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ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty

July 9, 2004

By E-Mail -rule-comments@sec.gov

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609
Attn: Jonathan G. Katz, Secretary

Re: Asset Backed Securities
Release Nos. 33-8419, 34-49644 (File No. S7-21-04)

Ladies and Gentlemen:

This letter is submitted on behalf of the Association of Financial Guaranty Insurers ("AFGI") in response to the Commission's request for comments in Release Nos. 33-8419, 34-49644 dated May 3, 2004 (the "Release"). The Release sets forth proposals intended to address comprehensively the registration, disclosure and reporting requirements for asset-backed securities ("ABS") under the Securities Act of 1933 and the Securities Exchange Act of 1934 (the "Exchange Act"). AFGI is commenting on selected portions of the Release which affect disclosure and reporting standards with respect to financial guaranty insurance, as described below. As set out below, AFGI submits that (i) the proposed terms of Regulation AB relating to Exchange Act reports for transactions involving financial guaranty insurance may significantly discourage the use of financial guaranty insurance by ABS issuers, to the detriment of investors, (ii) the proposed itemized disclosures with respect to transaction expenses should be revised to avoid indirect sharing of price information among competitors, (iii) the Commission should consider allowing less disclosure with respect to underlying pool assets and other credit features where ABS are guaranteed by a financial guaranty insurer having a sufficient rating and (iv) the Commission should pursue expanded grandfathering provisions with respect to existing transactions.

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ACA Financial Guaranty Corporation ▪ Ambac Assurance Corporation ▪ Assured Guaranty Corp.
CDC IXIS Financial Guaranty North America, Inc. ▪ Financial Guaranty Insurance Company ▪ Financial Security Assurance Inc.
MBIA Insurance Corporation ▪ Radian Asset Assurance Inc. ▪ RAM Reinsurance Company Ltd. ▪ XL Capital Assurance Inc.

AFGI is the trade association representing the ten insurers and reinsurers of asset-backed securities and municipal bonds. AFGI member companies are ACA Financial Guaranty Corporation, Ambac Assurance Corporation, Assured Guaranty Corp. (formerly ACE Guaranty Corp.), CDC IXIS Financial Guaranty North America, Inc., Financial Guaranty Insurance Company, Financial Security Assurance Inc., MBIA Insurance Corporation, Radian Reinsurance Inc., RAM Reinsurance Company Ltd. and XL Capital Assurance Inc. In 2003, AFGI members insured $391.5 billion principal amount of securities in domestic and international markets, of which $120.4 billion were U. S. asset-backed securities. For more information about AFGI members, please see AFGI's website, www.afgi.org.

1. ABS issuers should not be directly responsible for Exchange Act financial statement reporting with respect to financial guaranty insurers

Financial guaranty insurance serves the interests of public investors in ABS transactions by irrevocably and unconditionally guaranteeing the scheduled payments of one or more classes of securities issued in an ABS transaction, in exchange for a risk premium paid from available cash flows in the ABS structure. A financial guaranty insurer underwrites what is almost always an already investment grade risk, and by providing its guarantee enhances the rating of the security and simplifies an investor's evaluation of the creditworthiness of the underlying asset pool and the effect of internal credit enhancement features such as subordination. The Commission notes in the Release its stated intent to consolidate and codify current staff positions relating to disclosures as to financial guaranty insurance. The scope of required disclosure as to financial guaranty insurance should, in any event, be considered in recognition of the status of financial guaranty insurance as an exempted security under Section 3(a)(8) of the Securities Act. Disclosures as to financial guaranty insurance have evolved through formal and informal understandings between the staff and AFGI members since an AFGI member insured its first SEC registered offering in 1986. In this context, the Exchange Act reporting provisions of Regulation AB as proposed may discourage the use of financial guaranty insurance and therefore work to the detriment of investors.

