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Entire Financial System Needs Commonsense Review of Derivative Contracts: Let's Start with ABS

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Wikirating is publishing two letters and one e-mail in which I map risks to an asset-backed security (ABS) when the issuer is party to a swap contract, a widely used type of derivative contract. An ABS issuer enters into a swap contract to offset mismatches between an asset pool and an ABS with respect to interest rates, indexes, and currencies.

The addressees are staff of the U.S. Securities and Exchange Commission (SEC), which has regulatory oversight of ABS issuers and rating agencies in the United States. One letter is also addressed to staff of the European Securities and Markets Authority (ESMA), which has analogous oversight in the European Union.

While the letters are intended to be useful to a wide audience, they represent my best efforts in alerting the SEC and ESMA to yet another ABS debacle in the making—ABS issuers that have entered into swap contracts cannot repay ABS with likelihoods that accord with their ratings. (I have also briefed the Federal Reserve, the U.S. Commodity Futures Trading Commission, and the International Monetary Fund, while offering to so the same for the European Banking Authority.) To date, the SEC has not increased transparency of derivative contracts in ABS—a failure that its Regulation AB proposes to remedy.

Nor has the SEC or ESMA penalized rating agencies for promoting methodologies that incentivize ABS issuers to enter into swap contracts with hidden costs; each regulator professes to have its hands tied per orders from on high. The U.S. Constitution protects the free speech of rating agencies (SEC rationale for giving methodologies a free pass), and the International Organization of Securities Commissions discourages members from reviewing methodologies (the ESMA's rationale).

From 1999 to 2010, I was lead analyst at Moody's Investors Services (Moody's) for the swap contracts in question (securitization swaps). In 2006, I coauthored a comprehensive blueprint for a securitization swap that was intended to insulate ABS from hidden costs but which has been repudiated by market realities and legal rulings. Rather than retire the deficient blueprint and downgrade ABS, Moody's has doubled down in the other direction by diluting the blueprint and continuing to assign Aaa ratings to new ABS. Ditto S&P, Fitch, et al.

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Since retiring from Moody's in 2010, I have worked independently to assess the systemic costs of derivative obligations that are accumulating for ABS, providers of swap contracts (counterparties), and derivative reinsurers (i.e., taxpayers). The letter "ABS Losses Attributable to Securitization Swaps" also links to my separate evaluation of the underlying driver of inaccurate ratings: namely, the conflict of interest that operates internally within a rating agency by the directive of senior management.

Entire financial system needs a Y2K exercise for derivative contracts
Bond issuers in all sectors worldwide (sovereign, corporate, municipal, financial, ABS, etc.) routinely enter into derivative contracts by low-balling the costs of obligations (i.e., losses) that can arise under the contracts. Throughout the financial system, issuers and counterparties relentlessly assume more obligations under new derivative contracts and then simply pile them on top of existing obligations without adding a commensurate amount to reserves.

Derivative overload will periodically erupt into more fiascos that will later be portrayed by the principals involved as having been "unforeseeable." Fiascos aside, mispriced derivative contracts continually distort market signals and, in doing so, wreak havoc on investment decisions. Future generations will marvel at our proliferation of derivatives and wonder, as we do at the follies of previous generations, "What were they thinking?"

As with most bilateral contracts, a derivative contract engenders highly wishful thinking on the part of both parties. From initial negotiation to final payment, an issuer and a counterparty each price a derivative contract under the assumption that it will deliver finely honed benefits that will cure what ails without imposing unforeseen costs or losses.

Industry practice of treating a derivative contract as a low-cost panacea, rather than, first and foremost, a binding contract with trade-offs, is justifiable only under the assumption that the parties will not exit the contract ahead of schedule. Derivative contracts specify significant costs for early exit, regardless of whether the exit is voluntary or involuntary (e.g., after one party has become insolvent).

Nonetheless, analysts, regulators, policy makers, and rating agencies egg on issuers and counterparties in wishfully thinking that entering into a derivative contract is always beneficial, both for the parties themselves and for the wider economy as a whole. With every new derivative contract, a sovereign entity taps more markets, a corporation smoothes earnings, a municipality reduces borrowing costs, an ABS issuer securitizes more assets, and, in win-win fashion, a counterparty books a profit up front.

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For their part, rating agencies award credits to both parties to a derivative contract, rather than match a credit to one party with a corresponding debit to the other. Better still would be a net debit across all ratings to reflect derivative obligations, with the scale of the debit based on an ongoing tally of potential costs and losses. Currently, rating agencies don't bother to track derivative costs at all—they merely pencil in open-ended tabs that will be picked up by government bailouts and perfectly orchestrated bail-ins.

Accurate ratings would link derivative contracts across all sectors in a closed system that exactly offsets credits and debits, puncturing the wishful thinking that a derivative contract is a low-cost panacea for what ails a sovereign, corporate, municipal, financial, or ABS issuer.

Accurate ratings would also reflect an unsettling reality: We have less to work with than what derivative contracts would have us think.

Attachments:

2014-02-17: "Reg AB Disclosures for Securitization Swaps and Other Derivative Contracts"
2013-10-20: "Inaccurate ABS & DPC Ratings Attributable to Securitization Swaps"
2013-09-17: "ABS Losses Attributable to Securitization Swaps"

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