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April 20, 2023

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Mr. Chris Kirkpatrick

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Copy: Office of Credit Ratings, U.S. Securities and Exchange Commission; Supervision of Credit Rating Agencies, European Securities and Markets Authority; Credit Rating Supervision, UK Financial Conduct Authority; Assistant Governor, Financial System, at the Reserve Bank of Australia; Managing Director, Financial Stability, Bank of Canada; Central Bank of Ireland; Reserve Bank of New Zealand; Executive Director for Financial Stability Strategy, Bank of England, Fitch Ratings, Moody's Investors Service, and S&P Global Ratings

Via Electronic Mail

Re: U.S. Securities and Exchange Commission Petitions for Rulemaking "File No. 4-790"
(*"I seek a rulemaking by the Commission that prohibits a security-based swap dealer or other entity subject to Commission regulation from predicating a security-based swap or other financial instrument subject to Commission regulation on a flip clause, walk-away, or variable subordination"*)¹
AND
U.S. Securities and Exchange Commission Petitions for Rulemaking "File No. 4-799"
(*"Policy Clarification on Credit Rating Agencies"*)²
AND
U.S. Commodity Futures Trading Commission § 13.1 Petition for Rulemaking of May 26, 2020 (*"prohibit a swap dealer . . . from predicating a swap obligation on a flip clause, walkaway, or variable subordination"*)³
AND
U.S. Commodity Futures Trading Commission "GMAC Work Product Input"⁴
AND
Moody's Investors Service Requests for Comment "Moody's Approach to Rating RMBS Using the MILAN Framework: Proposed Methodology Update", March 6, 2023⁵
AND
Moody's Investors Service Requests for Comment "Moody's Approach to Rating RMBS Using the MILAN Framework: Proposed Updates to Settings for Australia, Canada, Ireland, New Zealand and the United Kingdom", March 6, 2023⁶
AND
Moody's Investors Service In-Use "Banks Methodology"⁷
AND
Fitch Ratings In-Use "Banks Criteria"⁸
AND
S&P Global Ratings In-Use "General: Financial Institutions Rating Methodology"⁹

1 (<https://www.sec.gov/rules/petitions/2022/petn4-790.pdf>).

2 (<https://www.sec.gov/rules/petitions/2023/petn4-799.pdf>).

3 ([CFTC-WJH-2020-6-26-Sec-13.1-Rulemaking-Petition-Acknowledgment WJHarrington 06-26-2020.pdf \(croataninstitute.org\)](https://www.cftc.gov/PressRoom/PressReleases/8703-23)).

4 (<https://www.cftc.gov/PressRoom/PressReleases/8703-23>).

5 (https://www.moodys.com/research/Moodys-proposes-updates-to-its-methodology-for-rating-RMBS-using--PBS_1348957).

6 (https://www.moodys.com/research/Moodys-proposes-updates-to-country-settings-for-rating-RMBS-in--PBS_1356275).

7 (https://www.moodys.com/research/Banks-Methodology--PBC_1269625).

8 (<https://www.fitchratings.com/criteria/banks>).

9 (<https://disclosure.spglobal.com/ratings/en/regulatory/comments/submitcmtArticle/2926025>).

Dear All,

My name is Bill Harrington. I am Senior Fellow at the non-profit research and action Croatan Institute.¹⁰

I work to boost the sustainability of the world financial system with the dual aims of rationalizing economic decision-making and avoiding bailouts.¹¹ I focus on governance decisions in the financial sector that establish the capitalization and regulation of complex finance, particularly derivative contracts and structured finance products.¹²

Today's letter and the six other documents that the delivering email attached comprise a joint submission to the U.S. Securities Exchange Commission, to the U.S. Commodity Futures Trading Commission, to Moody's Investors Service, to Fitch Ratings, and to S&P Global Ratings regarding each of the nine title-line matters.

The joint submission unequivocally demonstrates that the flip-clause-swap-contract is, by intentional design, intrinsically destructive. The contract undermines social compacts around the world by directing investment to sub-optimal uses, by eroding value of RMBS, ABS, and other structured debt, by incentivizing swap dealers to self-sabotage and under-capitalize, and by generating public bail-outs.

The joint submission also demonstrates that essentially all financial regulators, credit rating staff, and complex-finance practitioners worldwide have undermined social compacts for decades by mutely going with the flip-clause flow rather than speaking out and applying what they know.

The six additional documents are:

1. "WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019"
2. *Moody's Investors Service* Pre-Sale Report "Liberty Series 2023-2", 28 February 2023
3. *Moody's Investors Service* Rating Action "Moody's assigns definitive ratings to prime RMBS to be issued by Fortified Trust", 31 January 2023
4. *S&P Global Ratings* New Issue: "Finance Ireland RMBS No. 4 DAC", February 3, 2022
5. *S&P Global Ratings* Presale "Bluestone NZ Prime 2022-2 Trust", December 12, 2022 and
6. *Moody's Investors Service* Pre-Sale Report "Elstree Funding No.3 PLC", 9 March 2023

Please make the joint submission — i.e., all seven documents — publicly available on the respective sites for the nine title-line matters.

¹⁰ (<https://croataninstitute.org/>).

¹¹ (<https://croataninstitute.org/2021/05/30/injecting-accountability-into-the-u-s-and-global-financial-systems/>) and (<https://croataninstitute.org/william-j-harrington/>).

¹² Harrington, Bill, "Sometimes, Holding the Line is Progress", *Croatan Institute View*, November 17, 2022. (<https://croataninstitute.org/2022/11/17/sometimes-holding-the-line-is-progress/>).

“The Big Short” Shortchanged the Flip-Clause-Swap-Contract that Shortchanges the World!

Dealmakers the world over use the flip-clause-swap-contract to assemble RMBS, ABS, and other structured deals on the cheap. From the get-go, each artificially “cheap” deal distorts price signals and investment for all types of projects. Over the long-term, artificially “cheap” deals can implode and tax everyone in the form of bail-outs, deferred investment, and accelerated social fragmentation. Witness the 2008 financial calamity.¹³

“The flip-clause-swap-contract was a root cause of the 2008 global financial catastrophe. The flip-clause-swap-contract was an integral component of the under-capitalized structured debt that started, fueled, and pro-longed the 2008 financial catastrophe. The flip-clause-swap-contract was a tool that financial institutions such as AIG, Bear Stearns, Lehman Brothers, and many others used to under-capitalize themselves. The flip-clause-swap-contract was a tool that Greece, with the active assistance of Goldman Sachs, used to crash its own economy.”¹⁴

“The flip-clause-swap-contract was central to the EU financial crisis. Even so, EU issuers of RMBS and other ABS use the flip-clause-swap-contract under policy that the US has prudently rejected.”¹⁵

“Partly owing to the outsized losses that the Lehman Brothers Special Financing [LBSF] flip-clause-swap-contract portfolio incurred, LBSF creditors received lower recoveries than other Lehman creditors.”¹⁶

¹³ Harrington, William J. “Motion to File Proposed Amicus Curiae Brief to the US 2nd Circuit ‘Re: Case No. 18-1079-bk (Lehman vs 250 Financial Entities Re Flip Clause Enforceability)’”, 25 June 2019, in total. (<https://croataninstitute.org/wp-content/uploads/2021/06/WJH-Motion-to-File-Amicus-Brief-in-2nd-Circuit-Case-18-1079-bk-Lehman-Brothers-vs-the-World.pdf>).

¹⁴ Harrington, William J., “Electronic Letter to U.S. Commodity Futures Trading Commission, European Securities and Markets Authority, DBRS Morningstar, Fitch Ratings, Moody’s Investors Service, and S&P Global Ratings ‘Re: Deficient Accounting, Capitalization, Credit Ratings, and Regulation of EVERY Party to a Swap Contract with a Flip Clause or Other Walk-Away Provision””, December 28, 2020, “Questions for the CFTC, the SEC, the SFA, LSTA, DBRS, Fitch, Moody’s, and S&P Global”, p3. (https://croataninstitute.org/wp-content/uploads/2021/09/20201228_Harrington_J_William_Flip_Clause_Questions_to_CFTC-SEC-LSTA-SFA-DBRS-Fitch-Moodys-SP.pdf).

¹⁵ Harrington, William J, “Proposed Amicus Curiae Brief to the US 2nd Circuit ‘Re: Case No. 18-1079-bk (Lehman vs 250 Financial Entities Re Flip Clause Enforceability)’”, 25 June 2019, p38. (<https://croataninstitute.org/wp-content/uploads/2021/06/18-1079-bk-WJH-08-08-19-Letter-to-US-Court-of-Appeals-for-Second-Circuit-Proposed-Amicus-Curiae-Brief-Re-Case-No-18-1079.pdf>).

¹⁶ “Op. Cit. Harrington Motion to File ‘Lehman vs 250 Financial Entities Re Flip Clauses’”, p24.

Welcome Flip-Clause-Swap-Contract Trainees New and Old, One and All!

I am pleased to add new addressees to my two-decade-and-counting tutorial on the systemically disastrous flip-clause-swap-contract. Chins up, Newbies! Stay strong though today's submission shows that you degrade the public good day in and decade out. After all, permanent rookies such as Mr. Nicolas Weill, Chief Credit Officer for Global Structured Finance at Moody's Investors Service, Ms. Sarah Breeden, Executive Director for Financial Stability Strategy at the Bank of England, and many, many other practitioners the world over do exactly that, namely degrade the public good day in and decade out!

"Does every structured issuer around the world still undercapitalize debt when party to a flip-clause-swap-contract?"

"Does every provider of a flip-clause-swap-contract around the world still undercapitalize its self-referencing exposure to 100% loss of contract value under each flip clause?"¹⁷

As Mr. Weill, Ms. Breeden, and their reluctant fellow leaners can attest, I am among the few worldwide to rigorously assess the proliferation of gaping credit exposures that each flip-clause-swap-contract generates for a structured debt issuer, for a swap contract dealer, for domestic economies, and for the broader financial system. Moreover, I am the *only* person worldwide to publicly post and disseminate *all* rigorous assessments of the proliferation of gaping credit exposures that each flip-clause-swap-contract generates for a structured debt issuer, for a swap contract dealer, for domestic economies, and for the broader financial system.¹⁸

"Since resigning [as Moody's Investors Service senior vice president] in 2010, I have taught myself to be a public-citizen advocate by following financial practitioner leads in speaking to media, co-authoring academic papers and op-eds, and submitting public responses to proposals to regulate and assign credit ratings to complex-finance bonds. However, I break from industry practice in working entirely in the public domain, whereas industry representatives augment public relations with closed-door, off-the-record meetings with policymakers."¹⁹

Largely owing to my work, the Bank of England, the CFTC, the SEC, Fitch Ratings, Moody's Investors Service, S&P Global Ratings, and many, many, many other entities and people worldwide who should fully appreciate the proliferation of gaping credit exposures that each flip-

¹⁷ "Op. Cit. Harrington Electronic Letter to CFTC, ESMA, and Four NRSROs, December 28, 2020", "Questions for the CFTC, the SEC, the SFA, LSTA, DBRS, Fitch, Moody's, and S&P Global" Nos. 2 and 3, p15. (https://croataninstitute.org/wp-content/uploads/2021/09/20201228_Harrington_J_William_Flip_Clause_Questions_to_CFTC-SEC-LSTA-SFA-DBRS-Fitch-Moodys-SP.pdf).

