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**May 29, 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

**Re: File Number S7-18-11**
**Request for Re-proposal Relating to Nationally Recognized Statistical Rating Organizations**

Dear Secretary Murphy:

I am writing to urge the Commission to re-propose and extensively revise rule changes relating to Nationally Recognized Statistical Rating Organizations (NRSROs). In addition, I also urge the Commission to enforce Section 939G of Dodd-Frank, which makes NRSROs subject to expert liability under Sections 7 and 11 of the Exchange Act for disclosures of ratings in securities registration statements.

Since Dodd-Frank became effective, the Commission has suspended enforcement of Section 939G by means of administrative fiat—namely, the No-Action Letter relating to Ford Motor Credit Company LLC of November 23, 2010[1] and a preceding staff response letter. Failure to enforce Section 939G undermines the clear intent of Congress to change the liability standard for NRSROs and redress a root cause of the financial crisis: the lack of NRSRO accountability in assigning inflated ratings to asset-backed securities (ABS).

To date, the Commission has enabled NRSROs to assign inaccurate ratings with impunity. Failure to enforce Section 939G allows NRSROs to continue inflating ABS ratings, while the industry-friendly rule changes under consideration would empower NRSROs to continue rating inaccurately across all sectors—municipal, state, sovereign, supra-national, corporate, and financial, as well as ABS.

**NRSRO proposal would seed another derivative/ABS financial crisis**
In July 2010, I resigned as Senior Vice President in the Derivatives Group at Moody's Investors Service. For my 11-year tenure, my responsibilities centered on evaluating the impact of

[1] See <http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm>.

derivative contracts on structured finance ratings of end-users (e.g., ABS) and providers (e.g., derivative product companies, or DPCs) alike.

With respect to structured finance ratings of end-users of derivative contracts, I developed Moody's derivative methodologies for ABS worldwide;[2] for collateralized debt obligations[3] (aka CDOs, an ABS sector at the heart of the financial crisis); and for structured notes[4] (such as the Merrill Lynch programs assumed by Bank of America[5]). With respect to ratings of derivative providers, I was lead analyst for DPCs (which provide derivative contracts to all sectors—sovereign, financial, corporate, and municipal, as well as ABS), co-author of the 2009 revision to DPC methodology,[6] and co-leader of the team that assigned and monitored ratings of structured finance operating companies, which include DPCs and providers of credit default swaps.

In 2011, I offered commonsense alternatives to the proposed rule changes for NRSROs.[7] My counterproposal employs a commonsense litmus test: Good rules are those which, if in place prior to the financial crisis, would have obliged NRSROs to assign accurate ratings to ABS. The proposed NRSRO rules fail miserably; they would have made the 2008 crisis worse and, if adopted, would make a new crisis more likely.

Of particular concern, the proposed rules would enable NRSROs to continue awarding credits to both parties to a derivative contract (e.g., an ABS issuer and a large bank). By not applying any derivative debits at all, let alone balancing derivative debits and credits, NRSROs appease issuers and exploit earnings franchises, particularly in the ABS and financial sectors.

Good rules (i.e., revised rules) must obligate NRSROs to link derivative contracts across all sectors (sovereign, corporate, municipal, financial, ABS, etc.) in a closed system that rigorously applies offsetting debits and credits in equal measure. Better still would be a net debit across all ratings to reflect derivative obligations and risks, with the scale of the debit based on an ongoing tally of derivative contracts for each issuer.

**Unenforceable flip clauses prop up AAA ratings of ABS "liar loans"**

For two decades, NRSROs have applied a rating debit of 0.00% (i.e., no debit at all) to most derivative contracts between an ABS issuer and a derivative provider. An ABS issuer enters into

[2] "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions," Moody's Investors Service Methodology, May 10, 2007.

[3] "Guidelines for CDO Hedge Counterparties," Moody's Investors Service Guidelines, November 4, 2002.

[4] "Capping Hedge Termination Payments in Moody's Rated Structured Notes Following Default of the Underlying Debt Instrument," Moody's Investors Service Special Report, September 2004.

[5] "Bank of America Finds a Mistake: $4 Billion Less Capital," Eavis and Corkery, *New York Times*, April 28, 2014, available at <http://dealbook.nytimes.com/2014/04/28/bank-of-america-suspends-buyback-and-dividend-increase/?_php=true&_type=blogs&_r=0>.

[6] "Mitigating Voluntary Bankruptcy Risk of U.S. Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies," Moody's Investors Service Methodology, July 19, 2009.

[7] See my August 8, 2011 comment letter to the SEC, available at <http://www.sec.gov/comments/s7-18-11/s71811-33.pdf>. The letter, as well as other work of mine, including subsequent submissions to the Commission, Moody's derivative publications, and recent working papers, is also available at <http://www.linkedin.com/in/williamjharringtonmoodysvp>.

a derivative contract to offset depreciation of securitized assets vis-à-vis rated ABS with respect to interest rates, basis rates, currencies, or credit.

NRSROs have known since at least January 2010 that their derivative assessments for ABS are wildly inaccurate but still treat a derivative contract as 100.00% risk-free in assigning AAA ratings to new ABS; to do otherwise, for instance by applying even a minuscule rating debit of 0.01% to an ABS, places a AAA rating out of reach. Most flagrantly, NRSROs apply a rating debit of 0.00% to a swap contract with a "flip clause," even though a flip clause exposes one of the two parties (i.e., either a derivative provider or an ABS issuer) to 100.00% loss of contract value should the derivative provider become insolvent.

A swap contract with a flip clause is an NRSRO construct that underpins AAA ratings in most ABS sectors worldwide and has no analog among mainstream derivative contracts. Since the ABS industry's inception, issuers have jerry-rigged flip clauses into swap contracts as a means of keeping issuance costs artificially low. On its own, a swap contract generally costs nothing to enter and, to make a good thing even better, adding a flip clause ostensibly insulates ABS against the risk that an insolvent swap counterparty will claim a termination payment and siphon funds from an ABS.

