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ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty

April 19, 2013

Robert DeV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies [RIN 7100 AD 86]

The Association of Financial Guaranty Insurers ("AFGI") appreciates the opportunity to provide the Board of Governors of the Federal Reserve System ("Federal Reserve") with its comments on the proposed rulemaking regarding enhanced prudential standards and early remediation requirements for foreign banking organizations and foreign nonbank financial companies ("Proposed Rule").[1]

AFGI, a trade association representing the unique perspective of financial guaranty insurers and reinsurers, previously provided comments regarding the Federal Reserve's proposed enhanced prudential standards and early remediation requirements for certain U.S. banks and non-bank financial institutions considered systemically important ("U.S. SIFIs") and the Federal Reserve's joint proposed regulatory capital rules related to the standardized approach for risk weighting assets and market discipline and disclosure requirements.[2] Consistent with its previous comments to the Federal Reserve, AFGI agrees with the Federal Reserve's definition of "eligible protection providers" in this Proposed Rule, which does not exclude financial guaranty insurers for purposes of valuing the net credit exposure of large foreign financial institutions ("foreign SIFIs") to determine their single-counterparty credit limits. Indeed, AFGI believes that recognition of financial guaranty insurers as eligible protection providers is appropriate and consistent with the Basel III regulatory framework for banking organizations. AFGI also emphasizes that financial guaranty insurers are appropriately regulated through existing insurance laws in the United States and abroad.

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[1] Board of Governors of the Federal Reserve System, Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628 (Dec. 28, 2012) [hereinafter Proposed Rule].

[2] Comment Letters from AFGI to the Federal Reserve, Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies [RIN 7100-AD-86] (Apr. 19, 2012) and (Sept. 11, 2012); Comment Letter from AFGI to the Federal Reserve; Office of the Comptroller of the Currency, Treasury; and Federal Deposit Insurance Corporation, Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements (OCC RIN 1557-AD46; FDIC RIN 3064-AD96; FRB RIN [XX]) (Oct. 22, 2012).

Although AFGI is pleased with the Federal Reserve's proposed definition of "eligible protection providers," it continues to express concerns, as it has done in its previous comment letters, regarding the proposed single-counterparty credit limits (applicable to guaranteed transactions such as those insured by AFGI members) and the proposed counterparty definition (applicable to U.S. municipal obligations). AFGI believes that, absent modification, the proposed single-counterparty credit limits and counterparty definition will inevitably result in an extraordinary overstatement of risk exposures. Particularly, AFGI submits that foreign SIFIs should have the choice whether to shift exposures to eligible protection providers in the case of eligible guarantees.

I. Recognition of Financial Guaranty Insurers as Eligible Protection Providers is Appropriate

The Proposed Rule defines an eligible protection provider to mean "[...] a sovereign entity; [...] a multilateral development bank; a Federal Home Loan Bank; the Federal Agricultural Mortgage Corporation; a U.S. depository institution; a bank holding company; a savings and loan holding company; a registered broker dealer; an **insurance company**; a foreign banking organization; a non-U.S.-based securities firm or a non-U.S.-based insurance company [...]; or a qualifying central counterparty."[3]

This definition includes financial guaranty insurers. As such, we understand that financial guaranty insurers will be recognized as eligible protection providers and agree that this approach, which is functionally consistent with the Basel III regulatory framework for banking organizations, appropriately recognizes the credit risk mitigation value provided by financial guaranty insurers. Indeed, even though the Basel III definition of "eligible guarantor" excludes financial guaranty insurers as specifically recognized credit risk mitigants, the Basel III framework provides value for the benefit resulting from financial guaranty insurance that improves the external credit rating on obligations that are insured (moving an investment into a superior risk category).[4]

Moreover, AFGI submits that banking organizations in the U.S. and abroad already view financial guaranty insurers as protection providers, so their recognition as "eligible protection providers" by the Federal Reserve would avoid the adverse consequences that would result if they were required to exclude financial guaranty insurers from their credit exposure calculations. Particularly, if financial guaranty insurers were excluded from recognition as eligible protection providers, banks would be incentivized to sell their insured positions into an illiquid market in which they may not receive fair value. Additionally, in many cases, financial guaranty insurance products have so called

[3] Proposed Rule, *supra* note 1, at p. 76,656 (emphasis added).