¹⁸ "Op. Cit. Harrington Motion to File 'Lehman vs 250 Financial Entities Re Flip Clauses'", in total.

¹⁹ "Op. Cit. Harrington 'Sometimes, Holding the Line is Progress'". (<https://croataninstitute.org/2022/11/17/sometimes-holding-the-line-is-progress/>).

clause-swap-contract generates for a structured debt issuer, a swap contract dealer, domestic economies, and the broader financial system do fully appreciate the proliferation of gaping credit exposures.

Unfortunately for domestic economies, swap contract dealers, structured debt issuers, and the broader financial system, the Bank of England, the CFTC, the SEC, Fitch Ratings, Moody's Investors Service, S&P Global Ratings, and many, many, many other entities and people worldwide who should and do fully appreciate the proliferation of gaping credit exposures that each flip-clause-swap-contract generates *will not* mitigate the exposures, not even by a little bit.²⁰

*"Among complex-finance practitioners such as accountants, bankers, bond analysts, and legal counsel, the swap-contract-with-flip-clause is an unacknowledged open secret. No financial practitioner does defensible work on the contract because all practitioners that use the contract deliberately ignore deficiencies that stare them in the eye. The global credit rating companies Fitch Ratings, S&P Global Ratings, and my former employer Moody's Investors Service amplify the 'see no evil' approach in posting credit ratings and methodologies for practitioners the world over to exploit. Extending the systemic damage, Fitch, Moody's, and S&P are swamping ESG rating and analyses with the same 'see no evil' methods."*²¹

Credit rating companies *should* do what I do but do exactly the opposite.

"Unfortunately, NRSROs have been shirking these basic responsibilities for eight years with the help of SFIG and if its lobbying succeeds, the CFTC as well.

*"For instance, senior Moody's staff such as Chief Credit Officer for Structured Finance Nicolas Weill and Senior Vice President Edward Manchester have had first-hand knowledge since 2010 that the replacement assumption represents wishful thinking rather than commercial reality. Even so, the replacement assumption remains a AAA lynchpin of the Moody's methodology for uncleared swaps with RAC provisions and flip clauses seven years later and counting."*²²

²⁰ "Op. Cit. Harrington Electronic Letter to CFTC, ESMA, and Four NRSROs, December 28, 2020", "Financial Sector Apologists, Enablers, Cowering ChurchMice, and Fence-Sitters Also Know All About All the Myriad Flip Clause Problems", pp7-11. (https://croataninstitute.org/wp-content/uploads/2021/09/20201228_Harrington_J_William_Flip_Clause_Questions_to_CFTC-SEC-LSTA-SFA-DBRS-Fitch-Moodys-SP.pdf).

²¹ "Op. Cit. Harrington 'Sometimes, Holding the Line is Progress'". (<https://croataninstitute.org/2022/11/17/sometimes-holding-the-line-is-progress/>).

²² Harrington, William J., "Submission to U.S. Commodity Futures Trading Commission Re: 'Capital Requirements for Swap Dealers and Major Swap Participants', (Federal Register Vol 81, No. 242, Pages 91252-91334)", May 4, 2017, p44. (<https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61196&SearchText>).

Fitch Ratings, Moody's Investors Service, and S&P Global Ratings point-blank *refuse* to publicly post rigorous assessments of the proliferation of gaping credit exposures that each flip-clause-swap-contract generates for a structured debt issuer, for a swap contract dealer, for domestic economies, and for the broader financial system. Instead, Fitch, Moody's, and S&P negligently inflate credit ratings for **ALL** RMBS, ABS, and other structured debt of issuers worldwide that are party to a flip-clause swap-contract, for **ALL** swap contract dealers worldwide that provide the contract, and for **ALL** sovereigns that enable issuers or dealers to enter the contract.

At Moody's Investors Service, Mr. Nicolas Weill and I evaluated the flip-clause-swap-contract from 2005 until my resignation in July 2010.²³ In 2005-2006, we painstakingly line-edited innumerable late-stage drafts of what is to-date the only rigorous, comprehensive credit rating methodology for the flip-clause-swap-contract ("Moody's 2006 Hedge Framework").²⁴

I resigned as Moody's Investors Service senior view president in July 2010 after declining an unsolicited offer to join Mr. Weill in the group that oversees credit rating methodology development and application. Why decline-and-resign? Because Moody's studiously *ignored* the centrality of the flip-clause-swap-contract to the 2008 financial calamity and just as studiously *refused* to rigorously assess the proliferation of gaping credit exposures that each flip-clause-swap-contract generated for a structured debt issuer, for a swap contract dealer, for domestic economies, and for the broader financial system.

In May 2011, Moody's Investors Service refused to rigorously assess the proliferation of gaping credit exposures that each flip-clause-swap-contract generated for the swap contract dealer.

*"Thank you for your comments concerning Moody's bank rating methodology. We appreciate your sharing them with us and will give them appropriate consideration. We understand that you have contacted several Moody's employees to provide your comments . . . You are welcome to direct any further comments directly to me, and I will make sure that they are shared with the relevant rating and credit policy personnel."*²⁵

²³ "Structured Finance Responds to Issues of Counterparty Risk and Basel II in Calls for Comment", Inside Moody's CreditPolicy, January 2006, p4. (https://www.moodys.com/research/Moodys-Credit-Policy-Newsletter--PBC_96515). Also, "Op. Cit. Harrington CFTC Submission May 4, 2017". See "Weill" throughout, for instance footnote 130, p152. "Similarly, my Moody's colleagues Nicolas Weill . . . and I approved a standard form for UBS to use when entering into swap contracts with SPVs that issued debt backed by student loans."

²⁴ Manchester, Edward, Bill Harrington, and Nicholas Lindstrom, "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions—Structured Finance Rating Methodology", Moody's Investors Service, May 25, 2006, in "Brief of SIFMA and ISDA in Support of Defendants-Appellees and Affirmance Re: U.S. District Court for the Southern District of New York, Case No. 17-cv-1224-LGS, Lehman Brothers Special Financing, Inc. against Bank of America, National Association and all", June 16, 2017, Exhibit A. (<https://www.sifma.org/wp-content/uploads/2017/06/LehmanBrothers061617.pdf>).

²⁵ "Email response of Moody's Investors Service Chief Credit Officer Richard Cantor to Bill Harrington 'Re Recognizing the Market Loss That a Bank Agrees to Bear Under a Swap with a Securitization'",

After scrapping Moody's 2006 Hedge Framework in November 2013 because the framework's comprehensive rigor hurt business, Moody's Investors Service posted increasingly diluted, willfully negligent successor methodologies that minimized the proliferation of gaping credit exposures that each flip-clause-swap-contract generated for RMBS, ABS, or other structured debt and *entirely ignored* the gaping credit exposures that each contract generated for a contract dealer.

In 2017, Fitch Ratings refused to rigorously assess the proliferation of gaping credit exposures that each flip-clause-swap-contract generated for student loan company Navient and its ABS.

*"Thanks for sending this along. We will look into the issue."*²⁶

In 2018, S&P Global Ratings refused to acknowledge, let alone rigorously assess U.S. CLO credit exposures to poor governance when an issuer placed flip clauses in the priorities of payments but provided neither operational capabilities nor financial resources to comply with U.S. swap margin rules.

*"S&P Global Ratings has not rated a new or refinanced US CLO [with a flip clause] that [also] contains a swap during the time that the margin posting rules for uncleared swaps have been effective. Specifically, the ZAIS CLO 8 Ltd./ZAIS CLO 8 LLC transaction you reference in your e-mail was not structured with a swap, and accordingly margin posting was not an analytical consideration when issuing our ratings. If the ZAIS issuer were to enter into a swap, it would be at that time that we would apply our relevant criteria to assess any impact such a swap would have on our outstanding ratings. We maintain that we abided by our relevant criteria when rating ZAIS CLO 8 Ltd./ZAIS CLO 8 LLC."*²⁷

May 16, 2011, in "Op. Cit. Harrington CFTC Submission May 4, 2017", p135. **N.B.**, Cantor, now Moody's Investors Service Vice Chairman, was Chief Credit Officer until April 2022, according to his LinkedIn profile on April 17, 2023. (<https://www.linkedin.com/in/richard-cantor-b576617/>).

²⁶ Meghan Neenan, Managing Director — Financial Institutions, Fitch Ratings, email to Bill Harrington "Re Navient Solvency & Margin Rules for Uncleared Swaps", September 11, 2017.

²⁷ Mark Risi, Managing Director / Lead Analytical Director / Structured Finance, S&P Global Ratings email to Bill Harrington "Re NRSRO Ratings of U.S. CLOs with Flip Clauses but No Margin Posting Provisions", April 19, 2018. From WJH return email of April 19, 2018. "*I appreciate your reply, which proves my point. S&P does not abide by its methodologies when assigning ratings to US CLOs with flip clauses in the priorities of payment. II Most obviously, S&P represents that it conducts a forward-looking analysis on all features of a new deal such as ZAIS CLO 8 Ltd./ZAIS CLO 8 LLC. If so, what forward-looking analysis did S&P conduct with respect to the legal opinion on flip clause enforcement, the business plan to enter into a flip clause swap but not a margin posting swap, and manager quality? II S&P also represents that it applies applicable rating methodologies consistently across a given asset class. If so, what forward-looking comparisons did S&P conduct between US CLOs that do and do not have flip clauses in the priorities of payment?*"

“We did not feel the need to update our counterparty criteria following the introduction of the [U.S.] margin requirements as we continue to stand behind our methodology that incorporates reliance on replacement of counterparties.

II

“When a swap counterparty does not replace itself, we would not automatically downgrade our rating on the applicable security. In this case, we would analyze the particular transaction and assess if there are other mitigants that would cover the increased counterparty risk. For example, our cash flow analysis may show that there is sufficient credit enhancement available to cover interest rate risk in the event that the counterparty defaults. Another example would be the counterparty providing us with a detailed action plan outlining their strategy and our determination as to whether this information may give us comfort that there is no immediate need to downgrade the notes.”²⁸

Regarding the hundreds or more past instances of non-replacement worldwide — i.e., “[w]hen a swap counterparty does not replace itself” — S&P Global Ratings not only did “not automatically downgrade our rating on the applicable security.” S&P also failed to downgrade any applicable counterparty to reflect ballooning self-exposure to flip clause activation arising from non-replacement and increased probability “that the counterparty defaults.”²⁹ And why should S&P bother to assign accurate credit ratings to flip-clause-swap-contract dealers, anyway? After all, Lehman Brothers undoubtedly served up a great many “detailed action plan[s] outlining their strategy” to S&P prior to September 15, 2008, each one of which must have provided great “comfort that there . . . [was] no immediate need to downgrade the notes” or Lehman Brothers itself.