"Ostensibly" is the operative word, given that the validity of a flip clause is doubtful in many jurisdictions, including the U.S.[8] In jurisdictions where a flip clause may not be upheld in bankruptcy proceedings, a swap contract with a flip clause is akin to a "liar loan" in that it enables a borrower (i.e., an ABS issuer) to overstate its ability to fully repay its loan (i.e., an ABS).

The magnitude of an ABS issuer's lie—that is, whether a swap with a flip clause is a little white lie or a great big whopper—depends on the mismatch in payment characteristics between securitized assets and an ABS. Mismatched currencies, prepayment conditions, or coupon amounts make a swap with a flip clause a highly customized "have it your way" kind of whopper, one that can easily be supersized into a double or triple whopper simply by having an ABS issuer upsize the scale of a mismatch, or adding to its number.

**Flip side of a flip clause: A derivative provider's rating should be debited twice**
With respect to the rating of a derivative provider, an NRSRO should apply two (non-zero) debits to the swap contract: a first debit that reflects the credit profile of an ABS issuer and a second, much larger debit that reflects the punitive losses that a derivative provider inflicts upon itself in the event of insolvency. As an alternative to incurring the second derivative debit, a derivative provider can set aside significant reserves that must be augmented upon being downgraded.

However, counterparties are unlikely to continue providing swap contracts with flip clauses if required to account for their potential losses in a meaningful way. For example, derivative providers under my supervision while at Moody's (DPCs such as Nomura Derivative Products

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

Inc., Merrill Lynch Derivative Products AG, Lehman Brother Financial Products Inc., and Lehman Brothers Derivative Products Inc.) generally abstained from providing swap contracts with flip clauses after being apprised of their rating implications.[9]

Without flip clauses that make swap contracts look airtight against a major component of counterparty risk, ABS issuers would be forced to buy options or set aside reserves when bringing new ABS to market, i.e., the ABS industry could no longer offer artificially cheap credit to borrowers across ABS sectors. Some ABS sectors, such as student loan ABS, would grind to a complete halt and other sectors, such as residential mortgage ABS, would not be revived in their earlier form.

**ABS dodged derivative bullets during the crisis and aren't bulletproof against counterparty risk**

But for the 2008 mergers and bailouts, large counterparties such as Bear Stearns Financial Products Inc. (BSFP) and AIG might well have been cautionary tales for ABS exposure to derivative risk and, correspondingly, counterparty exposure to ABS issuers. For instance, had BSFP and 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 a counterparty, 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, NRSROs frame post-2008 outcomes as a successful trial by fire that validates their longstanding practice of assigning zero rating debits to all derivative contracts (not only swaps with flip clauses), rather than as a taxpayer-financed wake-up call to assign significant rating debits to a derivative contract in recognition of embedded risks for an ABS and a counterparty. For example, each NRSRO has diluted its derivative methodology for ABS by designating banks with almost "junk" ratings as riskless providers of zero-debit derivative contracts,[10] even though doing so ups the counterparty risk for associated ABS (as well as for the almost junk provider itself when the riskless derivative contract is a swap with a flip clause).

The implosion of Royal Bank of Scotland (RBS) is the latest case in point (and Barclays' bad bank may be the next[11]). Since being downgraded, RBS has reneged on obligations to post collateral and perform other credit-risk-mitigating actions under derivative contracts with ABS issuers[12] (ditto Barclays). Rather than apply an offsetting debit to associated ABS, i.e., downgrade the ABS in tandem with RBS, Moody's Investors Services has vetted the RBS coup

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[9] One DPC under my supervision, Bear Stearns Financial Products Inc., was a major provider of swap contracts with flip clauses to residential mortgage ABS. See pp. 10-14 of my April 1, 2013 letter to Michel Madelain, President and COO, Moody's Investors Services, reprinted on pp. 25-29 of my June 3, 2013 letter, "Comment on SEC Roundtable for Asset-Backed Securities," available at <http://www.sec.gov/comments/4-661/4661-28.pdf>.

[10] See "Approach to Assessing Swap Counterparties in Structured Finance Cashflow Transactions," Moody's Investors Service Cross Sector Methodology, November 12, 2013, available at <https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF344857>.

[11] See <http://www.bloomberg.com/news/2014-04-29/barclays-said-to-create-bad-bank-overseen-by-eric-bommensath.html>.

[12] See my April 4, 2014 letter to the European Securities and Markets Authority, available at <http://www.wikirating.org/data/other/20140404_Harrington_J_William_RBS_Ratings_Rest_on_Rot_-_Collateral_Damage_from_Slow_Implosion_of_RBS.pdf>.

as being consistent with revised methodology (i.e., newly diluted methodology) and kept the ABS ratings intact.[13] (Since 2012, Moody's has done the same for Barclays.[14])

**Open Secret #1: Bank and ABS ratings both assume derivative risk = *ZERO***

Michel Madelain, President and Chief Operating Officer, Moody's Investors Services, wrote in his 2011 comment letter on the proposed rules for NRSROs: "We are concerned that the wording of the proposed attestation could inadvertently lead users of credit ratings to believe that credit ratings address other types of risk, such as liquidity risk, market value risk or price volatility."[15]

Actually, according to Moody's own definition,[16] an issuer rating ostensibly addresses an issuer's derivative obligations such as posting collateral on a daily or weekly basis and paying termination amounts that may activate at any time; these derivative obligations evolve relentlessly with market values.

