

# A·F·G·I

## ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty

November 4, 2013

Robert E. Feldman  
Executive Secretary  
Attention: Comments/Legal ESS  
Federal Deposit Insurance Corporation,  
550 17th Street, N.W.  
Washington, D.C. 20429

Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule (FDIC RIN 3064-AD95)

The Association of Financial Guaranty Insurers (“AFGI”) appreciates the opportunity to provide the Federal Deposit Insurance Corporation (“FDIC”) with its comments on the interim final rule regarding the risk-based and leverage capital requirements for FDIC-supervised institutions (“interim final rule”).<sup>1</sup>

As a trade association representing the unique perspective of financial guaranty insurers and reinsurers, AFGI believes it is essential for the FDIC to fully understand the unintended consequences regarding changes made to the regulatory capital rules that will be imposed on U.S. banking organizations. AFGI provided comments to the FDIC, the Federal Reserve, and the Office of the Comptroller of the Currency (“OCC”) on October 22, 2012 regarding the now finalized rule related to the standardized approach for risk-weighted assets, market discipline, and disclosure requirements (“Standardized Approach”).<sup>2</sup> Through this letter, AFGI incorporates its previous comments with respect to the exclusion of financial guaranty insurers as eligible credit risk mitigants (*see* Appendix I).

As stated in its previous comment letter, AFGI believes that the FDIC interim final rule and the Standardized Approach depart from Basel III insofar as they disregard the credit rating enhancement benefit that may result from financial guaranty insurance while failing to provide a “proxy” for such benefit. Additionally, AFGI reiterates that

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<sup>1</sup> FDIC Interim Final Rule, 78 Fed. Reg. 55,340 (Sept. 10, 2013).

<sup>2</sup> AFGI Comment Letter to FDIC, Federal Reserve, and OCC Regarding 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).

excluding financial guaranty insurers from recognition as eligible credit risk mitigants (1) does not properly recognize the regulatory oversight provided by insurance, as opposed to bank, regulators; and (2) does not properly distinguish among different insurers that, AFGI submits, should be considered on a case-by-case basis.

## **I. Basel III Framework for Financial Guaranty Insurers**

AFGI members recognize that the regulatory agencies were bound to utilize the Basel III framework when formulating the Standardized Approach. However, 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.<sup>3</sup> Specifically, while financial guaranty insurers may not provide a Basel III benefit as eligible credit risk mitigants, the external credit rating enhancement typically provided by financial guaranty insurance provides a benefit under Basel III by moving an investment into a superior risk category.

As AFGI stated in its October 2012 letter to the regulatory agencies, the Standardized Approach, as highlighted again in the FDIC’s interim final rule, fails to recognize the value financial guaranty insurance adds to financial products. This results in a different treatment for insured securities that benefit from a credit rating enhancement than is applied in other jurisdictions implementing Basel III.

Further, through this comment letter, AFGI restates that, because of financial guaranty insurers’ current activities, risk profile, and ability to transfer the credit risk of one or more specific exposures to another party, financial guaranty insurers should be included as eligible credit risk mitigants for purposes of recognizing a bank’s credit risk mitigation in the FDIC’s interim final rule and the Standardized Approach.

## **II. Financial Guaranty Insurers Should Not be Excluded from Recognition as Eligible Credit Risk Mitigants**

The FDIC’s interim final rule, like the Standardized Approach, states that a credit risk mitigant is an entity “... (i) that at the time the guarantee is issued or anytime thereafter, has issued and outstanding an unsecured debt security without credit enhancement that is investment grade; (ii) whose creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees; and (iii) *that is not an insurance company engaged predominately in the business of providing credit protection (such as a monoline bond insurer or re-insurer).*”<sup>4</sup>

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<sup>3</sup> Basel Committee, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Dec. 2010, revised Jun. 2011).

<sup>4</sup> FDIC Interim Final Rule, 78 Fed. Reg. 55,477 (Sept. 10, 2013) (emphasis added).

As it provided in its October 2012 comments, AFGI submits that a blanket exclusion of financial guaranty insurers from recognition as “eligible guarantors” may have a material adverse effect on U.S. banking organizations. Particularly, if financial guaranty insurers were excluded from recognition as eligible credit risk mitigants, banks may be improperly motivated to sell their insured positions into an illiquid market in which they will be unlikely to receive fair value. Additionally, in many cases, financial guaranty insurance products have so called “representations to hold,” providing that the holder will lose its insurance if the insured security or CDS reference obligation is sold.

Further, AFGI reiterates that the FDIC interim final rule and the Standardized Approach could create disparities between U.S. and foreign banks. Particularly, the capital rules applicable to non-U.S. headquartered banks may (1) allow them to take greater advantage of capital relief afforded by financial guaranty insurer support and (2) permit some degree of reliance on external credit ratings.

