A▪F▪G▪I

ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty ®

September 19, 2011

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: Joint Public Roundtable on International Issues Relating to the Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Release No. 34–64939; File No. 4–636); Acceptance of Public Submissions for a Study on International Swap Regulation Mandated by Section 719(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Release 34-64926, File No. 4-635)

Dear Mr. Stawick and Ms. Murphy:

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 on the international swap regulation study pursuant to Section 719(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). AFGI is the trade association for financial guaranty insurers and reinsurers.

AFGI commends the Commissions for their efforts to identify the differences in regulations across jurisdictions and to recognize areas of regulation that could be harmonized. To this end, AFGI urges the CFTC and SEC to work with regulators abroad to ensure a consistent global approach to the regulation of financial guaranty insurance by generally exempting insurance contracts from regulation as derivatives. In particular, AFGI strongly encourages the Commissions to work to promote consistency between the European Commission's ("**EC**") European Market Infrastructure Regulations ("**EMIR**") and the Commissions' regulations, including the scope of the definitions for "swap," "security-based swap," and "mixed swap."[1]

[1] *See* Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29818 (May 23, 2011).

In the International Swap Regulation Study Release, the Commissions requested comments on, among other things, (a) the current regulatory framework for "swaps" and "security-based swaps" in jurisdictions outside the United States; and (b) whether the differences in other jurisdictions' regulatory frameworks are appropriate and desirable for regulatory purposes. We write (i) to discuss the present status of the EC's regulatory efforts; (ii) to describe the unintended consequences of EMIR and the potential benefits of harmonization; and (iii) to submit that the Commissions should ensure the consistent regulation of financial guaranty insurance in the United States and the EC as a step in achieving greater international harmonization.

The Scope of the EC's Derivative Contracts Definition under EMIR is Broad and Should be Harmonized with the Commissions' Product Definitions

The International Swap Regulation Study Release requested comments on the present status of regulatory efforts related to the definition of "swaps" and "security-based swaps" in jurisdictions outside of the United States.[2] In response, our comments focus on the EC's regulatory efforts. The efforts by the EC confirm the need for international harmonization in order to ensure consistency in the regulation of the swap market.

The EC is in the process of enacting regulations to reform the derivatives market, with the goal of ensuring that transparency and efficiency are balanced in the trading of financial instruments. To this end, the EC has proposed EMIR (or the "**Regulation**"), which in its present form has the potential to apply beyond derivative contracts to financial guaranty and other contracts of insurance.

The scope of the Regulation, and therefore of clearing and other obligations, hinges on the definition of a "derivative contract." Currently, the Regulation references the broad definition for financial instruments found in the Markets in Financial Instruments Directive ("**MiFID**").[3] MiFID by its terms does not apply to insurance and reinsurance undertakings.[4] However, the adoption of the MiFID language in the Regulation without an express exclusion for insurance contracts potentially causes the definition of a "derivative contract" to encompass a broader class of contracts than those traditionally regarded as derivative instruments, in particular, financial guaranty and other contracts of insurance.

Of note, the parties participating in the process of drafting the derivative provisions of EMIR have uniformly agreed that the derivative provisions do not extend to

[2] The International Swap Regulation Study, 76 Fed. Reg. 143, 44510 (July 26, 2011), requested commenters to answer, for each jurisdiction on which comment is being provided, whether swaps are "included within the scope of any statute, regulation, or other legal requirement in the jurisdiction" and "the status of regulatory efforts [...]."

[3] Directive 2004/39/EC Markets in Financial Instruments Directive, Annex I(C)(4) to (10).

[4] *Id.* at Art. 2(1)(a).

insurance contracts written by insurance undertakings subject to the Solvency II regime. However, there has been a reluctance to formally provide a clarifying insurance contract exclusion from the text of EMIR, or even a recital acknowledging the regulatory intent in this regard – which may result in the unintended consequence of including financial guaranties and other contracts of insurance as "derivative contracts." AFGI is concerned that the different approaches – acknowledging the insurance contract exclusion under the Dodd-Frank Act and not acknowledging insurance contracts in EMIR, may lead to an ultimately different interpretation in the application of the respective regulations to insurance contracts.

Thus, we respectfully submit that the Commissions should include the treatment of insurance contracts on the list of issues that require regulatory harmonization and coordinate their regulatory efforts with the EC. Such coordination should ensure that EMIR excludes insurance contracts while continuing to apply to derivative contracts entered into by insurers.

EMIR Has Unintended Consequences and Would Benefit from International Harmonization

The International Swap Regulation Study Release also requested comments on the potential benefits that may arise from harmonization of regulations across borders.[5] AFGI believes that swap markets across borders would benefit from greater regulatory harmonization. The benefits of greater harmonization include enhanced financial stability and market efficiency. Moreover, the lack of harmonization could result in unintended consequences to other sectors of the financial market.