In fact, a staggering amount of market value risk is supposedly reflected in just five Moody's ratings: those of the government-insured subsidiaries of five too-big-to-fail banks that together house more than 90% of U.S. derivatives.[17]

In other words, we should all be concerned with the wording of Mr. Madelain's comment. From September 2007 to May 2008, as unchecked derivative risk was wrecking the credit profiles of most issuers and world financial systems, Mr. Madelain's role at Moody's was "Executive Vice President, Fundamental Ratings…with responsibility for all Global Fundamental Ratings, including Corporate Finance, Financial Institutions, Public Finance and Infrastructure Finance."[18]

(In his defense, Mr. Madelain at least formulated responses to many components of the 600-page rule proposal for NRSROs. FitchRatings submitted a three-page comment letter.[19])

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[13] See two Moody's announcements: <https://www.moodys.com/research/Moodys-updates-on-impact-of-RBS-execution-of-deeds-of--PR_296262?WT.mc_id=NLTITLE_YYYYMMDD_PR_296262> and <https://www.moodys.com/research/Moodys-No-Negative-Rating-Impact-on-several-Lehman-Brothers-Small--PR_296781>.

[14] See <https://www.moodys.com/research/Moodys-updates-on-EMEA-RMBS-transactions-where-Barclays-Bank-PLC--PR_253346>.

[15] See "Credit Ratings Speak only to Credit Risk," p. 16 of the August 8, 2011 comment letter of Michel Madelain, President and COO, Moody's Investors Services, available at <http://www.sec.gov/comments/s7-18-11/s71811-48.pdf>.

[16] See Moody's "Rating Symbols and Definitions," available at <https://www.moodys.com/sites/products/AboutMoodysRatingsAttachments/MoodysRatingsSymbolsand%20Definitions.pdf>.

[17] See <http://dealbook.nytimes.com/2013/05/16/regulators-overhaul-derivatives-market-but-with-a-caveat/?_php=true&_type=blogs&_r=0>.

[18] See <http://www.forbes.com/profile/michel-madelain/>.

[19] See August 5, 2011 comment letter of Charles D. Brown, General Counsel, Fitch Inc., available at <http://www.sec.gov/comments/s7-18-11/s71811-24.pdf>.

While at Moody's, I briefed Moody's senior managers, banking group, and derivative group on outsize risks to banks, ABS, bank ratings, and ABS ratings under derivative contracts such as program swaps between a bank and its DPC affiliate[20] and swaps with flip clauses.

To date, Moody's senior management has not adjusted ratings to reflect derivative risk unless embarrassed into doing so.[21] Derivative managers have disclaimed responsibility for assessing the impact of their programs on bank ratings; and banking teams continue to base ratings on derivative evaluations from the banks themselves.

In contrast, Moody's analysts for insurer AIG repeatedly sought out the derivative group in the prior decade when assessing derivative contracts, but were told that AIG was not the derivative group's problem. In some instances, derivative managers were openly contemptuous of insurance methodologies and, in other instances, a derivative analyst like me had limited capacity to help the AIG analysts in their Sisyphean task.

**Open Secret #2: The Commission sanctions inflated bank and ABS ratings**

Since resigning from Moody's in 2010, I have submitted individual comment responses to S&P, FitchRatings, and Moody's regarding their respective proposals to dilute derivative methodologies for ABS,[22] particularly with respect to swaps with flip clauses.[23] Mirroring pre-crisis practices, the NRSROs have acted as one in watering down analogous ABS methodologies to keep from being frozen out of new business; in other words, NRSROs are once again racing to the bottom to preserve ABS market share.

I cc:ed staff of the SEC Office of Compliance Inspections and Examinations in my individual comment responses to Moody's, S&P, and FitchRatings, as well as on other work that critiques NRSRO derivative assessments and committee practices. I have not filed a whistleblower suit; instead, I deliver my work directly to a range of relevant entities such as NRSROs, regulators, legislators, journalists, and other researchers.

In 2012, I provided analysis to the U.K. House of Commons Treasury Select Committee to aid its inquiry into the role of rating agencies in the lead-up to the financial crisis.[24] Also in 2012, the Subcommittee on Oversight and Investigations of the House Committee on Financial Services invited me to examine NRSRO submissions pertaining to the collapse of MF Global and formulate questions to be posed to NRSRO officials at the public hearing "The Collapse of MF

[20] See "Moody's Approach to Rating Derivative Product Companies," Moody's Investors Service Rating Methodology, October 5, 2012, available at <https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF293573>.
[21] See <https://www.moodys.com/research/Moodys-Updates-Definition-of-Securities-Constituting-SF-Instruments--PR_249801>.
[22] See pp. 11-13 of my Sept 11, 2013 letter to the SEC and European Securities and Markets Authority, available at <http://www.wikirating.org/data/other/20130917_Harrington_J_William_ABS_Losses_Attributable_to_Securitization_Swaps.pdf>.
[23] See <http://www.bloomberg.com/news/2012-05-23/fitch-wavers-over-plans-to-relax-banks-derivatives-rules.html>.
[24] See <http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news/treausry-committee-to-question-credit-rating-agencies/>.

Global: Part 2."[25] Subsequently, subcommittee staff asked me to review the NRSRO section of the final staff report.[26]

In 2012-13, I submitted materials to the U.S. Department of Justice, the Securities and Exchange Commission, and the New York Attorney General via their joint Residential Mortgage-Backed Securities Working Group.[27] On April 16, 2012, I outlined the materials for Reed Brodsky, an Assistant U.S. Attorney for the U.S. Attorney's Office for the Southern District of New York,[28] at a conference we both attended. As follow-up to my conversation with Mr. Brodsky, I both emailed and phoned his office several times, but received no response or acknowledgement from him.

