

## MEMORANDUM

**To:** Commission File No. S7-08-10

**From:** Robert Errett  
Special Counsel  
Office of Structured Finance  
Division of Corporation Finance  
U.S. Securities and Exchange Commission

**Date:** April 30, 2014

**Re:** Teleconference with William Harrington and Marc Joffe

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On April 30, 2014, Kathy Hsu, Robert Errett, Hughes Bates, Michelle Stasny, and Kayla Florio of the Division of Corporation Finance and Igor Kozhanov of the Division of Economic and Risk Analysis had a teleconference with William Harrington and Marc Joffe. The participants discussed topics relating to the Commission's April 7, 2010 proposing release regarding asset-backed securities and related releases. Mr. Harrington provided the attached memorandum.

Attachment

"Disclosure of Derivative Assets and Swap Contracts with Flip Clauses under Reg AB."

William J. Harrington

Experts Board Wikirating.net – Key Expert on Structured Finance Topics

(Following is an abstract from my February 17, 2014 submission to the Commission, <<http://www.sec.gov/comments/s7-08-10/s70810-283.pdf>>.)

Commissioner Piwowar cited the following standard in his "Statement on the Re-Opening of the Comment Period for Asset-Backed Securities Disclosure and Registration" of February 25, 2014. <<http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370540851698#.U2AcBLIOX4g>>

"As amended by the Dodd-Frank Act, Section 7(c) of the Securities Act requires issuers of asset-backed securities to disclose asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence."

Disclosure by ABS issuers of derivative assets such as options and swaps with flip clauses is both "necessary for investors to independently perform due diligence" and long overdue.

But for the 2008 bailouts, large counterparties such as AIG might well have been cautionary tales for ABS exposure to derivative risk and, correspondingly, counterparty exposure to ABS issuers. For instance, had AIG not been propped up, issuers in all ABS sectors would have found that a flip clause did not nullify obligations to accelerate swap payments owed to AIG, losses in all ABS sectors would have been larger, ABS in all sectors would have been downgraded more steeply, and the financial crisis would have been more severe.

However, many in the ABS industry, (including some who have commented on the Reg AB rule proposal), frame post-2008 outcomes as a successful trial by fire that validates their longstanding practice of assigning zero risk to a derivative contract, rather than as a taxpayer-financed wake-up call to assess the embedded risks for an ABS and a counterparty under a swap with a flip clause.

The risks extend across all ABS sectors, i.e., the risks are not limited to sectors that performed poorly during the financial crisis. For instance, student loan ABS makes use of "balance-guarantees" swaps with flip clauses; these swaps are among the riskiest to investors and underpinned pre-crisis RMBS, particularly sub-prime RMBS.

The current implosion of Royal Bank of Scotland is a case in point for embedded derivative risk in ABS; since being downgraded, RBS has reneged on obligations to post collateral and perform other credit-mitigating actions under derivative contracts with ABS issuers. Currently, however, no data exists on ABS issuers that are counterparty to RBS under derivative assets, such as: interest rate swaps with flip

clauses and options; basis swaps with flip clauses or options; or currency swaps with flip clauses or options.

In other words, disclosure of derivative assets such as options and swap contracts with flip clauses is, to use the standard of Commissioner Piwowar: "necessary for investors to independently perform due diligence." Moreover, not only investors, but also third-party evaluators, regulators, and other interested parties track ABS risk.

A sophisticated, institutional investor or valuation specialist can form an independent assessment of ABS exposure to counterparty insolvency with the following disclosures.

1. Type of derivative contract
2. Notional amount of contract
3. Legal final maturity of contract
4. Upfront payment paid or received by ABS issuer
5. Counterparty to contract
6. Guarantor of counterparty to contract
7. Mark-to-market of contract on counterparty books and records
8. Collateral posted by counterparty to issuer
9. Presence of flip clause in contract or in priority of payments
10. Provisions that enable a counterparty to modify the contract without obtaining consent of ABS investors (often termed "RAC" provisions, shorthand for obtaining rating agency confirmation/satisfying rating agency condition)
11. RAC provisions obtained to-date
12. Previous counterparty or counterparties to contract
13. Previous guarantor of counterparty to contract

The disclosures serve a key aim of Regulation AB, namely that of facilitating independent scrutiny of ABS, both on an individual basis and in aggregate by issuer, sector, counterparty, counterparty guarantor, and industry as a whole.

Moreover, an issuer can make the disclosures, and update them, at minimal cost and without raising gatekeeping or privacy concerns.