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ASSOCIATION OF FINANCIAL GUARANTY INSURERS

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February 18, 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: Release No. 34-63452; File Number S7–39–10, Definitions (the "Proposed Interpretations")

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 on the Proposed Interpretations regarding the definitions of "swap dealer," "security-based swap dealer," "major swap participant" and "major security-based swap participant" pursuant to Title VII 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 evaluating the potential regulatory burden of their rulemakings under Title VII prior to adoption. Such an evaluation is consistent with President Obama's recent initiative to focus federal agencies on the proper balance between promoting economic growth and protecting the public interest.[1]

In the Proposed Interpretations, the Commissions requested comments on whether (a) state-regulated insurers should be excluded from regulation under certain

[1] Exec. Order No. 13563, 76 Fed. Reg. 3821 (Jan. 21, 2011).

aspects of Title VII; (b) the rules should exclude an entity from the definitions of major swap participant and major security-based swap participant if such entity's positions are limited to legacy portfolios; and (c) attribution of a swap or security-based swap position would be appropriate when third parties provide guarantees of swap or security-based swap obligations of unaffiliated entities.

For the reasons discussed in this letter, AFGI submits that (a) the Commissions should clarify that neither the definition of "swap" nor the definition of "security-based swap" encompasses insurance policies issued by state-regulated insurers (as a subsidiary matter, the exclusion of state-regulated insurers from the definitions of major swap participant and major security-based swap participant also would address some of AFGI's concerns); (b) financial guaranty insurers and their affiliated "transformers" (described below) that have ceased adding new swap and security-based swap transactions to their insured portfolios should not be characterized as swap dealers, security-based swap dealers, major swap participants or major security-based swap participants based on their legacy portfolios; and (c) attribution to a financial guaranty insurer of swap or security-based swap positions would not be appropriate when the insurer guarantees a swap or security-based swap obligation of an unaffiliated entity.

Overview of the Financial Guaranty Industry

Financial guaranty insurers provide 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 develop insurance and reinsurance policies, 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 local governmental authorities, utility districts and facilities, notes and bonds issued to finance international infrastructure projects and asset-backed securities issued by special purpose entities to provide financing for companies in the United States and internationally. 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. Smaller and lower-rated issuers rely on financial guaranty insurance to increase market liquidity. In fact, the majority of transactions insured by financial guaranty insurers in 2010 were small issuances – the average par amount of new insured issues was less than $20 million – usually by small and lower-rated issuers such as cities, towns and school districts that would not have been able to access the market without insurance. These policies also benefit investors, as the marketability and trading prices of otherwise illiquid, uncommon or complex debt obligations, as well as those issued by infrequent issuers such as rural municipalities, are generally improved by the application of a financial guaranty insurance policy.

In addition to issuing financial guaranty insurance policies directly covering third party obligations, prior to 2009 financial guaranty insurers also wrote policies insuring CDS of 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. No financial guaranty insurer has insured a CDS transaction since early 2009, other than in connection with loss mitigation and other remediation and restructuring efforts relating to existing books of business.

Exclusion of State-Regulated Insurers from the Definitions of Major Swap Participant and Major Security-Based Swap Participant

The Commissions have requested comments on whether state-regulated insurers should be excluded from the major swap participant and major security-based swap participant definitions on the grounds that such entities do not present the risks that are the focus of Title VII, and to avoid duplication of existing regulation. Exclusion of state-regulated insurers from the definitions of major swap participant and major security-based swap participant would address some of AFGI's concerns. However, as discussed in more detail below, AFGI submits that, as a preliminary matter, the definitions of "swap" and "security-based swap" should be interpreted by regulation to clarify that they exclude insurance policies, including financial guaranty insurance policies and surety bonds, issued by state-regulated insurers. Without such clarity, market participants are unable to thoughtfully gauge the impact of the proposed rules because they do not know what activity would be considered "swap" or "security-based swap" activity.