Market participants appreciate that where an ABS benefits from financial guaranty insurance, to some degree the underwriting of the ABS also involves an underwriting of the financial strength of the insurer. Both the ABS issuer and the underwriter of the ABS transaction, as well as the insurer itself, have responsibility for diligence and disclosure with respect to the financial statements of the insurer incorporated into the prospectus for the relevant securities.[1] Consents of the insurer's auditors are obtained for use of the insurer's financial statements, and the insurer enters into an agreement with the issuer and underwriter providing for customary representations and warranties in connection with due diligence and delivery of customary legal opinions.

[1] As the Commission notes in the Regulation AB Release, such financial statements are incorporated by reference into the disclosure for guaranteed ABS transactions pursuant to existing no action guidance. See Financial Security Assurance, Inc. (Jul. 16, 1993); MBIA Insurance Corp. (Sep. 6, 1996); and AMBAC Indemnity Corp. (Dec. 19, 1996).

The required disclosures with respect to financial guaranty insurers for the purposes of ongoing Exchange Act reports, however, are much less well understood in the market. A number of no action letters issued by the staff of the Commission with respect to ongoing Exchange Act reporting by ABS issuers have contemplated that issuers will incorporate by reference an insurer's financial statements in their periodic reports.[2] However, it would be fair to say that the actual practices of ABS issuers in incorporating an insurer's financial statements in ongoing reporting have been inconsistent – with such information being omitted in many instances from Exchange Act reports, or incorporated without required auditor consents -- and that the degree of responsibility assumed by an issuer when incorporating an insurer's information has not been well appreciated or understood. An ABS issuer has little or no access to an insurer for diligence or reporting purposes on an ongoing basis, and filings of periodic financial statements by an insurer are not coordinated or discussed in advance with the numerous ABS issuers whose structures may benefit from financial guaranty insurance.

Against this background, Regulation AB as proposed codifies a direct responsibility of each issuer of ABS which benefit from financial guaranty insurance for the content of the insurer's financial statements, for the full time that Exchange Act reporting applies to the insured transaction. Notably, the Commission has not proposed that an ABS issuer be required to provide any textual disclosure with respect to a financial guaranty insurer other than its financial statements, apart from the "general character of the business of such enhancement provider". (Section 229.1113(b)(1)(iii)). Similarly, the form of Section 302 certification proposed by the Commission does not impose on the ABS issuer the responsibility for making the same level of certification with respect to the financial statements of an insurer as would be the case for a corporate issuer's own financial statements. Nonetheless, even in the context of ABS issuers the Section 302 certification applies to all of the information contained in a Form 10-K filing, including the information incorporated by reference, and makes the signer of the certificate personally accountable for the information regarding the insurer. In the same vein, Section 229.1100(c)(1)(iv) allows incorporation by reference of information only where "[t]he filing incorporating the information by reference describes any and all material changes to the incorporated information which have occurred subsequent to the filing of the incorporated information," and it is the issuer who must make this determination with respect to the financial statement filings of an unaffiliated third party insurer. Thus, the Commission's proposed rule draws essentially no distinction between the responsibility of an ABS issuer for a financial guaranty insurer's financial statements, and the responsibility of the insurer itself.

Under existing market practices, an ABS issuer simply is not in a position to bear such direct responsibility in a meaningful manner. The Commission should appreciate the difficult position an ABS issuer is placed in when the issuer becomes responsible under the securities laws, on an ongoing basis, for the content of the financial statements of an unaffiliated third party. Absent a substantial change in market structure and practice, it is

[2] Volkswagen Credit Auto Receivables Corporation (May 9, 1997) (periodic filings "will include, if applicable, the audited or unaudited financials of the provider of the credit enhancement or notice of a material change in the rating assigned [to the insurer]"); see also First Union Residential Securitization Transactions, Inc. (April 1, 1997); American Express Credit Account Master Trust (December 6, 1996); Western Financial Auto Loans, Inc. (October 15, 1996); MLCC Mortgage Investors, Inc. (Feb. 23, 1996) (similar).

unrealistic to expect issuers of ABS to perform due diligence with respect to periodic filings of financial statements by insurers, to whom they have no right of access for such purpose. It is similarly unrealistic to expect the individual officer of an ABS issuer to attest to the accuracy of financial statement information being incorporated by reference for purposes of the Section 302 certifications required of an issuer pursuant to the Sarbanes-Oxley Act. The result will be that ABS issuers will be discouraged from using financial guaranty insurance, because the ABS issuer cannot assume liability for the insurer's financial statements in a responsible manner. And if issuers were actually to undertake the efforts needed to assume such liabilities consistent with due diligence, the attendant costs would similarly discourage the use of financial guaranty insurance. ABS issuers will therefore turn to other means to enhance the credit ratings of their securities, which may be much less well understood by investors.