On May 11, 2023, Moody’s Investors Service cited low “market interest in ratings that exclude government support” in doubling-down on refusing to rigorously assess the proliferation of gaping credit exposures that each flip-clause-swap-contract generated for RMBS, ABS, or other structured debt and for swap contract dealer. The result? Moody’s will continue to incentivize all non-U.S. RMBS, ABS, and structured debt issuers and swap dealers to enter flip-clause-swap-

²⁸ Katrien Van Acoleyen — Global Structured Finance Head Methodologies, S&P Global Ratings, email to Bill Harrington “Re Your letter to CFTC dated Feb. 2, 2018 Re: CFTC No Action Letter”, May 29, 2018.

²⁹ Regarding 25 downgraded swap dealers that collectively obtained 77 credit rating company permissions to unilaterally disregard replacement and other remedial obligations viz-z-viz 100-plus RMBS, ABS, and other structured debt issuers, see Structured Credit Investors (SCI), “Counterparty Conundrums”, 2 August 2013 in Harrington, William J., “Electronic Letter to the U.S. Securities and Exchange Commission and the European Securities and Markets Authority Re Inflated Credit Ratings of ABS and Derivative Product Companies”, September 11, 2013 , Appendix B, pp17-19. (https://www.wikirating.com/data/other/20130917_Harrington_J_William_ABS_Losses_Attributable_to_Securitization_Swaps.pdf).

contracts by assigning bank credit ratings and counterparty assessments that explicitly assume public support for bank swap dealers.

“Moody’s Investors Service published on April 5, 2022, a Request for Comment on the proposed introduction of ratings that exclude government support (XG ratings) alongside the existing approach to assigning ratings to banks. The Request for Comment also included the proposed introduction of a Counterparty Risk Assessment Excluding Government Support (XG CR Assessment) that would have applied to the same senior operating obligations and contractual commitments as those for which Moody’s already provides Counterparty Risk (CR) Assessments.

*“Following the closure of the comment period and review of submitted comments, Moody’s has decided that it will not update the banks methodology as proposed. ... **Moody’s decision reflects its view that market interest in ratings that exclude government support is currently low** [emphasis added].”³⁰*

Moody’s Investors Service imputed low “market interest in ratings that exclude government support” from just six respondents, including a mousy five who “requested confidentiality.” In other words, Moody’s justifies standard practice that harms people worldwide — namely, basing bank credit ratings and counterparty assessments on bailout expectations — on the private views of a handful of entities that almost certainly benefit from expectations of public support.

“Moody’s received a total of six comments submitted through the Request for Comment page in response to this RFC, for which five respondents requested confidentiality.”³¹

Credit Ratings for Flip-Clause-Swap-Contract Parties Assume Dealers Never-Ever-Ever Default and Public Support is Free

The flip clause subjects a swap dealer to its own credit risk, in addition to the credit risk of a structured debt counterparty. In fact, the rating of structured debt depends on the flip clause imposing a [total] loss on the swap dealer.

“Each aspect of the proposed model approval process and the computation of the credit risk charges ignores the 100% exposure to itself that a swap dealer bears under a flip clause, walkaway or similar provision in an uncleared swap or an uncleared security-based swap. These provisions enable the counterparty to an uncleared swap or an uncleared security-based swap to write off all payments that would otherwise be due a swap dealer simply because it is bankrupt, insolvent, non-performing or similarly impaired.

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³⁰ “Moody’s concludes proposal on ratings excluding government support for banks methodology, decides not to proceed with proposal”, Moody’s Investors Service Methodology RFC Announcement, May 11, 2023. (https://www.moodys.com/research/Moodys-concludes-proposal-on-ratings-excluding-government-support-for-banks--PBC_1364275).

³¹ “Ibid.”

“Moreover, the correlation of activation of all flip clauses, walkaways or similar provisions will be 100%, i.e., 100% of counterparties to uncleared swaps and uncleared security-based swaps with these clauses and provisions that are in-the-money to a swap dealer will simultaneously activate them against the swap dealer when it is bankrupt, insolvent, non-performing or similarly impaired.”³²

“The decision by the United States Bankruptcy Court for the Southern District of New York plainly shows that 100% of the flip clauses in 100% of the 44 CDOs ipso facto modified LBSF’s [Lehman Brothers Special Financing] rights by 100%.

“The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF under the Waterfall after proceeds were paid pursuant to Noteholder Priority.”³³

Australian, Canadian, Irish, New Zealand, U.K., and other non-U.S. RMBS, ABS, and other structured debt issuers that use the flip-clause-swap-contract need credit rating companies to do the following.

- (1) Minimize** the gaping credit exposures that each flip-clause-swap-contract generates for credit-rated debt.
- (2) Ignore** the gaping credit exposures that each flip-clause-swap-contract generates for a dealer.
- (3) Pretend** that the public incurs no costs when governments support / bail-out banks.

Fitch Ratings, Moody’s Investors Service, and S&P Global Ratings post willfully negligently credit rating methodologies and assign willfully negligent credit ratings that incentivize Australian, Canadian, Irish, New Zealand, UK, and other non-U.S. RMBS, ABS, and other structured debt issuers to enter swap-contracts-with-flip-clauses.

Likewise, Fitch Ratings, Moody’s Investors Service, and S&P Global Ratings post willfully negligently credit rating methodologies and assign willfully negligent credit ratings and counterparty assessments to banks that incentivize them to provide flip-clause-swap-contracts. Credit ratings, methodologies, and commentary entirely ignore the idiosyncratic self-sabotage that a swap dealer self-inflicts in assuming full exposure to itself for full value of each flip-clause-swap-contract that is an asset. Fitch, Moody’s, and S&P should, but categorically will not, assign accurate credit ratings to contract dealers, i.e., credit ratings that incorporate dealer credit

³² [“Op. Cit. Harrington CFTC Submission May 4, 2017”](#), p40 and throughout.

<https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61196&SearchText>).

³³ [“Op. Cit. Harrington Proposed Amicus Curiae Brief to US 2nd Circuit ‘Re: Case No. 18-1079-bk”](#), p47.

<https://croataninstitute.org/wp-content/uploads/2021/06/18-1079-bk-WJH-08-08-19-Letter-to-US-Court-of-Appeals-for-Second-Circuit-Proposed-Amicus-Curiae-Brief-Re-Case-No-18-1079.pdf>).

exposure to itself equal to 100% loss for 100% of flip-clause-swap contracts that are in-the-money assets.

Furthermore, Fitch Ratings, Moody's Investors Service, and S&P Global Ratings purposefully post willfully *negligently credit rating methodologies and assign willfully negligent credit ratings to sovereign entities that incentivize either RMBS, ABS, and other structured debt issuers or swap dealers to enter flip-clause-swap-contracts by ignoring the public costs of supporting banks.* Credit ratings, methodologies, and commentary entirely ignore the systemic damage that will follow simultaneous flip clause activation by all RMBS, ABS, and other structured debt issuers worldwide that are parties to an out-of-the-money flip-clause-swap-contract with a defaulted, bankrupt, or otherwise insolvent dealer. Fitch, Moody's, and S&P should, but categorically will not, assign accurate credit ratings to a sovereign that allows a dealer or dealers to expose the local economy and the broader financial system to Lehman Brothers havoc.

Luckily for the U.S. people, economy, and swap dealers, U.S. swap margin rules make the flip-clause-swap-contact commercially unviable.

"US Congress, markets, and regulators have consigned the flip-clause-swap-contract to the garbage heap of history. There, the contract rots away with aerosol sprays, trans-fats, asbestos tiles, and other toxic synthetics that poisoned users, producers, and our Country."³⁴

*"Fortunately for U.S. persons, our law and regulation render the contract in question commercially impracticable in the U.S. However, the good fortune is tenuous because financial dealmakers and industry groups periodically push for statutory and regulatory 'relief' to revive the contract. Luckily, my eleven-year-and-counting advocacy has just scored a major win that will at least slow, and might permanently block, contract revival in the U.S."*³⁵

As a happy result, U.S. swap dealers ceased self-sabotaging and wreaking systemic damage by ceasing to provide the flip-clause-swap-contract in 2017.³⁶ Unluckily for Australian, Canadian, Irish, New Zealand, U.K., and other non-U.S. persons and swap contract dealers, their respective swap margin rules do the opposite, namely greenlight non-U.S. dealers to self-sabotage and wreak systemic damage by incentivizing them to provide the contract.³⁷

³⁴ "ibid.", p23.

³⁵ "Op. Cit. Harrington 'Sometimes, Holding the Line is Progress'".

(<https://croataninstitute.org/2022/11/17/sometimes-holding-the-line-is-progress/>).

³⁶ Regarding U.S. swap margin rules, Harrington, Bill, "US margin rule for swaps obliges securitization issuers to overhaul structures, add resources, and rethink capital structures", *Debtwire ABS*, 5 November 2015. (<https://www.sec.gov/rules/petitions/2022/petn4-790-ex2.pdf>).

³⁷ The following non-U.S. swap dealers provided one (or more) *new* swap-contracts with-flip-clauses since October 2022, based on WJH daily review of Moody's Investors Service Pre-Sale Reports and

Australian, Canadian, Irish, New Zealand, and U.K. perpetuation of the flip-clause-swap-contact is a major headache for U.S. people! Separately and collectively, Australian policy makers' disregard of the well-being of the Australian people and economy, Canadian policy makers' disregard of the well-being of the Canadian people and economy, Irish policy makers' disregard of the well-being of the Irish people and economy, New Zealand policy makers' disregard of the well-being of the New Zealand people and economy, and U.K. policy makers' disregard of the well-being of the U.K. people and economy supply the CFTC with a seemingly innocuous rationale — namely, to “*amplify international comity*” — to harm the U.S. people and economy by proposing to reinstate the flip-clause-swap-contract for U.S. swap dealers and for U.S. RMBS, ABS, and other structured debt issuers.

*“[O]ver the next two years, the Commission will consider and vote on matters for consideration that . . . **amplify international comity** [emphasis added].”³⁸*

Five documents that the delivering email attached detail flip-clause-swap-contracts for credit-rated Australian RMBS, Canadian RMBS, Irish RMBS, New Zealand RMBS, and U.K. RMBS, respectively. The remainder of today's letter cites each flip-clause-swap-contract sequentially in proposing improvements to SEC oversight of credit rating companies and regulation of the flip-clause-swap-contract, to CFTC regulation of the flip-clause-swap-contract, to the CFTC GMAC Work Product, to respective Fitch Ratings, Moody's Investors Service, and S&P Global Ratings credit rating methodologies for RMBS, ABS, and other structured debt and for financial institutions, and to respective Australian, Canadian, Irish, New Zealand, and U.K. regulation and capitalization of swap dealers that are parties to one or more flip-clause-swap-contracts.

S&P Global Ratings Presales: ABN AMRO; ANZ (2); Barclays, BMO; BNP Paribas (8); BNZ (2); Citi; Coventry Building Society (2); Credit Agricole (2); DZ Bank (2); HSBC; ING (7); Investec (15); J.P. Morgan (2); Lloyds Bank (3); Merrill Lynch International; National Australia Bank (9); Natixis (2); NatWest; Nedbank; RBC (3); RCI Bank and Services (4); Santander (3); Scotiabank (3); SEB (7); SMBC Group; Standard Chartered Bank Korea; Toronto Dominion; UniCredit; and Westpac.