The McCarran-Ferguson Act Precludes the Regulation of Insurance, Including Financial Guaranty Insurance, as Swaps or Security-Based 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]

Title VII provides that swaps and security-based swaps are not to be considered insurance and the states may not regulate them as such,[5] thereby defeating recent state proposals to regulate as insurance all CDS, including those issued by banks and other financial institutions. Congressional intent to maintain exclusive federal jurisdiction over swaps and security-based swaps does not, however, suggest a similar intent to mandate the federal regulation of products long recognized and regulated as insurance. In fact, characterizing transactions already regulated as insurance as swaps or security-based swaps, together with the Dodd-Frank Act's prohibition on state regulation of swaps and security-based swaps, would have the perverse effect of displacing a currently active, substantial and comprehensive state regulatory regime with a regime not designed to

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[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).

[5] Dodd-Frank Act §§ 722, 767.

regulate insurance. There is no evidence that Congress intended to do this, and much evidence that it did not.[6]

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 and other provisions of the New York Insurance Law apply to all financial guaranty insurers incorporated or licensed in New York and impose comprehensive requirements on financial guarantors, including: 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.[7]

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,[8] 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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[6] For example, 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.

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

[8] 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 and Security-Based Swaps

There are numerous substantive differences between financial guaranty insurance policies (and surety bonds) issued in connection with the offering of a covered security and CDS contracts issued in reference to an obligation. While CDS may be used to hedge a wide range of exposures, such contracts also may 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. Similarly, unlike CDS that are independent of the underlying obligation, a financial guaranty insurance policy is inseparable from the covered security and necessarily trades with such security. In other words, a financial guaranty insurance policy is effectively part of the security to which it is attached and does not require any performance by the policy beneficiary (other than possession of the underlying obligation).[9]

Financial guaranty insurance policies generally pay interest shortfalls over time and principal when scheduled to be paid 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, 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). Because financial guaranty insurance policies do not provide for any mark-to-market termination payments(unless they guarantee CDS termination payments), such policies are not subject to the same volatility as CDS.

Further, 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, whereas the rights of CDS counterparties are generally much more limited. Financial guaranty insurance provides the insured securityholder with comfort that: (i) the underlying obligation was

[9] The Commissions have recognized a similar difference between swaps as opposed to securities and commodities by noting that swaps "are notional contracts requiring the performance of agreed terms by each party." 75 Fed. Reg. 80174, 80176 (Dec. 21, 2010).

underwritten by the insurer to comply with its underwriting standards requiring an investment grade underlying obligation; (ii) performance of the obligation will be monitored by the insurer over the life of the obligation; and (iii) the insurer will be responsible for controlling any remediation activities should that become necessary, with respect to the underlying obligation.

As a further distinction, an insured bond generally carries a rating based upon the higher of the rating of the insurer and the rating of the underlying obligation, which does not apply in the case of CDS.

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[10]and treatment of CDS addressed under ASC 815.[11] 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 Did Not Intend to Address Substantive Federal Regulation of Insurance in the Dodd-Frank Act

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. Barney Frank (D-MA), former Chairman of the House Financial Services Committee, stated after the passage of the Dodd-Frank Act that legislation regarding federal regulation of insurance, including an optional federal charter, was yet to come. Accordingly, we submit that Congress views substantive federal regulation of insurance as a topic for consideration in the future and not a bridge already crossed by the Dodd-Frank Act.

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

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

Exclusion of Legacy Portfolios in Determining Swap Dealers and Security-Based Swap Dealers

For the reasons set forth below, the Commissions should, for the avoidance of doubt, clarify that an entity may not be designated as a swap dealer or security-based swap dealer based solely on discontinued business activities.[12]

The Statutory Definitions of Swap Dealer and Security-Based Swap Dealer Solely Contemplate Current Swap Dealing Activities

The Dodd-Frank Act defines "swap dealer" as "any person who– (i) *holds* itself out as a dealer in swaps; (ii) *makes* a market in swaps; (iii) regularly *enters* into swaps with counterparties as an ordinary course of business for its own account; or (iv) *engages* in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps."[13] Significantly, the qualifying activities are defined in a functional manner, encompassing the nature of a person's activities in the market. In addition, Title VII makes it illegal "to act as a swap dealer unless . . . registered as a swap dealer,"[14] which provides further evidence of the statutory focus on a person's current actions and not its past activities. Similar provisions apply to security-based swaps.