In 2013-14, on three separate occasions I have briefed the Commission on systemic risks that accumulate under swaps with flip clauses and other derivative contracts entered into by ABS issuers. These briefings were attended by staff from the Office of Compliance Inspections and Examinations, the Office of Credit Ratings, the Office of Structured Finance, the Division of Trading and Markets, and the Division of Economic and Risk Analysis.[29]

On May 14, 2013, I attended the SEC Credit Ratings Roundtable for ABS[30] held at SEC headquarters in Washington after having offered to be one of the roundtable's 30 panelists.[31] I also provided discussion themes for each of the day's three panels[32] and subsequently submitted a detailed appraisal[33] of the proceedings.[34]

In 2014, I briefed staff of the Federal Reserve, the Commodity Futures Trading Commission, the International Monetary Fund, and the European Securities and Markets Authority on systemic risks that accumulate under swaps with flip clauses and offered to similarly brief the European Banking Authority, the European Central Bank, and the Bank of England.

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[25] See <http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=276489>.
[26] See < http://financialservices.house.gov/uploadedfiles/256882456288524.pdf>.
[27] See <http://www.stopfraud.gov/leadership.html>.
[28] See <http://www.gibsondunn.com/lawyers/rbrodsky>.
[29] The SEC has posted two of my briefings on sec.gov and Wikirating has posted the third on Wikirating.net.

a. See <http://www.sec.gov/comments/s7-08-10/s70810-301.pdf> for the April 30, 2014 briefing given by Wikirating colleague Marc Joffe and me for the Office of Structured Finance and Division of Economic and Risk Analysis.

b. See <http://www.sec.gov/comments/s7-18-11/s71811-76.pdf> for my November 12, 2013 briefing for the Division of Trading and Markets and Office of Credit Ratings.

c. See <http://www.wikirating.org/data/other/20131020_Harrington_J_William_Email_Inaccurate_ABS&DPC_Ratings_Attributable_to_Securization_Swaps.pdf> for my October 16, 2013 briefing for the Office of Compliance Inspections and Examinations and the Office of Credit Ratings.

[30] See <http://www.sec.gov/spotlight/credit-ratings-roundtable.shtml>.
[31] See <http://www.sec.gov/news/press/2013/2013-83-bios.htm>.
[32] See <http://www.sec.gov/comments/4-661/4661-9.htm>.
[33] See my June 3, 2013 comment letter to the SEC, available at <http://www.sec.gov/comments/4-661/4661-28.pdf>.
[34] Webcast is available at <http://www.sec.gov/news/otherwebcasts/2013/credit-ratings-roundtable-051413.shtml>.

My briefings for regulators, as well as my comment responses to Moody's, S&P, and FitchRatings, are contained in comment files on the SEC website[35] and in postings on the Wikirating website.[36] My analysis of NRSRO ratings of MF Global is available on request.

**Open Secret #3: NRSROs inflate derivative-based ratings rather than bear bad news**
With respect to MF Global, NRSRO submissions and testimony showed that no NRSRO queried the competency of MF Global to manage existing derivative risks, let alone take on new risks under an expanded derivatives platform. Right up to the MF Global bankruptcy filing, NRSROs based ratings of MF Global on derivative information provided by the company itself.

NRSROs are taking a similar, laissez-faire approach to enormous derivative risks that have been permanently foisted on government-insured Bank of America, NA (BANA) by its parent Bank of America Corp. (BAC). Over a single weekend in October 2011, BAC unloaded $20 trillion notional of legacy Merrill Lynch derivative contracts on BANA.[37] This massive, zero-sum transfer instantaneously degraded the credit profile of BANA on both an outright basis and relative to the correspondingly enhanced credit profile of BAC.

However, Moody's neither downgraded BANA in the wake of the derivative transfer nor upgraded BAC relative to BANA at a later date. In fact, Moody's maintained BANA's rating advantage at two notches above BAC for two years after the transfer and then raised the gap to three notches on November 14, 2013 by simultaneously upgrading BANA while leaving the rating of BAC unchanged.[38]

The SEC and other regulators may want NRSROs to continue assigning inflated ratings that ignore the extent to which derivative risks undermine the credit profiles of both issuers and the financial system as a whole, given that accurate ratings would reflect an unsettling reality. Quoting from my Wikirating blog post of March 1, 2014: "We have less to work with than what derivative contracts would have us think."[39]

**Reopened and extended comment period for ABS rules warrants revised NRSRO rules**
On February 25, 2014, the Commission reopened a comment period for two separate proposed rule changes relating to ABS[40] after having postponed a vote on the rule changes that had been

[35] My submissions may be accessed by searching "William J. Harrington" and "Bill Harrington" on sec.gov. See <http://secsearch.sec.gov/search?utf8=%E2%9C%93&sc=0&query=%22William+J.+Harrington%22&m=&affiliate=secsearch&commit=Search> and <http://secsearch.sec.gov/search?utf8=%E2%9C%93&sc=0&query=%22Bill+Harrington%22&m=&affiliate=secsearch&commit=Search>.
[36] See <http://www.wikirating.org/wiki/UserWiki:WilliamHarrington>.
[37] See <http://www.bloomberg.com/news/2011-10-18/bofa-said-to-split-regulators-over-moving-merrill-derivatives-to-bank-unit.html>.
[38] See <https://www.moodys.com/research/Moodys-concludes-review-of-eight-large-US-banks--PR_286790>.
[39] See my Wikirating.org blog post "Entire Financial System Needs Commonsense Review of Derivative Contracts: Let's Start with ABS," available at <http://blog.wikirating.net/2014/03/01/entire-financial-system-needs-commonsense-review-of-derivative-contracts-lets-start-with-abs/>.
[40] See <http://www.sec.gov/rules/proposed/2014/33-9568.pdf>.

scheduled for February 5, 2014.[41] On March 28, 2014, the Commission extended the reopened comment period by an additional month.[42]

The changes under consideration would amend Regulation AB, the same regulation suspended in part since July 22, 2010 by the Ford Motor Credit Company No-Action Letter. Regulation AB and NRSRO rules operate in conjunction to specify ABS information that is made available to investors and other interested parties. These two sets of rules cannot be considered in isolation from each other without compromising the utility of ABS information as a whole.