*Alternative Treatment that Recognizes Existing Oversight and Differences Among Insurers*

AFGI emphasized, in its previous comment letter, that making general assumptions about the correlation between an insurer’s creditworthiness and credit risk level ignores the differences among insurers, the reliability of insurance capital models, and the comfort provided by State supervision of financial guaranty insurers. Further, such assumptions disregard the measures already taken by insurers, regulators, and rating agencies specifically based upon the experience in the recent financial crisis.

In failing to recognize the credit rating enhancement provided by financial guaranty insurance or adopting other means to recognize the value of such insurance, the FDIC, Federal Reserve, and OCC have penalized insured securities in a manner inconsistent with Basel III as implemented outside the United States.

To address this inconsistency, AFGI proposed in its October 2012 letter an alternative treatment for financial guaranty insurers. In short, under the alternative treatment, a bank that owns a debt instrument insured by a financial guaranty insurer would compare its market value to a debt instrument of the same issuer and credit characteristics, but which is not insured. Then, in a case where the market value of the insured debt is higher (indicating a benefit from the insurance), the following calculation would be made: (1) the market value of the reference debt would be divided by (2) the sum of the market values of the insured debt and the reference debt. This calculation would yield a decimal that would be multiplied by the risk weighting determined without the benefit of the insurance. The regulators could set maximum risk weight benefit limits if deemed necessary. In its October 2012 letter, AFGI further proposed that in determining the mitigating effect of financial guaranty insurance, the Standardized Approach be modified to allow banks the option to use either the formula described above or a substitution approach. In using a substitution approach, a bank should be allowed the flexibility to determine the extent, if any, to which it will employ the substitution approach.

Through this comment letter, AFGI stresses its continued belief that this proposed

alternative treatment and use of the substitution approach more accurately reflects the Basel III framework and measures a guarantor's eligibility as a credit risk mitigant.

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We thank the FDIC for the opportunity to comment on its interim final 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](mailto:bstern@assuredguaranty.com) or (212) 339-3482.

Sincerely,

A handwritten signature in blue ink, appearing to read "Bruce Stern". The signature is fluid and cursive, with a large initial "B" and "S".

Bruce E. Stern, Chairman

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## ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty

October 22, 2012

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

Robert E. Feldman  
Executive Secretary  
Attention: Comments/Legal ESS  
Federal Deposit Insurance Corporation,  
550 17th Street, N.W.  
Washington, D.C. 20429

Office of the Comptroller of the Currency  
250 E Street, SW  
Mail Stop 2-3  
Washington, DC 20219

Re: 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])

The Association of Financial Guaranty Insurers (“AFGI”) appreciates the opportunity to provide the Board of Governors of the Federal Reserve System (“Federal Reserve”), the Federal Deposit Insurance Corporation (“FDIC”), and the Office of the Comptroller of the Currency (“OCC”) (together the “regulatory agencies”) with its comments on the joint notice of proposed rulemaking regarding the regulatory capital rules related to the standardized approach for risk weighting assets and market discipline and disclosure requirements (“Standardized Approach NPR”).<sup>1</sup>

As a trade association representing the unique perspective of financial guaranty insurers and reinsurers, AFGI believes it is essential for the regulatory agencies to fully understand the unintended consequences regarding changes made to the regulatory capital rules that will be imposed on U.S. banking organizations. AFGI respectfully submits that the Standardized Approach NPR inappropriately excludes financial guaranty insurers, who play an important role in the capital markets by reducing or transferring

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<sup>1</sup> Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; and the Federal Deposit Insurance Corporation, Joint Notice of Proposed Rulemaking, 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]) (June 7, 2012) [hereinafter “Standardized Approach NPR”].

credit risk exposure, from recognition as eligible credit risk mitigants. AFGI believes that excluding financial guaranty insurers from recognition as eligible credit risk mitigants (a) does not properly recognize the regulatory oversight provided by insurance, as opposed to bank, regulators and (b) does not properly distinguish among different insurers that, AFGI submits, should be considered on a case by case basis. Additionally, AFGI submits that the Standardized Approach NPR represents an unintended and inappropriate departure from Basel III insofar as the Standardized Approach NPR, as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), disregards the credit rating enhancement benefit that may result from financial guaranty insurance while failing to provide a “proxy” for such benefit.

