

**A·F·G·I**  
**ASSOCIATION OF FINANCIAL GUARANTY INSURERS**  
**Unconditional, Irrevocable Guaranty**

March 14, 2013

Secretariat  
Basel Committee on Banking Supervision  
Bank for International Settlements  
Centralbahnplatz 2  
CH-4002 Basel  
Switzerland

Secretariat  
International Organization of Securities Commissions  
C/ Oquendo 12  
28006 Madrid  
Spain

Re: Public Comment on Second Consultative Document Regarding Margin Requirements for Non-Centrally Cleared Derivatives

Dear Basel Committee on Banking Supervision and International Organization of Securities Commissions:

The Association of Financial Guaranty Insurers (“AFGI”) appreciates the opportunity to provide the Basel Committee on Banking Supervision (“BCBS”) and the International Organization of Securities Commissions (“IOSCO”) with comments regarding its second consultative document on the *Margin Requirements for Non-Centrally Cleared Derivatives* (“Consultative Document”).<sup>1</sup>

AFGI supports the efforts of the BCBS and IOSCO to develop consistent international standards for margin requirements on non-centrally cleared derivatives. In particular, AFGI supports the phased implementation of the requirement to exchange two-way initial margin, which would minimize unnecessarily large liquidity, operation, and transition costs. In order to ensure the smooth implementation of such margin requirements in light of other existing regulatory requirements, this letter (1) outlines the main substantive differences between financial guaranty insurance policies and

---

<sup>1</sup> Basel Committee on Banking Supervision (“BCBS”) and International Organization of Securities Commissions (“IOSCO”), *Margin Requirements for Non-Centrally Cleared Derivatives*, Second Consultative Document (Feb. 2013).

derivatives, and (2) suggests that the BCBS and IOSCO provide clarification that financial guaranty insurance policies are exempt from the proposed margin requirements.

## **I. Overview of the Financial Guaranty Insurance Industry**

AFGI is a trade association of insurers and reinsurers of public finance obligations, infrastructure bonds, asset-backed securities (“ABS”), and other financial obligations. Financial markets employ financial guaranty insurance in order to help governmental and other issuers reduce their borrowing costs and provide investors with payment default protection, risk management, and improved liquidity for their investments. Financial guaranty insurance provided by AFGI members generally guarantees the timely payment of scheduled payments of interest and principal due on insured securities. Investors in insured securities may also benefit from the due diligence, surveillance, and remediation activities performed by financial guaranty insurers. Unlike a trustee or a credit rating agency, a financial guaranty insurer has capital at risk, more closely aligning its interests with those of the holders of the insured securities.

Currently, AFGI members are appropriately and directly regulated in Europe by the applicable sovereign insurance regulators (primarily the U.K. Financial Services Authority) and will be subject to the requirements imposed under “Solvency II”<sup>2</sup> once implemented. Similarly, in the United States, AFGI members are appropriately and directly regulated by the applicable state insurance regulators and are subject to the requirements imposed under state insurance law.

Financial guaranty insurers have discontinued certain business lines as a result of the financial crisis. Since 2009, financial guaranty insurers have ceased insuring credit default swaps (“CDS”) (other than in connection with remediation activities), residential mortgage-backed securities (“RMBS”), and collateralized debt obligations (“CDOs”) comprised of RMBS. Thus, new risk associated with these activities is no longer being originated, while existing risk in these sectors is running off.

## **II. Differences Between Financial Guaranty Insurance Policies and Derivatives**

In light of the many substantive differences between financial guaranty insurance policies and CDS (“traditional” derivatives), we understand that insurance contracts, including financial guaranty insurance policies, are not considered derivatives. AFGI has

---

<sup>2</sup> See European Commission, Amended Solvency II Proposal (Feb. 2008). Solvency II, which codifies and harmonizes insurance regulation in the European Union, addresses the risk of insolvency in the insurance industry by implementing a holistic approach to risk management. It takes into consideration capital standards as part of its quantitative requirements, and couples this consideration with governance, risk management, and transparency requirements. *Id.*

confirmed this understanding with the primary European regulator for its member companies (the U.K. Financial Services Authority) as well as with the European Commission in the context of discussing the application of the European Market Infrastructure Regulation (“EMIR”). Financial guaranty insurance differs from CDS in a number of material respects, including that:

- (1) financial guaranty insurance cannot be separated from, or traded apart from, the insured obligation, whereas CDS may not require the credit protection buyer to hold the obligation referenced by the CDS;
- (2) financial guaranty insurance generally applies to a specific security or other obligation to which the insurance is attached, whereas numerous CDS may reference the same single obligation resulting in a mismatch between the face amount of the reference obligation and the aggregate notional amount of the CDS referencing such obligation;
- (3) financial guaranty insurance generally insures scheduled payments of principal and interest on the insured obligations and does not permit acceleration of payments except at the option of the insurer, whereas CDS generally provide for a market value termination payment upon the occurrence of a “credit event”;
- (4) financial guaranty insurers generally have privity with the issuer of the insured obligations, and typically have rights and remedies in the event of an issuer default, whereas sellers of protection under CDS typically have few rights and no privity;
- (5) financial guaranty insurers are typically exposed to the credit risk of the obligor, with financial interests aligned with both the obligor and holder of the insured security, whereas CDS can be used to “short” or otherwise bet against obligor performance;
- (6) financial guaranty insurance serves a substantial public purpose in lowering borrowing costs for issuers, whereas CDS can be used for arbitrage and speculation in a “zero sum” arrangement between the credit protection seller and credit protection buyer;
- (7) financial guaranty insurance can be sold solely by licensed and regulated insurance companies whereas, historically, CDS could be provided by a wide range of potential counterparties; and
- (8) financial guaranty insurance is subject to accounting standards for revenue recognition and liability measurement, whereas CDS are generally subject to “fair value” accounting.

Market participants have long distinguished financial guaranty insurance policies from CDS. In addition, the Financial Accounting Standards Board has issued separate accounting guidance,<sup>3</sup> and entities dealing in both types of transactions are required to apply different accounting methodologies, including with respect to premium revenue recognition and claims liability measurements.

### **III. Insurance Contracts Are Not Subject to Margin Requirements**

Given the substantial differences between financial guaranty insurance policies and derivatives, and our understanding that financial guaranty insurance policies are not considered derivatives, AFGI understands that the proposed margin requirements for non-centrally cleared derivatives are not applicable to insurance policies and contracts, but suggests that the BCBS and IOSCO consider clarifying this distinction to eliminate uncertainty. Insurance generally contemplates that the insurer's premiums are pooled and generally available to pay claims. Accordingly, imposing margin requirements runs counter to the purpose of insurance, since margin effectively divides the insurer's assets among individual policyholders rather than allowing the collective assets to be available to pay policyholders if claims arise.

AFGI notes that financial guaranty insurers are already regulated extensively by applicable insurance law. For example, 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.<sup>4</sup> Such state laws generally prohibit or discourage collateralization of insurance policy exposures because collateralization would provide a preference for one policyholder over another policyholder in insolvency. Similarly, AFGI members are regulated in Europe by applicable sovereign insurance regulators, including primarily the U.K. Financial Services Authority. AFGI believes that clarifying that financial guaranty insurance policies are not subject to the Consultative Document's margin requirements would further the goal of harmonizing the international regulatory approach to the financial guaranty insurance industry.

\* \* \* \*

We thank the BCBS and IOSCO for the opportunity to comment on its

---

<sup>3</sup> See Financial Account Standards Board, ASC 944: Financial Services – Insurance; *see also* Financial Account Standards Board, ASC 815: Derivatives and Hedging.

<sup>4</sup> See New York Insurance Law §§ 6901-6909.

March 14, 2013  
Page 5 of 5

Consultative Document on *Margin Requirements for Non-Centrally Cleared Derivatives* and appreciate their attention to the recommendations highlighted by AFGI in this letter. If you have any questions, please feel free to contact the undersigned at [bstern@assuredguaranty.com](mailto:bstern@assuredguaranty.com) or (212) 339-3482.

Sincerely,

A handwritten signature in blue ink, appearing to read "Bruce Stern". The signature is fluid and cursive, with the first name "Bruce" and last name "Stern" clearly distinguishable.

Bruce E. Stern, Chairman