In their present form, ABS and NRSRO rule proposals would codify longstanding practice by ABS issuers, underwriters, NRSROs, auditors, and counsel, as well as by the Commission itself, to conceal risks under derivative contracts with respect to individual ABS, counterparties, and the ABS sector as a whole. As a result, no investor or other interested parties—be they bank regulators, corporate risk managers, ABS analysts, bank analysts, valuation consultants, independent researchers, financial journalists, private U.S. citizens, or the Commission itself—will have enough information to price ABS accurately, to measure bank capital accurately, to track systemic risks accurately, or to gauge the scale of the next bailout accurately.

For a start, the proposed ABS rules do not require an ABS issuer to disclose the market value of a derivative contract on a periodic basis or to provide other information that would enable a third party to estimate a contract's value over the course of its life. Instead, an ABS issuer satisfies all disclosure requirements with respect to derivative contracts merely by appending to the closing documents information on those contracts that are in place at the time of an ABS closing. Post-closing, an ABS issuer need not provide follow-up information on existing derivative contracts, nor disclose entry into new derivative contracts.

As a result, an investor or other party wishing to evaluate an ABS will not have basic information with respect to its derivative exposure, starting with whether or not derivative exposure is present and, if so, in how many derivative contracts. Even for derivative contracts that are disclosed, a third party will lack information on 1) contract value; 2) counterparty performance in posting collateral, arranging replacement, or obtaining a guarantee; 3) changes in counterparty and counterparty guarantor; and 4) changes to the contracts themselves.

The NRSRO rule proposal does not close the information gap on ABS exposure to derivative contracts at all. An NRSRO is not required to reflect the presence of derivative contracts in an ABS rating, but instead can continue to hand out rating debits of 0.00% to all derivative contracts irrespective of contract risk and the credit profile of a derivative provider. As a result, an NRSRO can continue to assign a AAA rating to ABS with zero, moderate, and substantial derivative exposure.

In sum, investors and other interested parties will be unable to glean from a rating whether or not an ABS has derivative exposure and, if so, whether the exposure is to a small, standard derivative contract (e.g., a near-the-money Libor cap that covers a few securitized assets) or to an all-encompassing, idiosyncratic derivative contract (e.g., a balance-guarantee currency swap with

[41] See <http://www.sec.gov/news/openmeetings/2014/ssamtg020514-amended.htm>.
[42] See <http://www.sec.gov/rules/proposed/2014/33-9568.pdf>.

a flip clause that covers all securitized assets). Along the same lines, a rating will not reflect whether an ABS is exposed to a derivative provider rated as high as AAA or as low as BBB-.

Since 2011, I have repeatedly urged the Commission to remedy gaps in the quality and accuracy of ABS information that would result under current proposals for NRSROs and ABS. Most recently, I submitted a February 17, 2014 comment letter that assesses the proposed rule changes to Regulation AB with respect to interest rate swaps with flip clauses and other derivative assets held by ABS issuers.[43] I also discussed my assessment with staff from the Office of Structured Finance and the Division of Economic and Risk Analysis on April 30.[44] My proposal for disclosure items for derivative contracts is contained in my discussion notes in the appendix of this letter (p. 20).

Unfortunately, the Commission has relegated ABS and NRSRO rulemaking to separate silos and has not tasked either silo, or any other working group, with assessing ABS information in aggregate with respect to accuracy, relevance, and sufficiency. In the absence of a holistic prescription for good information on ABS exposure to derivative contracts—i.e., good NRSRO rules—a core source of systemic instability will remain in place: ABS issuers that have entered into derivative contracts cannot repay ABS with likelihoods that come close to matching their ratings.

**Does NRSRO freedom of speech have corresponding obligations?**

My outreach to the SEC, other regulators, legislators, and the NRSROs themselves highlights the underlying problem: An NRSRO faces no accountability in assigning or monitoring ratings. For its part, the Commission parrots the dubious notion that it cannot regulate the content of NRSRO methodologies or even assess the accuracy of NRSRO ratings. After all, each methodology and rating is an opinion, and any opinion, whether that of a human being or a corporate entity such as an NRSRO, is protected speech under the First Amendment of the U.S. Constitution.

Commission timidity has birthed a singular paradigm for NRSROs that other regulated companies must envy: NRSROs are exempted from regulation and other oversight by their own regulator, the SEC. Moreover, NRSROs do not compensate for the lack of regulatory quality control by setting self-imposed guidelines such as those that shape the professional speech of attorneys, auditors, and medical practitioners (i.e., industry standards and liability concerns) and the everyday speech of individuals (i.e., personal ramifications.)

By placing NRSRO opinions off limits for review—in other words, by making ratings and methodologies untouchable—the Commission has granted a privileged position to the opinions of NRSROs without correspondingly seeing that NRSROs produce the best opinions possible.

For their part, NRSROs seem to consider their privileged position as publishers of unsubstantiated opinions as no more than their due. As proof, NRSROs don't bother to represent their ABS ratings as being accurate or even good; at most, an NRSRO may occasionally respond

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[43] See <http://www.sec.gov/comments/s7-08-10/s70810-283.pdf>. (For preceding letter of February 2, 2014, see <http://www.sec.gov/comments/s7-08-10/s70810-256.pdf>.)

[44] See <http://www.sec.gov/comments/s7-08-10/s70810-301.pdf>.

to having lost new ABS business to a competitor by denigrating the competitor's methodologies and ratings.[45]

No one else in the ABS industry—investors, underwriters, analysts, auditors, researchers, journalists, etc.—vouches for the accuracy of ABS ratings either. For example, NRSRO panelists and other participants at the SEC Credit Roundtable for ABS did not defend ABS ratings. Quoting from my follow-up comments: "At the ABS Roundtable, NRSRO panelists did not back their rating opinions as accurate or even valid but merely offered that applicable methodologies are freely available on their companies' websites" per Commission guidelines.