³⁸ CFTC Chair Rostin Behnam, “Testimony Before the Subcommittee on Agriculture, Rural Development, Food and Drug Administration and Related Agencies Committee on Appropriations, U.S. House of Representative”, March 28, 2023. (<https://www.cftc.gov/PressRoom/SpeechesTestimony/opabeznam35>).

Moody's Investors Service Pre-Sale Report "Liberty Series 2023-2", 28 February 2023, informs the below response to "Moody's Approach to Rating RMBS Using the MILAN Framework: Proposed Methodology Update", 6 March 2023, and to "Moody's Approach to Rating RMBS Using the MILAN Framework: Proposed Updates to Settings for Australia, Canada, Ireland, New Zealand and the United Kingdom", 6 March 2023.

Moody's must update both the proposed methodology and the proposed settings updates to accurately assign outsized expected losses to RMBS when one of the following conditions apply and assign higher-still expected losses when both conditions apply.

- (1) An issuer is party to a flip-clause-swap-contract that has the largest expected loss of any flip-clause-swap-contract, namely one that is both "*balance-guaranteed*" and cross-currency.
- (2) An Issuer enacted *disastrous governance* in entering a flip-clause-swap-contract that does not obligate a downgraded provider to novate or obtain a guarantee.

Moody's Investors Service Pre-Sale Report "Liberty Series 2023-2", 28 February 2023, informs the below comment on the in-use credit rating methodologies / criteria Fitch Ratings "Banks Criteria", Moody's "Banks Methodology", and S&P Global Ratings "General: Financial Institutions Rating Methodology", respectively.

Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria to accurately assess swap dealer exposure to 100% loss of value under a flip-clause-swap-contract when either of the following conditions apply.

- (3) A dealer exposes itself to the largest expected losses of any flip-clause-swap-contract, namely one that is both "*balance-guaranteed*" and cross-currency.
- (4) A dealer may retain permanent self-exposure to 100% loss of contract value because it is not obligated to novate a flip-clause-swap-contract.

Furthermore, and crucially, Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria for financial institutions to do the following with utmost rigor.

- (5) Track each flip-clause-swap-contract that a dealer has with an RMBS, ABS, or other structured debt issuer anywhere in the world, regardless of whether Fitch, or Moody's, or S&P, or another credit rating company, or no credit rating company assigns credit ratings to the respective RMBS, ABS, or other structured debt.
- (6) Assess all contract terms.
- (7) **Assign plausible likelihood of NO NOVATION** to each flip-clause-swap-contract, based on *realistic* evaluation of novation provisions.
- (8) Assume 100% correlation of flip clause activation against a dealer for *ALL* in-the-money flip-clause-swap-contracts with RMBS, ABS, and other structured debt issuers everywhere in the world.

Moody's Investors Service Pre-Sale Report "Liberty Series 2023-2", 28 February 2023 informs the following comment on Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulation and capitalization of swap dealers.

Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulators must *prohibit* swap dealers both from entering new flip-clause-swap-contracts anywhere in the world and from extending maturities of existing contracts anywhere in the world.

Australian regulators may study Coventry Bond Trust 2023-1 as template for an Australian RMBS issuer that is **NOT** party to a flip-clause-swap-contract or any other derivative contract.

(<https://www.spglobal.com/ratings/en/research/pdf-articles/230329-presale-coventry-bond-trust-2023-1-12652592>).

Canadian regulators may study the above deal Coventry Bond Trust 2023-1 and the below deals Shamrock Residential 2023-1, Bridgegate Funding PLC, and Verus Securitization Trust 2023-1 as templates for a Canadian RMBS issuer that is not party to a flip-clause-swap-contract.

Irish regulators may study Shamrock Residential 2023-1 as template for an Irish RMBS issuer that is **NOT** party to a flip-clause-swap-contract **BUT DOES OWN A FULLY-PAID INTEREST-RATE CAP**. "The issuer benefits from an interest rate cap with a strike rate of 3.50% for the next 10 years".

(<https://www.spglobal.com/ratings/en/research/pdf-articles/230213-presale-shamrock-residential-2023-1-dac-12627964>).

New Zealand regulators may study the above deals Coventry Bond Trust 2023-1 and Shamrock Residential 2023-1 and the below deals Bridgegate Funding PLC and Verus Securitization Trust 2023-1 as templates for a New Zealand RMBS issuer that is not party to a flip-clause-swap-contract.

U.K. regulators may study Bridgegate Funding PLC as template for a U.K. RMBS issuer that is **NOT** party to a flip-clause-swap-contract or any other derivative contract. "There will be no hedging in place at close."

(<https://www.fitchratings.com/research/structured-finance/fitch-assigns-bridgegate-funding-plc-expected-ratings-06-01-2023>).

U.S. regulators may study Verus Securitization 2023-1 as template for a U.S. RMBS issuer that is **NOT** party to a flip-clause-swap-contract or any other derivative contract.

(<https://www.spglobal.com/ratings/en/research/pdf-articles/230110-presale-verus-securitization-trust-2023-1-12608496>).

Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulators must obligate swap dealers to immediately post capital equal to 100% of value against every legacy flip-clause-swap-contract anywhere in the world.

National Australia Bank shows why, for instance, Australian regulators must *prohibit* swap dealers from both entering new flip-clause-swap-contracts anywhere in the world and

extending maturities of existing contracts anywhere in the world, and furthermore, must also obligate dealers to immediately post capital equal to 100% of value against every legacy flip-clause-swap-contract anywhere in the world.

NAB relentlessly self-sabotages by simultaneously providing new flip-clause-swap-contracts and negligently under-capitalizing them by ignoring self-exposure to 100% loss of value for 100% of in-the-money flip-clause-swap-contracts in the event of its own (i.e., NAB) default, bankruptcy, or insolvency. From January 1, 2023, to April 20, 2023 alone, NAB agreed to provide at least eight new flip-clause-swap-contracts to RMBS, ABS, and other structured issuers that solicited Moody's credit ratings.³⁹

Moody's Investors Service Pre-Sale Report "Liberty Series 2023-2", 28 February 2023 informs the following comment on CFTC "GMAC Work Product Input."

- (9) Regarding the *"role of derivatives for proper asset-liability management and functioning of funding markets"*, the GMAC Global Market Structure Subcommittee must advocate that the CFTC and all U.S. financial regulators spurn "international comity" viz-a-viz Australian and other non-U.S. regulators who perpetuate the flip-clause-swap-contract. If need be, U.S. regulators must stand alone in preserving and enforcing best-in-world swap margin rules that regulate the contract out-of-existence for U.S. swap dealers and for U.S. RMBS, ABS, and other structured debt issuers.
- (10) Regarding the same topic, the GMAC Global Market Structure Subcommittee must advocate that the CFTC enact my § 13.1 Petition for Rulemaking of May 26, 2020 (*"prohibit a swap dealer . . . from predicating a swap obligation on a flip clause, walkaway, or variable subordination"*).
- (11) Regarding *"recommendations to improve international standardization and amalgamation of trade reporting for swaps market oversight"*, the GMAC Technical Issues Subcommittee must advocate that every swap dealer around the world that is party to one or more flip-clause-swap-contracts clearly identify each such contract and report the gross value of contracts that are mark-to-market assets.

Moody's Pre-Sale Report "Liberty Series 2023-2", 28 February 2023 describes an Australian RMBS issuance with a cross-currency, balance-guaranteed, flip-clause-swap-contract provided by Sumitomo Mitsui Banking Corporation, Tokyo.

Moody's should, but demonstrably does not, assign credit ratings to Liberty Series 2023-2 RMBS and to Sumitomo Mitsui Banking Corporation, Tokyo, respectively, that recognize the

³⁹ WJH individual review of 27 results from search of Moodys.com for *"National Australia Bank & swap & counterparty"*, constrained by *"Structured Finance"* sector, *"Pre-Sale / New Issue Reports"*, and period January 1, 2023, to April 20, 2023.

outsized credit exposures of all to Sumitomo under the balance-guaranteed, cross-currency, flip-clause-swap-contract that does not obligate a downgraded Sumitomo to novate or obtain a guarantee.

Moody's should, but demonstrably does not, assign credit ratings to Sumitomo Mitsui Banking Corporation, Tokyo that recognize the outsized credit exposures occasioned by the 100% correlation of flip-clause activation by ALL RMBS, ABS, and other structured debt issuer counterparties around the world that would have out-of-the-money flip-clause-swap-contracts should Sumitomo default, enter bankruptcy, or become insolvent.

"Allocation of payments", pages 14-15, omits mention of swap contract receipts and payments. However, the flip clause may be inferred from the Aaa rating of the yen-denominated Class A1 Notes and other information, such as the inclusion of *"Class A1 Currency Swap SMBC"* in *"Exhibit 18—Structural Diagram"*, page 13, and *"Class A1 currency swap"*, page 19, below in its entirety.

"Liberty Funding will enter into a currency swap with SMBC to convert the proceeds from the issue of the Class A1 Notes to A\$ and to hedge the currency exposure associated with its obligation to pay interest and principal on the Class A1 Notes denominated in Japanese Yen.

"If a swap provider's Counterparty Risk Assessment falls below A3(cr), the swap provider must post collateral. If the swap provider's Counterparty Risk Assessments fall below Baa1(cr), the swap provider must also use commercially reasonable efforts to either arrange a novation or a guarantee from an entity with a Counterparty Risk Assessment of Baa1(cr) or rated Baa1 or higher."

The flip-clause-swap-contract is the type that exposes both credit-rated debt and swap dealer to the largest respective expected loss of any flip-clause-swap-contract, namely one that is both *"balance-guaranteed"* and cross-currency. A *"balance-guaranteed"* contract has an unknown, variable notional schedule rather than a predetermined, known notional schedule. A cross-currency swap contract generates enormous exposure from the outset until maturity, in contrast to the much smaller and decreasing exposures of most interest rate swap contracts.

Making already high expected losses higher still for both Liberty Series 2023-2 RMBS and Sumitomo Mitsui Banking Corporation, Tokyo, the latter can avoid arranging *"a novation or a guarantee"* owing to the toothless standard *"commercially reasonable efforts"*.⁴⁰ And, in

⁴⁰ In contrast, Moody's 2006 Hedge Framework contained a suite of provisions to *"maximize the likelihood of replacement occurring."* See summary that I wrote, and that Nicolas Weill and I painstakingly line-edited, on page 5. *"Many aspects of the framework are intended to maximize the likelihood of replacement occurring. The Second Trigger is set at a level which is high enough to ensure that a Counterparty begins replacing itself where possible, prior to the emergence of potential inhibitors to its ability to do so. The collateral amounts and valuation percentages at the Second Trigger incorporate 30 additional business days in their measurement periods, to provide sufficient resources and time for the SPV to pay a replacement bid directly, should that be*

further self-sabotage, Sumitomo voluntarily piles up yet more expected losses because it can obtain a “*guarantee*”, which preserves flip clause exposure, rather than “*novate or transfer*” the contract, which extinguishes flip clause exposure.

