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ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty ®

VIA FEDERAL EXPRESS
VIA E-MAIL (comments@fdic.gov)

June 23, 2010

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: RIN # 3064-AD53

Dear Mr. Feldman:

The Association of Financial Guaranty Insurers (“AFGI”) is writing to comment on the FDIC's Notice of Proposed Rulemaking (“NPR”) relating to *Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After September 30, 2010* (“Proposed Rule”).¹

In particular, we are writing to express our opposition to the proposed disqualification from the securitization “safe harbor” of securitizations that include pool level external credit support or guarantees (“Pool Level Support”) provided by financial guaranty insurance insofar as the securitization would have qualified for the safe harbor absent such insurance. We believe that the Proposed Rule’s restriction on the use of financial guaranty insurance could jeopardize a valuable service relied upon by issuers of and investors in residential mortgage-backed securities (“RMBS”).

Background

The Association of Financial Guaranty Insurers (“AFGI”) is a trade association of seven insurers and reinsurers of municipal bonds and asset-backed securities. Our members' service, financial guaranty insurance, is utilized in the financial markets to help municipal issuers and securitization sponsors reduce borrowing costs and to provide investors security, risk management and improved liquidity for their investments. A security insured by an AFGI member has the guaranty that scheduled payments of interest and principal will be made on time and in full. Issuers, taxpayers and investors benefit from the financial guaranty insurance provided by AFGI members:

¹ Federal Register. Vol. 75, No. 94 p. 27471 (May 17, 2010).

- Benefits to Issuers and Taxpayers:
 - o Allows credit rating of the guarantor to be applied to the bonds
 - o Reduced cost of funds
 - o Broader funding sources
 - o Streamlined execution
 - o In case of small municipal issuers, access to capital markets only possible through a financial guaranty.
- Benefits to Investors:
 - o Default protection
 - o Bond guarantor waives all defenses including fraud and non-payment of premiums
 - o Enhanced liquidity
 - o Reduced secondary-market price volatility, particularly if underlying issue is downgraded
 - o Consolidated analysis, diligence and surveillance
 - o Exercise of remedies when necessary
 - o Unlike a trustee or a rating agency, a financial guaranty insurer has capital at risk, therefore its interest aligns with those of bondholders.

Because an insured issue receives the higher rating of its insurer, municipal issuers and their taxpayers benefit from lower financing costs that result from insurance. AFGI estimates that since the industry's inception in 1971 municipalities and their taxpayers have saved more than \$40 billion in interest costs as a result of bond insurance. In the asset-backed markets, insurance reduces borrowing costs for securitization sponsors, and offers better market access and greater ease of transaction execution. Investors are financially protected against issuer default through the insurer's guarantee of payments.

Proposed Rule

Our comments are focused specifically on the exclusion of Pool Level Support in the form of financial guaranty insurance. While the Proposed Rule appears to apply only to RMBS transactions, our discussion below applies equally to RMBS and other asset-backed securities ("ABS").

In summarizing the Proposed Rule, the NPR expresses the FDIC's view "that permitting pool level, external credit support in an RMBS can lead to overleveraging of assets, as investors might focus on the credit quality of the credit support provider as opposed to the sufficiency of the financial asset pool to service the securitization obligations."² We recognize that the current economic crisis has resulted in deteriorated credit-worthiness or default by a number of financial guaranty insurers and other financial institutions. Now, more than ever, we believe that investors in insured securities look both to the credit quality of the insurer AND the credit quality of the underlying obligation. To disqualify insured RMBS from the safe harbor is to ignore the significant benefits of insurance on RMBS that would otherwise qualify for the safe harbor. As

² P. 27477.

discussed in more detail below, financial guaranty insurers provide underwriting, due diligence, monitoring and loss mitigation expertise for the benefit of investors of insured securities. Insofar as a transaction otherwise qualifies for the safe harbor, AFGI respectfully submits that the addition of insurance augments credit quality and credit stability for the investor and accordingly should not be discouraged.