While we support the Commissions' view that the definitions should not be interpreted in a constrained manner, we believe that the legislative intent, when Congress cast these definitions in the present tense, was to limit the designations as swap dealer or security-based swap dealer solely to persons who currently or on an ongoing basis engage in swap or security-based swap dealing activities.

Designation as a Swap Dealer or Security-Based Swap Dealer Based on Discontinued Business Activities Would Do Little to Promote Title VII Policy Goals

Title VII provides business conduct standards to promote fair dealing and codifies best practices and reporting and recordkeeping requirements to reduce risk and

[12] For the reasons set forth above, we assume that financial guaranty insurance is not a swap or security-based swap under the Dodd-Frank Act and therefore exclude such insurance policies from our discussion of the definitions of "swap dealer" and "security-based swap dealer."

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

[14] Dodd-Frank Act §§ 731, 764.

enhance operational standards.[15] These and related requirements, however, address the execution of swaps and security-based swaps and supporting activities. As such, application of these standards to those who no longer enter into new swap or security-based swap transactions would do little to advance these policy goals.

We recognize and support Title VII's goals of increasing swaps and security-based swaps market integrity and reducing counterparty risk through the improved soundness of its participants.[16] Requiring an entity to comply with capital and margin requirements with respect to legacy portfolios, however, could actually reduce the stability of the market. In addition, the retroactive application of margin requirements to private bilateral contracts, which were specifically negotiated to exclude such terms, could be detrimental to the financial condition and liquidity of the counterparties. Moreover, compliance with margin requirements, even if possible, would also subordinate insured municipal bondholders and other policyholders to CDS counterparties (generally large financial institutions).

We agree with Chairman Gensler and Chairman Schapiro, who recognized this risk when they testified before the Senate Banking Committee and indicated that margin requirements "should be prospective, not retrospective" and that the Commissions "would be hard pressed to suggest that there ought to be retroactive application of margin."[17] Similarly, the application of new capital requirements to entities whose swap and security-based swap positions are limited to legacy portfolios would not advance the policy goals of Title VII.

To avoid uncertainty, the interpreting regulations should specify that entities are not to be designated as swap dealers or security-based swap dealers solely based on discontinued activities.

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[15] Dodd Frank Act § 731, 764.

[16] We also recognize Title VII's goal of transaction transparency but respectfully submit that designation as a swap dealer or security-based swap dealer is a secondary method for providing the appropriate information to the market and the Commissions because Title VII and the Commissions' rules require the reporting of all swaps and security-based swaps, regardless of the counterparties' status.

[17] *Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. (2010).

<u>The Definitions of Major Swap Participant and Major Security-Based Swap Participant</u>[18]

The definitions of "major swap participant" and "major security-based swap participant" focus on the market impacts and risks associated with an entity's swap and security-based swap positions.[19] The Commissions have requested comment on whether the proposed rules further defining major swap participant and major security-based swap participant should exclude certain entities that maintain legacy portfolios of credit default swaps that previously had been entered into in connection with the activities of monoline insurers.[20] We believe that further regulation of such entities as major swap participants or major security-based swap participants would do little to reduce market risk.

<u>Designation as a Major Swap Participant or Major Security-Based Swap Participant Based on Discontinued Business Activities Would Do Little to Promote Title VII Policy Goals</u>

In particular, no financial guaranty insurer has insured a CDS of an affiliated transformer since early 2009, other than in connection with loss mitigation and other remediation and restructuring efforts relating to existing books of business, and it is unlikely that any existing financial guaranty insurers would write policies covering transformer CDS in the future.[21] Additionally, state insurance departments have undertaken significant efforts to address the impact of the economic crisis on financial guaranty insurers, including the impact on their legacy CDS portfolios, in an orderly manner that limits claims jumping and avoids larger systemic impact.

By definition, legacy portfolios present a risk to the market that diminishes as a result of the passage of time without the addition of new business. Not only does the aggregate outward exposure of an entity's portfolio decline over time, but the number of

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[18] For the reasons set forth above, we assume that financial guaranty insurance is not a swap or security-based swap under the Dodd-Frank Act and therefore exclude such insurance policies from our discussion of the definitions of "major swap participant" and "major security-based swap participant."

[19] 75 Fed. Reg. 80174, 80185 (Dec. 21, 2010).