In short, should Sumitomo Mitsui Banking Corporation, Tokyo default, enter bankruptcy, or become insolvent and is in-the-money under the balance-guaranteed, cross-currency, flip-clause-swap-contract, Sumitomo will lose up to 100% of contract value.⁴¹

The Liberty Series 2023-2 issuer enacted ***disastrous governance*** in entering the balance-guaranteed, cross-currency, flip-clause-swap-contract that does not obligate a downgraded Sumitomo Mitsui Banking Corporation to novate or obtain a guarantee. Accordingly, Moody’s Investors Service fails its own self-governance by assigning “*low*” governance risks to Liberty Series 2023-2 RMBS. See the Pre-Sale report, page 2.

“Governance risks for this transaction are low based on the presence of transaction features such as R&W framework that support the integrity of the transaction’s operations for the benefit of investors. (See ‘Additional structural analysis - ESG - Governance considerations’).”

Likewise, Moody’s Investors Service doubles-down on failed self-governance in imputing “[s]trong RMBS governance” to Liberty Series 2023-2 while *ignoring* the balance-guaranteed, cross-currency, flip-clause-swap-contract that does not obligate a downgraded Sumitomo to novate or obtain a guarantee. See the Pre-Sale report “*ESG - Governance considerations*”, page 19.

“Strong RMBS governance relates to transaction features that promote the integrity of the operations of transaction for the benefit of investors, as well as the data provided to investors. The following are some of the governance considerations related to the transaction: Risk retention . . . Third-party reviews . . . [and] R&W framework.”

necessary. And the definition of Market Quotation is amended to enable replacement to occur wherever at least one eligible bidder is ready to step into an existing hedge.” Moody’s 2006 Hedge Framework in “Brief of SIFMA and ISDA in Support of Defendants-Appellees and Affirmance Re: U.S. District Court for the Southern District of New York, Case No. 17-cv-1224-LGS, Lehman Brothers Special Financing, Inc. against Bank of America, National Association and all”, June 16, 2017, Exhibit A. (<https://www.sifma.org/wp-content/uploads/2017/06/LehmanBrothers061617.pdf>).

⁴¹ Sumitomo might lose *more than 100% of contract value* if, as occurred with the Lehman Brothers estate, the controller of a defaulted, bankrupt, or insolvent Sumitomo litigates flip-clause-swap-contracts with counterparties such as the Liberty 2023-2 issuer and loses.

Moody's Investors Service Rating Announcement "Moody's assigns definitive ratings to prime RMBS to be issued by Fortified Trust", 31 January 2023 informs the below response to "Moody's Approach to Rating RMBS Using the MILAN Framework: Proposed Methodology Update", March 6, 2023, and to "Moody's Approach to Rating RMBS Using the MILAN Framework: Proposed Updates to Settings for Australia, Canada, Ireland, New Zealand and the United Kingdom", March 6, 2023.

Moody's must update both the proposed methodology and the proposed settings updates to accurately assign outsized expected losses to RMBS when the following condition applies.

- (1) An issuer is party to a flip-clause-swap-contract.
- (2) A credit rating company cannot ascertain the likelihood that a downgraded dealer may continue as counterparty owing to novation and guarantee provisions that are unknown, ambiguous, or weak.

Moody's Investors Service Rating Announcement "Moody's assigns definitive ratings to prime RMBS to be issued by Fortified Trust", 31 January 2023 informs the below comment on the in-use credit rating methodologies / criteria Fitch Ratings "Banks Criteria", Moody's "Banks Methodology", and S&P Global Ratings "General: Financial Institutions Rating Methodology", respectively.

Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria to accurately assess swap dealer exposure to 100% loss of value under a flip-clause-swap-contract when the following condition applies.

- (3) A credit rating company cannot ascertain the likelihood that a dealer may retain permanent self-exposure to 100% loss of flip-clause-swap-contract value owing to novation provisions that are unknown, ambiguous, or weak.

Furthermore, and crucially, Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria for financial institutions to do the following with utmost rigor.

- (4) Track each flip-clause-swap-contract that a dealer has with an RMBS, ABS, or other structured debt issuer anywhere in the world, regardless of whether Fitch, or Moody's, or S&P, or another credit rating company, or no credit rating company assigns credit ratings to the respective RMBS, ABS, or other structured debt.
- (5) Assess all contract terms.
- (6) **Assign plausible likelihood of NO NOVATION** to each flip-clause-swap-contract, based on *realistic* evaluation of novation provisions.
- (7) Assume 100% correlation of flip clause activation against a dealer for *ALL* in-the-money flip-clause-swap-contracts with RMBS, ABS, and other structured debt issuers everywhere in the world.

Moody's Investors Service Rating Announcement "Moody's assigns definitive ratings to prime RMBS to be issued by Fortified Trust", 31 January 2023 informs the following comment on Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulation and capitalization of swap dealers.

Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulators must *prohibit* swap dealers both from entering new flip-clause-swap-contracts anywhere in the world and from extending maturities of existing contracts anywhere in the world.

Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulators must obligate swap dealers to immediately post capital equal to 100% of value against every legacy flip-clause-swap-contract anywhere in the world.

Moody's Investors Service Pre-Sale Report ""Moody's assigns definitive ratings to prime RMBS to be issued by Fortified Trust", 31 January 2023 informs the following comment on CFTC "GMAC Work Product Input."

- (8) Regarding the *"role of derivatives for proper asset-liability management and functioning of funding markets"*, the GMAC Global Market Structure Subcommittee must advocate that the CFTC and all U.S. financial regulators spurn "international comity" viz-a-viz Canadian and other non-U.S. regulators who perpetuate the flip-clause-swap-contract. If need be, U.S. regulators must stand alone in preserving and enforcing best-in-world swap margin rules that regulate the contract out-of-existence for U.S. swap dealers and for U.S. RMBS, ABS, and other structured debt issuers.
- (9) Regarding the same topic, the GMAC Global Market Structure Subcommittee must advocate that the CFTC enact my § 13.1 Petition for Rulemaking of May 26, 2020 (*"prohibit a swap dealer . . . from predicating a swap obligation on a flip clause, walkaway, or variable subordination"*).
- (10) Regarding *"recommendations to improve international standardization and amalgamation of trade reporting for swaps market oversight"*, the GMAC Technical Issues Subcommittee must advocate that every swap dealer around the world that is party to one or more flip-clause-swap-contracts clearly identify each such contract and report the gross value of contracts that are mark-to-market assets.

Moody's Investors Service Rating Announcement "Moody's assigns definitive ratings to prime RMBS to be issued by Fortified Trust", 31 January 2023 describes a Canadian RMBS issuance with a fixed-for-floating floating flip-clause-swap-contract provided by Bank of Montreal.

Moody's should, but demonstrably does not, assign credit ratings to Fortified Trust RMBS and to Bank of Montreal, respectively, that recognize the outsized credit exposures of all to Bank of Montreal under the flip-clause-swap-contract.

Moody's should, but demonstrably does not, assign credit ratings to Bank of Montreal that recognize the outsized credit exposures occasioned by the 100% correlation of flip-clause activation by ALL RMBS, ABS, and other structured debt issuer counterparties around the world that would have out-of-the-money flip-clause-swap-contracts should Bank of Montreal default, enter bankruptcy, or become insolvent.

The announcement does not disclose the priority of payments but the flip clause can be imputed from Aaa rating of the Class A notes.

The announcement *does* mischaracterize the flip-clause-swap-contract as providing “credit enhancement”.

“Excess spread provides the first source of credit enhancement to all of the classes of notes through an interest rate swap with BMO as the counterparty. The swap arrangement provides the Trust with 1.35% in annual excess spread, payable monthly.”

Fortified Trust 2023-1 *assets*, not the flip-clause-swap-contract, provide “*credit enhancement*” in the form of “*excess spread*.” At initiation, the flip-clause-swap-contract is *on-the-money* — i.e., market neutral — and *cannot* generate excess spread or indeed any credit enhancement. What the contract *does do* from initiation straight through to maturity is exchange and re-exchange the asset-generated-excess-spread by simultaneously receiving the spread from the issuer and paying it right back. Moreover, as with every flip-clause-swap-contract, the contract exposes Fortified Trust RMBS to significant *credit exposure* to the swap dealer.

Moody's Investors Service Pre-Sale Report “Fortified Trust, Series 2023-1”, 26 January 2023, may provide more information on the flip-clause-swap-contract, but was “locked”, i.e., available only to paid subscribers, at time of writing.

S&P Global Ratings New Issue: "Finance Ireland RMBS No. 4 DAC", February 3, 2022, informs the below response to "Moody's Approach to Rating RMBS Using the MILAN Framework: Proposed Methodology Update", March 6, 2023, and to "Moody's Approach to Rating RMBS Using the MILAN Framework: Proposed Updates to Settings for Australia, Canada, Ireland, New Zealand and the United Kingdom", March 6, 2023.

Moody's must update both the proposed methodology and the proposed settings updates to accurately assign outsized expected losses to RMBS when one of the following conditions apply and assign higher-still expected losses when both conditions apply.

- (1) An issuer is party to a flip-clause-swap-contract with outsized expected loss, namely a "*balance-guaranteed*", fixed-for-floating, flip-clause-swap contract.
- (2) Moody's cannot ascertain issuer governance regarding novation and guarantee provisions in a flip-clause-swap-contract.

S&P Global Ratings New issue: "Finance Ireland RMBS No. 4 DAC", February 3, 2022, informs the below comment on the in-use credit rating methodologies / criteria Fitch Ratings "Banks Criteria", Moody's "Banks Methodology", and S&P Global Ratings "General: Financial Institutions Rating Methodology", respectively.

Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria to accurately assess swap dealer exposure to 100% loss of value under a flip-clause-swap-contract when either of the following conditions apply.

- (3) A dealer exposes itself to a "*balance-guaranteed*" flip-clause-swap contract, which has higher expected losses than an otherwise similar contract with known amortization.
- (4) A credit rating company cannot ascertain the likelihood that a dealer may retain permanent self-exposure to 100% loss of flip-clause-swap-contract value owing to novation provisions that are unknown, ambiguous, or weak.

Furthermore, and crucially, Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria for financial institutions to do the following with utmost rigor.

- (5) Track each flip-clause-swap-contract that a dealer has with an RMBS, ABS, or other structured debt issuer anywhere in the world, regardless of whether Fitch, or Moody's, or S&P, or another credit rating company, or no credit rating company assigns credit ratings to the respective RMBS, ABS, or other structured debt.
- (6) Assess all contract terms.
- (7) **Assign plausible likelihood of NO NOVATION** to each flip-clause-swap-contract, based on *realistic* evaluation of novation provisions.
- (8) Assume 100% correlation of flip clause activation against a dealer for *ALL* in-the-money flip-clause-swap-contracts with RMBS, ABS, and other structured debt issuers everywhere in the world.

S&P Global Ratings New issue: "Finance Ireland RMBS No. 4 DAC", February 3, 2022, informs the following comment on Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulation and capitalization of swap dealers.

Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulators must *prohibit* swap dealers both from entering new flip-clause-swap-contracts anywhere in the world and from extending maturities of existing contracts anywhere in the world.

Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulators must obligate swap dealers to immediately post capital equal to 100% of value against every legacy flip-clause-swap-contract anywhere in the world.