Accordingly, we see no reason for the FDIC to prohibit Pool Level Support in the form of financial guaranty insurance, which has traditionally improved liquidity of financial assets and benefited U.S. consumers by, among other things:

- o facilitating market access for new entrants, thereby increasing competition and lowering borrowing costs for consumers;
- o facilitating securitizations of credit extensions to borrowers that may not otherwise have access to the capital markets, thus increasing liquidity of those assets and credit availability for that segment; and
- o facilitating lower costs of financing for issuers compared with alternative uninsured transactions, which translates to reduced costs for consumers.

Although not discussed at length in the NPR, it appears that the FDIC's reasons for considering a prohibition on Pool Level Support include one or more of the following beliefs: (i) that payments on obligations issued in securitizations with Pool Level Support do not depend primarily on the performance of the underlying financial assets; (ii) that prohibiting Pool Level Support would help to better align incentives between underwriting and securitization performance; or (iii) that Pool Level Support adds to the complexity of transactions and thus works against market understanding of structures. As discussed below, none of these possible beliefs is correct when applied to financial guaranty insurance. In fact, Pool Level Support provided by financial guaranty insurance supports two of the primary goals that the FDIC has identified for the Proposed Rule: increasing liquidity of financial assets and reducing consumer costs.

Reliance on Asset Performance

Financial guaranty insurers generally only provide their guaranty to obligations that are investment grade without the benefit of the guaranty. Accordingly, Pool Level Support provided by financial guaranty insurance acts as a secondary level of credit protection, in the event that collections on the underlying financial assets are not sufficient to make insured payments on the related obligations. Consequently, the presence of financial guaranty insurance does not eliminate the primary reliance on performance of the underlying financial assets. The expectation under base case and even reasonably stressed scenarios is that the required payments will be made entirely from collections on the underlying financial assets (including amounts attributable to subordinated tranches, excess spread or over-collateralization) or internal transaction cash reserves. As a result, the FDIC should not be concerned that the use of financial guaranty insurance is inconsistent with the contemplated Proposed Rule requirement that payments on the issued obligations depend primarily on the performance of the underlying financial assets.

Aligning Incentives

Consistent with the statements above, financial guaranty insurers do not stand in a first-loss position vis-a-vis the underlying financial assets. Instead, insurers require internal (to the transaction) credit support for their Pool Level Support exposures, generally including some combination of subordinated tranches, excess spread, overcollateralization or cash reserves. Also, if insurance claims are paid to cover losses on the underlying assets, the sources of reimbursement to the insurer are generally limited to collections on the underlying assets and internal credit supports of the types described above. As a result, insurers are keenly interested in the underwriting and performance of the underlying exposures and carry out their own due diligence on these matters.

We understand that the FDIC may believe that the market as a whole did not historically have sufficient incentives to police underwriting practices, but we respectfully submit that insurance was not a contributing factor to that situation. Indeed, the vast majority of insured RMBS had underlying ratings of “triple-A”, with insurers typically requiring safeguards in addition to those required by the rating agencies to attract the highest ratings. Going forward, we expect both the rating agencies and the insurers to be more cautious than in the past in underwriting RMBS risks, as the experience of the current financial crisis is reflected in stress case performance models. Credit rating agencies carry out significant due diligence on underwriting and related matters in insured transactions because insurers are required to receive shadow ratings on the credit quality of their Pool Level Support exposures, which is driven by performance of the underlying financial assets. The insurer’s own due diligence acts as a mechanism to police underwriting and thus help align incentives, typically augmenting the process performed by the rating agencies. Finally, the disclosure provided to investors about underlying assets is substantially the same, whether or not there is insurance, so the RMBS or ABS underwriters have the same securities law due diligence requirements in both types of transaction. Thus, the presence of financial guaranty insurance would not impact the quantity or quality of information made available by issuers and underwriters to investors.

