September 20, 2012

Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20219
Attention: David A. Stawick, Secretary

Re: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants

Dear Mr. Stawick:

The American Securitization Forum ("ASF")[1] is submitting this letter in connection with the re-opening of comment period for proposal by the Commodity Futures Trading Commission (the "Commission") with respect to Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (the "Margin Proposal").[2] The Commission is required to adopt margin regulations as part of the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). We previously submitted a comment letter to the CFTC and the prudential regulators on this issue on July 11, 2011.[3] We appreciate the opportunity to provide further comment at this time.

ASF supports appropriate reforms within the over-the-counter ("OTC") derivatives market as it relates to the securitization market. ASF was founded as a means to provide industry consensus on market and regulatory issues, and we have established an extensive track record of providing meaningful comment to various regulatory agencies on issues affecting our market. Our views as expressed in this letter are based on feedback received from our broad membership.

We strongly support the Commission's proposal not to require margin retroactively for existing swaps. We believe that most if not all securitizations are structured in such a way that it would be impossible to retroactively add margin requirements to their existing swaps.[4] We also believe

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[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

[2] *See* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-9598a.pdf.

[3] *See* http://www.americansecuritization.com/uploadedfiles/asfswapmarginletter20110711.pdf.

[4] For the same reason, we believe that when a securitization vehicle may be required to register as a major swap participant or major security-based swap participant (a "Major Participant") as a result of legacy swap positions,

that harmonization of margin rules across swap dealers (whether regulated primarily by the Commission or the prudential banking regulators, and whether domestic or foreign) will facilitate more consistent approaches to structuring the use of swaps by securitization vehicles and will avoid the competitive disadvantages that might arise if U.S. banks and captive finance companies were unable to use swaps in securitizations of their assets while comparably situated non-U.S. entities had no such constraints.[5]

As we have noted in our communications with the Commission and staff relating to the issues faced by the securitization industry in connection with the possible application of the Commission's rules for commodity pool operators to participants in this industry, securitizations generally use swaps in ways that are incidental to the securitization, typically to hedge asset-liability mismatches. The ability to continue to use swaps in this way is important to securitizations and has broader implications for the availability of funding for consumers and businesses.

Our comments in this letter relate to the challenges the securitization industry will face as a result of requirements to post margin for both uncleared swaps and, if clearing is required, for cleared swaps. We discuss margin in both contexts because we believe the issues are comparable and intertwined. We believe (and ask the Commission to confirm) that securitizations sponsored by captive finance companies will be able to use the captive finance company end-user exception from clearing and will also qualify as end-users for purposes of the margin regulations, as we believe Congress intended the end-user exception from clearing to go hand-in-hand with an exemption from regulatory margin requirements. We further believe that many of the swaps used in securitizations will be excluded from the clearing mandate because they have conditional notional amounts that step down on an unpredictable schedule as the issuer's liabilities or underlying securitized assets amortize. In other circumstances, however, it appears that swaps used in securitizations may be subject to the clearing mandate, and we have significant concerns that a clearing requirement (or a requirement to post margin for uncleared swaps) may make

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imposition on such vehicles with legacy positions of capital rules of the type proposed by the Commission for swap dealers and major swap participants would be unworkable. *See* Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg, 27802 (May 12, 2011). We note that the Commission and the SEC in May of this year indicated that the Agencies "intend to pay particular attention to the special issues raised by the application of [substantive Title VII] rules to legacy portfolios," and that, for example, in conjunction with its proposed margin and capital rules applicable to Major Participants, the SEC expected to request comment on how the rules should apply to entities with legacy portfolios. *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596, 30691, fn. 1170 (May 23, 2012). Securitizations use limited purpose entities that generally have constraints, in both their charters and their key agreements, on their ability to raise additional capital. We understand that there are a limited number of securitization vehicles that would face a potential conflict between any Commission-imposed capital requirements of the type proposed in May 2011 for swap dealers and major swap participants generally and the vehicles' governing documents, and we encourage the Commission to work with the SEC to develop an approach to the question of capital that will be consistent with such limitations.

