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ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty

February 15, 2013

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

Re: Release No. 34-68071; File No. S7-08-12 Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers

Dear Ms. Murphy:

The Association of Financial Guaranty Insurers ("AFGI") appreciates the opportunity to provide the Securities and Exchange Commission (the "SEC" or "Commission") with comments on the Commission's proposed rules regarding capital, margin, and segregation requirements for security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs") and capital requirements for broker-dealers (the "Proposed Rule"), issued pursuant to Sections 763 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1]

As the trade association representing financial guaranty insurers and reinsurers, AFGI recognizes the goals of the Dodd-Frank Act to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things, regulating SBSDs and MSBSPs. To ensure these goals are achieved in a fair and balanced manner, AFGI submits the following comments on the SEC's proposed capital and margin requirements for MSBSPs. Particularly, AFGI would like to comment on the applicability of the Proposed Rule to financial guaranty insurers' legacy portfolios and loss mitigation activities within such legacy portfolios.

Of note, in accordance with the SEC and Commodity Futures Trading Commission (the "CFTC") joint rulemaking defining swaps and security-based swaps ("SBS") dealers and major participants, AFGI members are currently conducting calculations to determine whether they meet the threshold for registration as MSBSPs.

[1] 77 Fed. Reg. 70,214 (Nov. 23, 2012).

I. Overview of the Financial Guaranty Insurance Industry

Financial guaranty insurers have historically provided insurance policies in both U.S. and international public finance, infrastructure, and structured finance markets. Such insurers apply their credit underwriting judgment, risk management skills, and capital markets experience to provide insurance and reinsurance products, including the insurance of principal and interest payments on U.S. municipal bonds issued by state and municipal governmental authorities and by utility districts and facilities. AFGI members also insure securities issued to finance international infrastructure projects, and asset-backed securities.

In addition to issuing financial guaranty insurance policies directly covering third party obligations, prior to 2009 financial guaranty insurers also wrote insurance policies insuring credit default swaps ("CDS") provided by affiliated special purpose entities known as "transformers." The transformers' sole purpose was to sell credit protection, and they typically engaged in no business other than writing CDS insured by their affiliated insurers. Of note, <u>no</u> financial guaranty insurer has insured a new CDS transaction since 2009, other than in connection with loss mitigation and other remediation and restructuring efforts relating to existing books of business.

II. Applicability of Capital Requirements for MSBSPs

The Proposed Rule establishes that "a nonbank MSBSP would be required at all times to have and maintain positive tangible net worth."[2] The Proposed Rule notes that the tangible net worth standard is different than the net liquid assets test utilized for SBSDs because the entities that may need to register as nonbank MSBSPs "may engage in a diverse range of business activities different from, and broader than, the securities activities conducted by" SBSDs.[3]

We support the proposed requirement that MSBSPs maintain a positive tangible net worth. However, it is important that the SEC's proposed capital requirements not conflict with existing state insurance law requirements. For this reason, AFGI believes that any MSBSP standard should recognize and respect state insurance regulators' role in ensuring the capital adequacy of financial guaranty insurers, and should accordingly recognize that, in the case of a financial guaranty insurer, any positive tangible net worth requirement should be satisfied if an insurer maintains the minimum statutory capital and complies with the investment requirements under applicable insurance law. Moreover, to the extent that financial guaranty insurers use affiliates to write CDS that they in turn insure, and insofar as such affiliates are designated as MSBSPs, AFGI submits that the

[2] *Id.* at 70,256.

[3] *Id.*

positive tangible net worth test should refer back to the financial guaranty insurer itself – the entity that CDS counterparties look to for paying the affiliates' obligations under the insured CDS. The affiliates have never been intended to be capitalized at the level needed to pay the amounts due under the insured CDS. In referring back to the financial guaranty insurer in these circumstances, we reiterate that the existing capital requirements and investment restrictions imposed by state insurance regulators already appropriately ensure financial guaranty insurers' capital adequacy and liquidity.

