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ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty ®

April 19, 2012

Jennifer Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies [RIN 7100-AD-86]

Dear Ms. Johnson:

The Association of Financial Guaranty Insurers ("AFGI") appreciates the opportunity to provide the Board of Governors of the Federal Reserve System (the "Board") with its comments on the enhanced prudential standards proposed for certain banks and non-bank financial institutions, in accordance with Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1]

As a trade association representing the unique perspective of financial guaranty insurers and reinsurers, AFGI believes it is essential for the Board to carefully draft the enhanced prudential standards that will apply to certain banks and non-bank financial institutions considered systemically important ("SIFIs"). To that end, AFGI writes to clarify (I) the proposed definition of "capital stock and surplus" related to single-counterparty credit limits, as applied to financial guaranty insurers; (II) the proposed valuation rules for calculating gross credit exposure, as applied to financial guaranty insurance; and (III) the proposed definition of "eligible guarantees" to ensure that financial guaranty insurance qualifies as an eligible guarantee.

AFGI reiterates, as noted in its letter to the Financial Stability Oversight Council ("FSOC") on December 1, 2011,[2] that financial guaranty insurance companies do not currently pose a threat to the financial stability of the United States and as such, AFGI

[1] Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012); *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act [hereinafter Dodd-Frank Act], Public Law 111–203, 124 Stat. 1376 (2010).

[2] Association of Financial Guaranty Insurers Comment Letter, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 64264 (Oct. 18, 2011).

does not expect any of its members to be designated as a non-bank SIFI by the FSOC. However, AFGI understands the importance of the Board's efforts in identifying prudential standards, which may ultimately be engrained as part of financial institutions' best practices for capital and risk management. That said, AFGI is concerned that the differences between banking and insurance business are not fully recognized in terms of risk and impact of failure. Similarly, in the unlikely event that an AFGI member becomes a designated SIFI, it will be important that the Board's prudential standards properly define key terms to reflect the perspective and particular circumstances of financial guaranty insurers.

As with all regulations resulting from the Dodd-Frank Act, AFGI would like to reiterate the importance of international harmonization, urging the Board to apply a consistent global approach to the regulation of covered financial institutions. Moreover, to the extent that the Board determines to apply prudential standards to non-bank SIFIs engaged in the insurance business, we urge the Board to carefully consider the degree to which existing and proposed global insurance-specific prudential standards, such as Solvency II, achieve or complement the Board's objectives.

I. The Capital Stock and Surplus Definition Should Take into Account the Particular Circumstances of Financial Guaranty Insurers

In Question 28 of its proposed rule, the Board requests comments regarding the proper definition for some of the key terms used to implement enhanced prudential standards, including the single counter-party exposure limits. These key terms include the definition of "capital stock and surplus." The Board's proposed rule notes that capital stock and surplus of a bank holding company is defined as "the sum of the company's total regulatory capital as calculated under the risk-based capital adequacy guidelines [...] and the balance of the allowance for loan and lease losses [...] not included in tier 2 capital."[3] For non-bank SIFIs, the definition includes "the total regulatory capital of such company on a consolidated basis, as determined under the risk-based capital rules the company is subject to by the rule or order of the Board."[4]

We are concerned that there has been relatively little work done to develop risk-based capital rules that work across different financial industries. While we do not yet know the specific rules the Board may propose for non-bank SIFIs, traditional bank-oriented metrics are not sufficient to capture the unique characteristics of the financial guaranty insurance industry and the differences between financial guaranty insurers and banks.

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[3] Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 615 (Jan. 5, 2012).

[4] *Id.*

Therefore, in the unlikely event that any financial guaranty insurer is designated a SIFI, it is imperative that the risk-based capital rules enacted by the Board consider and adjust for those differences. Particularly, AFGI notes that, in those states (specifically New York, California, and Connecticut) where financial guaranty insurance is defined as a separate line of insurance, the state insurance laws measure risk limits for financial guaranty insurers against the sum of policyholders' surplus and contingency reserves. Contingency reserves are a statutory reserve that financial guaranty insurers must maintain based upon the amount and category of debt service they insure. As such, the sum of policyholders' surplus and contingency reserves should represent "regulatory capital" for purposes of the proposed standards as applied to financial guaranty insurers.[5]

As the Board defines capital stock and surplus in determining the limits on a covered company's credit exposures, AFGI believes that the Board should recognize that the existing regulatory framework for financial guaranty insurers adequately considers all risk measures in the context of determining statutory capital.