Because the reach of the swap definition in the Regulation is unclear, EMIR could potentially be inconsistent with regulations being implemented in the United States pursuant to the Dodd-Frank Act. The Commissions' proposed swap and security-based swap definitions generally exempt insurance contracts from regulation as derivatives. In fact, the Commissions have acknowledged the need for clarification to ensure that insurance products are not regarded as derivatives.[6]

By potentially going beyond derivative contracts, EMIR could create a situation in which financial guaranty insurance contracts would have to allow for the provision of margin and collateral. This would in turn encourage financial instability in difficult market conditions. Constraining the ability of financial guarantors to perform their

[5] International Swap Regulation Study, 76 Fed. Reg. 143, 44510 (July 26, 2011).

[6] *See* proposed rule 1.3(xxx)(4) under the Commodity Exchange Act (the "**CEA**") and proposed rule 3a69-1 under the Securities Exchange Act of 1934 (the "**Exchange Act**"). These exclusions recognize that financial guaranty insurance, as implemented through financial guaranty insurance policies and surety bonds, can be distinguished on structural, legal and economic grounds from credit default swaps intended to be regulated by Title VII of the Dodd-Frank Act.

market function would restrict funding for vital infrastructure projects as well as other forms of essential finance.

The difficulties in reconciling the regulatory regime for insurers and the proposed Regulation for over-the-counter derivatives would be exacerbated by the EC's reforms proposed in Solvency II. Solvency II seeks to regulate financial guaranty insurance contracts and impose a harmonized risk-based capital adequacy regime for insurers and reinsurers across Europe. Because Solvency II is expected to be implemented on January 1, 2013, EMIR and Solvency II are likely to come into force almost concurrently. The multiple, overlapping, and inconsistent requirements of these two regimes would be a significant administrative burden and would be economically damaging to insurers.

For the reasons noted above, AFGI submits that international harmonization, including the exclusion of insurance products from EMIR, would result in substantial benefits to the market's stability and efficiency.

Harmonization is Necessary to Ensure that Jurisdictions Outside the United States do not Regulate Derivatives as Traditional Financial Guaranty Insurance

The Commissions recognize that financial guaranty insurance can be distinguished from credit default swaps and have made significant efforts to exclude financial guaranty insurance from the definitions of the terms "swap" and "security-based swap." The exclusions also acknowledge that insurance is already subject to comprehensive state regulation and that Congress did not intend to regulate insurance under the Dodd-Frank Act.[7]

The same distinctions between financial guaranty insurance and credit default swaps exist at the international level. In addition, financial guaranty insurance providers already are regulated as insurance undertakings under Directive 73/239/EEC. On the other hand, the business of dealing in derivative instruments is regulated under MiFID, which contains an exemption for insurance undertakings.

Key differences between financial guaranty insurance and traditional derivatives include: (1) differences in ownership of an insured obligation – buyers of protection under traditional derivatives are not required to hold the underlying obligation; (2) differences in legal rights – insurers maintain direct control while sellers of protection are limited in their rights by the buyers of protection; (3) differences in the risk of acceleration – insurers have no risk of acceleration; (4) differences in termination payments – insurance policies do not provide for mark-to-market termination payments upon termination of the policy while, under traditional derivatives, the risk of mark-to-market termination payments exists upon termination of the instrument; (5) differences in accounting treatment – financial guaranty insurance applies methodologies that include revenue recognition and claim liability measurement, while traditional derivatives use

[7] *Id.*

mark-to-market accounting; and (6) differences in market perception – market participants do not consider financial guaranty insurance policies to be derivatives.

AFGI respectfully submits that, given the key differences noted above and the Commissions' recognition of the distinction between financial guaranty insurance and credit default swaps, there should be greater harmonization in general, and particularly between the Commissions' and the EC's regulations. Such harmonization should be consistent with U.S. regulations by including a bright line exclusion of insurance policies and contracts, which are already subject to comprehensive regulatory schemes by the EC.

* * * *

We commend the Commissions for addressing the concerns of the financial guaranty insurance industry regarding the regulation of financial institutions across jurisdictions and the need for harmonization. Particularly, AFGI endorses the Commissions' recognition that financial guaranty insurance should be excluded from the proposed definitions of "swaps" and "security-based swaps" under the Dodd-Frank Act. Similarly, we urge the Commissions to encourage such an approach as they work with regulators abroad to ensure the consistent regulation of derivatives.

We thank the Commissions for the opportunity to comment on these matters. 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