

MEMORANDUM

TO: File
FROM: Richard Grant
RE: Meeting with Representatives from the Association of Financial Guaranty Insurers
DATE: August 10, 2012

On August 6, 2012, representatives from the Securities and Exchange Commission (“SEC”) met with representatives from the Association of Financial Guaranty Insurers (“AFGI”). The SEC representatives present at the meeting were Brian Bussey, Randall Roy, Joanne Rutkowski, Michael Gaw, Donna Chambers, Richard Gabbert, and Richard Grant. The AFGI representatives present at the meeting were Matthew Morse (Syncora Guarantee), James Lundy (Syncora Guarantee), Janet Moore (Radian Asset Assurance), Bruce Stern (Assured Guaranty), Ling Chow (Assured Guaranty), Willard Hill (MBIA), Gail Makode (MBIA), Teresa Casey (AFGI), Ethan James (Debevoise & Plimpton LLP), Carolyn Walsh (Patton Boggs LLP), and Mara Giorgio (Patton Boggs LLP).

At the meeting, the AFGI representatives provided their views and observations on the application of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act to financial guaranty insurers, including with respect to the definitions of “security-based swap” and “major security-based swap participant,” and applicable capital, margin, reporting, recordkeeping and business conduct requirements.



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ASSOCIATION OF FINANCIAL GUARANTY INSURERS

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SEC Meeting: Application of “Swap” Definitions and “Major Swap Participant” Requirements to Financial Guaranty Insurers

August 6, 2012

Background

- Financial guaranty (FG) insurance increases market efficiency, reduces borrowing costs for issuers and provides insurance, liquidity, underwriting, surveillance, remediation and other value to investors
- Prior to the financial crisis, FG insurers insured credit default swaps (CDS)
- Since 2009, FG insurers have ceased insuring new CDS
 - Outstanding CDS are running off rapidly
- Since 2009, only one group of FG companies (Assured Guaranty) has had material new business originations
 - One or more FG industry members expect to re-enter the market upon resolution of outstanding litigation or other impediments
 - A new FG mutual insurance company announced commencement of operations last month
- New business FG originations on an industry-wide basis consist predominantly of U.S. domestic municipal bond insurance

Background

- Traditional FG policies insure scheduled payments due on specific securities and should not be characterized as swaps or security-based swaps (SBS)
 - The insurance cannot be separated from the insured obligation
 - The insurer undertakes to pay the amount of any defaulted scheduled payment on the insured obligations in exchange for the right to receive the defaulted payment (unlike with CDS, a defaulted payment cannot trigger insurance payments by multiple counterparties)
 - The insurer's payment obligation equals the defaulted payment obligation (unlike with most CDS, the dollar amount of the insurer's payment obligation is not based on market value)

Loss Mitigation Activities

- Application of the rules could have an adverse impact on important loss mitigation activities of FG insurers, which tend to be heavily regulated transactions
- FG insurers sometimes seek to offset exposure on existing insured securities, swaps, and SBS by obtaining protection from the beneficiary of the existing insurance. Requiring such trades to include margin may have the effect of preventing such transactions and increasing losses.
- When an FG insurer amends existing insured swap or enters into another swap in connection with loss mitigation 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 revise the pool of reference obligations or increase its deductible

Loss Mitigation Activities

- Loss mitigation activities should be allowed to qualify for:
 - the insurance grandfather provision; or
 - the grandfather provision for margin (*i.e.* external business conduct rules) and other requirements
- Posting margin in excess of certain levels is prohibited by the New York Department of Financial Services
- An FG insurer in run-off is unlikely to have assets to post as margin

