Statement of:

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Challenges Facing the U.S. Capital Markets to Effectively Implement Title VII of the Dodd-Frank Act

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Introduction

Chairman Garrett, Ranking Member Waters, and distinguished Members of the Subcommittee, I thank you for this opportunity to testify here today on behalf of the 330 member institutions of the American Securitization Forum[1] (ASF) that represent all the various constituencies in the global structured finance markets, including issuers, investors, financial intermediaries, lenders, trustees, servicers and rating agencies.

In the testimony that follows, we address in detail two key issues—commodity pools and margin requirements—that the implementation of Title VII of the Dodd-Frank Act poses for the structured finance industry. However, we would not have expected in the summer of 2010 for securitization to be a topic of conversation at this type of hearing, as we did not think that commodity pool and margin regulations were intended to apply to most securitizations.

Most of the uses of derivatives in securitization transactions are of the most plain-vanilla type, such as the use of interest rate or currency swaps to eliminate securitization investors' exposure to interest rate or currency fluctuations. For example, a captive auto finance company may package a number of auto loans into a securitization to sell to investors. Typically, auto loans are fixed rate loans, since car buyers usually want certainty about their monthly car payments. However, captive finance companies often find that some institutional investors in their auto securitizations want to buy floating rate securities. As such, the lender will cause the securitization vehicle to enter into a fixed-to-floating interest rate swap to accommodate the desirable issuance of floating rate securities to investors, while still providing desirable fixed rate loans to borrowers.

To provide another example, an English mortgage lender may package a number of the loans it made to English homeowners into a securitization to sell to U.S. investors. The English homeowners are required to pay their loans back in English pounds, but the U.S. institutional investors have to pay back their obligations to U.S. pensioners and mutual fund investors in U.S. dollars. When the English lender causes the securitization vehicle to enter into a basic currency swap, they effectively negate the currency risk to investors, but instead allow investors to focus their expertise on credit and prepayment risks of the mortgage loans.

In both of these examples, all parties to the transactions—borrowers, issuers and investors—benefit greatly from the plain-vanilla swaps in the deals. But because of recent proposals, the presence of these basic swaps triggers two potential compliance challenges for some of the transaction parties that may hurt all of the beneficiaries of the deal.

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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.

I. **First, the securitization transaction may be required to post cash margin and take on the risk of margin calls, which would result in higher costs for consumers without tangible benefit; and**

II. **Second, the securitization transaction may have been treated as a "commodity pool" and hence be required to comply with costly regulations not designed to improve investor or prudential regulation of this type of transaction.**

To avoid having to comply with costly regulations that have no benefit to investors, foreign issuers may choose to avoid U.S. regulations and not make their products available to U.S. investors. Alternatively, U.S. issuers selling part of their offerings to overseas investors may not have as competitive pricing as their foreign counterparts. In the two below sections, we discuss in more detail these inadvertent and unnecessary outcomes.

I. Clearing Mandate and Margin Requirements

The clearing mandate and margin requirements for uncleared swaps, as proposed, would create tall, and perhaps insurmountable, hurdles for many securitizations. These rules were proposed by the CFTC on April 28, 2011[2] and by the Prudential Regulators on May 11, 2011.[3] The comment periods were later reopened to allow additional comment in light of the July 6, 2012 consultative document on margin requirements for non-centrally cleared derivatives published by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO).[4] ASF provided detailed comments[5] to each of these proposed rules, but final rules for margin requirements for uncleared swaps have not yet been finalized. Clearing determinations for interest rate swaps have just been made and the clearing requirement would begin to apply in June 2013 and other swap clearing determinations are expected in the future.

Our strong concern is that many securitizations that use "plain vanilla" interest rate and currency swaps to hedge mismatches between their assets and their liabilities may be required to clear the swaps they enter into after the applicable effective date of the clearing mandate. For uncleared swaps, they may be required to post cash margin and to take on the risk of margin calls, which would be challenging for typical securitization structures given some of their core features.