[4] Basel Committee, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (Dec. 2010, revised Jun. 2011).

"representations to hold," providing that the holder will lose its insurance if the insured security or CDS reference obligation is sold.

II. Financial Guaranty Insurers are Appropriately Regulated through Existing Insurance Laws

In Question 50, the Proposed Rule asks whether there should be "additional or alternative requirements" on eligible protection providers. In response, AFGI submits that the existing regulatory regime for financial guaranty insurers, as described herein, is sufficient to ensure their capacity to perform on their guarantee obligations.

The financial guaranty insurance industry is a monoline insurance industry, participating in financial guaranty insurance and related products only – financial guarantors may not write traditional property/casualty insurance or life insurance. As a result, financial guaranty insurance companies are operated as separately capitalized entities, providing guaranties of financial obligations only. This separation minimizes the systemic connection between financial guaranty insurers and other "traditional" property/casualty or life insurers upon an economic downturn, providing an additional level of protection to the marketplace. Financial guaranty insurers do not participate in insurance security funds, such that the insolvency of a financial guaranty insurer will not risk contagion to consumer-oriented insurers such as automobile, home, or life insurers.

Issuers generally use financial guaranty insurance when applying such insurance would result in lower overall financing costs than would otherwise result from issuing securities on an uninsured basis. Insofar as financial guaranty insurance is used predominantly in connection with financing obligations of public issuers and projects serving a substantial public purpose (such as schools, water and other utilities, public hospitals, and roads), financial guaranty insurance itself serves a substantial public purpose by lowering the financing costs for such public issuers and projects. Further, financial guaranty insurers have discontinued certain business lines as a result of the financial crisis. Particularly, since 2009, financial guaranty insurers have ceased insuring credit default swaps ("CDS") (other than in connection with remediation activities), residential mortgage-backed securities ("RMBS"), and collateralized debt obligations ("CDOs") comprised of RMBS. Thus, new risk associated with these activities is no longer being originated, while existing risk in these sectors is in run-off.

Financial guaranty insurers' activities are regulated at the State level. The New York State Department of Financial Services ("DFS") is the primary prudential regulator for most United States financial guaranty insurance companies, and those domestic insurers that are not domiciled in New York are licensed to issue financial guaranty insurance under New York Insurance Law Article 69 ("Article 69") and are therefore also subject to regulation by the DFS.[5] Since its adoption, Article 69 and other provisions of the New York Insurance Law have provided the regulatory standard for the industry,

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[5] N.Y. Code ISC Insurance §§ 6901-09 (2010).

implementing a comprehensive regulatory framework. This framework includes market conduct rules, financial reporting standards, contingency reserves, single and aggregate risk limits, investments requirements, and regulatory examinations. Additionally, financial guaranty insurers domiciled in Europe and Bermuda are regulated appropriately and directly by the applicable sovereign insurance regulators in Europe, and will be subject to the requirements of the Solvency II Directive when implemented.

Given the nature of financial guaranty insurers' business and the existing regulatory system described above, AFGI believes that no additional requirements for eligible protection providers are necessary. Further, recognition of financial guaranty insurers as eligible protection providers appropriately recognizes the oversight that State insurance law and State insurance regulators provide, and the value that financial guaranty insurers add.

III. The Proposed Single-Counterparty Credit Limits and Counterparty Definition will Result in an Extraordinary Overstatement of Risk Exposures

Risk Exposure to Eligible Protection Providers

In its proposed rule, the Federal Reserve notes that, during the financial crisis, many large financial firms nearly collapsed, adding that "counterparties of a failing firm were placed under severe strain when the failing firm could not meet its financial obligations."[6] As a result, the proposed rule applies limits to foreign SIFIs' single-counterparty credit risk exposures, but allows them to reduce their credit exposure to a counterparty by obtaining eligible guarantees such as financial guaranty insurance. The rule requires that, in calculating its net credit exposure to the counterparty, a foreign SIFI buying eligible protection "reduce its gross credit exposure to the counterparty by the amount of any eligible guarantee from an eligible protection provider."[7] Question 51 of the Proposed Rule asks whether foreign SIFIs "should have the choice of whether or not to fully shift exposures to eligible protection providers in the case of eligible guarantees or to divide an exposure between the original counterparty and the eligible protection provider in some manner."[8]