Moreover, the burdens that would be placed on ABS issuers with respect to ongoing financial guaranty insurer information being incorporated by reference do not produce any significant incremental disclosure benefits to investors. Where the insurer is a reporting company (or where its financial statements are included in the filings of a reporting parent), the insurer and its auditors are of course already accountable for the accuracy of the information being provided to the Commission. Regardless whether an insurer (or its parent) files financial statements, however, all insurers provide financial statements to their insurance regulators, which generally are available to the public. Insurers may also provide financial statements and other information to nationally recognized municipal securities information repositaries ("NRMSIR's"), which the Commission permits to be included by referral in official statements for municipal securities pursuant to rule 15c(2)-12.

Nor does the additional direct liability of the ABS issuer for such information provides any significant benefit to investors. In the case of most ABS structures, the issuer will be a special purpose depositor having an insignificant capitalization. At the same time, such depositors do not have the capacity to perform any effective review of the insurer's financial statement information. This situation is distinct from that presented by the initial underwriting of a transaction, where the role of a broker-dealer as underwriter in a public distribution of securities adds both an additional source of due diligence with respect to the insurer, as well as a further accountable party with real capital at risk.

For purposes of Exchange Act reporting, the relationship between an ABS issuer and a financial guaranty insurer, after initial distribution of the guaranteed securities, is comparable to that of a depositor who is repackaging securities of an existing reporting company, but has no access to information regarding such underlying issuer for purposes of underwriting the repackaged securities. In this situation, the Commission recognizes the great difficulty of making an issuer and underwriter responsible for the information regarding the underlying issuer, weighed against the marginal benefit such responsibility would add to the available information for investors, and allows simply a reference to the publicly available information regarding the issuer. The Commission should strike a similar balance here: the proposed Regulation AB should be revised to provide that for purposes of an ABS issuer's Exchange Act reports with respect to securities for which credit enhancement is provided by an unaffiliated third party insurer having a sufficient credit rating,[3] financial statement information required with respect to the insurer in Exchange Act reports of the ABS issuer may be referred to in accordance with the standards of Section 229.1100(c)(2), if the insurer (or its parent company responsible for Exchange Act filings in which the insurer's financial statements are included) also meets one of the standards of Section 229.1100(c)(2)(ii). The Commission should also consider broadening Section 229.1100(c)(2)(ii) to include information filed with regulatory authorities and information filed with NRMSIR's. Such a term would encourage the use of financial guaranty insurance, which aids investors, without impairing in any respect the investing public's access to and ability to rely on the financial statement information respecting the insurer.

2. Regulation AB should not require itemized disclosure of the fees and expenses of credit support providers, trustees, and other service providers.

Section 229.1112(c) requires an itemized list of all of the fees and expenses payable out of the cash flows from the pool assets. This level of detail is not material to investors, may in some circumstances require disclosure of sensitive commercial information of parties providing services to the transaction and will have potentially anti-competitive consequences. Section 229.1112 should be revised to permit disclosure only of the total expenses paid from the cash flows, except where, in the context of the particular transaction, disclosure of a particular party's charges is material to investors.

In general, investors care about *total* fees and expenses – how much is to be paid and how much of it will be paid in the "waterfall" ahead of the investor. Therefore the disclosure to investors is sufficient if the total amount of the expenses that will be paid from the cash flows – or from each point in the waterfall – is described. To whom those expenses are paid and how much is paid to each party are immaterial to investors.[4]

[3] We express no view as to what the rating threshold ought to be. However, we note that most major monoline financial guaranty insurers are rated AAA. Some are rated lower, but the nature of the business – such insurers essentially sell their rating – ensures that they must be well rated.