[5] We note that there are a number of financial products that may not be considered securitizations, but which nevertheless exhibit many of the same structural features. This includes asset-backed commercial paper and the guarantee element of structured covered bonds. The special purpose entities in these transactions often enter into swaps and the concerns about posting margin by securitization vehicles expressed in this letter would be equally applicable to those entities.

impossible or impracticable the use of swaps by securitizations to effect basic hedging of interest rate and currency mismatches between the assets and liabilities of the securitization vehicles. We are similarly concerned that, for existing securitization vehicles, the replacement of a swap for which a termination event or event of default occurs may be impossible under the securitization's governing documents if that swap must be cleared or would be subject to margin posting requirements. Accordingly, margin requirements, whether resulting from central clearing requirements or from the Commission's rules for uncleared swaps, may have a material adverse effect on the securitization markets and the ability of issuers to appropriately hedge risk and meet investor demand.

Background

Although a large number of types of vehicles may be considered securitization vehicles, a significant portion of the market consists of "plain vanilla" securitization vehicles that are established as funding sources for loan or lease receivables originated by banks, captive finance companies or other businesses. The vehicles are used to allow banks, captive finance companies and other businesses to fund portfolios of credit card, auto loan or lease, student loan, mortgage loan and other loan or lease receivables, including "trade receivables" that represent amounts invoiced by Main Street businesses to their customers. Securitization vehicles are not operating vehicles—in other words, they own a portfolio of financial assets that will pay down over time, and they essentially do nothing more than collect the receivables and distribute proceeds to investors.

Securitization vehicles for amortizing asset classes, such as auto loans, are generally static vehicles that acquire loans and issue securities in an initial transaction and then amortize on a monthly basis as principal is paid on the loans. These vehicles will temporarily invest cash in high quality liquid assets pending distributions to investors, but otherwise they acquire no additional assets and issue no additional securities. Securitization vehicles for revolving asset classes, such as credit cards (where cardholders continually pay down existing balances and generate new receivables on the same accounts), often use "master trust" structures, in which a much larger pool is established and new securities are offered over time backed by the same receivables pool. In these structures, principal collections are automatically "reinvested" in new receivables originated in existing accounts that have been designated to the master trust until the securities are paid based on a pre-agreed schedule. Master trusts are still, however, essentially passive vehicles that are structured to provide funding to the originators of the receivables. Both types of "plain vanilla" securitization vehicles generally use swaps only to hedge mismatches between the interest rate or currency of the underlying assets and that of the securities. Such mismatches typically arise as a result of investor demands.

In these types of securitizations, loan or lease receivables are transferred from the originator to a special purpose vehicle in a "true sale" transaction, meaning that the receivables would be considered to be owned by the vehicle rather than by the originator in an insolvency proceeding of the originator. The securitization vehicle also typically is established with separateness covenants designed to minimize the risk that the securitization vehicle would be substantively consolidated with the originator in an insolvency proceeding—in other words, to ensure that the originator and the securitization would not be treated as a single entity with shared ownership of

assets and shared liabilities—and is structured to be bankruptcy remote. This structuring is intended to legally isolate the assets to allow investors to obtain more certainty that they are only investing in assets and not in an operating company (i.e., the originating bank or captive finance company). It also has the effect of protecting swap counterparties, who are taking on only the counterparty risk of the securitization vehicle—and thus of the assets—rather than the risks of the originator. Securitization structures allow originating companies to obtain more highly rated, and thus less expensive, funding than they would be able to obtain if they were issuing securities directly or borrowing under lines of credit.

These types of securitization vehicles generally make payments to investors once a month, using collections received during the prior month. They have very limited ability to use collections outside of the monthly distribution process. Moreover, the structures depend on having a high degree of certainty as to the nature, amount and timing of expenses for which the vehicle may be obligated. As a result, there are both logistical challenges posed by the possibility that these entities might be subject to margin calls, and more fundamental challenges in terms of the certainty of their overall economics. An unexpected cash requirement, for instance, could jeopardize interest payments to investors. A termination of a swap because of issues relating to the clearing agreement with a futures commission merchant (FCM) could likewise impair the securitization's ability to make payments to investors, and thus the risk of such a termination may well be inconsistent with obtaining the credit ratings required by investors under their investment guidelines. Securitization vehicles are not designed to manage the uncertainty of fluctuating margin requirements and certain other aspects of the clearing process, and our members have so far been unable to identify a structural approach that would facilitate clearing while still preserving essential investor protections. Accordingly, these vehicles may be unable to use swaps unless the risks posed by such requirements can be resolved. In some circumstances, such as a cross border securitization, the inability to use a currency swap may effectively inhibit the viability of the transaction.