The SEC's Proposed Rule also requires MSBSPs to establish, document, and maintain a system of internal risk management controls "to assist in managing the risks associated with their business activities, including market, credit, leverage, liquidity, legal, and operations risks."[4] Although AFGI recognizes the need for strong internal risk controls, it cautions the SEC against imposing unnecessarily burdensome, duplicative, and costly risk management controls on financial guaranty insurers. Indeed, the risk management processes of financial guaranty insurers are currently regulated extensively by state insurance law. AFGI believes that the SEC's Proposed Rule should utilize existing prudential guidance that has been codified by regulators who are familiar with the business model and risks presented by the particular MSBSP. Specifically, in the case of financial guaranty insurers, AFGI submits that the internal risk management controls required under applicable New York insurance law should be deemed to satisfy the risk management control requirements applicable to MSBSPs.[5] If a financial guaranty insurer is determined to be an MSBSP, it should be able to establish compliance with the SEC's Proposed Rule by virtue of compliance with the New York Department of Financial Services Circular Letter No. 14 (copy attached), which calls for the establishment of comprehensive internal risk management controls.

III. <u>Applicability of Margin Requirements for MSBSPs</u>

AFGI strongly supports the Commission's determination to include an exception from the Proposed Rule for account equity requirements for SBS legacy accounts.[6] Indeed, retroactively applying margin requirements to legacy SBS would undermine the expectations that the parties had when entering into the SBS, impose new burdens which would not effectively address policy considerations in the context of existing trades, and likely contravene applicable requirements of state insurance law by prioritizing one class of policy holders over another.

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[4] *Id.* at 70,257.

[5] *See* NYDFS Circular Letter No. 14, *Enterprise Risk Management* (2011).

[6] 77 Fed. Reg. 70,271 (Nov. 23, 2012).

The underlying agreements for legacy SBS were negotiated based on the law in effect at the time of execution, and the parties' understanding of that law informed their evaluation of the risks and benefits of such transactions. Further, as noted above, financial guaranty insurers are subject to extensive regulation by state insurance authorities, and their SBS guarantees reflect the restrictions and obligations imposed by those regimes.

For transactions executed after the compliance date, SBS dealers, MSBSPs, and their counterparties all will be on notice of the new regulatory regime and will be able to structure transactions accordingly. In contrast, with regard to legacy transactions, financial guaranty insurers and their counterparties would not be afforded the same opportunity. Thus, applying new rules to legacy transactions would be highly disruptive and could have financial consequences that neither party foresaw or desired. There is also no added benefit to applying the new rules to legacy transactions as such application would not further the SEC's stated objectives of protecting investors and promoting efficiency, competition, and capital formation. For these reasons, AFGI agrees with the SEC's determination to include an exception for account equity requirements for SBS legacy accounts.

Moreover, in response to the SEC's request for comments on whether a nonbank MSBSP should be required to calculate a daily margin amount for each counterparty,[7] AFGI emphasizes that financial guaranty insurers should not be required to calculate a daily margin in respect of their legacy portfolios. The types of derivatives that financial guaranty insurers have guaranteed are bespoke positions for which quoted market prices are not available. Accordingly, financial guaranty insurers necessarily have developed a methodology for defining the appropriate fair value of a transaction (1) based on internally developed models that input market-based or independently sourced market parameters such as yield curves, interest rates, and debt prices, or (2) with the assistance of an independent third-party using a discounted cash flow approach and the third party's proprietary pricing models. In addition to this information, models also incorporate transaction details such as the maturity of the instrument and contractual features designed to reduce an insurer's credit exposure (e.g. rights to collateral). These inputs are not readily available and, accordingly, the fair value of a financial guaranty insurer's legacy portfolio is not easily determined – making it impractical, if not impossible, to calculate a meaningful daily margin amount and also marginalizing any benefit that might be obtained from having daily, as opposed to less frequent, marks.

AFGI members generally mark their legacy portfolio to market (if at all) once per quarter (in connection with preparation of their quarterly financial statements), given that more frequent calculations are not required by the contracts or counterparties, and the additional processes required for more frequent calculations would impose significant burdens without commensurate benefits. As explained above, requiring such calculation

[7] *Id.* at 70,263.

would be burdensome, would not provide any discernible benefit for market participants, and would not satisfy any existing need given the bespoke nature of financial guaranty insurers' legacy portfolios.

A. Loss Mitigation Activities

Prior to proposing this rule, the SEC and the CFTC finalized the swap and SBS definitional rule in August 2012. The joint definitional rule established an Insurance Grandfather provision expressly excluding insurance transactions entered into on or before October 12, 2012 from the swap and SBS definitions.[8] This Proposed Rule's SBS legacy account exception from account equity requirements is consistent with the finalized joint definitional rule and its Insurance Grandfather provision. However, the joint definitional rule did not specify the intended treatment of legacy insurance transactions that are later modified for loss mitigation or credit strengthening purposes.