S&P Global Ratings New Issue: "Finance Ireland RMBS No. 4 DAC", February 3, 2022, informs the following comment on CFTC "GMAC Work Product Input."

- (9) Regarding the *"role of derivatives for proper asset-liability management and functioning of funding markets"*, the GMAC Global Market Structure Subcommittee must advocate that the CFTC and all U.S. financial regulators spurn "international comity" viz-a-viz Irish and other non-U.S. regulators who perpetuate the flip-clause-swap-contract. If need be, U.S. regulators must stand alone in preserving and enforcing best-in-world swap margin rules that regulate the contract out-of-existence for U.S. swap dealers and for U.S. RMBS, ABS, and other structured debt issuers.
- (10) Regarding the same topic, the GMAC Global Market Structure Subcommittee must advocate that the CFTC enact my § 13.1 Petition for Rulemaking of May 26, 2020 (*"prohibit a swap dealer . . . from predicating a swap obligation on a flip clause, walkaway, or variable subordination"*).
- (11) Regarding *"recommendations to improve international standardization and amalgamation of trade reporting for swaps market oversight"*, the GMAC Technical Issues Subcommittee must advocate that every swap dealer around the world that is party to one or more flip-clause-swap-contracts clearly identify each such contract and report the gross value of contracts that are mark-to-market assets.

S&P Global Ratings New Issue: "Finance Ireland RMBS No. 4 DAC", February 3, 2022, details an Irish RMBS issuance with a fixed-for-floating, balance-guaranteed flip-clause-swap-contract provided by BNP Paribas, London Branch.

S&P should, but demonstrably does not, assign credit ratings to Finance Ireland RMBS No. 4 DAC and to BNP Paribas, London Branch, respectively, that recognize the outsized default probabilities of all to BNP Paribas under the balance-guaranteed flip-clause-swap-contract with dubious novation and guarantee provisions.

S&P should, but demonstrably does not, assign credit ratings to BNP Paribas, London Branch, that recognize outsized default probabilities occasioned by the 100% correlation of flip-clause activation by ALL RMBS, ABS, and other structured debt issuer counterparties around the world that would have out-of-the-money flip-clause-swap-contracts should BNP Paribas default, enter bankruptcy, or become insolvent.

“Table 4—Priority of Payments—Revenue priority of payments (simplified)”, p17, omits the subordinated portion of the flip clause but it can be imputed from both the Class A AAA rating and other information such as the following on page 19. “The collateral posting and replacement triggers in the draft swap documents are in line with our counterparty criteria.”

The flip-clause-swap-contract is *“balance-guaranteed”*, which means that the contract has an unknown, variable notional schedule rather than a predetermined, known notional schedule that exposes both Finance Ireland RMBS No. 4 DAC RMBS and BNP Paribas, London Branch to larger expected losses relative to an otherwise similar contract that is not *“balance-guaranteed.”* See page 19. *“This is a balance-guaranteed swap.”*

“Counterparty Risk / Table 10 / Supporting Ratings” lists the respective credit rating triggers at which a downgraded BNP Paribas, London Branch is obligated to post collateral and then to novate (the latter, *“find a replacement”*). However, there is no mention of whether the standard to novate is the toothless *“commercially reasonable efforts”*, a similarly weak standard, or one that is more robust. See page 22.

“The documented replacement mechanisms adequately mitigate the transaction's exposure to counterparty risk in line with our counterparty criteria.

II

“BNP Paribas, London Branch . . . A-1+ (post collateral) A+ 90 to find a replacement”

S&P Global Ratings Presale "Bluestone NZ Prime 2022-2 Trust", December 12, 2022, informs the below response to "Moody's Approach to Rating RMBS Using the MILAN Framework: Proposed Methodology Update", March 6, 2023, and to "Moody's Approach to Rating RMBS Using the MILAN Framework: Proposed Updates to Settings for Australia, Canada, Ireland, New Zealand and the United Kingdom", March 6, 2023.

Moody's must update both the proposed methodology and the proposed settings updates to accurately assign outsized expected losses to RMBS when one of the following conditions apply and assign higher-still expected losses for each additional condition that applies.

- (1) An issuer is party to a very large flip-clause-swap-contract.
- (2) An issuer may choose, or be obligated, to increase both the maturity and notional of a flip-clause-swap-contract or to enter additional contracts in the future.
- (3) Moody's cannot ascertain issuer governance regarding flip-clause-swap-contract provisions for swap dealer collateralization, novation, and obtaining a guarantee.

S&P Global Ratings Presale "Bluestone NZ Prime 2022-2 Trust", December 12, 2022, informs the below comment on the in-use credit rating methodologies / criteria Fitch Ratings "Banks Criteria", Moody's "Banks Methodology", and S&P Global Ratings "General: Financial Institutions Rating Methodology", respectively.

Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria to accurately assess swap dealer exposure to 100% loss of value under a flip-clause-swap-contract when either of the following conditions apply.

- (4) A swap dealer may choose, or be obligated, to increase flip-clause-swap-contract notional or provide additional contracts post-close.
- (5) A credit rating company cannot ascertain the likelihood that a dealer may retain permanent self-exposure to 100% loss of flip-clause-swap-contract value owing to novation provisions that are unknown, ambiguous, or weak.

Furthermore, and crucially, Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria for financial institutions to do the following with utmost rigor.

- (6) Track each flip-clause-swap-contract that a dealer has with an RMBS, ABS, or other structured debt issuer anywhere in the world, regardless of whether Fitch, or Moody's, or S&P, or another credit rating company, or no credit rating company assigns credit ratings to the respective RMBS, ABS, or other structured debt.
- (7) Assess all contract terms such as possible increase of contract maturity or notional.
- (8) **Assign plausible likelihood of NO NOVATION** to each flip-clause-swap-contract, based on *realistic* evaluation of novation provisions.

- (9) Assume 100% correlation of flip clause activation against a dealer for ALL in-the-money flip-clause-swap-contracts with RMBS, ABS, and other structured debt issuers everywhere in the world.

S&P Global Ratings Presale "Bluestone NZ Prime 2022-2 Trust", December 12, 2022, informs the following comment on Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulation and capitalization of swap dealers.

Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulators must *prohibit* swap dealers both from entering new flip-clause-swap-contracts anywhere in the world and from extending maturities of existing contracts anywhere in the world.

Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulators must obligate swap dealers to immediately post capital equal to 100% of value against every legacy flip-clause-swap-contract anywhere in the world.

S&P Global Ratings Presale "Bluestone NZ Prime 2022-2 Trust", December 12, 2022, informs the following comment on CFTC "GMAC Work Product Input."

- (10) Regarding the *“role of derivatives for proper asset-liability management and functioning of funding markets”*, the GMAC Global Market Structure Subcommittee must advocate that the CFTC and all U.S. financial regulators spurn “international comity” viz-a-viz New Zealand and other non-U.S. regulators who perpetuate the flip-clause-swap-contract. If need be, U.S. regulators must stand alone in preserving and enforcing best-in-world swap margin rules that regulate the contract out-of-existence for U.S. swap dealers and for U.S. RMBS, ABS, and other structured debt issuers.
- (11) Regarding the same topic, the GMAC Global Market Structure Subcommittee must advocate that the CFTC enact my § 13.1 Petition for Rulemaking of May 26, 2020 (*“prohibit a swap dealer . . . from predicating a swap obligation on a flip clause, walkaway, or variable subordination”*).
- (12) Regarding *“recommendations to improve international standardization and amalgamation of trade reporting for swaps market oversight”*, the GMAC Technical Issues Subcommittee must advocate that every swap dealer around the world that is party to one or more flip-clause-swap-contracts clearly identify each such contract and report the gross value of contracts that are mark-to-market assets.

S&P Global Ratings Presale "Bluestone NZ Prime 2022-2 Trust", December 12, 2022, details a New Zealand RMBS issuance with a large, and potentially growing, fixed-for-floating, flip-clause-swap-contract provided by Bank of New Zealand.

S&P should, but demonstrably does not, assign credit ratings to Bluestone NZ Prime 2022-2 Trust RMBS and to Bank of New Zealand, respectively, that recognize the outsized default probabilities of all to BNZ under the large and potentially growing flip-clause-swap-contract with dubious novation and guarantee provisions.

S&P should, but demonstrably does not, assign credit ratings to Bank of New Zealand that recognize the outsized default probabilities occasioned by the 100% correlation of flip-clause activation by ALL RMBS, ABS, and other structured debt issuer counterparties around the world that would have out-of-the-money flip-clause-swap-contracts should BNZ default, enter bankruptcy, or become insolvent.

The report omits the priority of payments but the flip clause can be imputed from the AAA ratings for the three Class A tranches (Class A1-S, Class A1-L, and Class A2). The swap notional is large owing to the mismatch between 70% fixed-rate assets and at least 90% floating-rate liabilities, and will not step down for at least five years. See page 15.

“The portfolio consists of 69.6% fixed-rate loans with a maximum fixed-rate period of up to five years.”

Moreover, the large swap notional may grow larger after close. See pages 15 and 16, respectively.

“The transaction documents allow for variable-rate loans to convert to a fixed rate of interest and for existing fixed-rate loans to refix for another fixed-rate period, subject to the fixed interest rate being hedged under an interest-rate swap and that the net receipt to the trust from the fixed-rate loans (after the interest-rate swap) meets a documented minimum margin.”

II

“Fixed- to floating-rate swaps have been entered into to hedge the fixed-rate loans included in the portfolio at closing and any loans that convert to fixed rate after transaction close.”

The S&P Presale offers little useful information on flip-clause-swap-contract parameters, but raises alarms by indicating potentially massive governance failures by both issuer and Bank of New Zealand. To wit, should S&P Global Ratings downgrade BNZ, the latter may evade posting collateral, novating, obtaining a guarantee, or taking any action to limit issuer losses. See page 15.

*“The swap agreements include downgrade language that requires the posting of collateral or the replacement of the swap counterparties **or other remedy** [emphasis added], consistent with our ‘Counterparty Risk Framework: Methodology And Assumptions’ criteria, published on March 8, 2019, should the rating of the counterparties fall below the applicable ratings.”*

Post-2008, a slew of downgraded swap dealers, often with credit rating companies and issuers approvals, defined “other remedy” as “no action” so as to ignore obligations to post collateral, to novate, to obtain a guarantee, or to otherwise mitigate increased risk of non-performance.

“Given the difficulty of replacing counterparties and expense of posting collateral for cashflow securitisations, high volumes of swap-related rating agency confirmations [RACs] look set to continue, potentially eroding investor protections in their wake.

II

“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.

II

“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.”⁴²

The S&P Presale misstates RMBS credit exposure to the Bluestone NZ Prime 2022-2 Trust issuer's governance as “below average, in line with sector benchmark”. That is flat-out wrong because

⁴² Structured Credit Investors (SCI), “Counterparty Conundrums”, 2 August 2013 in Harrington, William J., “Electronic Letter to the U.S. Securities and Exchange Commission and the European Securities and Markets Authority Re Inflated Credit Ratings of ABS and Derivative Product Companies”, September 11, 2013 , Appendix B, pp17-19. (https://www.wikirating.com/data/other/20130917_Harrington_J_William_ABS_Losses_Attributable_to_Securitization_Swaps.pdf).

the “sector” however defined — say, New Zealand and other non-U.S. RMBS, ABS, and other structured debt issuers — routinely uses flip-clause-swap-contracts. See page 3.