**One Commissioner wants useful ABS and NRSROs rules. How about two more?**
At the "SEC Speaks" conference of February 21, 2014, Commissioner Stein also linked rule changes for ABS and NRSROs in mapping Commission priorities:[46] "We also need to finally and firmly address the conflicts of interest in asset-backed securitizations and the provision of credit ratings."

Certainly, rule changes for ABS and NRSROs are long overdue. The financial crisis erupted in 2008 after having been seeded by deficient ABS more than a decade ago. Moreover, the NRSRO release[47] and the two ABS releases[48] grow increasingly stale, having been proposed three and four years ago, respectively.

However, enacting bad NRSRO and ABS rules that in tandem would permanently allow issuers to bring insufficiently capitalized ABS to market is not the answer. With the reopening of the ABS comment period, the Commission has the opportunity to overhaul its approach to NRSRO rules. It would be pulling its weight to redress a root cause of the financial crisis that falls squarely within its purview.

**NRSROs treat derivative contracts as costless, risk-free, and win-win all around**
NRSROs inflate ratings in all sectors not only by underestimating the costs that attach to both parties to a derivative contract, but also by overestimating contract benefits for the two parties, as well as for the financial system as a whole.

In particular, NRSRO methodologies credit each party to a derivative contract with sound business acumen simply for having entered into the derivative contract in the first place. Issuer methodologies treat a derivative contract as a fully operational hedge that stabilizes cash flows otherwise exposed to market value risk, and bank methodologies treat the same contract as a reliable earnings stream that adheres to rigorous risk management standards.

Moreover, NRSROs do not bother to track system-wide costs that accumulate within the swap portfolios of the government-insured subsidiaries of five large banks that are counterparties to most U.S. derivative contracts. NRSROs merely pencil in open-ended tabs that will be picked up

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[45] See <http://www.bloomberg.com/news/2014-05-02/s-p-miscalculated-risk-in-postponed-mortgage-bonds-fitch-says.html>.
[46] See <http://www.sec.gov/News/Speech/Detail/Speech/1370540830487#.Uz1SYLlOX4g>.
[47] See <http://www.sec.gov/news/press/2011/2011-113.htm>.
[48] See <http://www.sec.gov/rules/proposed/2010/33-9117.pdf>.

by the U.S. government in the form of optimally orchestrated bail-ins[49] and, if necessary, more bailouts.

In other words, bank methodologies treat wind-down of a troubled financial institution as a systemic boon; government-insured bank subsidiaries are protected, swap and other derivative obligations are honored in full, and bondholders enjoy above-average recoveries.

The FDIC and other regulators need comprehensive information on bank assets and liabilities if they are to initiate an "earlier intervention and a more orderly resolution, which may in turn lead to higher recoveries compared with historical U.S. bank and thrift holding company defaults,"[50] i.e., to make the happy land of exquisitely timed bail-ins a reality and spare taxpayers more bailouts.

Unfortunately for taxpayers, inflated ABS ratings provide misleading information on bank holdings of ABS, which in aggregate may reach $500 billion.[51] In other words, NRSROs undercut their published rationales for rating bank debt above stand-alone levels with each ABS rated.

Two banks provide examples of the scale of ABS holdings at individual institutions. At the end of 2013, Capital One Financial Corp. had "over $10 billion in private-label residential and commercial mortgage-backed securities ("MBS") and consumer ABS" in its investment portfolio, according to the company's April 28, 2014 submission to the Commission regarding the proposed rule changes for Regulation AB.[52]

At the end of 2012, JPMorgan Chase held $70 billion of U.K. residential mortgage-backed securities alone.[53] These RMBS have particularly high derivative risks (cross-currency swaps of fixed U.K. sterling for floating U.S. dollars that are cancellable in part as individual mortgages default or are prepaid) and hence wildly inflated ratings. Upping the derivative risks further (and making the RMBS ratings still more inflated), RBS and Barclays are counterparties to some of the RMBS issuers and are reneging on obligations such as posting collateral and finding higher-rated counterparties.

**Brief primer on lose-lose derivative costs**

Moody's provides still more misleading ABS information to regulators by omitting derivative

[49] "Moody's Investors Service has concluded its review of eight large US banking groups. The credit ratings of these banking groups each benefit from the agency's assumption of government support." The support "may result in earlier intervention and a more orderly resolution, which may in turn lead to higher recoveries compared with historical US bank and thrift holding company defaults." See <https://www.moodys.com/research/Moodys-concludes-review-of-eight-large-US-banks--PR_286790>.

[50] Ibid.

[51] "U.S. banks securities concerns ease as portfolios swing into black" by Tracy Alloway, *Financial Times*, November 13, 2013 and follow-up comments, available at <http://www.samachar.com/US-bank-securities-concerns-ease-as-portfolios-swing-back-into-black-nlecOphigjb.html>.

[52] See p. 1 of the April 28, 2014 comment letter of Thomas A. Feil, Treasurer, Capital One Financial Corporation, available at <http://www.sec.gov/comments/s7-08-10/s70810-291.pdf>.

[53] See <http://economicmusings.tumblr.com/post/50615896653/jpm-cio-swings-hits-home-run-on-uk-rmbs>.

costs in mapping ABS stress tests.[54]

The costs of a derivative contract are intertwined obligations and risks that migrate back and forth between the two parties, evolving relentlessly with changes in market indices and credit conditions. In other words, a derivative contract is continually subject to market value risk that shuffles and reshuffles the assets and liabilities of both parties to the contract and continuously reshapes their credit profiles. However, ratings generally exclude derivative costs altogether or, at most, reflect derivative costs as static, point-in-time snapshots.

The primary obligations under a derivative contract include 1) making scheduled payments of amounts that vary by reference to market indices, 2) collateralizing the daily market value of variable amounts to be paid in the future, and 3) prepaying the same market value in full upon specified termination events.

