CFTC relief for swap providers that fail to comply with CFTC regulations regarding legacy securitization swaps

4. Relief will embroil the CFTC, very late in the day, in decade-long dissembling by the SEC, rating agencies, securitization issuers and securitization vendors such as accountants, counsel, valuation firms, etc., that is leading to the end days of securitization swaps.
   -- With or without relief, securitization swaps will implode from inherent deficiencies with respect to both ABS investors & counterparties, setting off a chain reaction of ABS downgrades across all sectors, etc.
   4a. Thus far, securitization swaps have been propped up by: rating agencies, which have diluted methodologies for securitization swaps multiple times, rather than downgrade ABS for growing exposure to downgraded bank counterparties; the SEC, which issued a no-action letter with respect to a central provision of Dodd-Frank that was intended to hold rating agencies accountable for their opinions; rating agencies (again), which have issued hundreds of no-downgrade letters that have enabled bank counterparties to renege on contractual obligations under legacy securitization swaps to post collateral, etc.; issuers, who enter into securitization swaps, rather than pay upfront premium to buy options, and who choose not to hold reserves against termination payments owed under securitization swaps; counsel, who do not advise issuers that flip clauses may be unenforceable; auditors, who ignore the highly idiosyncratic provisions of securitization swaps when marking them as plain vanilla; and bank counterparties, who agree to flip clauses which, if enforceable, trade away 100% of mark-to-market assets of securitization swaps upon becoming insolvent.
   4b. No industry participant defends replacement, guarantees or flip clauses, i.e., the linchpins of securitization swaps, nor securitization swaps in general.
   4c(i). Rating agencies cannot dilute methodologies for securitization swaps again without endorsing below-investment-grade banks as riskless counterparties for ABS issuers.
   4c(ii). Rating agencies cannot issue no-downgrade letters for barely-investment grade counterparties not to post collateral to ABS issuers.

Additional Rationale - No CFTC relief for swap providers that fail to comply with CFTC regulations regarding legacy securitization swaps (continued)

4d(i). Banks made their bed; I spoke with many in 2004-6, etc. regarding costs to them under Moody's Hedge Framework.

----- Many swaps deep in the money because also loaned money to CDOs and other ABS as cheaper than selling equity.-------

4d(ii). Bank counterparties are gearing up to shuffle legacy securitization swaps in-house one last time, most likely to FDIC-insured subs or Derivative Product Companies (DPCS). After the current round of replacement is completed, banks will have exhausted suitably-rated affiliates to re-house securitization swaps in the event that, at some future date, FDIC-insured subs and DPCs are downgraded.

4d(iii). Bank trading might prefer to sell options to ABS issuers, rather than enter into new securitization swaps, but first have to protect their deep-in-the-money, legacy securitization swaps. Industry conference calls have suggested that total bank assets in the form of securitization swaps may be $5-6 billion.

4d(iv). In-house replacement will be costless to banks with respect to in-the-money securitization swaps (and may save money with respect to out-of-the-money swaps, by deferring the obligation to post collateral.) CFTC relief will be a bonus for banks in preserving the entirety of in-the-money securitization swaps, as it will remove uncertainty that in-house transfers will be enforceable should either a bank or an ABS issuer subsequently enter bankruptcy.

4d(v). -- Impact on investors from last resting place of securitization swap -----

4d(vi). Bank trading desks can't defend accepting flip clauses other than by recognizing that the clauses are unenforceable.

4e(i) Ultimately, securitization swaps rest on the assumption that bank counterparties are too big to fail. The assumptions are both explicit and implicit.

4e(ii) Moody's and other agencies assign explicit "credit uplift" to FDIC-insured bank subsidiaries, as well as to most bank holding companies. However, the "credit uplift" is most pronounced with respect to FDIC-insured subs, generally a whole rating category, e.g., Baa3 to A3.

4e(iii) Securitization swaps embed triggers based on the "credit uplift" ratings of bank counterparties, not the "standalone ratings."

4e(iv) Securitization industry overlooks repudiation of many provisions of securitization swaps, notably replacement, guarantees, and flip clauses, because they only come into play when a counterparty becomes insolvent. If a counterparty never becomes insolvent, i.e., is too big to fail, then securitization swaps are fine.

4e(v) Bank trading desks cannot justify accepting "flip clauses", i.e. trading away assets in the event of bank insolvency, unless bank insolvency cannot occur.

4e(vi) Ditto bank regulators.

4f. next up – role of securitization swaps in RMBS, winding-down Freddie and Fannie, etc;

enforceability discussions referencing CFTC letter.

4g. CFTC, almost only regulator doing its job, wants to join the circus of “no-action?” SEC (Ford Motor Credit), rating agencies (no downgrade letters)