10-012
COMMENT
CL-00033

From: no-reply@erulemaking.net
Sent: Monday, September 20, 2010 8:29 PM
To: secretary <secretary@CFTC.gov>
Subject: Public Submission for 2010-20567
Attach: Public Submission for 2010-20567.zip

Please refer to the attached file.

ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty ®

September 20, 2010

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File Number S7-16-10

Dear Ms. Murphy and Mr. Stawick:

The Association of Financial Guaranty Insurers ("**AFGI**") appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**") and the Securities and Exchange Commission (the "**SEC**" and, together with the CFTC, the "**Commissions**") with its comments regarding the impact on financial guaranty insurers of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), which provides for regulation of swap markets. AFGI is the trade association for financial guaranty insurers and reinsurers.

The distinctions between swaps and security-based swaps (together, "**swaps**") and financial guaranty insurance policies are such that the Commissions should clarify that the term "swap" does not include financial guaranty insurance policies or surety bonds. Financial guaranty insurance, which consists of financial guaranty insurance policies and surety bonds, is already subject to comprehensive state regulation designed to balance the public benefits and attendant risks of such activity. Further, in assessing whether an entity regularly enters into swaps in the ordinary course of business or maintains a substantial position in swaps, the Commissions should focus on the entity's current activities, rather than activities conducted prior to the enactment of the Dodd-

Frank Act. As a result, financial guaranty insurers and their affiliated "transformers" (described below) should not be characterized as major swap participants or swap dealers based on legacy credit default swap (**"CDS"**) portfolios which are not writing new business. We believe that the regulations promulgated by the Commissions pursuant to the Dodd-Frank Act should so clarify the intended scope of the terms swap, swap dealer and major swap participant and the related "security-based" terms.

Overview of the Financial Guaranty Industry

Financial guaranty insurers provide insurance products to the United States and international public finance, infrastructure and structured finance markets. Such insurers apply their credit underwriting judgment, risk management skills and capital markets experience to develop insurance and reinsurance products, including their primary product: the guaranty of principal and interest payments on third party debt securities. Debt securities guaranteed by such insurers include municipal finance obligations issued by state and municipal governmental authorities, utility districts and facilities, as well as notes and bonds issued for international infrastructure projects and asset-backed securities issued by special purpose entities. Financial guaranty insurers market these products directly to issuers and underwriters of public finance, infrastructure and structured finance securities and to U.S. and foreign investors in such debt obligations.

Financial guaranty insurance policies facilitate the access of municipalities and other issuers to the capital markets and lower their borrowing costs. These policies also benefit investors, as the marketability and trading prices of illiquid, uncommon or complex debt obligations are generally improved by the application of a financial guaranty insurance policy.

In addition to their issuance of financial guaranty insurance policies directly covering third party obligations, financial guaranty insurers also previously wrote policies insuring CDS of affiliated special purpose entities known as "transformers." The transformers' sole purpose was to sell credit protection, and they engaged in no business other than writing CDS insured by their affiliated insurers.

Financial Guaranty Insurance Policies and Title VII of the Dodd-Frank Act

Title VII of the Dodd-Frank Act establishes a regulatory framework for a broad range of previously unregulated transactions in the derivatives market. The definition of "swap" in Title VII includes, subject to enumerated exclusions, "any agreement, contract,

or transaction . . . that provides for any purchase, sale, payment, or delivery . . . that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence."[1] While this extraordinarily broad formulation could be read to encompass a wide range of insurance products, including financial guaranty insurance, the definition of "swap" does not refer to insurance at all. For the reasons set forth below, we believe that the definition of swap should be clarified by regulation to exclude insurance policies, including financial guaranty insurance policies and surety bonds.

The McCarran-Ferguson Act Precludes the Regulation of Insurance, Including Financial Guaranty Insurance, as Swaps Under the Dodd-Frank Act

Congress did not intend for Title VII of the Dodd-Frank Act to introduce a new regime for the regulation of insurance. The McCarran-Ferguson Act[2] requires Congress to express a clear intention to override state regulation of insurance when it intends to do so, and the Dodd-Frank Act does not include any such clear expression.