The primary risk under a derivative contract is that of receiving less than the full amount owed of either 1) variable payments as scheduled, or 2) prepayment in full of the market value of variable amounts to be received in the future.

**Box 1: Detroit bankruptcy makes swaps lose-lose for the city and counterparties**

The bankruptcy of Detroit is demonstrating how lose-lose outcomes can evolve under derivative contracts: in this case, two interest rate swaps with two different banks.[55]

The terms of each swap obligate Detroit, as a bankrupt party, to prepay in full the market value of variable amounts owed. The combined market value for the two swaps has approached $300 million on some days.

Daily market values of the swaps were irrelevant to Detroit while it was solvent; the city planned to pay amounts owed as due over many years, as stipulated in the respective swap schedules.

In contrast, each bank counterparty valued its swap on a daily basis for official books and records. The valuations were based primarily on the referenced interest rates and only secondarily on the credit profile of Detroit.

With Detroit in bankruptcy, the market value of the two swaps has effectively been written down to the amount a bankruptcy judge agrees is fair for Detroit to pay: namely 30 cents on the dollar, payable in installments over several years.

In other words, what were for many years two standard interest rate swaps morphed quickly into instruments based primarily on the credit profile of bankrupt Detroit. Right off the bat, the banks

[54] See <http://www.moodysanalytics.com/Publications/Risk-Perspectives/2013/RP02/Risk-Perspectives-Stress-Testing-North-America/Regulatory-Spotlight-Overview/The-Challenges-of-Stress-Testing-US-Structured-Finance?mkt_tok=3RkMMJWWfF9wsRonvKzMce%2FhmjTEU5z17OsvWq6g38431UFwdcjKPmjr1YIIScpiI%2BSLDwEYGJlv6SgFQ7bEMatj0LgOWxk%3D>.

[55] See <http://www.usatoday.com/story/news/nation/2014/04/11/detroit-bankruptcy-judge-approves-swaps-deal/7590517/>.

must write off swap receivables equal to 70 cents on the dollar and also be prepared to write off the remaining 30 cents if Detroit cannot honor its reduced obligations as due under the new installment schedule.

Had one of the two banks rather than Detroit entered bankruptcy, the city still would have been obligated to prepay the full market value of variable amounts owed under the affected swap; bankruptcy of either party accelerates a swap.

Moreover, the swap's market value would have remained 100 cents on the dollar rather than shrinking to 30 cents on the dollar. In other words, Detroit would not have leverage to unilaterally revalue the swap based on its ability to pay.

Instead, the wind-down entity for the insolvent bank would obligate all entities that owed variable amounts under swaps, including Detroit, to pay as close to 100 cents on the dollar as possible, i.e., the wind-down agent would act to maximize incoming payments. (By inserting unenforceable flip clauses into swap contracts, the ABS sector pretends it and it alone will be exempt from the obligation to prepay 100% of the market value of variable amounts owed under swaps with an insolvent counterparty—in other words, ABS issuers are banking on receiving special treatment from the wind-down agent of an insolvent bank.)

If the insolvent bank had a large swap portfolio, a systemically disruptive number of entities across all economic sectors would be obligated to prepay 100% of the market value of variable amounts owed, just as in 2008.

**Box 2: Wikirating.org fosters good speech as antidote to bad ABS ratings**

NRSROs entirely ignore swap risk that permeates most ABS sectors and that is, in aggregate, concentrated within just a handful of financial entities that serve as swap counterparties.[56] Insolvency of a single counterparty will trigger swap terminations across ABS sectors en masse, siphon funds away from investors, and warrant widespread downgrades similar to those that unleashed the 2008 crisis.

Residential mortgage ABS and student loan ABS have pronounced exposure to counterparty risk, given their reliance on a highly idiosyncratic type of swap: a *balance-guarantee* swap with a flip clause. "Balance guarantee" indicates that the swap offsets two mismatches in payment characteristics between securitized assets and ABS—a standard mismatch such as that between basis rates, interest rates, or currencies and a second, highly idiosyncratic mismatch between prepayment rates.

I have apprised the Commission on the risks to ABS under swap contracts that conform to NRSRO methodologies on multiple occasions—for instance, in my September 11, 2013 letter addressed to the Commission and the European Securities and Markets Authority and in follow-up meetings with Commission staff.

[56] See pp. 2-3 of my February 17, 2014 comment letter to the SEC, available at <http://www.sec.gov/comments/s7-08-10/s70810-283.pdf>.

Wikirating published my September 11, 2013 letter,[57] as well as my summary of a follow-up meeting with SEC staff from the Office of Compliance Inspections and Examinations and the Office of Credit Ratings.[58]

The following six paragraphs quote pages 3-4 of my September 11, 2013 letter. (Distinct from a credit default swap, a *securitization swap* is an interest rate swap with a flip clause, a basis swap with a flip clause, a currency swap with a flip clause, or a balance-guarantee swap with a flip clause.)

"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 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.

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[57] See my September 11, 2013 letter to the SEC and European Securities and Markets Authority, available at <http://www.wikirating.org/data/other/20130917_Harrington_J_William_ABS_Losses_Attributable_to_Securitization_Swaps.pdf>.

[58] See <http://www.wikirating.org/data/other/20131020_Harrington_J_William_Email_Inaccurate_ABS&DPC_Ratings_Attributable_to_Securization_Swaps.pdf>.

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

"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."

**NRSROs inflate/deflate/inflate ABS ratings to serve the whole franchise**

Corporate boards and senior managers steer methodology development and rating decisions so as to maximize franchise-wide earnings. As proof, Moody's Corporation, the parent of Moody's Investors Services, has chalked up 44 consecutive quarters of positive earnings since becoming a stand-alone company on September 30, 2000.