Ongoing Insurance of Third Party Interest Rate and Currency Swaps

- Insured bond transactions might include interest rate or currency swaps. In these cases, the FG insurer typically insures the issuer's obligation under these swaps.
 - Insuring these swaps provides credit protection to the issuer, swap counterparty, and insurer insofar as the insurance reduces the likelihood that the swap/hedge can be terminated as a result of an issuer-related termination event
 - AFGI seeks consideration of whether insuring these types of swaps should subject FG insurers to Dodd-Frank Act regulations of derivatives products
 - In this context, the Dodd-Frank Act allocation of jurisdiction over interest rate and currency swaps will impose CFTC regulation on a transaction already governed by the securities laws

Major Swap Participant Definition

- CFTC has indicated that it expects 5-6 institutions to be major swap participants or major security-based swap participants (MSPs)
- FG insurers would only qualify as MSPs because of their legacy portfolios.
- Would an entity be required to register as an MSP even if its legacy positions will decline below MSP thresholds within 12 to 24 months of the effective date due to projected run-off or terminations?
- If an entity's swap positions exceed the MSP thresholds when measured other than on a daily averaging basis (*i.e.*, quarterly), will it still be necessary to measure its positions daily?
 - The majority of members do not have the capacity or the resources to measure positions daily

Substantive Requirements for Legacy Portfolios

- Imposing requirements applicable to MSPs on currently regulated companies with legacy portfolios is arguably not beneficial to creditors of these entities or to the financial market in general.
 - Capital
 - Reporting for pre-enactment trades with non-swap dealers
 - Recordkeeping regarding positions and interactions with counterparties
 - Internal business conduct rules

- Will these requirements be applied in the same manner for entities registered due to their ongoing business and entities registered due to their legacy portfolios?
 - AFGI suggests that, for entities registered solely because of their legacy portfolios, the Commissions should consider a flexible approach to the application of such requirements
 - FG insurers are already subject to extensive state insurance law and regulations

 - What guidance will the SEC provide?

Substantive Requirements for Legacy Portfolios

- Capital requirements:
 - Capital requirements should not be applied to the legacy portfolios of FG insurers or their affiliated transformers that entered into CDS transactions
 - Requirements may conflict with existing state insurance law requirements
 - Insurance regulators are focused on ensuring no FG insurers will have a systemic impact and have been extensively involved in restructuring the FG insurers impaired by the financial crisis
 - Most industry members lack the means to comply with additional capital requirements
 - The consequences of non-compliance are unclear. Inability to comply may result in more losses and market disruption.

Substantive Requirements for Legacy Portfolios

- Reporting for Pre-Enactment Trades with Non-Swap Dealers (SDs)
 - Burden of creating new system for portfolios in run off; data captured at swap inception may not match data required to be reported
 - Many insured swaps are currently not subject to fair value accounting under GAAP, and valuing such swaps presents a significant burden for the insurers
 - Reporting requirements for MSPs would not apply when counterparties are SDs. However, many of the counterparties to the insurers are foreign financial institutions and their status as SDs is uncertain.

Substantive Requirements for Legacy Portfolios

- Recordkeeping regarding positions and interactions with counterparties
 - FG insurers are not conducting trading operations; portfolios are static or declining by natural terms and loss mitigation activity
 - FG activities and recordkeeping regarding portfolio are subject to regulation and supervision of state insurance regulators
 - Recordkeeping should not be overly burdensome and should reflect existing insurance regulation (*i.e.*, Circulars 14 and 19)
 - Mark-to-market valuations are ordinarily done quarterly to the extent applicable (many insured CDS are not subject to fair value accounting and therefore not subject to mark-to-market by the insurers)

Substantive Requirements for Legacy Portfolios

- Internal Business Conduct Rules—
 - Risk management
 - Business trading unit policies
 - Diligent supervision
 - Business continuity and disaster recovery
 - Information availability
 - Antitrust policies
 - Conflicts of interest
 - Designation of a CCO
 - Training
- We understand that the Commissions are focused on recordkeeping and risk management for those companies with legacy portfolios
- AFGI submits that existing recordkeeping and enterprise risk management requirements applicable to FG insurers sufficiently overlap with Dodd-Frank Act regulations, which target the risks posed by MSPs



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