The McCarran-Ferguson Act states that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance." The Supreme Court has stated that the law "seeks to protect state regulation primarily against *inadvertent* federal intrusion – say, through enactment of a federal statute that described an affected activity in broad, general terms, of which the insurance business happens to constitute one part."[3] The Second Circuit has similarly stated that "federal laws will be presumed not to reach insurance unless Congress expressly states an intent do so."[4]

In order to counter a recent proposal to create a new regime to regulate all CDS, including those issued by banks and other financial institutions, as insurance at the state level, Title VII provides that swaps are not to be considered insurance and the states may

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[1] Dodd-Frank Act §§ 721, 761. While the definitions of swap and security-based swap vary, the relevant portions for the purposes of this letter are substantially similar.

[2] 15 U.S.C. §§ 1011-1015.

[3] *Barnett Bank of Marion County, N.A. v. Nelson*, 517 U.S. 25, 39 (1996) (emphasis in original).

[4] *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 115 (2d Cir. 2001).

not regulate them as such[5]. Congressional intent to maintain exclusive federal jurisdiction over swaps does not, however, suggest a similar intent to mandate the federal regulation of products long recognized and regulated as insurance. In fact, characterizing as swaps transactions already regulated as insurance, together with the Dodd-Frank Act's prohibition on state regulation of swaps, would have the perverse effect of displacing a currently active, substantial and comprehensive state regulatory regime with a regime not designed to regulate insurance. There is no evidence that Congress intended to do this, and much evidence that it did not.

When speaking on the Dodd-Frank Act, Rep. Peters noted that Title VII was intended to, "for the first time, bring transparency and oversight to the *currently unregulated* $600 trillion derivatives market" (emphasis added). Similarly, Sen. Stabenow noted that reform was necessary as "[f]or too long the over-the-counter derivatives market has been unregulated." To our knowledge, no member of Congress explicitly suggested that Title VII was intended to replace or even supplement state insurance regulation.

More generally, the Dodd-Frank Act gives broad deference to the historic role of states in regulating insurance. The newly created Federal Insurance Office's functions are primarily related to information gathering and monitoring, and its authority to preempt state law is heavily curtailed, both substantively and procedurally.[6] The liquidation or rehabilitation of insurance companies generally will still be carried out under applicable state law, rather than by the Federal Deposit Insurance Corporation under the orderly liquidation authority.[7] The Bureau of Consumer Financial Protection is prohibited from exercising authority over persons engaged in the business of insurance and subject to regulation by a state insurance regulator (except to the extent such person otherwise engages in the provision of consumer financial products or services, or is otherwise subject to certain consumer laws).[8] Although the June 2009 Treasury White

[5] Dodd-Frank Act §§ 722, 767.

[6] Dodd-Frank Act § 502(a).

[7] Dodd-Frank Act §§ 201, 203.

[8] Dodd-Frank Act §§ 1002, 1011.

Paper suggested a potential role for federal insurance regulation to help mitigate systemic risks,[9] Congress chose not to follow Treasury's lead in this respect.

Financial Guaranty Insurers are Already Subject to Extensive State-Based Regulation

Financial guaranty insurers are currently regulated extensively by state insurance law. For example, Article 69 of the New York Insurance Law applies to all financial guaranty insurers incorporated or licensed in New York and imposes the following requirements on financial guarantors:

- minimum surplus to policyholders (i.e., minimum capital levels) and contingency reserves;
- single and aggregate risk limits;
- investment portfolio diversification requirements;
- dividend payment restrictions;
- financial reporting and market conduct rules; and
- books and records examinations.[10]

During the fall of 2008, in order to address the challenges faced by the financial guarantors during the financial crisis, the New York Insurance Department issued Circular Letter No. 19,[11] which set forth certain "best practices" applicable to all New York-licensed financial guarantors. Notably, Circular Letter No. 19 prohibits financial guaranty insurers from posting collateral in connection with structured credit transactions. This is consistent with the long-standing public policy against favoring one set of insurance policyholders over another in insolvency. Circular Letter No. 19 also requires financial guarantors to, among other things, limit their issuance of policies that back collateralized debt obligations of asset-backed securities, apply stricter single risk limits, increase their capital and surplus levels and comply with additional reporting requirements. Clearly, this extensive state regulatory regime would be impaired or superseded by the application of Title VII's requirements to financial guaranty insurers.