The spinout of Moody's Corp. coincided with ABS revenues contributing significantly to NRSRO earnings as ABS teams inflated ratings to write as much new business as possible. However, maximizing earnings also entails minimizing costs: When reputational costs for having inflated ABS ratings exploded during the financial crisis, each NRSRO directed ABS teams to reverse rating inflation by downgrading ABS en masse and withdrawing some ABS ratings altogether.[59]

Initially, NRSROs neither forfeited new business by deflating ABS ratings (ABS issuance was moribund) nor lost revenues (issuers of existing rated ABS, no matter how impaired, continued to pay full monitoring fees to NRSROs[60]). Deflating ABS ratings while the financial crisis played out was simply smart business; if ABS issuance revived later, NRSROs could once again inflate ratings.

However, Congress rendered rating inflation permanently unprofitable for NRSROs by making them subject to expert liability under Section 939G of Dodd-Frank. Rather than stand behind the accuracy of their ratings, NRSROs indicated that they would halt all rating activity for ABS once Section 939G took effect; NRSROs would not assign new ABS ratings[61] or update existing ones.

[59] See pp. 72, Appendix Q1: "Fitch Ceases Rating DPCs in 2011" of my April 1, 2013 letter to Michel Madelain, President and COO, Moody's Investors Services, reprinted on p. 87 of my June 3, 2013 comment letter to the SEC, available at <http://www.sec.gov/comments/4-661/4661-28.pdf>.

[60] Taxpayers essentially subsidized monitoring fees paid to NRSROs by ABS issuers, given that TARP propped up most existing ABS.

[61] "Several of the 'nationally recognized statistical rating organizations' (NRSROs) have indicated that they are not willing to provide their consent to the inclusion of their names or ratings in registration statements or prospectuses until they have had time to assess the implications of such consent." See <http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120-incoming.pdf>.

In other words, NRSROs banded together and threatened a strike[62] that would compromise the accuracy of existing ABS ratings (by letting them die on the vine) and freeze the market for ABS issuance (at a time of anemic economic activity).

**SEC nullifies Dodd-Frank and green lights NRSROs to reinflate ABS ratings**

The Division of Corporate Finance caved immediately to NRSRO threats (and pressure from the wider ABS industry[63]) by issuing a July 22, 2010 staff response letter to Ford Motor Credit Company that suspended enforcement of Section 939G for a six-month period—i.e., the Division nullified Section 939G before it took effect. On November 23, 2010 (the Tuesday before Thanksgiving), the Division of Corporate Finance extended the suspension of Section 939G indefinitely by issuing the Ford Motor Credit Company No-Action Letter. This no-action letter is framed as a temporary accommodation,[64] but it has no expiry and remains in place almost four years after enactment of Dodd-Frank.

The Commission seemingly places 100% priority on facilitating ABS issuance[65] (irrespective of whether an ABS is adequately capitalized) and 0% priority on enforcing Congressional mandates under Dodd-Frank to instill accountability into ABS ratings so that rating accuracy, information, and quality, as well as ABS transparency, are improved. "Seemingly" is the operative word (and "questionable legality" an operative phrase); the Division of Corporate Finance did not post a notice or a request for comments prior to issuing the staff response letter of July 22, 2010 or the Ford Motor Credit Company No-Action Letter of November 23, 2010.

Nor has the Commission published 1) a rationale for not enforcing Section 939G; 2) an assessment of the costs and benefits of not enforcing Section 939G; or 3) a request for comments regarding the utility of enforcing Section 939G and the appropriateness of actions by the Division of Corporate Finance to suspend enforcement of Section 939G.

**Good rules will oblige ratings to bear bad news: ABS liar loans are brewing a new debacle**

The Commission must reverse course and obligate NRSROs to assign accurate ratings that aid economic decision making both by individuals (e.g., a subprime borrower considering an auto purchase) and by the country as a whole (can a common securitization platform for residential mortgages replace Freddie Mac and Fannie Mae?).

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[62] See <http://www.creditslips.org/creditslips/2010/07/rating-agencies-on-strike.html>.

[63] See <http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120-incoming.pdf>.

[64] "Given the current state of uncertainty in the asset-backed securities market…, the Division is extending the relief issued to you by letter dated July 22, 2010." See <http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm>.

[65] Ibid. "We understand that the rating agencies continue to indicate that they are not willing to provide their consent at this time, and that without an extension of our no-action position, offerings of asset-backed securities would not be able to be conducted on a registered basis."

Revised rule changes for NRSROs are essential. Otherwise, NRSROs will continue to manipulate ratings with the sole aim of maximizing franchise earnings.

Already, a new cycle of rating inflation for ABS and other sectors with outsized derivative risk is, like the retreat of Antarctica glaciers, well under way.[66] If not reversed, this cycle will usher in yet another derivative debacle, followed by mass downgrades and rating withdrawals.

Sincerely yours,

William J. Harrington
Experts Board, Wikirating.org – Key Expert, Structured Finance Topics

cc: The Honorable Mary Jo White, Chair
The Honorable Luis Aguilar, Commissioner
The Honorable Daniel Gallagher, Commissioner
The Honorable Michael Piwowar, Commissioner
The Honorable Kara Stein, Commissioner

[66] "As Trading Hurts JPMorgan, Auto Loans Aid Wells Fargo" by Silver-Greenberg and Corkery, *New York Times*, April 11, 2014, available at <http://dealbook.nytimes.com/2014/04/11/jpmorgan-earnings-fall-18-5-on-slowdown-in-trading-and-mortgage-lending/?_php=true&_type=blogs&_r=0>.

## Appendix

Briefing on April 28, 2014 by William J. Harrington for SEC Staff from the Division of Corporate Finance and the Division of Economic and Risk Analysis

Subject: Derivative Disclosures under Regulation AB

"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#.U2AcBLlOX4g>

"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.