Securitizations provide robust collateral to their swap counterparties, but may be unable to post margin or satisfy margin calls.

Securitization vehicles generally secure their performance under their swap agreements by granting a security interest in all of their assets, rather than by posting initial margin (i.e., a performance bond) and variation margin in the form of cash or liquid securities. The swap counterparty is usually secured together with the securitization investors and protected by restrictions that prohibit the securitization vehicle from incurring other debt.[6] The swap counterparty's rights are also relatively senior in the priority of payments, generally senior to, or at the same level as, the payment of interest on the senior-most class of securitization interests. This method of protecting the swap counterparty is highly effective and can be evaluated by the swap counterparty through a credit approval process comparable to that for secured loans. Certain securitizations, such as REMIC securitizations and other structures that issue ownership certificates, rather than debt securities, to investors, achieve a similar level of protection for the

[6] In some circumstances, termination payments may be placed lower in the priority of payments to ensure that the unexpected expense of such a payment does not prevent timely payment to investors.

swap counterparty by structuring payments to the swap provider senior to the senior-most class of securitization interests (other than for certain termination payments as noted above).

Securitization vehicles operate based on a model in which the financial assets they hold convert to cash over time, and the cash collections of those assets are aggregated and allocated among security holders, swap counterparties and service providers on a monthly basis. Such securitization vehicles typically do not have any ability to use their funds at any time other than the established monthly "payment dates" or "distribution dates." As a result, under the current model, they will not have any ability to meet margin calls. As a practical matter, this may mean that securitization vehicles will not be able to enter into swaps if they are subject to the Commission's margin regulations. Although, as noted above, we believe that securitizations sponsored by captive finance companies may be able to be treated as non-financial end-users, and thus be able to negotiate provisions that do not require the payment of variation margin, we believe that margin rules as proposed would likely impose margin requirements on most other securitizations. We therefore request that these rules be modified to permit swap dealers to accept a collateral package for securitization vehicles that includes a pledge of all or substantially all of the assets of the securitization but does not require the payment or posting of cash margin.

Any structure that reduces liquidity risk for securitizations with respect to margin will be expensive and may shift risk to banks or other financial entities.

As noted above, securitizations typically provide a lien on all of their assets to their swap counterparties, or in ownership structures provide the swap counterparty with a senior payment position in the securitization's operative documents. Any alternative approach to protecting the swap counterparty for a securitization, including requiring the posting of margin, will add cost and risk to both the securitization and the swap. Securitizations do not have the flexibility in terms of their liquidity structures to meet margin calls. Although they might be able to consider structural or contractual means of preparing for this possibility, all of the options of which we are aware have costs and risks. For example, a cash reserve set aside within the securitization, not to function as margin but to provide a reservoir of funds for a margin call, would both create negative carry on the funds and leave open the risk that the reserve would prove to be insufficient and trigger a termination event or event of default under the swap. For some types of structures, such as straight pass-through vehicles, it would likely be impossible to establish such a reserve. A letter of credit or revolving credit facility to make funds available for margin calls would eliminate the need for a cash reserve within the securitization but would be expected under Basel III to shift the cost of liquidity coverage to the provider of the letter of credit or credit facility and would create separate counterparty risk for the securitization with respect to the provider of the facility. In addition, such an approach would merely place the provider of the credit or revolving credit facility in the same position with respect to the securitization that the provider of the swap would have been in had the swap been secured in the typical manner (i.e., the swap provider has a lien on the pool assets). Securitization sponsors may well reach the counterintuitive conclusion that there is less risk to their structures in leaving positions unhedged. In addition, for some structures, such as cross border financings, going unhedged is

not an option. We believe current methodologies for protecting swap counterparties are far superior to any alternative that creates the risk of margin calls.[7]

The protections required by derivatives clearing organizations and futures commission merchants, including those required by the CFTC as their regulator, appear to be inconsistent with core investor protections in securitizations.