For this reason, we write to (I) provide an overview of the financial guaranty insurance business and the existing State regulatory framework for the industry; (II) distinguish the Basel III framework from the regulatory agencies’ Standardized Approach NPR; and (III) submit that credit enhancement provided by financial guaranty insurers should be recognized and propose an alternative to the Standardized Approach NPR’s failure to recognize enhancement of external credit ratings provided by financial guaranty insurance as mandated by the Dodd-Frank Act. Of note, AFGI joins with concerns expressed by various industry organizations and Members of Congress regarding potential unintended consequences of the regulatory agencies’ proposed rulemakings on small and community banks, the banking system, and the overall U.S. economy.

## **I. Overview of the Financial Guaranty Insurance Business**

The Standardized Approach NPR defines a guarantee to mean “a financial guarantee, letter of credit, insurance, or other similar financial instrument (other than a credit derivative) that allows one party (beneficiary) to transfer the credit risk of one or more specific exposures (reference exposure) to another party (protection provider).”<sup>2</sup> This definition, on its face, would include financial guaranty insurance that generally guarantees that scheduled payments on specific obligations will be paid when due to the holder of those 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.

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<sup>2</sup> Standardized Approach NPR, p. 171.

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.<sup>3</sup> 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, 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 submits that the Standardized Approach NPR’s exclusion of financial guaranty insurers from recognition as eligible credit risk mitigants inappropriately ignores the oversight that State insurance law and State insurance regulators provide, and the value that financial guaranty insurers add. Moreover, as explained herein, the products that proved problematic for financial guaranty insurers during the financial crisis have been discontinued, as reflected in new underwriting guidelines, rating agency standards and regulations arising from the experience gained from the financial crisis. Taking these changes into account, AFGI submits that financial guaranty insurers are properly regulated and should be recognized as credit risk mitigants.

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<sup>3</sup> N.Y. Code ISC Insurance §§ 6901-09 (2010).

## **II. The Standardized Approach NPR Improperly Applies the Basel III Framework to Financial Guaranty Insurers**

AFGI members recognize that the regulatory agencies were bound to utilize the Basel III framework when formulating the Standardized Approach NPR. However, 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.<sup>4</sup> Specifically, while financial guaranty insurers may not provide a Basel III benefit as eligible credit risk mitigants, the external credit rating enhancement typically provided by financial guaranty insurance provides a benefit under Basel III by moving an investment into a superior risk category.

Due to restrictions on the use of credit ratings imposed by the Dodd-Frank Act, the Standardized Approach NPR does not rely on external credit ratings for the treatment of certain exposures. As a result, the Standardized Approach NPR fails to recognize the value financial guaranty insurance adds to financial products. This results in a different treatment for insured securities that benefit from a credit rating enhancement than is applied in other jurisdictions implementing Basel III.

For this reason, AFGI believes that the Standardized Approach NPR incorrectly applies the Basel III framework. Moreover, AFGI submits that, because of its current activities, its risk profile, and its ability to transfer the credit risk of one or more specific exposures to another party, financial guaranty insurers should be included as eligible credit risk mitigants for purposes of recognizing a bank’s credit risk mitigation in the Standardized Approach NPR.

## **III. Financial Guaranty Insurers Should Not be Excluded from Recognition as Eligible Credit Risk Mitigants**

The Standardized Approach NPR states that a credit risk mitigant is an entity “(1) that at the time the guarantee is issued or anytime thereafter, has issued and outstanding an unsecured debt security without credit enhancement that is investment grade; (ii) whose creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees; and (iii) **that is not an insurance company engaged predominately in the business of providing credit protection** (such as a monoline bond insurer or re-insurer).”<sup>5</sup>

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<sup>4</sup> Basel Committee, “Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems” (Dec. 2010, revised Jun. 2011).

<sup>5</sup> Proposed Rule, pp. 51-52.

AFGI submits that a blanket exclusion of financial guaranty insurers from recognition as “eligible guarantors” may have a material adverse effect on U.S. banking organizations. Particularly, if financial guaranty insurers were excluded from recognition as eligible credit risk mitigants, banks may be improperly motivated to sell their insured positions into an illiquid market in which they will be unlikely to receive fair value. Additionally, in many cases, financial guaranty insurance products have so called “representations to hold,” providing that the holder will lose its insurance if the insured security or CDS reference obligation is sold.

AFGI also understands that there is uncertainty among banks on whether the Standardized Approach NPR applies to financial guaranty insurance on CDS obligations, as the NPR does not specifically mention application to CDS obligations. Insofar as the regulatory agencies apply the exclusion from recognition as eligible credit risk mitigants to financial guaranty insurance on CDS obligations, AFGI expects there to be increased dislocation among the banking community. To that end, we request that the regulatory agencies clarify the scope of application for the exclusion of financial guaranty insurers as credit risk mitigants and appropriately consider the costs and benefits of the resulting dislocation.