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[9] Department of the Treasury, A New Foundation: Rebuilding Financial Supervision and Regulation (2009), pg 40.

[10] New York Insurance Law §§ 6901-6909.

[11] State of New York Insurance Department, "Best practices" for financial guaranty insurers (2008), *available at* http://www.ins.state.ny.us/circltr/2008/cl08_19.pdf.

Financial Guaranty Insurance Policies Differ Significantly from Traditional Swaps

There are numerous substantive differences between financial guaranty insurance policies (and surety bonds) and traditional CDS contracts. While CDS may be used to hedge a wide range of exposures, such contracts may also be used to take purely speculative positions without any ownership stake in the underlying obligation. Unlike the beneficiaries of financial guaranty insurance policies, CDS counterparties are not required to have an insurable interest in the reference obligation, and transactions can be structured to allow the outstanding notional amounts of CDS to far exceed the outstanding principal amount of the reference obligation. Because there are no mark-to-market termination payments under financial guaranty insurance policies that guarantee principal and interest payments on third party debt securities, such policies are not subject to the same volatility that CDS entail.

Whereas financial guaranty insurers typically have control, information and inspection rights with respect to the insured obligations and often provide direct assistance in restructuring transactions and remediating defaults, the rights of CDS counterparties are generally much more limited. Financial guaranty insurance policies generally pay interest shortfalls over time and principal at maturity when due according to the terms of the insured obligation (as if there were no default) and do not permit acceleration of payments except at the option of the insurer. In contrast, traditional CDS may require physical settlement of the entire notional amount upon specified events, such as a failure to pay (even if the payment failure relates to a relatively small fraction of the notional amount, such as a single interest payment).

Market participants have long distinguished financial guaranty insurance policies from CDS. In addition, the Financial Accounting Standards Board has issued separate accounting guidance, with treatment of financial guaranty insurance addressed under ASC 944[12] and treatment of CDS addressed under ASC 815.[13] Entities dealing in both types of transactions are required to apply different accounting methodologies, including with respect to premium revenue recognition and claims liability measurement.

Congress is Likely to Address Federal Regulation of Insurance in the Future

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[12] Financial Account Standards Board, ASC 944: Financial Services – Insurance.

[13] Financial Account Standards Board, ASC 815: Derivatives and Hedging.

The Dodd-Frank Act requires the director of the Federal Insurance Office to prepare a report for Congress on improving U.S. insurance regulation. The report must cover, among other topics, the costs and benefits of potential federal regulation of insurance and the feasibility of regulating only certain lines at the federal level. In addition, Rep. Frank stated after the passage of the Dodd-Frank Act that there will be a "major push" to consider new legislation regarding federal regulation of insurance, including an optional federal charter, during the next Congressional session. Clearly, Congress views substantive federal regulation of insurance as a topic for consideration in the future and not a bridge already crossed in the Dodd-Frank Act.

Regulatory Language Precedents

New York Insurance Law defines "insurance contract" as "any agreement . . . whereby one party . . . is obligated to confer benefit of pecuniary value upon another party . . . dependent upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event."[14] The obvious parallels between this definition and the Title VII definition of "swap" suggest that it would be instructive to look to current federal regulatory regimes which call for a clear delineation between insurance and the target of the federal regime.

Existing provisions in the Securities Act of 1933 and the Investment Company Act of 1940 suggest language which could be used to make unambiguous Congress's intent not to include financial guaranty insurance and other types of insurance in the Title VII regulatory regime. The Securities Act exempts from the definition of "security" any "insurance or endowment policy . . . issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia."[15] Similarly, the Investment Company Act provides an exemption from the scope of "investment company" for any company that is "organized as an insurance company, whose primary and predominant business activity is the writing of insurance or

[14] New York Insurance Law § 1101(a)(1).

[15] 15 U.S.C. 77(c)(a)(8).

the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or similar official or agency of a State."[16]

This approach has a long history under the securities laws and is well understood by the regulated community, making it an ideal means for clarifying the purpose and scope of Title VII.

