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

June 26, 2013

*Submitted via e-mail: baselcommittee@bis.org*

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Basel, Switzerland

Re: Consultative Document: Supervisory Framework for Measuring and Controlling Large Exposures

The Association of Financial Guaranty Insurers ("AFGI") appreciates the opportunity to provide the Basel Committee on Banking Supervision ("Basel Committee") with its comments on the proposed supervisory framework for measuring and controlling large exposures ("Proposed Framework").[1]

AFGI, a trade association representing the unique perspective of financial guaranty insurers and reinsurers, agrees with the Basel Committee's inclusion of guarantees and credit derivatives as credit risk mitigants under the Proposed Framework. Indeed, AFGI believes that recognition of financial guaranty insurers as eligible protection providers is appropriate and consistent with the Basel III risk-based capital standard framework for banking organizations. AFGI also emphasizes that financial guaranty insurers are appropriately regulated through existing insurance laws in the United States and abroad.

Although the Proposed Framework appropriately recognizes guaranteed transactions, such as those insured by AFGI members, we are concerned about the effects of the substitution approach for reducing a bank's exposure based on credit risk mitigation techniques. AFGI believes that, absent modification, the proposed substitution approach for credit risk mitigants will inevitably result in an extraordinary overstatement of risk exposures. Particularly, AFGI submits that banks should have the choice whether to shift exposures to eligible protection providers in the case of eligible guarantees.

[1] Basel Committee, Consultative Document: Supervisory Framework for Measuring and Controlling Large Exposures (March 2013).

## I. Overview of Financial Guaranty Insurance and Existing Regulatory Framework

AFGI submits that the existing regulatory regime for financial guaranty insurers, as described herein, is sufficient to ensure their capacity to perform on their guarantee obligations.

The financial guaranty insurance industry is a monoline insurance industry, participating in financial guaranty insurance and related products only – financial guarantors may not write traditional property/casualty insurance or life insurance. As a result, financial guaranty insurance companies are operated as separately capitalized entities, providing guaranties of financial obligations only. This separation minimizes the systemic connection between financial guaranty insurers and other "traditional" property/casualty or life insurers upon an economic downturn, providing an additional level of protection to the marketplace. Financial guaranty insurers do not participate in insurance security funds, such that the insolvency of a financial guaranty insurer will not risk contagion to consumer-oriented insurers such as automobile, home, or life insurers.

Issuers generally use financial guaranty insurance when applying such insurance would result in lower overall financing costs than would otherwise result from issuing securities on an uninsured basis. Insofar as financial guaranty insurance is used predominantly in connection with financing obligations of public issuers and projects serving a substantial public purpose (such as schools, water and other utilities, public hospitals, and roads), financial guaranty insurance itself serves a substantial public purpose by lowering the financing costs for such public issuers and projects. Further, financial guaranty insurers have discontinued certain business lines as a result of the financial crisis. Particularly, 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 in run-off.

Financial guaranty insurers' activities are regulated at the State level in the United States. The New York State Department of Financial Services ("DFS") is the primary prudential regulator for most United States financial guaranty insurance companies, and those domestic insurers that are not domiciled in New York are licensed to issue financial guaranty insurance under New York Insurance Law Article 69 ("Article 69") and are therefore also subject to regulation by the DFS.[2] Since its adoption, Article 69 and other provisions of the New York Insurance Law have provided the regulatory standard for the industry, implementing a comprehensive regulatory framework. This framework includes market conduct rules, financial reporting standards, contingency reserves, single and aggregate risk limits, investments requirements, and regulatory examinations.

[2] N.Y. Code ISC Insurance §§ 6901-09 (2010).

Additionally, financial guaranty insurers domiciled in Europe and Bermuda are regulated appropriately and directly by the applicable sovereign insurance regulators in Europe, and will be subject to the requirements of the Solvency II Directive when implemented.