The swaps included in securitizations are drafted in light of the bankruptcy remote nature of the vehicle and the credit ratings of the securities issued by the vehicle. For instance, they generally include non-petition and limited recourse clauses intended to support bankruptcy remoteness, and provisions requiring replacement of the counterparty or collateralization of the obligations if the counterparty is downgraded. These provisions are included to satisfy the criteria of the applicable credit rating agencies providing the ratings on the securities, and to our knowledge these credit rating agencies have not developed guidelines that would allow securitization vehicles to enter into cleared swaps while still achieving the desired ratings.[8] Moreover, it appears unlikely that DCOs would be permitted to enter into swaps that include the provisions required under the ratings criteria currently in place. Credit ratings are a critical aspect of investors' ability and willingness to purchase securitization interests, and transactions that cannot achieve desired ratings are not completed. As a result, ratings criteria that are inconsistent with clearing are likely to prevent securitizations from being able to use cleared swaps, even if the margin issues in doing so could be resolved.

In particular, we note that the Commission acknowledged, in its proposal to designate interest rate swaps as subject to mandatory clearing, that swaps with "idiosyncratic issues related to the particular needs of a counterparty" such as "special representations added to address particular

[7] Appendix I to this letter reflects the potential costs of a margin requirement for an interest rate swap related to an auto loan securitization. We have assumed that the principal amount of the securitization and the related notional amount of the swap are each $100, the duration of the offering is 4.25 years, the required initial margin is 2% of the notional amount, the securitization and the swap notional amount amortize according to historical prepayment levels, and variation margin is posted dollar for dollar with no threshold. Appendix I shows the effect of posting liquid margin under two scenarios. In Scenario 1, we have assumed that interest rates have moved during the relevant time period by 95% of the historical movement in interest rates over such a period since January 1984. However, Scenario 1 may understate the required amount of the margin reserve if the sponsor of the securitization intends to seek a triple-A credit rating for any class of securities being offered in the securitization. For that reason, in Scenario 2, we have assumed that interest rates have moved during the relevant time period by 150% of the historical movement in interest rates over such a period. In both scenarios, creation of a margin reserve will reduce the amount of funding obtained by the sponsor at issuance to make new loans. In Scenario 1, $9.83 would be held in reserve, while in Scenario 2, $21.13 would be held in reserve, in each case reducing the amount of available funding obtained through the securitization by an equivalent amount. Accordingly, requiring the posting of liquid margin can have significant effects on the availability of auto financing and hence on automobile sales—part of the real economy.

[8] Credit rating issues also may limit the ability of securitizers to structure swaps that would not be subject to the clearing mandate. For instance, in some circumstances an affiliate of the securitization entity might be able to enter into the swap with the securitization in reliance on the affiliate exemption and then lay off the risk through a back-to-back swap. There are, however, a limited number of securitization sponsors who have a rating high enough to meet the credit rating criteria.

legal issues, unique termination events, special fees, and conditions tied to events specific to the parties" are not cleared by any derivatives clearing organization.[9] However, the Commission generally has not proposed to exclude such swaps from the clearing mandate, instead observing that while the absence of an exclusion could have an effect on the economics of the swap, it "believes that counterparties may account for the effects of such specifications with adjustments to other specifications or in the price of the swap."[10] Although the Commission expressed concerns that narrow clearing specifications might allow counterparties to structure swaps to facilitate "clearing avoidance,"[11] the Commission did not address the correlative difficulty that a broad clearing mandate creates for those parties that, for legal or other reasons, cannot enter into swaps without such tailored provisions.

Standard FCM agreements may also add too much risk to a securitization to support a necessary credit rating. These agreements, for instance, often include events of default even in the absence of any trigger other than a determination by the FCM that it would be better protected by terminating the agreement. This type of provision would create a significant risk that a securitization might be forced to close out a swap position if the FCM felt insecure. Such a risk would not be consistent with investor or credit rating agency expectations.

Swaps in securitizations pose little risk, but the inability to use them may have significant consequences for the real economy.