[4] We recognize that there are exceptions to this general conclusion. For example, the details of the fees paid to a pool asset manager or servicer may be important to understanding the economic incentives that manager or servicer has in the transaction and the influence of those incentives on its behavior. Disclosure of such detail should be required where it is material.

At the same time, disclosure of itemized expenses has at least two potential negative consequences. First, it may require disclosure of information that is confidential from the perspective of persons providing services and receiving payments. For example, a trustee or a financial guaranty insurer may not want it known to competitors or other customers that it has made a price concession to the sponsor of a particular transaction. Indeed, concerns about other customers demanding similar concessions might deter the service provider from offering its best price in public deals – to the detriment of investors. Second, the disclosure has the effect of creating a mandatory price sharing mechanism among competing service providers, with potentially anti-competitive results. Each provider could, simply by reviewing Commission filings, know reliably and exactly what its competition is charging for the same services.

Therefore we recommend that, instead of requiring an itemization of expenses, Section 229.1112(c) require disclosure of the total expenses payable from the deal cash flows or of an assumed cap on total expenses. If payment of such expenses is to be made at several points in the waterfall – for example, if certain expenses, or expenses in excess of a certain amount, are subordinated to some or all of the classes of securities offered – disclosure should be required of the expenses payable at each point in the waterfall. If the expenses are variable, disclosure of the ceiling on expenses or worst case amounts should be sufficient. Further disclosure of the expenses paid to particular parties, especially participants in the transactions, should be required only where the information is material.

3. The Commission should consider relaxing certain disclosure requirements when all payments on the securities are guaranteed by a highly rated financial guaranty insurer.

Regulation AB imposes a number of new disclosure requirements, including static pool delinquency and loss information (Section 229.1110(c)), financial information for swap or cap providers,[5] and, on an ongoing basis, information concerning breaches of representations or warranties (Section 229.1119(l)) and on ratios, coverage tests or other tests (Section 229.1119(m)). The Commission should consider which, if any, of these disclosures are unnecessary and could be omitted or reduced if the transaction benefits from a financial guaranty insurance policy written by a highly rated insurer.

[5] Financial information is required on any such person if it is contingently liable for 10% or more of the cash flows and financial statements are required if it is contingently liable for 20% or more of the cash flows. Section 229.1113(b)(2). Since the thresholds are not probability weighted, and since in extreme, and very unlikely, interest rate scenarios, swap or cap cash flows can often become arbitrarily large, this would often require full financial disclosure of all such arrangements, regardless of how important they were expected to be under realistic interest rate scenarios. Certainly, it will require disclosure in many cases where such information is not provided under current practice because an issuer judges it not to be material.

When their securities are unconditionally and irrevocably guaranteed by a highly rated financial guaranty insurer, investors normally, and rationally, are concerned less about the details of the pool assets, the other parties to the transaction and any ancillary credit support. In such circumstances, the investors are looking primarily to the credit and the rating of the insurer; the insurer, in turn, is responsible for – and is in part being paid for the service of -- underwriting the assets.[6] So, for example, if an insurer has insured all payments on the securities, a cap or swap in the transaction structure would have the effect of protecting the insurer against interest rate risk; the security holders are protected by the insurance policy. Only on the assumption of a default by the insurer, which for many insurers has a "AAA" likelihood of not occurring, do the credit characteristics of the swap counterparty become relevant for investors.

The Commission already recognizes this principle in the instructions to Section 229.1111(b) of Regulation AB as proposed. Where financial statements of a significant obligor of underlying assets in an ABS structure would otherwise be required, the Commission allows such information to be omitted where the significant obligor is guaranteed by a foreign government, without even disclosure as to the foreign government being required where the underlying assets are investment grade. The same principle ought to apply where a transaction is guaranteed by a sufficiently rated financial guaranty insurer. The Commission should thus consider whether some disclosures directed entirely or primarily at credit risk of the underlying assets – in particular disclosures of swap counterparty or other significant obligor financials -- should be omitted when all the publicly issued securities are insured by a financial guaranty insurance policy written by a sufficiently well rated insurer. AFGI would further propose that Regulation AB be revised to specify that an issuer may determine, in the context of a transaction guaranteed by a sufficiently well rated financial guaranty insurer and where the requirements as to Regulation AB disclosures regarding the insurer are met, that one or more of the detailed disclosure requirements as to the underlying pool assets are not material to investors, and accordingly omit them.[7]

4. The grandfather provisions of Regulation AB should permit transactions closed prior to the effective date of the regulation to report under preexisting law for so long as their securities are outstanding.

