From: Bill Harrington [redacted]
Subject: Inaccurate ABS & DPC Ratings Attributable to Securitization Swaps
To: [redacted]
Cc: [redacted]
Date: Sunday, October 20, 2013, 8:39 PM

Mr. Losice:

I am following-up on our meeting of October 16, 2013 in which your colleagues, you, and I discussed inaccurate ratings of asset-backed securities (ABS) and derivative product companies (DPCs.) $5 trillion equivalent of cashflow ABS worldwide carry inflated ratings, including $2 trillion of U.S. cashflow ABS.

As we discussed, Moody's, S&P, Fitch, DBRS, Kroll and Morningstar knowingly maintain inaccurate ratings of cashflow ABS across all sectors, e.g., the auto, commercial mortgage, credit card, equipment, future royalties, housing, and settlement sectors, to name a few.

Attached is my September 11, 2013 letter to you that maps flawed methodologies for rating ABS which was our discussion guide. My letter links, via the SEC website, to my earlier submissions to the SEC regarding inaccurate ratings of ABS and DPCs (June 3, 2013) and proposed rules for rating agencies (August 8, 2011).

The second and third attachments provide third-party information which you requested as corroboration of points that I had raised. The second attachment contains two recent articles from Structured Credit Investor, an ABS industry publication, that detail losses to European ABS under securitization swaps with Lehman Brothers as a counterparty. Five years after the 2008 Lehman bankruptcy, the affected ABS are still linked to Lehman, still incurring losses, still party to litigation, and likely to be written down substantially.

The third attachment contains two Moody's announcement of no-downgrade letters that were issued to counterparties of securitization swaps that opted not to fulfill contractual obligations to ABS issuers. The first Moody's announcement impacts 11 CDOs whose issuers remained counterparty to Goldman Sachs after it obtained Moody's permission not to replace itself after having been downgraded to a replacement trigger. As a result, each of the 11 CDOs faces increased risk of making a termination payment in the event of a Goldman insolvency. The second Moody's announcement details a no-downgrade letter issued to Bank of America N.A. (BANA) that allows BANA to obtain a guarantee of its obligations under a securitization swap from MLDP, a DPC that, in circular fashion, is itself guaranteed by BANA.

I am glad that your colleagues and you had each read the entirety of my September 11, 2013 letter, as well as my August 8, 2011 submission. Your colleagues and you delved into many of my written points, including: 1) Moody's dual system of in-house ratings and public ratings for ABS; 2) the lack of a U.S. replacement market for securitization swaps; 3) no-downgrade letters; 4) lack of valid mark-to-markets for securitization swaps; and 5) rating agency reliance on DPC management for DPC risk measures, among other topics.

Inaccurate ratings mask real-world risks in most cashflow ABS under securitization swaps that hedge mismatches of interest rates, basis rates, currencies, etc. Each securitization swap is highly idiosyncratic and ties an ABS issuer to its counterparty, thereby embedding ABS with significant event risk related to counterparty non-performance. Issuers of cashflow ABS are not obligated to enter into securitization swaps -- they are free to purchase options or implement other hedging strategies.

Key provisions of securitization swaps have been repudiated by the market (no U.S. replacement market exists), by legal decisions (flip clauses are not enforceable in the U.S.), by internal flaws (guarantees, an alternative to replacement, don't negate the obligation of an ABS issuer to make a termination payment), and by rating agencies (methodologies for securitization swaps are watered-down and no-downgrade letters are issued.)

Neither Moody's, nor S&P, nor Fitch, nor DBRS, nor Kroll, nor Morningstar can critique competitor methodologies for securitization swaps without also critiquing their own methodologies. All rating agencies rate ABS under the identical assumption that no losses accrue to ABS under a securitization swap from missed hedge receipts, collateral insufficiency, forced termination payments, contract repudiation, or litigation with the estate of an insolvent counterparty.

No rating agency devotes sufficient resources to assess the discredited assumptions that all use to evaluate securitization swaps in rating the equivalent of $5 trillion of cashflow ABS worldwide. Counterparties are distinguished only by rating and not on an individual basis that assesses competence and capacity to enter into securitization swaps, past history in fulfilling contractual obligations to post collateral to ABS issuers and obtain replacement or a guarantee, and applicable laws regarding flip clauses and other provisions common to securitization swaps.

Rating agencies do not query ABS issuers on hedging strategy, choice of hedging instruments, or contingency plans should a counterparty become insolvent. Rating agencies do not assign attorney analysts trained in the law of each domicile to evaluate the enforceability of one-domicile-fits-all templates for securitization swaps. Nor do rating agencies query ABS trustees who forward counterparty requests for no-downgrade letters to rating agencies, even though each no-downgrade letter deprives ABS issuers of collateral and other contractual protections.

On its own, the decision of a U.S. bankruptcy court in 2010 to vitiate a flip clause invalidated ratings of some $2 trillion of U.S. cashflow ABS, yet no downgrades followed nor was meaningful review of affected cashflow ABS conducted. In fact, Moody's, S&P, Fitch, DBRS, Kroll and Morningstar each continue to rate ABS by treating flip clauses as 100% enforceable in all domiciles, including the U.S. As example, Moody's comment request "Approach to Assessing Linkage to Swap Counterparties in Structured Finance Cashflow Transactions" (which I discussed at length with your colleagues and you) omits review of review of flip clauses entirely and addresses only ABS losses from "loss of hedging."

Taken with failure of a U.S. market for replacement by independent, third-party entities to materialize, the non-enforceability of flip clauses means that most U.S. cashflow ABS should be subject to a cap of BBB. Instead, rating agencies preserve inaccurate ratings at inflated levels and issue no-downgrade letters that effectively bind ABS issuers more closely to existing counterparties and increase the event risk embedded in affected ABS.

S&P and Fitch also explicitly link their respective, watered-down methodologies for securitization swaps to allied methodologies for DPCs, even though the rating assumptions for an ABS issuer that has entered into a securitization swap and a DPC that provides a securitization swap are in direct conflict. For a start, a DPC bases its capital and collateral holdings on frequent mark-to-markets of its portfolio and so can only guesstimate mark-to-markets for its securitization swaps. Each securitization swap is a static, standalone instrument with no objective mark-to-market -- securitization swaps cannot be netted, traded, cleared or fully hedged. After incurring a trigger event, a DPC also lacks assets to post collateral to ABS issuers or obtain replacement.

By maintaining inaccurate ratings of cashflow ABS and DPCs, rating agencies incentivize ABS issuers to continue entering into securitization swaps rather than hedge in an alternative manner, e.g. by purchasing options. Unlike a securitization swap, an option can be marked-to-market objectively, replaced easily and can never be a liability to an ABS issuer, i.e. will never require an ABS issuer to make a termination payment to a counterparty.

I would be happy to meet with you again, both to continue our discussion and to speak with your colleagues who could not participate on October 16, 2013 owing to the government shutdown.

Regards,

Bill Harrington

Attachments:

- http://www.wikirating.org/data/other/20131020_Moodys_Announcements_of_No-Downgrade_Letters_Pertaining_to_Securitization_Swaps.pdf

- http://www.wikirating.org/data/other/20131020_Losses_to_European_ABS_under_Securitization_Swaps_with_Lehman_as_Counterparty_SCI.pdf