A. Posting Liquid Margin

Securitizations generally provide robust collateral for their swap exposures, eliminating the need for posting margin. These provisions generally include a security interest in all of the

[2] *See* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-9598a.pdf.
[3] *See* http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-10432.pdf.
[4] *See* http://www.bis.org/publ/bcbs226.pdf.
[5] *See* ASF's July 11, 2011 swap margin comment letter at: http://www.americansecuritization.com/uploadedfiles/asfswapmarginletter20110711.pdf, and ASF's September 20, ASF's September 20, 2012 swap margin comment letter at: http://www.americansecuritization.com/WorkArea/DownloadAsset.aspx?id=8163.

assets of the securitization[6] and/or a position in the cash distribution waterfall that ranks equal to or ahead of the interest due to the most senior class of securities. Because the entire securitization pool is pledged or otherwise available, the swap dealer has access to a much larger pool of assets than would be posted under clearinghouse rules or under the uncleared margin rules, potentially providing even greater protection. The securitization assets are generally financial assets that by their terms convert into cash in a finite period of time—in other words, assets such as credit card receivables and auto loans that are paid over time by their borrowers. Adverse events that trigger the prepayment of the securitization obligations would also typically trigger a termination event under the swap. Securitizations do not, however, post liquid margin. Moreover, it is common for securitizations to allocate cash collections only once per month to investors, swap counterparties, trustees and other service providers. Accordingly, these vehicles generally would not have available funds to meet daily margin calls. We view a shift from the broad collateral currently provided to a liquid margin requirement as presenting a significant challenge to the use of both cleared and uncleared swaps in securitizations.

Appendix I reflects the potential costs of a liquid margin requirement for an interest rate swap related to an auto loan securitization. By detailing two basic scenarios, we show that creating a margin reserve will significantly reduce the amount of funding to make new loans obtained by the securitization sponsor. In Scenario 1, where interest rates are within expectations based on historical movements, the amount of available funding obtained through the securitization vehicle would be reduced by approximately **9.83%**, since that amount is what would be the "total required collateral" outcome in the chart. In Scenario 2, where interest rates rise 1.5 times the historical rate movement, available funding would be even more substantially reduced by **21.13%**. Accordingly, requiring the posting of liquid margin can have dramatic real economy effects on the availability of auto financing and hence on automobile sales because issuers will have to respond to this lower funding availability by either increasing borrower costs or decreasing credit availability.

Margin requirements for uncleared swaps also present issues, even if the posted margin is segregated. In addition to making the securitizations less efficient, by requiring them to maintain cash positions to provide security even though such security is already provided by the pledge of their financial assets, there is a real concern that they will not have cash on hand to meet daily margin calls, even if they set up cash reserves. If they address this issue with a letter of credit or other liquidity backstop, the effect would be to shift risk within the financial system but not to reduce it.

B. Contractual Concerns

Furthermore, certain types of securitization provisions, including non-petition clauses, limited recourse provisions and ratings-based termination events, are generally not consistent with a clearing model in which derivatives clearing organizations apply standardized legal terms to their agreements.

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[6] This is similar to the way in which commercial end-users secure their swap positions using the same collateral package that secures their credit agreements. Indeed, securitization vehicles are end-users in the context of swaps, and differ from commercial end-users only in that many of them may be considered financial entities.

1. Bankruptcy Provisions

Certain contractual provisions in securitizations are intended to preserve the bankruptcy-remote aspects of the structure. Bankruptcy-remote structures are an important aspect of many securitizations in that they help ensure that allocations will be made under the contractual waterfall on which investors have based their investment decisions, rather than under potentially different bankruptcy provisions. They also help to ensure that the entity transferring assets to the securitization will not subsequently be able to claim that those assets should be part of a consolidated bankruptcy of the transferor and the securitization entity, which would expose the securitization investors to enterprise risks beyond those related solely to the assets. One required provision to achieve this is a non-petition clause, in which every party to any agreement with the securitization vehicle agrees that it will not join a petition to commence involuntary bankruptcy proceedings against the entity. Another is a limited recourse clause, under which these parties agree that they will not have claims against the vehicle beyond the amounts available to make payments to them under the distribution waterfall, to ensure that the securitization does not become insolvent.

2. Credit Rating Triggers

Another standard set of provisions in securitization swaps is intended to preserve the credit rating of the securities, again preserving investor expectations. For example, a transaction with fixed rate assets may require an interest rate swap to protect its ability to make floating rate payments to investors in highly rated debt. If the swap counterparty does not have a sufficiently high credit rating, some portion of the interest rate risk will be borne by the securitization investors. Accordingly, swap counterparties typically are required to agree that they may be replaced if their credit rating falls below required levels.