The SEC's Proposed Rule now requests public comment on "What should be deemed a legacy security-based swap? For example, if a nonbank SBS dealer holds an existing legacy security-based swap that is subsequently modified for loss mitigation or credit strengthening purposes, should this be deemed a new security-based swap transaction or should it continue to be treated as a legacy security-based swap?"[9] In response to this request for comment, AFGI submits that SBS legacy accounts (and the SEC's proposed SBS legacy account exception) should encompass transactions amending legacy portfolios (i.e. those entered into on or before October 12, 2012). In particular, AFGI believes that, when a financial guaranty insurer amends an existing insured swap or enters into another swap in connection with loss mitigation or credit strengthening efforts and does not increase the principal amount insured, its activities should not be viewed as creating new derivatives. For example, an insurer may seek to adjust the pool of reference obligations, increase its deductible, or amend the applicable margin requirements.

Financial guaranty insurers sometimes seek to offset exposure on existing insured securities, swaps, and SBS by obtaining CDS protection from the beneficiary of the existing insurance in a situation where it is impractical to cancel the insurance. This situation may arise where an insurer seeks to cancel insurance on an insured bond held by *one* bondholder, but where the insurance policy is held by a bond trustee for the benefit of *all* holders of the insured bond issue. Where cancelling or amending the insurance policy may be impractical, the insurer may implement an arrangement with the

[8] Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,222-26 (Aug. 13, 2012).

[9] 77 Fed. Reg. 70,248 (Nov. 23, 2012).

consenting bondholder to write a CDS in favor of the insurer that offsets any amounts the bondholder may receive as a result of claims payments under the insurance policy. Requiring such CDS to include margin may have the effect of preventing insurers from implementing these de-risking transactions and increasing loss exposure for the insurers, at least insofar as a financial guaranty insurer may lack available assets to post as margin or otherwise be inhibited from providing collateral to a particular policyholder. Moreover, posting margin for legacy CDS counterparties may be prohibited by applicable insurance regulators to the extent that doing so prioritizes one class of policyholders over another.[10]

For the reasons stated above, when a financial guaranty insurer amends an SBS legacy account for loss mitigation or credit strengthening purposes and without increasing the notional exposure, AFGI requests that such SBS and its underlying insurance continue to be considered a legacy account.

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We thank the Commission for the opportunity to comment on these matters. If you have any questions, please do not hesitate to contact me at [redacted] or [redacted]

Very truly yours,

Bruce E. Stern, Chairman

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[10] *See* NYDFS Circular Letter No. 19, *"Best practices" for Financial Guaranty Insurers* (2008).

Insurance Circular Letter No. 14 (2011)
December 19, 2011

TO: All Domestic Insurers and Public Health Law Article 44 Health Maintenance Organizations ("HMOs") (Collectively, "Insurers")

RE: Enterprise Risk Management

STATUTORY REFERENCES: N.Y. Ins. Law §§ 201, 301, 310, 1115, Articles 13 and 14.

Summary

Given the importance of risk management, the Department of Financial Services ("Department") expects every insurer to adopt a formal Enterprise Risk Management ("ERM") function. An effective ERM function should identify, measure, aggregate, and manage risk exposures within predetermined tolerance levels, across all activities of the enterprise of which the insurer is part, or at the company level when the insurer is a stand alone entity.

Discussion

The Department encourages all insurers to effectively manage enterprise risk. As used in this Circular Letter, enterprise risk means any activity, circumstance, event or series of events involving one or more affiliates of an insurer that, if not remedied promptly, is likely to have a material adverse effect upon the financial condition or liquidity of the insurer or its insurance holding company system as a whole.

The ERM function should be appropriate for the nature, scale, and complexity of those risks. Further, the Department recognizes that a dedicated ERM function may be impractical or too costly for small insurers.

The Department views ERM as a key component of the risk-focused surveillance process. An insurer that maintains an effective ERM function upon which examination teams may rely will assist the Department with performing a more efficient examination.

The Department recently has established evaluation criteria to assess an insurer's ERM practices. Specifically, the Department has implemented a process of evaluating an insurer's ability to identify, measure, aggregate, and manage risk exposures within predetermined guidelines across all activities. The Department expects to perform the evaluation in conjunction with the statutory examination, but may also conduct the evaluation as a stand-alone exercise. The evaluation includes obtaining an understanding of the ERM function through interviews, questionnaires, and other documentation to be supplied by the insurer. The Department will also substantiate and validate key components of the insurer's ERM function.