Legacy CDS Portfolios of Financial Guarantors

As noted above, financial guaranty insurers also previously wrote policies insuring CDS of affiliated special purpose entities known as transformers. The transformer structure was approved by state insurance regulators and codified in New York as a permissible method for financial guaranty insurers to provide credit protection in the form of CDS. We believe that financial guarantors should not be subjected to heightened regulation due to transactions that were entered into prior to the enactment of the Dodd-Frank Act. In particular, the capital and margin requirements should not apply retroactively to existing transactions.

The Application of Title VII to Inactive Businesses Would Not Advance the Policy Goals of the Dodd-Frank Act

No financial guaranty insurer has insured a CDS since early 2009, other than in connection with the restructuring of existing books of business. Additionally, most financial guaranty insurers do not expect to write policies covering CDS in the future. The characterization of an entity as a major swap participant or a swap dealer should be based upon the entity's current activities.

In particular, the application of retroactive margin requirements to private bilateral contracts, which were specifically negotiated to exclude such terms, could be detrimental to the financial condition and liquidity of financial guarantors. The posting of collateral, even if possible, would also subordinate insured municipal bondholders and other policyholders to the transformers' CDS counterparties (generally large financial institutions). Such collateral posting would also conflict with existing New York Insurance Law, which prohibits financial guaranty insurers from posting collateral in connection with insured CDS.

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[16] 15 U.S.C. 80a-2(a)(17).

Furthermore, if margin requirements were imposed on financial guaranty insurers in contravention of current state regulations, many insurers could be financially incapable of complying. As former New York Insurance Superintendent Eric Dinallo indicated in recent testimony before the Financial Crisis Inquiry Commission, state insurance departments have undertaken significant efforts to address the impact of the economic crisis on financial guaranty insurers in an orderly manner that limits claims jumping and avoids larger systemic impact. As a result, many industry participants have undergone significant restructurings since the crisis, and their existing portfolios are in run-off. In this context these entities generally have little or no access to additional capital. Furthermore, the legacy CDS portfolios of financial guarantors have never presented any meaningful systemic risk, and the risk they present to individual institutions has diminished significantly as a result of the passage of time without the addition of new business and the extensive restructurings that have occurred since the onset of the financial crisis. Consequently, retroactive application of margin requirements to the legacy portfolios of financial guarantors would do little to fulfill the policy objectives of Title VII and could force many insurers to default. Congress could not possibly have intended that the Dodd-Frank Act would put additional financial strain on financial guaranty insurers in the name of economic stability.[17]

The application of capital requirements to financial guaranty insurers pursuant to the Dodd-Frank Act could similarly conflict with the current insurance regulations, which require such insurers to maintain certain capital levels. In addition, the application of capital requirements to transformers on a retroactive basis would not serve any regulatory purpose given the lack of resources at the transformers to comply with such requirements.

Finally, to the extent that the Commissions determine that an affiliate of a financial guarantor should be subject to heightened regulation, such entity should be designated as a "major swap participant," rather than as a "swap dealer." Financial guarantors and their affiliates generally remain party to financial guaranty insurance policies and CDS, as applicable, until such contracts mature and do not actively trade in and out of positions. Moreover, financial guaranty insurers and their affiliates do not

[17] The Supreme Court has consistently "declined to give retroactive effect to statutes burdening private rights unless Congress had made clear its intent." *Landgraf v. USI Film Prods.*, 511 U.S. 244, 270 (1994). The Court reasoned that "[r]equiring clear intent assures that Congress itself has affirmatively considered the potential unfairness of retroactive application and determined that it is an acceptable price to pay for the countervailing benefits." *Id.* at 272-273.

hold themselves out as dealers in swaps and are not commonly known as dealers or market makers in swaps, as they only assumed one-sided market exposure (i.e., they sold, but did not purchase, credit protection). In addition, the legacy CDS portfolios of financial guaranty insurers are in runoff, and neither such insurers nor their affiliated transformers will regularly enter into swaps in the ordinary course of business in the future.

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We thank the Commissions for the opportunity to comment in advance of their joint rulemaking to implement the Dodd-Frank Act. We appreciate the Commissions' consideration of our views on the impact of Title VII on financial guaranty insurers. If you have any questions, please do not hesitate to call the undersigned at (212) 339-3485 or Bruce Stern, Chairman, AFGI Government Affairs Committee, at bstern@assuredguaranty.com or (212) 339-3482.

Sincerely,

Séan W. McCarthy
Chairman, AFGI