“The transaction's exposure to governance credit factors is below average, in line with the sector benchmark. Given the nature of structured finance transactions, most have relatively strong governance frameworks that typically restrict what activities the special-purpose entity can undertake. We consider the risk-management and governance practices in place to be consistent with industry standards and our benchmark expectations.”

S&P Global Ratings fails its own self-governance by setting governance benchmarks that *willfully ignore* the outsized expected losses incurred by each New Zealand and other non-U.S. RMBS, ABS, and other structured debt issuer that is party to a flip-swap-contract. The following re-work of the Presale is more accurate.

“The transaction's exposure to governance credit factors is abysmal, in line with the sector benchmark of routinely incurring outsized expected losses by entering flip-clause-swap-contracts. Moreover, the issuer doubled-down on abysmal governance to incur still more outsized expected losses by agreeing that a downgraded Bank of New Zealand may take “other remedy” such as “no action” to avoid collateralizing, or novating, or obtaining a guarantee.”

Moody's Investors Service Pre-Sale Report "Elstree Funding No. 3 PLC", 9 March 2023 informs the below response to "Moody's Approach to Rating RMBS Using the MILAN Framework: Proposed Methodology Update", March 6, 2023, and to "Moody's Approach to Rating RMBS Using the MILAN Framework: Proposed Updates to Settings for Australia, Canada, Ireland, New Zealand and the United Kingdom", March 6, 2023.

Moody's must update both the proposed methodology and the proposed settings updates to accurately assign outsized expected losses to RMBS when one of the following conditions apply and assign higher-still expected losses when both conditions apply.

- (1) An issuer is party to a huge flip-clause-swap-contract.
- (2) An Issuer enacted *disastrous governance* in entering a flip-clause-swap-contract that does not obligate a downgraded provider to novate or obtain a guarantee.

Moody's Investors Service Pre-Sale Report "Elstree Funding No. 3 PLC", 9 March 2023 informs the below comment on the in-use credit rating methodologies / criteria Fitch Ratings "Banks Criteria", Moody's "Banks Methodology", and S&P Global Ratings "General: Financial Institutions Rating Methodology", respectively.

Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria to accurately assess swap dealer exposure to 100% loss of value under a flip-clause-swap-contract when the following condition applies.

- (3) A dealer may retain permanent self-exposure to 100% loss of contract value because it is not obligated to novate a flip-clause-swap-contract.

Furthermore, and crucially, Fitch, Moody's, and S&P must update the respective credit rating methodologies / criteria for financial institutions to do the following with utmost rigor.

- (4) Track each flip-clause-swap-contract that a dealer has with an RMBS, ABS, or other structured debt issuer anywhere in the world, regardless of whether Fitch, or Moody's, or S&P, or another credit rating company, or no credit rating company assigns credit ratings to the respective RMBS, ABS, or other structured debt.
- (5) Assess all contract terms.
- (6) **Assign plausible likelihood of NO NOVATION** to each flip-clause-swap-contract, based on *realistic* evaluation of novation provisions.
- (7) Assume 100% correlation of flip clause activation against a dealer for *ALL* in-the-money flip-clause-swap-contracts with RMBS, ABS, and other structured debt issuers everywhere in the world.

Moody's Investors Service Pre-Sale Report "Elstree Funding No. 3 PLC", 9 March 2023 informs the following comments on Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulation and capitalization of swap dealers.

Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulators must *prohibit* swap dealers both from entering new flip-clause-swap-contracts anywhere in the world and from extending maturities of existing contracts anywhere in the world.

Australian, Canadian, Irish, New Zealand, U.K., and U.S. regulators must obligate swap dealers to immediately post capital equal to 100% of value against every legacy flip-clause-swap-contract anywhere in the world.

Moody's Investors Service Pre-Sale Report "Elstree Funding No. 3 PLC", 9 March 2023 informs the following comment on CFTC "GMAC Work Product Input."

- (8) Regarding the *"role of derivatives for proper asset-liability management and functioning of funding markets"*, the GMAC Global Market Structure Subcommittee must advocate that the CFTC and all U.S. financial regulators spurn "international comity" viz-a-viz U.K. and other non-U.S. regulators who perpetuate the flip-clause-swap-contract. If need be, U.S. regulators must stand alone in preserving and enforcing best-in-world swap margin rules that regulate the contract out-of-existence for U.S. swap dealers and for U.S. RMBS, ABS, and other structured debt issuers.
- (9) Regarding the same topic, the GMAC Global Market Structure Subcommittee must advocate that the CFTC enact my § 13.1 Petition for Rulemaking of May 26, 2020 (*"prohibit a swap dealer . . . from predicating a swap obligation on a flip clause, walkaway, or variable subordination"*).
- (10) Regarding *"recommendations to improve international standardization and amalgamation of trade reporting for swaps market oversight"*, the GMAC Technical Issues Subcommittee must advocate that every swap dealer around the world that is party to one or more flip-clause-swap-contracts clearly identify each such contract and report the gross value of contracts that are mark-to-market assets.

Moody's Investors Service Pre-Sale Report "Elstree Funding No. 3 PLC", 9 March 2023 and the second document that the delivering email attached "WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019" inform the following comments on U.K. regulation and capitalization of swap dealers.

Bank of England perpetuation of the flip-clause-swap-contract is a major headache for U.S. people! BoE disregard of the well-being of U.K. people and the U.K. economy supplies U.S. regulators with a seemingly benign rationale — namely, amplifying *"international comity"* — to

harm U.S. people and the U.S. economy by proposing to reinstate the flip-clause-swap-contract for U.S. swap dealers and for U.S. RMBS, ABS, and other structured debt issuers.⁴³

By 2016 at the latest, U.K. regulators should have already prohibited swap dealers from both entering new flip-clause-swap-contracts anywhere in the world and extending maturities of existing contracts anywhere in the world.

By 2016 at the latest, U.K. regulators should have already obligated swap dealers to immediately post capital equal to 100% of value against every legacy flip-clause-swap-contract anywhere in the world.

Since at least May 31, 2014, I have spoon fed Bank of England staff and other U.K. financial regulators with clear-sighted evidence of economic damage that the flip-clause-swap-contract wreaks. For example, I have happily provided evidence to Ms. Sarah Breeden. Her colleague Ms. Allison Parent also relayed my evidence to Ms. Breeden and other BoE staff several times after I met Ms. Parent and Michalis Vasios in-person at the BoE on March 18, 2015. In preparing for our meeting, Ms. Parent requested that I send “Efficient, commonsense actions to foster accurate credit ratings” by Norbert J. Gaillard and me.⁴⁴

*“From: Parent, Allison
To: wjharrington@yahoo.com
Cc: "Nicola.Anderson@bankofengland.co.uk";
"Andy.Haldane@bankofengland.co.uk";
"Sarah.Breeden@bankofengland.co.uk";
"Lewis.Webber@bankofengland.co.uk";
"Michael.Hume@bankofengland.co.uk";
Alexandra.Ellis@bankofengland.co.uk
Sent: Friday, March 13, 2015 at 12:03:05 PM EDT
Subject: RE: Non-Clearable Swap Contracts with Flip Clauses and No Margin Posting*

“Afternoon Bill,

“Thank you for your offer to meet next week. Does next Wednesday, 18th at 4pm still work for you?”

⁴³ CFTC Chair Rostin Behnam, “Testimony Before the Subcommittee on Agriculture, Rural Development, Food and Drug Administration and Related Agencies Committee on Appropriations, U.S. House of Representative”, March 28, 2023. “[O]ver the next two years, the Commission will consider and vote on matters for consideration that . . . amplify **international comity** [emphasis added].” (<https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam35>).

⁴⁴ Gaillard, Norbert J. and William J. Harrington, “Efficient, commonsense actions to foster accurate credit ratings”, *Capital Markets Law Journal* 11, no. 1 (2016): 38-59. See “flip clause” throughout. (<https://doi.org/10.1093/cmlj/kmv064>).

“Prior to joining the Bank, I worked in the US Congress as General Counsel of Senate Budget Committee focusing on both fiscal and financial services issues. I am familiar with the OTCDs reform having negotiated the text of Title VII of DFA and working with CFTC in the development of their rules. Glad to hear you will be participating at their upcoming roundtable and will be able to share your points with them directly at the event.

*“The Bank looks forward to learning more about the issues you reference below. **Please send along your paper in advance for us to review to help facilitate the dialogue and to share with others who regrettably will be out of the office next week** [emphasis added].”⁴⁵*

Why has Ms. Breeden not convinced the Bank of England to regulate the flip-clause-swap-contract out of existence? The flip-clause-swap-contract poses immense dangers to U.K. bank swap dealers, to the U.K. financial system, to the wider U.K. economy, to BoE prudential regulation, and, most importantly, to the U.K. people. Ms. Breeden’s experience indicates that eliminating the flip-clause-swap-contract should be Priority Number 1.

“Sarah is the Executive Director for Financial Stability Strategy and Risk and a member of the Financial Policy Committee . . . the United Kingdom’s ‘macroprudential’ authority. It is tasked by Parliament with guarding against the financial system damaging the wider economy. Sarah is responsible for the Bank of England’s work to deliver that objective.

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“Prior to her current role, Sarah was the Executive Director for UK Deposit Takers Supervision, responsible for the supervision of the UK’s banks, building societies and credit unions. Before that, she was Executive Director for International Banks Supervision, where having joined the directorate in 2015, she was responsible for supervision of the UK operations of international banks.

“Before moving into supervision, Sarah was a Director in the Bank’s Financial Stability Strategy and Risk Directorate, where she focused on developing the UK’s macroprudential policy making framework and supporting the Financial Policy Committee. Previously she was head of the division that assessed risks to financial stability from financial markets, the non-bank financial sector, and the real economy.

“Sarah led the Bank’s work to support the transition of prudential regulation of banks and insurers from the Financial Services Authority to the Bank.

“Prior to that she was head of the Bank’s Risk Management Division and head of Special Projects in the Markets Directorate, leading the design and risk management of financial

⁴⁵ Allison Parent email to Bill Harrington “Re Non-Clearable Swap Contracts with Flip Clauses and No Margin Posting”, March 13, 2015, in “WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019”, p5.

market operations undertaken by the Bank including those launched during the financial crisis.”⁴⁶

On June 1, 2014, then Bank of England Chief Economist Andy Haldane introduced me to Sarah Breeden and Niki Anderson in replying to my email of the previous day.

“Thanks Bill. I am copying in colleagues here at the Bank leading on this work, Sarah [Breeden] and Niki [Anderson], who I am sure will be interested in your thoughts.”⁴⁷

My thoughts have held firm since well before cold-emailing Andy Haldane on May 31, 2014.