The Standardized Approach NPR paints all financial guaranty insurers with the same broad brush and does not discriminate on the basis of the capital adequacy of the guaranty provider. Given the importance of the capital rules to the banks that represent the financial guaranty insurers’ customers, we believe this issue calls for a more nuanced approach. Further, such a broad exclusion creates disparities between U.S. and foreign banks, because the capital rules applicable to non-U.S. headquartered banks will allow them to take greater advantage of capital relief afforded by financial guaranty insurer support, and because non-U.S. versions of the Basel III framework permit some degree of reliance on external credit ratings.

AFGI notes that the treatment of financial guaranty insurer support under the regulatory agencies’ Advanced Approach proposed rule differs from that contained in the Standardized Approach NPR. Particularly, in the Advanced Approach proposed rule, financial guaranty insurers are not included in the definition of “eligible double default guarantor,” which excludes financial guaranty insurer support from being utilized for double default methodology in determining credit support relief.<sup>6</sup> However, this definition presumably does not apply to other methodologies for determining such relief, including the Probability of Default (“PD”) Substitution and the Loss Given Default (“LGD”) Adjustment approaches. AFGI therefore reads the Advanced Approach

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<sup>6</sup> Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; and the Federal Deposit Insurance Corporation, Joint Notice of Proposed Rulemaking, Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule, pp. 27-30 (OCC RIN 1557-AD46; FDIC RIN 3064-AD97; FRB RIN [XX]) (June 7, 2012) [hereinafter “Advanced Approach NPR”].

proposed rule as permitting “Advanced Approach” banks to utilize financial guaranty insurer support in determining capital relief using those techniques.

#### *Alternative Treatment*

AFGI proposes an alternative treatment under the Standardized Approach for financial guaranty insurers. Under this alternative treatment, a bank that owns a debt instrument insured by a financial guaranty insurer would compare its market value to a debt instrument of the same issuer and credit characteristics, but which is not insured. As long as the uninsured debt has some measurable market value, the differential between the two values could be treated as a “proxy” for the incremental value of the financial guaranty insurance. Thus, the risk weighting for a “wrapped” debt instrument could be obtained by first observing market values of the insured debt and similar uninsured “reference” debt. Then, in a case where the market value of the insured debt is higher (indicating a benefit from the “wrap”), the following calculation would be made: (1) the market value of the reference debt would be divided by (2) the sum of the market values of the insured debt and the reference debt. This calculation would yield a decimal that would be multiplied by the risk weighting determined without the benefit of the insurance. The regulators could set maximum risk weight benefit limits if deemed necessary. The formula would not be used where the market value of the reference debt without insurance equals zero; in that case, a bank would be permitted to utilize one of the alternative credit support methodologies provided under the Advanced Approach NPR.

AFGI further proposes that, in determining the mitigating effect of financial guaranty insurance, the Standardized Approach NPR be modified to allow banks the option to use either the formula described above or a substitution approach. In using a substitution approach, the regulatory agencies should allow a bank the flexibility to determine the extent, if any, to which it will employ the substitution approach, instead of requiring the bank to shift the full face value of an insured exposure from the underlying reference name to that of the financial guaranty insurer. Banks should be permitted to make a good faith determination of how much of an exposure will be shifted from an underlying obligor to a financial guaranty insurer. Such determinations would be made pursuant to written policies and procedures and subject to existing supervisory review.

For the reasons stated above, AFGI submits that regulatory agencies have inappropriately excluded financial guaranty insurers from their proposed eligibility requirements for guarantors recognized as credit risk mitigants. Indeed, making general assumptions about the correlation between an insurer’s creditworthiness and credit risk level ignores the differences among insurers, the reliability of insurance capital models and the comfort provided by State supervision of financial guaranty insurers. Further, such assumptions disregard the measures already taken by insurers, regulators, and rating agencies specifically based upon the experience in the recent financial crisis.

In failing to recognize the credit rating enhancement provided by financial guaranty insurance or adopting other means to recognize the value of such insurance, the regulatory agencies have penalized insured securities in a manner inconsistent with Basel III as implemented outside the United States. To address this inconsistency, AFGI suggests that the regulatory agencies adopt the alternative treatment for financial guaranty insurers proposed in this letter, which more accurately reflects the Basel III framework and measures a guarantor's eligibility as a credit risk mitigant.

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We thank the regulatory agencies for the opportunity to comment on the Standardized Approach NPR 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](mailto:bstern@assuredguaranty.com) or (212) 339-3482.

Sincerely,

A handwritten signature in blue ink, appearing to read "Bruce Stern".

Bruce E. Stern, Chairman