The insurers that the Department selects for an ERM evaluation will receive advance notice. If the Department intends to conduct the ERM evaluation in conjunction with the statutory examination, the Department will distribute a request for information with the standard pre-exam planning materials sent to the insurer prior to the examination. The Department will incorporate the results of the ERM evaluation into the standard exam process to enhance the risk-focused surveillance process.

When conducting an ERM evaluation, the Department will look for adherence to the following ERM function objectives:

- An objective ERM function, headed by an appropriately experienced individual with the requisite authority and access to the board of directors and senior management, that is adequately resourced and has competent personnel who are able to provide the insurer's board of directors and management with ongoing assessments of the insurer's risk profile.

- A written risk policy that delineates the insurer's risk/reward framework, risk tolerance levels, and risk limits. An insurer's ERM function should provide for the identification and quantification of risk under a sufficiently wide range of outcomes using techniques that are appropriate to the nature, scale, and complexity of the risks the insurer bears and are adequate for capital management and solvency purposes.

- A process of risk identification and quantification supported by documentation providing appropriately detailed descriptions and explanations of risks identified, the measurement approaches used, key assumptions made, and outcomes of any plausible adverse scenarios that were run. Prospective solvency assessments, including scenario and stress testing, should be a key component of the ERM function, as they can help highlight the impact of such scenarios and stresses on an insurer's future solvency. The insurer's ERM function should incorporate risk tolerance levels and limits in the policies and procedures, business strategy, and day-to-day strategic decision-making processes.

- In the context of its overall ERM framework, an insurer should consider a risk and capital management process to monitor the level of its financial resources relative to its economic capital and the regulatory capital requirements. Additionally, an effective ERM function should incorporate investment policy, asset-liability management policy, effective controls on internal models, longer-term continuity analysis, and feedback loops to update and improve ERM continuously.

- An insurer should address as part of its ERM all reasonably foreseeable and relevant material risks including, as applicable: insurance; underwriting; asset-liability matching; credit; market; operational; reputational; liquidity; and any other significant risks associated with group membership. The assessment should include identifying the relationship between risk management and the level and quality of financial resources necessary as determined with quantitative and qualitative metrics.

- Additionally, an insurer's board of directors and senior management should contemplate having the insurer perform its own risk and solvency assessment ("ORSA") as part of the ERM function to assess the adequacy of its risk management and current and future solvency position. Insurers should keep current with NAIC developments with regard to reporting on their ORSA. The ability of an insurer to reflect risks in a robust manner in its own assessment of risk and solvency is a key component of an effective overall ERM function. Insurers should consider the guidance provided in the ORSA Guidance Manual when conducting their ORSA. An insurer should perform their ORSA on a regular basis and should share the results of the assessment with senior management and its board of directors.

- If an insurer is part of a holding company, consolidated enterprise, conglomerate, or other group characterized by common control or management, then the insurer's ERM function should identify, quantify, and manage any risks to which the insurer may be exposed by transactions, or affiliation, with the holding company or the other affiliates within the group. That is, the insurer should assess and identify methods to manage the impact of affiliated entities or the holding company on the insurer. If systems to perform these functions are located at the common control and management level (e.g., holding company), then the insurer should be able to demonstrate how those systems anticipate and mitigate or manage the risks to which affiliates expose the insurer. This demonstration should include not only those risks that may result in direct financial loss to the insurer through transactional or common control ties, but also reputational and other risks where the loss of confidence in one member of the group may cause distress to the insurance company.

An insurer that believes that any of the records it submits to the Department in connection with its ERM contain "trade secrets . . . or if disclosed would cause substantial injury to the competitive position of the subject enterprise" may request, pursuant to New York Public Officers Law § 87(2)(d), that the Department except such documents from disclosure pursuant to Public Officers Law § 89(5)(a)(1). Should the Department receive a request for records for which an insurer requested an exception from disclosure, the Department will notify the insurer and provide the insurer with an opportunity to respond in accordance with Article 6 of the Public Officers Law.

Conclusion

The Department views ERM as a key component of the risk-focused surveillance process, and expects every insurer to adopt a formal ERM function that identifies, measures, aggregates, and manages risk exposures within predetermined tolerance levels, across all activities of the enterprise of which the insurer is part, or at the company level when the insurer is a stand alone entity.

Please direct any questions or comments regarding this circular letter to Tim Nauheimer, Chief Risk Management Specialist, Markets Division, at (212) 709-1538 or timothy.nauheimer@dfs.ny.gov.

Very truly yours,

Matti Peltonen
Acting Executive Deputy Superintendent