As a result, disqualification of insured RMBS from the safe harbor would not be necessary or even helpful in properly aligning incentives between underwriting and securitization performance. In an insured transaction, the financial guaranty insurer serves as an additional party policing originator underwriting practices.

Surveillance and Enforcement of Remedies

Investors in RMBS are generally ill-prepared to monitor or enforce remedies on these investments as necessary. While underwriting guidelines and single risk limits may discourage investing in controlling interests in RMBS, the dispersion of investors combined with the passivity of bond trustees has historically left investors in distressed RMBS in a situation where investors fail to benefit from representations, warranties and other legal rights to which they are entitled. Investors in insured securities, however, generally benefit from the surveillance and enforcement of remedies provided by the financial guaranty insurers. Experience has shown, for example, that insurers are more likely and more able to exercise remedies and mitigate losses on troubled RMBS transactions than is the case in uninsured transactions. In the case of the vast

majority of uninsured RMBS transactions that have had material shortfalls during the current financial crisis, trustees have failed to enforce representation and warranty breaches, litigate or take other enforcement action, and security holders have been too dispersed or otherwise disorganized to exercise control of these situations.

Complexity

There is a tension between (i) the diversity obtained from making small investments in a number of RMBS; (ii) the modeling and underwriting resources needed to evaluate individual RMBS; and (iii) the control rights and economic interest needed to monitor RMBS and enforce remedies. While recognizing that the underwriting performed by rating agencies and insurers has not always been satisfactory in the past, we submit that discouraging the use of these experts is poor policy. The views of rating agencies and the availability of insurance are meaningful to investors, without suggesting that investors should rely exclusively on third parties in making investment decisions.

Liquidity and Consumer Costs

Pool Level Support provided by financial guaranty insurance affirmatively promotes two of the goals that the FDIC has identified for the Proposed Rule - increasing the liquidity of financial assets and reducing consumer costs. Financial guaranty insurance promotes liquidity of financial assets in at least two ways. First, insurance has traditionally been used most frequently in securitizations of financial assets that are viewed as novel or involving higher credit risks. By facilitating securitizations of asset classes that the broader market of investors is not prepared to fund without supplemental credit enhancement, financial guaranty insurance has increased the liquidity of these financial assets.

Second, financial guaranty insurance has been used to facilitate market access by originators with financial or operational difficulties, as insurers have the opportunity to extensively diligence these entities and (when warranted) achieve a level of comfort that is difficult for the broader universe of investors. This increases the liquidity of financial assets held by institutions that need it most. To the extent the distressed originators are insured depository institutions, this continued market access can directly reduce the likelihood of failure and resulting draws on the insurance fund.

Financial guaranty insurance has tended to reduce borrowing costs for consumers by facilitating market access by new entrants, thereby increasing competition at the consumer level.

Conclusion

Relying on our significant expertise in this area, we have demonstrated why we believe that reasons suggested by the NPR for prohibiting Pool Level Support provided by financial guaranty insurance under the Proposed Rule do not support such a prohibition. When considered in light of the customary ways in which financial guaranty insurance has been written and used for 25 years, we believe that financial guaranty insurance remains an effective tool that furthers the

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FDIC's stated goals for the Proposed Rule. We therefore strongly oppose any prohibition on the use of financial guaranty insurance for securitizations qualifying for the safe harbor rule.

We appreciate this opportunity to comment on the NPR. Should you have any questions about the foregoing, please feel free to contact me at 212-339-3482 and bstem@assuredguaranty.com or my colleague at Assured Guaranty, Ruth Cove, at 212-261-5543 and rcove@assuredguaranty.com (our address is Assured Guaranty, 31 West 52nd Street, New York, New York 10019).

Very truly yours,

ASSOCIATION OF FINANCIAL GUARANTY
INSURERS

By: 

Bruce E. Stern
Chairman of Government Affairs Committee