3. Alternate Approaches Should be Permitted

We are very concerned that both clearing and posting of margin for uncleared swaps may make the use of swaps by securitization unworkable, either by exposing the vehicle to risks that are inconsistent with the credit quality of the issued securities or by creating significant financial costs that change the economics of the transactions in ways that make them undesirable and do not add meaningful protection to their counterparties. We believe that alternate approaches should be permitted to preserve the use of swaps by securitizations.

II. Inadvertent Commodity Pool Regulation

We want to begin this section by commending the Commodity Futures Trading Commission (CFTC) and its Staff for their ongoing efforts to be responsive to our requests[7] for relief from the market challenges created by the inadvertent possible regulation of many securitization vehicles as "commodity pools" due to the swaps positions they hold. In its most basic form, a commodity pool is an enterprise in which investor funds are combined for the purpose of actively trading in futures contracts, such as in oil and gas. Securitization trusts, by comparison, are passive entities that are not operated "for the purpose of trading" in swaps, but rather for the purpose of funding consumer and business credit, such as auto loans and equipment leases. Securitizations issue fixed-income securities and do not provide allocations of accrued profits and losses to investors in a manner comparable to commodity pools. Thus, the purposes of commodity pool regulation are not applicable to securitization, and many of the compliance burdens, including disclosure of audited financial statements and net asset value, are simply not relevant to securitization investors. Securitization disclosure is already broadly regulated by the Securities and Exchange Commission (SEC) through Regulation AB and other rulemakings, and Dodd-Frank added additional regulations including risk retention, conflicts of interest, representation and warranties disclosure, and due diligence requirements. For these reasons, ASF has been actively engaged with the CFTC over the last six months to determine the best way to distinguish securitization vehicles from commodity pools without creating an overly broad exclusion.

Through a series of interpretative releases and no-action letters[8] that reference existing provisions promulgated by the SEC to address similar issues, the CFTC, as of this past Friday, has excluded nearly all securitization vehicles that use swaps only for hedging or credit enhancement purposes from the definition of "commodity pool." In addition, the CFTC has granted broad no-action relief to the operators of "legacy" securitizations—those formed before October 12, 2012, when the definition of the term "swap" became effective. Such relief acknowledges that even the very few legacy securitizations that may have indicia of commodity pools would have little ability to comply with new regulations given their passivity and amortizing nature.

Furthermore, we appreciate that the CFTC recognized for legacy securitizations that the added costs of compliance with additional regulation would largely have been unnecessarily borne by investors. The CFTC has also delayed registration requirements for the operators of remaining vehicles until March 31, 2013 to allow industry participants sufficient time to evaluate their structures.

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[7] *See* ASF's August 17, 2012 commodity pool relief request letter at:
http://www.americansecuritization.com/uploadedFiles/ASF_Commodity_Pool_Exclusion_Request_8_17_12.pdf,
ASF's October 5, 2012 commodity pool relief request letter at:
http://www.americansecuritization.com/WorkArea/DownloadAsset.aspx?id=8241,
ASF's November 15, 2012 commodity pool relief request letter at:
http://www.americansecuritization.com/WorkArea/DownloadAsset.aspx?id=8453.

[8] *See* CFTC's October 11, 2012 relief letter to ASF at:
http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-14.pdf and
CFTC's December 7, 2012 relief letter at:
http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-45.pdf.

Although we believe that the actions of the CFTC to date address most of the industry's concerns in light of the new statutory mandate, there remains uncertainty that some securitization parties may still inappropriately be roped into regulation as "commodity pool operators," even after accounting for the two recent CFTC relief letters. We look forward to working with the CFTC prior to the new March 31, 2013 compliance date to address the remaining issues or transactions that may be outside the coverage of the CFTC's most recent December 7, 2013 letter.

Conclusion

ASF greatly appreciates the invitation to appear before this Subcommittee to share our views related to these current issues. I look forward to answering any questions the Subcommittee may have.

Thank you.

Appendix I

Auto Loan Securitization with Swap

Scenario 1

Budgeting for collateral reserve allocated at time zero

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**

Scenario 2

Budgeting for collateral reserve allocated at time zero

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**