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ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty

January 7, 2013

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Consultative Document: A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities

Ladies and Gentlemen:

The Association of Financial Guaranty Insurers ("AFGI") appreciates the opportunity to provide the Financial Stability Board (the "FSB") with comments on the Consultative Document titled "A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities" (the "Consultative Document").[1] AFGI is the trade association for financial guaranty insurers, whose members include ten insurers and reinsurers of municipal, infrastructure, and asset-backed securities ("ABS") in various markets, including the United States and Europe.

AFGI applauds the FSB for its continued efforts to develop policies to mitigate potential systemic risks associated with shadow banking. As submitted by AFGI in a May 2012 letter to the European Commission in response to its Green Paper on Shadow Banking, AFGI members should not be considered shadow banking entities and do not currently engage in shadow banking activities.[2] As such, AFGI writes to (1) reiterate the nature of its members' business and existing prudential supervision of the industry, and (2) discuss the FSB's Consultative Document provisions related to credit enhancements and their potential to create a "risk of imperfect credit risk transfer."[3] Particularly, AFGI submits that financial guaranty insurers' activities do not present the risks related to shadow

[1] Financial Stability Board, Consultative Document: A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities (Nov. 18, 2012), *available at* http://www.financialstabilityboard.org/publications/r_121118a.pdf [hereinafter Consultative Document].

[2] Association of Financial Guaranty Insurers, Comment Letter regarding the European Commission's Green Paper on Shadow Banking (May 24, 2012), *available at* http://ec.europa.eu/internal_market/consultations/2012/shadow/individual-others/afgi_en.pdf.

[3] Consultative Document, *supra* note 1, at p. 8.

banking identified in the Consultative Document. Moreover, while we are encouraged by the FSB's activities-based approach in identifying shadow banking issues, AFGI believes that the examples used to demonstrate the risks of facilitating credit creation misinterpret the business of financial guaranty insurers.

I. The Business of Financial Guaranty Insurers and Existing Prudential Supervision

Overview of Financial Guaranty Insurance Business

The activities of financial guaranty insurers are straightforward. Financial markets employ financial guaranty insurance in order to (a) help public finance issuers and securitization sponsors reduce their borrowing costs and (b) provide investors with payment default protection, improved liquidity, surveillance, and remediation services for their investments. Financial guaranty insurers generally insure that scheduled payments on specific obligations will be paid when due to the holder of those obligations. The business of financial guaranty insurance consists predominantly of the insurance of securities sold in capital markets.

Financial guaranty insurance generally results in a lower interest rate on insured securities than would otherwise apply absent such insurance. Typically, the issuer pays a portion of this interest rate savings to the insurer as an insurance "premium," while the issuer retains the balance of this savings as its incentive to use the insurance. Since issuers of securities have the option to sell their securities on an uninsured basis, issuers employ financial guaranty insurance when doing so results in material cost savings for the issuer. Notably, financial guaranty insurance is therefore a highly substitutable, albeit often valuable, product. Insofar as financial guaranty insurance is used predominantly in connection with financing obligations of public issuers (such as state and local governments) and projects (such as schools, water and other utilities, public hospitals, and roads) serving a substantial public purpose, financial guaranty insurance itself serves a substantial public purpose.

Existing Prudential Supervision of Financial Guaranty Insurers

The Consultative Document notes, "credit insurers and guarantors are, in essence, insurance companies. It can therefore be argued that they should be prudentially supervised like any other insurance company. Where this is the case, the tools may be viewed as considerations informing the prudential regime, rather than separate tools."[4] This distinction is relevant only insofar as any financial guaranty insurers are not in fact regulated as insurance companies. The Consultative Document's assessment of the existing prudential supervision regime for financial guaranty insurers is on point.

[4] *Id.* at fn. 12.

In fact, AFGI members are appropriately and directly regulated in Europe by the applicable sovereign insurance regulators (primarily the U.K. Financial Services Authority) and will be subject to the requirements imposed under "Solvency II," when implemented. Similarly, in the United States, AFGI members are regulated by the applicable State insurance regulators and are subject to the requirements imposed under State insurance law.

AFGI members operate in the European Economic Area through separately capitalized insurance company subsidiaries, licensed in the United Kingdom or another home jurisdiction and permitted to operate in other European Economic Area countries using "passports" or through licensed branches. The U.K. Financial Services Authority and, when implemented, the Solvency II Directive, regulate the insurance company subsidiaries of AFGI members based in the United Kingdom. Solvency II, which codifies and harmonizes insurance regulation in the European Union, addresses the risk of insolvency in the insurance industry by implementing a holistic approach to risk management.[5] It takes into consideration capital standards as part of its quantitative requirements, and couples this consideration with governance, risk management, and transparency requirements.[6]

In the United States, AFGI members operate through separately capitalized "monoline" financial guaranty insurance companies. The New York State Department of Financial Services (the "DFS") is the primary prudential regulator for most U.S. financial guaranty insurance companies. AFGI members that are U.S. domestic insurers not domiciled in New York are nonetheless licensed to issue financial guaranty insurance under New York Insurance Law Article 69 ("Article 69") and therefore also subject to regulation by the DFS.[7] Since its adoption, Article 69 and other provisions of the New York Insurance Law have provided the regulatory standard for the industry, implementing a comprehensive regulatory framework. This framework includes market conduct rules, financial reporting standards, contingency reserves, single and aggregate risk limits, investments requirements, enterprise risk management standards and regulatory examinations.

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[5] European Commission, Amended Solvency II Proposal (Feb. 2008).

