Fw: CFTC Open Commission Meeting of March 7, 2019

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From: Bill Harrington <wjharrington@yahoo.com>
To: Chris Kirkpatrick <ckirkpatrick@cftc.gov>; ggiancarlo@cftc.gov <ggiancarlo@cftc.gov>; bquintenz@cftc.gov <bquintenz@cftc.gov>; Rostin Behnam <rbehnam@cftc.gov>; dstump@cftc.gov <dstump@cftc.gov>; dberkovitz@cftc.gov <dberkovitz@cftc.gov>
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Sent: Friday, March 1, 2019, 1:47:18 PM EST
Subject: CFTC Open Commission Meeting of March 7, 2019

Dear All,

My name is Bill Harrington. I am a senior fellow at Croatan Institute. My work focuses on identifying the undercapitalization of derivative contracts, securitizations, and the nexus of the two, i.e., a flip clause swap contract.

I am writing to urge the CFTC to preserve the rigorous policy with respect to the securitization sector in deciding the first two agenda items of the Open Commission Meeting of March 7, 2019, namely: **(1)** the amendment to the comparability determination for Japan; and **(2)** the comparability determination for Australia.

Of critical importance, and in accordance with the US swap margin rules:
(1) securitization issuers must exchange full variation margin daily and with a de minimus threshold under a new or amended swap, especially a flip clause swap; and
(2) all non-GSE securitization debt, i.e., private-label securitization debt, must be excluded from eligible collateral and haircut by 100% if posted.

Please find four documents attached to this email.
1. My letter to Secretary Kirkpatrick of today (March 1, 2019), which provides rationale for the points I raise immediately above [See page 1, further below in this compilation for Wikirating.org].
2. My *Debtwire ABS* article "US margin rule for swaps obliges securitization issuers to overhaul structures, add resources, and rethink capital structures" of November 5, 2015 [not compiled here, available on request].
3. My *Debtwire ABS* article "CFTC swap margin rule denies relief for ABS; shines light on 'flip clauses'" of December 18, 2015 [not compiled here, available on request].
4. My *Debtwire ABS* article "CFTC lets ABS sector guess on global implementation of swap margin rules" of September 26, 2016 [not compiled here, available on request].

I am available to communicate at any time [not compiled here, available on request].

Best regards,

Bill Harrington
917-680-1465

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March 1, 2019

VIA ELECTRONIC MAIL

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodities Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: CFTC Open Commission Meeting of March 7, 2019

Dear Mr. Kirkpatrick,

My name is Bill Harrington. I am a senior fellow at Croatan Institute. My work focuses on identifying the undercapitalization of derivative contracts, securitizations, and the nexus of the two, i.e., a flip clause swap contract.

Prior to joining Croatan Institute, I worked as a: research journalist at *Debtwire ABS;* senior vice president in the derivatives group of Moody's Investors Service; structurer of currency and fixed income derivative contracts at Merrill Lynch; and currency and interest rate economist at Wharton Econometrics. My biography on the Croatan Institute website provides my bona fides and links to my work.

I have directly communicated findings on the intrinsic deficiencies of flip clause swap contracts to CFTC staff on many occasions and also to prudential regulator staff. On March 12, 2015, a colleague and I shared findings in a joint call with staff of each of the six regulators.

The prudential regulators and the CFTC both incorporated the conference call findings into the respective 2015 rules for swap margin. Please see the first two of my *Debtwire ABS* articles also attached to the delivering email: **(1)** "US margin rule for swaps obliges securitization issuers to overhaul structures, add resources, and rethink capital structures" of November 5, 2015; and **(2)** "CFTC swap margin rule denies relief for ABS; shines light on 'flip clauses'" of December 18, 2015.

As a result, the two parallel sets of margin rules are much more rigorous with respect to the securitization industry than the rules of any other jurisdiction. Of critical importance, the US rules: **(1)** obligate securitization issuers to exchange full variation margin daily under a new or

amended swap, including a flip clause swap; and **(2)** exclude all non-GSE securitization debt from eligible collateral. The rules of many domiciles do neither.