“The fatal flaw in the swap contracts most commonly used by ABS issuers is a ‘flip clause.’ Flip clause risk should be a major concern of the Bank of England, for instance with respect to the bad bank portfolios of swap providers such as RBS and Barclays.”⁴⁸

Flip-clause-swap-contracts rendered RBS and Barclays “bad bank portfolios” much, much badder than commonly understood by even the Bank of England. As damning evidence, my email of May 31, 2014, cited my “May 29 comment letter to the U.S. SEC that proposes derivative disclosures with respect to securitisations. [<https://www.sec.gov/comments/s7-18-11/s71811-84.pdf>].”⁴⁹

“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 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.

⁴⁶ “Sarah Breeden”, Bank of England website, accessed April 17, 2023.

(<https://www.bankofengland.co.uk/about/people/sarah-breeden/biography>).

⁴⁷ Andy Haldane email to Bill Harrington “Re Improving Securitisation Quality - WJH Comment Letter to U.S. SEC on ABS Ratings”, June 1, 2014, in “WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019”, p2.

⁴⁸ Bill Harrington email to Andy Haldane “Re Improving Securitisation Quality - WJH Comment Letter to U.S. SEC on ABS Ratings”, May 31, 2014, in “WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019”, p1.

⁴⁹ “Ibid.”

“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.”⁵⁰

I copied Sarah Breeden and other Bank of England staff in six additional emails pertaining to the flip-clause-swap-contract between June 14, 2014, to June 26, 2019.⁵¹ My email of May 12, 2015, provided a link to an extremely amusing, extremely effective presentation that a former Moody’s colleague and I made that day to staff of six U.S. financial regulators — the CFTC and the five prudential regulators the FCA, FDIC, FHFA, FRB, and OCC. The presentation and meeting helped convince the six regulators to adopt best-in-world swap margin rules that regulate the flip-clause-swap-contract out of existence for U.S. swap dealers and for U.S. RMBS, ABS, and other structured debt issuers.⁵²

“Attached please find the presentation that I gave today to the teams from the CFTC, FCA, FDIC, FHFA, FRB, and OCC with respect to margin posting by ABS issuers, flip clauses, and clearinghouses.

[<https://www.cftc.gov/node/157371> and https://www.cftc.gov/sites/default/files/idc/groups/public/@swaps/documents/dfs_submission/dfssubmission_051215_2376_0.pdf].”

My email of May 12, 2015, also raised the “UK referendum on remaining in the EU.”

“A point that came up in the call is the UK referendum on remaining in the EU. This uncertainty argues that there is no reason to be harmonizing EU and US financial regulations until after the UK status is settled.”⁵³

The Bank of England in the person of Allison Parent summarily dismissed BREXIT referendum concerns and entirely ignored flip-clause-swap-contract concerns. Clearly, The Old Lady of

⁵⁰ Harrington, William J., “Response to U.S. Securities and Exchange Commission Re: ‘File Number S7-18-11 Request for Re-proposal Relating to Nationally Recognized Statistical Rating Organizations’”, May 29, 2014, pp3-4. (<https://www.sec.gov/comments/s7-18-11/s71811-84.pdf>).

⁵¹ Bill Harrington emails of June 23, 2014, March 8, 2015, March 13, 2015, March 24, 2015, May 12, 2015, and June 10, 2019, respectively, in “WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019”, pp3, 4, 6, 7, 9, and 11, respectively.

⁵² For summary of the joint prudential regulators’ rule, see Harrington, Bill, “US margin rule for swaps obliges securitization issuers to overhaul structures, add resources, and rethink capital structures”, *Debtwire ABS*, 5 Nov 2015. (<https://www.sec.gov/rules/petitions/2022/petn4-790-ex2.pdf>).

⁵³ Bill Harrington email to Allison Parent “Re: Non-Clearable Swap Contracts with Flip Clauses and No Margin Posting”, May 12, 2015, in “WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019”, p9.

Threadneedle Street always knows what's best for the U.K. financial system, the wider U.K. economy, and, most importantly, the U.K. people. Witness the extremely happy circumstances that a few or even several U.K. people enjoy today, owing to the stellar U.K. economy.

"Thank you, Bill for forwarding along to us the presentation you shared with US regulators. We appreciate you keeping us in the loop.

"The debate around cross-border regulation for all areas (tax, financial reform, accounting, etc.) will always be a complicated topic for many reasons, including political uncertainty. Thank you for flagging the uncertainty the US regulators see related to the referendum question in regards to cross border derivatives reform."⁵⁴

I emailed Ms. Breeden directly regarding the flip-clause-swap-contract on June 10, 2019.

"I hope that you will discuss the damage that financial catastrophes have on public appetite for climate mitigation at tomorrow's CFTC Market Risk Advisory Committee Meeting.

II

*"As an update, I affiliated as a senior fellow with Croatan Institute in November 2017. The Institute, which actively assesses climate sustainability and finance, posted my Working Paper 'Can Green Bonds Flourish in a Complex-Finance Brownfield?' in July 2018. The Working Paper proposes a financial sustainability score to measure the impact of a financial instrument on the sustainability of the financial system. **Unsurprisingly, flip clause swap contracts, including ones in prominent EU 'green' RMBS deals, score among the worst with respect to both a given deal and the swap dealer that assumes walk-away risk to its own credit profile** [emphasis added].*

[\[https://croataninstitute.org/2018/07/01/can-green-bonds-flourish-in-a-complex-finance-brownfield/\]](https://croataninstitute.org/2018/07/01/can-green-bonds-flourish-in-a-complex-finance-brownfield/)

"Following is a link to the comment 'Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (In the Event of No-Deal Brexit)' that I submitted to the CFTC on May 31, 2019.

<https://comments.cftc.gov/PublicComments/CommentList.aspx?id=2960>.

"The comment take-away: 'The CFTC must amend the CFTC No-Deal Brexit Rule to exclude a swap contract with a flip clause, other walkaway provision, or rating agency condition/ confirmation (RAC) that is transferred to an affiliate, branch, or other entity domiciled in the US.'⁵⁵

⁵⁴ Allison Parent email to Bill Harrington "[Re: Non-Clearable Swap Contracts with Flip Clauses and No Margin Posting](#)", May 13, 2015, in "[WJH and Bank of England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019](#)", p10.

⁵⁵ Bill Harrington email to Sarah Breeden "[Re: CFTC MRAC June 12 2019 + 'Improving Securitisation Quality - WJH Comment Letter to U.S. SEC on ABS Ratings'](#)", June 10, 2019, in "[WJH and Bank of](#)

Moody's Investors Service Pre-Sale Report "Elstree Funding No. 3 PLC", 9 March 2023 details a U.K. RMBS issuance with fixed-for-floating, predetermined-schedule flip-clause-swap-contract provided by NatWest Markets.

Moody's should, but demonstrably does not, assign credit ratings to Elstree Funding No. 3 PLC RMBS and to NatWest Markets, respectively, that recognize the outsized credit exposures of all to NatWest under the huge flip-clause-swap-contract that does not obligate a downgraded NatWest to novate or obtain a guarantee.

Moody's should, but demonstrably does not, assign credit ratings to NatWest Markets that recognize the outsized credit exposures occasioned by the 100% correlation of flip-clause activation by ALL RMBS, ABS, and other structured debt issuer counterparties around the world that would have out-of-the-money flip-clause-swap-contracts should NatWest default, enter bankruptcy, or become insolvent.

"Flow of funds, Allocation of payments/pre-accelerated revenue waterfall", Steps 2 and 16, page 17 constitute the flip clause.

The Elstree Funding No. 3 PLC flip-clause-swap-contract is HUGE because 95% of residential mortgage loans are initially fixed-rate. The contract is "**not balance guaranteed.**" See page 20.

"[A]bout 95.3% of the loans in the pool are fixed-rate mortgages, which will revert to West One's SVR or BBR plus a margin between December 2023 and October 2029.

II

"The swap notional follows a predetermined schedule and does not reference the actual outstanding amount of loans being hedged during each period. This feature has in recent years become more common in other UK RMBS transactions . . ."

The issuer moderately mitigated poor governance in entering the flip-clause-swap-contract by eliminating a balance-guaranteed component sometime after soliciting credit ratings from S&P Global Ratings. From the S&P Presale "Elstree Funding No. 3 PLC", 9 March 2023.⁵⁶

"The transaction no longer features a balance-guaranteed swap and instead the notional for the swap follows a schedule."

Unfortunately, the issuer and NatWest Markets each enacted a massive governance failure by omitting a hard transfer obligation ("replacement") from the flip-clause-swap-contract. See Moody's Pre-Sale, page 20.

England Staff -- Flip Clause Meeting and Correspondence -- 31 May 2014 to 26 June 2019", pp11-12.

⁵⁶ (<https://www.spglobal.com/ratings/en/research/pdf-articles/230309-presale-elstree-funding-no-3-plc-12584847>).

“However, there is no transfer trigger in the swap definition and swap counterparty must post collateral or transfer rights.”

NatWest ability to avoid either transferring the flip-clause-swap-contract or obtaining a guarantee by instead merely posting collateral even if approaching default, bankruptcy, or insolvency increases the expected losses of Elstree Funding No. 3 PLC RMBS today. The lack of hard transfer obligation all but ensures that a defaulted, bankrupt, or insolvent NatWest will remain counterparty to the contract and expose the issuer to outsize losses 100% of the time, i.e., both when the contract is in-the-money to the issuer and when the contract is out-of-the-money.

Likewise, NatWest ability to avoid transferring the flip-clause-swap-contract by instead merely posting collateral even if approaching default, bankruptcy, or insolvency increases NatWest expected losses today. The lack of hard transfer obligation all but ensures that a defaulted, bankrupt, or insolvent NatWest will remain counterparty to the contract and, if in-the-money, lose 100% of contract value.

The Elstree Funding No. 3 PLC issuer exposes its RMBS to an extreme level of governance risk, i.e., well beyond the already high governance risk that is the baseline for U.K. RMBS! Most U.K. RMBS are exposed to high governance risk because most issuers are party to flip-clause-swap-contracts. Moody’s Pre-Sale describes eight *“other transactions by the same originator and comparable transactions.”* Each has a *“hedge in place”* that is a *“fixed-floating swap”* and all such swaps are, with 100% certainty, flip-clause-swap-contracts. See page 20.

Moody’s Investors Service fails its own self-governance by setting governance benchmarks that *willfully ignore* the outsized expected losses incurred by each U.K. and other non-U.S. RMBS, ABS, and other structured debt issuer that is party to a flip-swap-contract. The following re-work of Moody’s Pre-Sale, page 3, is more accurate.

“UK RMBS sector governance risk is high, based on issuers’ pervasive use of flip-clause-swap-contracts, many of which are disproportionately huge.

II

“Governance: Governance risks for this transaction are high based on the presence of a huge flip-clause-swap-contract with no hard obligation for a downgraded NatWest Markets to transfer or obtain a guarantee.”

Likewise, the following re-work of Moody’s Pre-Sale, pages 21-22, is more accurate.

“ESG - Governance considerations

“Strong RMBS governance relates to transaction features that promote the integrity of the operations of the transaction for the benefit of investors, as well as the data provided to investors. The following are some of the governance considerations related to the transaction:

“» Absence of flip-clause-swap-contract.

“ ... ”

Best regards,

Bill Harrington