[20] *Id*. at 80202 (Dec. 21, 2010).

[21] Obviously any new CDS transactions would not benefit from an exclusion for legacy transactions and would have to be analyzed in the context of the regulatory framework in place at the time.

individual institutions facing the entity decreases as the transactions expire. Because the run-off swap and security-based swap portfolios insured by financial guaranty insurers are confined to affiliated special purpose vehicles who do not conduct any other business activities, the related risk to the insurers is also more transparent and isolated. In addition, the fact that many financial guaranty insurers have already undergone significant restructurings since the crisis, without meaningful impact on the broader financial services sector, indicates that financial guaranty insurers do not present the systemic risk at issue in Title VII.

Policy concerns that justify considering only the current activities of an entity for purposes of the definitions of swap dealer and security-based swap dealer apply equally to the definitions of major swap participant and major security-based swap participant. That is: (a) the business conduct standards are only relevant in the context of on-going business activities; (b) the retroactive application of margin and capital requirements would be unnecessarily and unfairly disruptive if applied to legacy portfolios; and (c) the recordkeeping and reporting requirements of Title VII are adequately addressed without the designation of financial guarantors or their transformers as major swap participants or major security-based swap participants. As a result, an entity should not be deemed to be a major swap participant or major security-based swap participant solely as a result of its holding a legacy portfolio of swaps or security-based swaps.

Swaps and Security-Based Swaps of Unaffiliated Entities Should Not Be Attributed to Financial Guaranty Insurers Which Guarantee the Swaps or Security-Based Swaps as Part of their Basic Business

The Commissions have requested comment on whether attribution of swap and security-based swap positions would be appropriate when third parties provide guarantees on behalf of unaffiliated entities and, similarly, whether the major swap participant and major security-based swap participant definitions should be interpreted to encompass an entity that provides a guarantee of a named swap or security-based swap counterparty's obligations.

In addition to the activities of transformer affiliates described above, financial guarantors have often guaranteed, through the issuance of a financial guaranty insurance policy, the obligations of unaffiliated parties under swaps with other unaffiliated parties. These insurance policies typically cover obligations of municipalities under interest rate or basis swaps relating to bonds issued by municipalities or in connection with asset-backed securities. During the past decade, these swaps played a significant role in the financing activities of many municipal issuers, and the combination of swaps and financial guaranty insurance has often helped municipalities lower and stabilize their borrowing costs. As such, these policies are an integral part of financial guarantors' basic business.

In a typical transaction of this nature, a municipality issues floating-rate bonds at the same time that it enters into a floating-to-fixed rate swap with the bank that is underwriting the bonds. The financial guaranty insurer will issue two policies: one to protect bondholders from the municipality's default on the bonds, and the other to protect the bank from the municipality's default on the swap. However, because the bank continues to pay the floating-rate leg of the swap even if the municipality has defaulted on the swap (because the financial guarantor makes the fixed-rate payments), the financial guarantor's exposure is of the same character or risk profile as a guarantee on a fixed-rate bond issued by the municipality. In the vast majority of these types of policies, the financial guarantor is not exposed to the fluctuating termination value of the interest rate swap, as it does not guarantee payment of that amount. In every case, the decision to provide the financial guaranty insurance is part of the standard underwriting process at the financial guarantor. This is the fundamental business of financial guarantors and is therefore subject to the comprehensive risk management, capital, regulatory and other constraints discussed in more detail above.

As a result, the swap obligations of municipalities which benefit from financial guaranty insurance policies should not be attributed to the provider of the policy for purposes of the definitions of major swap participant and major security-based swap participant.

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For the reasons stated above, the Commissions should clarify by regulation that: (1) the definitions of "swap" and "security-based swap" exclude insurance policies, including financial guaranty insurance policies and surety bonds; (2) an entity may not be designated as a "swap dealer," "security-based swap dealer," "major swap participant" or "major security-based swap participant" based on discontinued business activities; and (3) a named swap or security-based swap counterparty's position should not be attributed to an unaffiliated entity guaranteeing such counterparty's obligations through a financial guaranty insurance policy.

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 contact me at bstern@assuredguaranty.com or (212) 339-3482.

Sincerely,

Bruce E. Stern
Chairman, AFGI Government Affairs Committee