More broadly, and in accordance with the Basel Committee's concern regarding "material losses in one systemically important financial institution (SIFI) [that] can trigger concerns about the solvency of other SIFIs,"[3] it is important to note that the International Association of Insurance Supervisors (IAIS) is currently examining potential global insurance industry risks. Particularly, IAIS is in the process of assessing industry participants regarding the "potential systemic importance of some institutions and significant disruption to the global financial system and economic activity."[4]

Given the nature of financial guaranty insurers' business and the existing regulatory systems described above, AFGI believes that no additional requirements for eligible protection providers are necessary. Further, recognition of financial guaranty insurers as eligible protection providers appropriately recognizes the oversight that State insurance law and State insurance regulators provide, and the value that financial guaranty insurers add.

## II. <u>The Proposed Substitution Approach for Risk Mitigation Techniques May Result in an Extraordinary Overstatement of Risk Exposures</u>

*Risk Exposure to Eligible Protection Providers*

In its Proposed Framework, the Basel Committee notes that, "when banks use eligible credit risk mitigation techniques (funded or unfunded credit protection), the effects of these techniques on the maximum possible loss should be reflected in a reduction in the exposure value."[5] As a result, the Proposed Framework allows banks to reduce their credit exposure to a counterparty by obtaining eligible guarantees such as financial guaranty insurance. The rule requires "a one-for-one reduction in the underlying exposure by the amount of the hedge (guarantee, credit derivative or financial collateral)."[6]

[3] Basel Committee, Consultative Document: Supervisory Framework for Measuring and Controlling Large Exposures, p. 2 (March 2013).

[4] International Association of Insurance Supervisors, *The IAIS Proposed Assessment Methodology for Global Systemically Important Insurers* (May 31, 2013).

[5] Basel Committee, Consultative Document: Supervisory Framework for Measuring and Controlling Large Exposures, p. 9 (March 2013).

[6] *Id.* at 13.

Additionally, the bank is required to "risk-weight this amount using the risk-weight of the credit risk mitigation provider" in accordance with the Basel Committee's risk-based capital requirements.[7]

AFGI is concerned about the requirement to fully shift exposures to eligible protection providers in the case of eligible guarantees. We believe that such a requirement would overstate the exposure that banks have to eligible protection providers such as financial guaranty insurers, since the actual incremental risk exposure that a bank securityholder has to an insurer of a security is a function of the credit worthiness of the underlying obligor on such security. In other words, shifting the entire notional exposure of an insured security to the insurer assumes that the underlying obligor on the security fails to pay even in part.

If this proposed methodology was applied to a large and diverse number of insured securities owned by a bank, the methodology would grossly overstate the actual credit exposure that the bank has to the insurer. Indeed, shifting the full face amount of the exposure from the underlying obligors to the eligible protection provider could potentially characterize the purchase of financial guaranty insurance as increasing rather than mitigating risk. Moreover, such shifting requirement could discourage banks from mitigating risks when it would be otherwise appropriate to do so, specifically when the value to the bank of credit enhancement outweighs the cost of financial guaranty insurance.

AFGI recognizes that it may not be practicable to employ a scheme whereby the exposure to a credit protection provider is a function of the credit of the insured obligor. Thus, AFGI submits that banks should have the <u>choice</u> whether or not to shift exposures to eligible protection providers, with the understanding that the shift should be mandatory if the credit-worthiness of the underlying obligor is not "investment grade." AFGI also proposes that such choice be subject to written policies and procedures, of the extent, if any, it would shift an exposure from an underlying obligor to an eligible credit protection provider when the bank purchases credit protection. Such policies and procedures would be subject to examination and review by each country's regulators in their supervisory capacity.

* * * *

We thank the Basel Committee for the opportunity to comment on the Proposed Framework and appreciate its attention to the concerns highlighted by AFGI in this letter. If you have any questions, please do not hesitate to contact the undersigned at

[7] *Id.*

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

Very truly yours,

Bruce E. Stern, Chairman