[6] *Id.*

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

II. The "Facilitation of Credit" Provisions in the Consultative Document Misinterpret the Business of Financial Guaranty Insurers

AFGI agrees with the FSB's use of an activities-based approach in judging the extent of nonbank financial entities' involvement in shadow banking "by looking through to their underlying *economic functions* rather than *legal names* or *forms*."[8] Among the five "economic functions" that will be used to identify the sources of shadow banking risks in nonbank financial entities, the Consultative Document includes the "facilitation of credit creation."[9] Particularly, the Consultative Document states that credit enhancements help to facilitate bank and/or nonbank credit creation, but "may create a risk of imperfect credit risk transfer," "may aid in the creation of excessive leverage in the system," and "may potentially aid in the creation of boom-bust cycles and systemic instability."[10] While the foregoing may apply to the activities of financial guaranty insurers conducted prior to the recent financial crisis, AFGI submits that its members' ongoing activities do not create a risk of imperfect credit risk transfer, excessive leverage, or systemic instability. In addition, AFGI cites some misunderstandings in the examples used to demonstrate the risks that may result from using credit enhancement.

First, the Consultative Document states that financial guaranty insurers facilitate potentially excessive risk-taking and inappropriate risk-pricing because they insure structured securities such as credit-default swaps ("CDS").[11] Of note, the composition and business of the financial guaranty insurance industry has changed dramatically since the advent of the financial crisis. Prior to the crisis, the financial guaranty insurance industry included seven "triple-A rated" insurers engaged in the business of insuring municipal bonds, asset-backed securities ("ABS"), and infrastructure financings. This pre-crisis business included the insurance of CDS provided by nominally capitalized affiliates (often called "transformers") primarily providing credit protection in respect of structured finance and infrastructure finance securities.

However, since 2009, financial guaranty insurers have ceased insuring CDS (other than in connection with remediation activities) and have also ceased insuring residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") comprised of RMBS. Additionally, the insurance of CDS as previously conducted by financial guaranty insurers is no longer viable under applicable insurance law

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[8] Financial Stability Board, Strengthening Oversight and Regulation of Shadow Banking: An Integrated Overview of Policy Recommendations (Nov. 18, 2012), *available at* http://www.financialstabilityboard.org/publications/r_121118.pdf.

[9] Consultative Document, *supra* note 1, at p. 8.

[10] *Id.*

[11] *Id.*

requirements,[12] and by reason of margin and clearing requirements applicable to new CDS under the applicable provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") in the United States and the European Infrastructure Markets Regulation ("EMIR") in Europe. As a result, the asset-backed and CDS obligations previously insured by industry members are running off rapidly. Notably, the new financial guaranty insurance business being written and proposed to be written by existing and potential industry participants is comprised predominantly of the insurance of U.S. tax-exempt municipal bonds sold to U.S. investors. As a result, there is no reason to believe that the current business of financial guaranty insurers facilitates excessive risk taking or inappropriate risk pricing.

Second, the Consultative Document notes that financial guaranty insurers may provide credit enhancements to loans, thus becoming "prone to 'runs' if their funding is heavily dependent on wholesale funding."[13] While some financial guaranty insurers provided insurance to securitizations backed by credit card, corporate, and other types of loans, dependent on wholesale funding such as "ABCPs, CPs and repos or short-term bank commitment lines" as noted in the Consultative Document, these securitizations did *not* subject the insurer to "runs" absent a bank failure.[14] Specifically, the liquidity lines provided to support these types of securitization transactions were typically provided by commercial banks (with A1/P1 short-term credit ratings), specifically because such banks had the short-term funding capacity (and related short-term credit ratings) required by these transactions. The insurer was only exposed to a "run" in the event of a failure of the bank committed to provide liquidity to such transactions. Specifically, in these transactions, financial guaranty insurers relied upon the funding capacity provided by the bank liquidity providers, rather than vice versa. In any event, financial guaranty insurers have not insured these types of securitization transactions since at least 2009, and any existing business is in rapid run-off. The current business of financial guaranty insurers, insuring scheduled payments on municipal bonds and other securities, does not include deposit-like funding structures that may lead to "runs."[15] Moreover, State laws expressly prohibit financial guaranty insurers from insuring payments due upon acceleration, unless

[12] *See* e.g., NY Insurance Dept. Circular Letter No. 19, *"Best Practices" for Financial Guaranty Insurers* (Sept. 22, 2008).

[13] Consultative Document, *supra* note 1, at p. 9.

[14] *Id.* at pp. 7-9.

[15] Prior to the crisis, auction rate municipal bonds represented a deposit-like funding structure. During the crisis, some auctions failed as a result, in whole or in part, of the ratings downgrades of some financial guaranty insurers. The prevalence of auction rate municipal bonds has declined significantly since the financial crisis. AFGI understands that there have been no new issues of auction rate municipal bonds (whether or not insured) since the crisis.

such payments are in the insurer's sole discretion.[16] This in turn mitigates the liquidity exposure that financial guaranty insurers might face following a payment default on an insured obligation.

Since the types of credit facilitation currently provided by AFGI members do not present a material risk of imperfect credit risk transfer, excessive leverage, or systemic instability, there is no need for further oversight and regulation of financial guaranty insurers apart from the comprehensive oversight and regulation already provided by insurance regulators, that have responded in due course to the concerns raised by the financial crisis.

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We appreciate this opportunity to comment on the FSB's Consultative Document. 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

[16] *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 insurance] corporation […].").