II. <u>The Valuation Rules Related to Credit Exposure Should Include a Definition for Maximum Potential Loss that Properly Identifies a Company's Risk</u>

In Question 35 of its proposed rule, the Board requests comments on the valuation rules that should be considered for calculating the gross credit exposure of a covered company to a counterparty on a credit transaction. Particularly, the proposed rule notes that, in making such calculation, "guarantees and letters of credit issued by a covered company on behalf of the counterparty are equal to the maximum potential loss to the covered company on the transaction."[6]

AFGI respectfully submits that, as applied to financial guaranty insurers, the guaranty exposure should be equal to *the lesser of* the principal amount insured or the maximum potential loss to the covered company on the transaction. This clarification is necessary to distinguish between the principal amount insured and the total debt service insured. The total debt service represents the sum of principal and interest payments insured, which might otherwise be characterized as the maximum potential loss. AFGI members guarantee scheduled principal and interest payments on the obligations they insure, with the insurer's right (but not the obligation) to pay the principal on an accelerated basis, should the insurer elect to do so in its sole discretion following a payment default by the obligor. Accordingly, for purposes of measuring risk, this calculation should reflect the actual credit exposure, taking into account the fact that the

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

[6] Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 617 (Jan. 5, 2012).

insurer may choose to pay the principal on an accelerated basis. Moreover, if the calculation were to include interest payments, it would have the unintended effect of disproportionately increasing the cost of capital for buying a guarantee and would, in turn, unfairly impact the business of financial guaranty insurers.

This proposed clarification for the definition of the amount at risk under guarantees is similar to the limitation already included in the definition of the amount at risk under credit or equity derivative transactions in the proposed rule. Specifically, the proposed rule states that, in calculating credit or equity derivative transactions between the covered company and a third party where the covered company is the protection provider, the transactions "are valued in an amount equal to *the lesser of* [emphasis added] the face amount of the transaction or the maximum potential loss to the covered company on the transaction."[7]

AFGI also believes that the definition of "maximum potential loss" should consider the value at risk ("VAR") in determining a company's credit exposure. Including the VAR in a company's credit exposure valuation rules would avoid the unintended consequences that may result from establishing the same capital costs for lower and higher quality credit risks, which may encourage excessive risk-taking in an effort to increase returns on equity.

III. <u>Financial Guaranty Insurance Should be Qualified as an Eligible Guarantee</u>

In Question 48 of the proposed rule, the Board requests comments on the definition of an eligible protection provider of eligible guarantees. Particularly, the proposed rule identifies a protection provider's eligible guarantee as a guarantee that, among other criteria, "covers all or a pro rata portion of all contractual payments of the obligor on the reference entity."

The foregoing provision may be interpreted to require that an eligible guarantee covers amounts due upon "acceleration" of the principal owed on an obligation, in the event of a default with respect to such obligation. Financial guaranty insurance covers scheduled payments of principal and interest on insured obligations. Specifically, state laws expressly prohibit AFGI's financial guaranty insurers from insuring payments due upon acceleration, unless such payments are in the insurer's sole discretion.[8] This

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[7] *Id.*

[8] *See* N.Y. Code ISC Insurance § 6905 (2010) (noting, "[e]very such [financial guaranty insurance] policy shall provide that, in the event of a payment default by or insolvency of the obligor, there shall be no acceleration of the payment required to be made under such policy unless such acceleration is at the sole discretion of the [financial guaranty insurer] corporation [...]."

prohibition is intended to mitigate the liquidity exposure that financial guaranty insurers might face following a payment default on an insured obligation. Thus, AFGI submits that the Board should clarify the definition of "eligible guarantee" to provide that an eligible guarantee need not cover payments due upon acceleration, so long as such guarantee covers those payments as originally scheduled to be paid.

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We thank the Board for the opportunity to comment on some of the key definitions to be included in the Board's final rules regarding enhanced prudential standards for covered companies, and we appreciate the Board's 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.

Sincerely,

Bruce E. Stern, Chairman