

William J. Harrington

**February 17, 2014**

***VIA ELECTRONIC MAIL***

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

Dear Ms. Murphy:

I am writing with respect to Regulation AB and disclosures by an issuer of a cash-flow asset-backed security (ABS) when party to a derivative contract.

An ABS issuer enters into a derivative contract to augment cash proceeds from an asset pool that can fall short owing to depreciation of a non-credit element, such as a basis rate, interest rate, currency, or prepayment/extension rate, relative to an ABS.

This letter expands on my earlier one of February 2, 2014 that asked whether the Commission would examine a widely used derivative contract, a securitization swap with a flip clause, in adopting rules revising the disclosure, reporting, and offering process for ABS.

Under a securitization swap, a counterparty pays cash to an ABS issuer, or vice-versa, in an amount that is determined by the extent to which a non-credit element of an asset pool has depreciated relative to an ABS since closing (counterparty pays) or appreciated (issuer pays.)

A securitization swap with a flip clause has long been the go-to derivative contract for the ABS industry, chiefly because securitization swaps keep issuance costs artificially low. An ABS issuer pays no upfront amount to enter into a securitization swap, nor sets aside reserves against counterparty insolvency.

Securitization swaps sustain issuance in some ABS sectors (e.g., student loans and RMBS) and support issuance in others (e.g., equipment leases, autos, and TruPS CDOs). Even sectors that don't typically rely on securitization swaps at issuance (e.g., CMBS, CLOs and credit cards) routinely place flip clauses in priorities of payments so that issuers can enter into securitization swaps after closing.

### **Counterparty solvency critical for an issuer to pay ABS interest and principal**

An ABS issuer is linked to the same counterparty for the life of a securitization swap, and thus can only pay interest and principal to an ABS according to its terms and conditions while a counterparty remains solvent, regardless of whether a securitization swap is a mark-to-market asset or liability.

An insolvent counterparty will deplete issuer cash when a securitization swap is a mark-to-market asset (i.e., the referenced, non-credit element of an asset pool has depreciated from closing levels) or a mark-to-market liability (i.e., the referenced element has appreciated from closing levels.) In the latter case, a flip clause is unlikely to preserve issuer cash.

### **Disclosure of derivative assets and liabilities under Regulation AB**

ABS issuers make few disclosures with respect to derivative contracts, counterparties, or counterparty guarantors, even though the parameters of a derivative contract and the credit profiles of a counterparty and guarantor underpin the likelihood that an can pay ABS interest and principal.

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

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

The disclosures serve a key aim of Regulation AB, namely that of facilitating independent scrutiny of ABS, both on an individual basis and in aggregate by issuer, sector, counterparty, counterparty guarantor, and industry as a whole. Moreover, an issuer can make the disclosures, and update them, at minimal cost.

### **Disclosures will show lots of securitization swaps riding on just a few guarantors**

A marked concentration of securitization swaps across all ABS sectors have counterparties that are guaranteed either singly by Merrill Lynch Derivative Products AG, or jointly by Goldman Sachs Group, Inc., and Mitsui Sumitomo Insurance Co., Ltd.

Neither type of guarantee will prevent an insolvent counterparty from depleting the cash of a great many ABS issuers at the same time. Issuers with swaps that are mark-to-market assets are unlikely to hold collateral to offset cash shortfalls from depreciated asset pools, and issuers with swaps that are mark-to-market liabilities will be obligated to divert cash from ABS interest and principal to pay lump-sum termination amounts, instead.

Merrill Lynch Derivative Products AG (MLDP) is a derivative products company (a type of structured finance operating company) that is domiciled in Switzerland and supported by Bank of America, N.A. (BANA). In circular fashion, MLDP turns right around and guarantees BANA payment and performance obligations under securitization swaps, as well as the payment and performance obligations of Bank of America Corporation, Merrill Lynch & Co., Inc., Merrill Lynch Capital Services, Inc., Merrill Lynch International Bank Limited, and AIG.

In fact, the counterparties have no payment or performance obligations whatsoever, given that the securitization swaps are mark-to-market liabilities to ABS issuers. Moreover, the MLDP guarantees do not protect ABS issuers from having to monetize the liabilities in full by making lump-sum termination payments to an insolvent counterparty, be it BANA, Bank of America Corporation, Merrill Lynch & Co., Inc., Merrill Lynch Capital Services, Inc., Merrill Lynch International Bank Limited, or AIG. Under the guarantees, ABS issuers have no recourse to MLDP in the likely event that flip clauses are not upheld against an insolvent counterparty.

Goldman Sachs Mitsui Marine Derivative Products, L.P. (GSMMDP) is a shell entity with few resources other than a joint guarantee by Goldman Sachs Group, Inc., and Mitsui Sumitomo Insurance Co., Ltd. In the event that one guarantor does not perform or becomes insolvent, the other assumes sole responsibility for all GSMMDP obligations. The shell nature of GSMMDP means that it will implode quickly with the failure of one guarantor, leaving ABS issuers completely dependent on the remaining guarantor for payments and collateral.

Please place this letter with my letter of February 2, 2014, and my email of February 3, 2014 with attachments, in the public comment file. Also, please forward the same materials to the Division of Economic and Risk Analysis, along with my assessment that securitization swaps embed all ABS sectors, and thus the financial system as a whole, with concentrated exposure to a handful of counterparties and even fewer guarantors.

Sincerely yours,

William J. Harrington