On September 8, 2016, the CFTC followed best practice in imposing rigor on the securitization sector in making its first comparability determination, i.e., that regarding Japan. Please see the third of my *Debtwire ABS* articles attached to the delivering email "CFTC lets ABS sector guess on global implementation of swap margin rules" of September 26, 2016. The article's fourth section (headed *"Secondly, US dealers must exchange daily margin with Japanese ABS"*) describes the good securitization policy in the 2016 determination. The fifth section (head *"Thirdly, margin posting neutralizes a flip clause. JPY repacks of AAA CLOs at risk?"*) lists US CLOs and US swap dealer affiliates that the comparability determination covers. The sixth section (headed *"Setting the stage for examining the EU margin regime?"*) describes the prudential regulator policy on comparability determinations.

I urge the CFTC to preserve the rigorous policy with respect to the securitization sector in deciding the first two agenda items of the Open Commission Meeting of March 7, 2019, namely: **(1)** the amendment to the comparability determination for Japan; and **(2)** the comparability determination for Australia.

Unfortunately, the CFTC rejected best practice with respect to the securitization sector in approving the comparability determination for the EU on October 13, 2017.

The following excerpts regarding eligible EU collateral show why.
"The most senior tranche of a securitization, as defined in Article 4(61) of Regulation (EU) No 575/2013, that is not a re-securitization as defined in Article 4(63) of that Regulation"
"Securitization positions meeting the criteria in Article 4(1)(o): Residual maturity of less than one year"
Securitization positions meeting the criteria in Article 4(1)(o): Residual maturity between one and five years"
"Securitization positions meeting the criteria in Article 4(1)(o): Residual maturity of more than five years"
"Other differences concern... the most senior tranche of a securitization...which are allowed under the EU margin rules but not under the Final Margin Rule. However, the EU margin rules do address the inherent risk posed by these assets by including additional safeguards when using these types of collateral....Regarding the most senior tranche of a securitization, a counterparty must use an ECAI's credit quality assessment to assess the tranche's credit quality."

(As note, ECAI (external credit assessment institutions) analysts such as those at S&P Global don't understand, let alone assess, credit quality for a securitization when an issuer is party to a flip clause swap contract. Please see my email exchange with S&P analysts of February 16, 2018 to May 10, 2018.)

Furthermore, the EU rules de-facto exempt most securitization issuers from the daily exchange of full variation margin by means of a very high threshold. The de-factor exemption compounds the likelihood that securitization debt posted as collateral will be inadequately capitalized.

CFTC Chairman Giancarlo attested to the need for robust provisions for the securitization industry in remarks at the DerivCon 2019 Conference in New York City on February 27, 2017.

"You know, twenty years ago there was a CFTC chairwoman, who proposed to review US regulation of OTC swaps at a time of relatively healthy market conditions. She was harshly attacked by some who preferred the status quo (especially by fellow financial regulators in her own party). As a result, nothing was done.

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"If, instead, steps had been taken then to bring swaps into the traditional principles-based regime of the CFTC, we might not have had to hurriedly address it in the wake of 2008 financial crisis and implement it in as wooden a fashion as was done."

Indeed! If the CFTC had implemented robust provisions regarding the securitization industry in 2005 rather than 10 years later in 2015, the financial crisis might never have occurred. The daily exchange of full variation margin would have obligated issuers of collateralized debt obligations, residential mortgage-backed securities, and repackaged securities to either add much more capital to their respective deals or not issue them in the first place. The exclusion of private-label securitization debt as eligible collateral would have eliminated an incentive for swap dealers such as Lehman Brothers to underwrite and hold under-capitalized deals.

I will ask my colleagues at Wikirating.org to post this letter.

Best regards,

Bill Harrington
917-680-1465