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[6] This is highlighted by the fact that AAA rated financial guaranty insurers are often asked to insure – and are paid a modest premium for insuring – classes of securities that already would carry a "AAA" rating without the benefit of the insurance.

[7] Again, we express no view as to what rating threshold the Commission should specify.

The release suggests that Regulation AB would be applied to outstanding transactions beginning six months after its effective date. However, because ABS are typically issued by special purpose vehicles with limited management and no assets beyond those securitized and dedicated to investors, it will be difficult or impossible for many existing transactions ever to comply with Regulation AB. Accordingly, the grandfather provisions should allow outstanding transactions to continue indefinitely reporting under current practice.[8]

Most ABS issuers are special purpose entities without active management; sometimes with no management at all. Their constitutional documents, whether a trust agreement, a limited liability company agreement or a corporate charter, are designed to allow the entity to run largely on "autopilot." Those documents will have provisions for SEC reporting that were designed to comply with the legal regime in existence when the transaction closed. There may be no party in the transaction who is responsible for any additional reporting for the transaction. Furthermore, because the transaction governance is "hard wired" into the documents, compliance with the new requirements of Regulation AB may require amending those documents. The amendment process, which may require consent of security holders, would be difficult and expensive and might in some circumstances be impossible.[9]

Finally, even if a transaction can be brought into conformance with Regulation AB, it will inevitably incur additional expense to do so. For example, as noted above, in Section 1, ongoing incorporation by reference of credit support providers' financial information may require additional payments to the credit support providers' auditors, whose consent is required. The typical transaction has no assets with which to pay those expenses except the pool assets, the cash flows from which are dedicated to its security holders.[10]

Accordingly, we recommend that outstanding transactions be grandfathered and enabled to use existing reporting practices until their maturity.[11]

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[8] We would, of course, recommend that outstanding transactions be permitted to adopt all or any part of Regulation AB that they desire. This would permit such transactions to adopt the new regime to the extent it is possible and not unduly burdensome for them to do so.

[9] For example, it may prove impossible to obtain the consent of holders of privately placed residual securities, who may perceive no benefit from the additional reporting and who will bear the costs noted in the text below.

[10] The cost benefit analysis and regulatory burden analysis for Regulation AB should take into account that, because of the limited recourse, special purpose entity, nature of most ABS transactions, the costs of compliance for existing transactions will fall almost entirely on whatever investor owns the residual or junior cash flows in the transaction. Those may be effectively retained by the sponsor of the transaction or an affiliate, but they need not be; such securities are often sold in private placements or pledged to support financing.

[11] As the Commission noted in the Regulation AB release, many ABS transactions can and do cease reporting after the fiscal year of their inception. For these transactions, the grandfather provisions may not be critical. An important exception is exchange listed transactions. One unintended consequence of subjecting existing transactions to Regulation AB might be delisting of transactions – resulting is loss of liquidity and perhaps value to their investors, as well as the investor transparency gained from the reporting they are now doing – to enable suspension of reporting.

We hope these comments will be helpful to the Commission and its staff. AFGI and its counsel would be please to respond to whatever questions the staff may have in considering these comments. If you have any questions regarding these comments or require any additional information with respect thereto, please feel free to contact Bruce Stern at Financial Security Assurance Inc. (telephone: 212-339-3482; e-mail: BStern@FSA.com) or Michael Mazzuchi at Cleary Gottlieb Steen & Hamilton (telephone: 202-974-1572; e-mail: mmazzuchi@cgsh.com).

Respectfully submitted,

/s/ Bruce E. Stern

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