In its September 11, 2012 comment letter to the Federal Reserve regarding similar requirements for U.S. SIFIs, AFGI expressed concerns regarding a requirement that would fully shift exposures to eligible protection providers in the case of eligible guarantees.[9] As it noted in AFGI's September 2012 letter, such requirement would

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[6] Proposed Rule, *supra* note 1, at p. 76,653.

[7] *Id.* at p. 76,656.

[8] *Id.*

[9] Comment Letter from AFGI to the Federal Reserve, Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies [RIN 7100-AD-86] (Sept. 11, 2012).

overstate the exposure that U.S. and foreign SIFIs have to eligible protection providers such as financial guaranty insurers. In fact, such requirement would ignore the reduced likelihood that a SIFI will experience a loss because that would require both the counterparty and the protection provider to fail. Shifting the full face amount of the exposure from the reference name to the eligible protection provider would transform a risk mitigant into a risk exaggeration. Moreover, such shifting requirement could result in higher costs and a significant reduction in the availability of protection products. Finally, it has been shown that banks have consistently increased exposures to municipal bonds due to their profitability, quality, and high yield, as well as the declining demand for commercial loans.[10] This growing exposure underlines the increased importance of municipal bonds and the unintended consequences that could result from discouraging municipal bond insurance by adding a mandatory requirement to shift risk exposures to eligible guarantors given the high percentage of outstanding municipal bonds that are insured.

Thus, AFGI submits that U.S. and foreign SIFIs should have the choice whether or not to shift exposures to eligible protection providers. AFGI also proposes that such choice be subject to written policies and procedures, of the extent, if any, it would shift an exposure from an underlying obligor to an eligible credit protection provider when the SIFI purchases credit protection. Such policies and procedures would be subject to examination and review by the Federal Reserve in its capacity as supervisor.

Further, AFGI is encouraged by the Federal Reserve's statement that it is "considering modifications to the [December 2011] proposal [on enhanced prudential standards for U.S. SIFIs]" in response to industry comments. AFGI hopes that these modifications will include a provision permitting a choice by U.S. SIFIs of whether or not to fully shift exposures to eligible protection providers.[11]

Counterparty Definition

This Proposed Rule, similar to the Federal Reserve's December 2011 proposed rule on enhanced prudential standards for U.S. SIFIs, includes within the definition of counterparty, "a State and all of its agencies, instrumentalities, and political subdivisions (including any municipalities) collectively."[12] As such, the Proposed Rule requires the aggregation of exposures to all municipalities in the same State simply because they are in the same State. In fact, the aggregation is done irrespective of the local economy,

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[10] The Bond Buyer, U.S. Banks Keep Beefing Up Their Muni Portfolios (Mar. 13, 2013), *available at* http://www.bondbuyer.com/issues/122_48/u-s-banks-keep-beefing-up-their-muni-portfolios-1049514-1.html.

[11] Proposed Rule, *supra* note 1, at p. 76,653.

[12] *Id.* at p. 76,691.

revenue sources, or creditworthiness of the agencies, instrumentalities, and political subdivisions of a U.S. State.

AFGI submits that this aggregation method lacks a reasonable justification and in fact links risks that may have no actual connection or little correlation. Thus, AFGI believes that SIFIs should be allowed to treat exposures to States, agencies, and municipalities in the same way as the existing lending limits are applied to national banks. This means that, in some cases, a SIFI's exposures would be exempt from the single-counterparty credit risk limits altogether. However, such SIFI's existing credit risk management framework would still provide adequate protection.

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We thank the Federal Reserve for the opportunity to comment on the Proposed Rule and appreciate its attention to the concerns highlighted by AFGI in this letter. If you have any questions, please do not hesitate to contact the undersigned at bstern@assuredguaranty.com or (212) 339-3482.

Very truly yours,

Bruce E. Stern, Chairman