Securitizations are an important source of funding for the consumer economy in the U.S. and for manufacturing and other businesses. Swaps are an important way in which mismatches between assets and liabilities in the securitization are hedged. There is no leverage in these swaps, which are equivalent in that respect to the swaps used by commercial end-users. They provide robust collateral packages with security interests in, and/or senior contractual rights to cashflow from, self-liquidating assets. Neither a clearing model nor a margining model that subjects securitizations to the risk of margin calls will be workable in this space, and the unavailability of swaps to securitizations may have material adverse effects on banks', captive finance companies' and other businesses' ability to fund consumer and other credit. The resulting effect will be less liquidity in these markets (e.g. for mortgages, auto loans and credit cards), thereby creating adverse consequences as the economy struggles to recover.

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[9] Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed Reg. 47170, 47191 (August 7, 2012).

[10] *Id.* at 47192. We believe the Commission is mistaken in its belief as it relates to securitization swaps.

[11] *Id.* at 47217.

ASF very much appreciates the opportunity to provide the foregoing concerns. Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact me at 212.412.7107 or at tdeutsch@americansecuritization.com, Evan Siegert, ASF Managing Director, Senior Counsel, at 212.412.7109 or at esiegert@americansecuritization.com, or ASF's outside counsel on this matter, Ellen Marks of Latham & Watkins LLP at 312.876.7626 or at ellen.marks@lw.com.

Sincerely,

Tom Deutsch

Tom Deutsch
Executive Director
American Securitization Forum

cc: Via Email

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Farm Credit Administration
Federal Housing Finance Agency
Working Group on Margining Requirements, Basel Committee on Banking Supervision and International Organization of Securities Commissions

Appendix I—Illustration of a swap used in an Automobile Loan Securitization

<u>Budgeting for collateral reserve allocated at time zero</u>
95th percentile historical interest rate movement

	t=1	**t=2**	**t=3**	**t=4**
Size	$100.00	$100.00	$100.00	$100.00
Duration at inception	4.25	4.25	4.25	4.25
Required upfront	2%	2%	2%	2%
Required upfront $	$2.00	$2.00	$2.00	$2.00
95% interest rate movement	2.87%	4.65%	5.37%	5.25%
Remaining duration at that time	3.25	2.25	1.25	0.25
Remaining balance at that time	$81.94	$62.97	$43.01	$22.04
Swap 95% mtm movement	$7.63	$6.59	$2.89	$0.29
Collateral haircut	98%	98%	98%	98%
Total required collateral	**$9.83**	**$8.77**	**$4.99**	**$2.34**
Effective existing overcollateralization	8.3x	7.2x	8.6x	9.4x
Funding cost (bps)	50	50	50	50
Collateral earnings (bps)	0	0	0	0
Negative carry (bps)	-50	-50	-50	-50
Total net running collateral cost $	-$0.05	-$0.04	-$0.02	-$0.01
Total net running collateral cost (bps)	**-4.92**	**-4.38**	**-2.49**	**-1.17**

<u>Budgeting for collateral reserve allocated at time zero</u>
1.5x maximum historical interest rate movement

	t=1	**t=2**	**t=3**	**t=4**
Size	$100.00	$100.00	$100.00	$100.00
Duration at inception	4.25	4.25	4.25	4.25
Required upfront	2%	2%	2%	2%
Required upfront $	$2.00	$2.00	$2.00	$2.00
Max x 1.5 interest rate movement	7.02%	7.94%	9.09%	10.69%
Remaining duration at that time	3.25	2.25	1.25	0.25
Remaining balance at that time	$81.94	$62.97	$43.01	$22.04
Swap max x 1.5 mtm movement	$18.71	$11.24	$4.89	$0.59
Collateral haircut	98%	98%	98%	98%
Total required collateral	**$21.13**	**$13.51**	**$7.03**	**$2.64**
Effective existing overcollateralization	3.9x	4.7x	6.1x	8.3x
Funding cost (bps)	50	50	50	50
Collateral earnings (bps)	0	0	0	0
Negative carry (bps)	-50	-50	-50	-50
Total net running collateral cost $	-$0.11	-$0.07	-$0.04	-$0.01
Total net running collateral cost (bps)	**-10.57**	**-6.76**	**-3.52**	**-1.32**