

(June 9, 2009)

Members of the NCOIL CDS Task Force:

In response to your request during Friday's NCOIL CDS Task Force call, I am pleased to provide below a summary of the verbal comments I made during the call.

As indicated in the comment letter AFGI submitted on NCOIL's proposed model bill that would regulate CDS, AFGI believes that financial guaranty insurance should be among the lines of insurance that a monoline credit default insurer be authorized to write (under a separate license). The model presently provides that a credit default insurer may also be licensed to transact surety, residual value, and credit insurance. These are the same three lines of insurance that financial guaranty insurers are authorized to be licensed to write under the monoline regulatory regime of Article 69.

As you know, Article 69 of the New York Insurance Law regulates financial guaranty insurance. California law and the NAIC model legislation regarding financial guaranty insurance are very similar. The NCOIL model CDS bill is largely modeled on Article 69, with the concept of "credit default insurance" replacing "financial guaranty insurance."

In response to my question regarding whether NCOIL's intention was to replace Article 69/financial guaranty insurance with this model bill/credit default insurance, Assem. Morelle said that NCOIL had drafted the model bill to accommodate states that do not separately regulate financial guaranty insurance. Assem. Morelle said further that, in the few states that have financial guaranty insurance statutes, credit default insurance language could be "snapped on" to existing law.

I noted that incorporation of the credit default insurance concept into Article 69 would probably be the simplest and most effective approach.

I also noted that, although AFGI has taken no position regarding regulation of other parties that write CDS, the model bill could have unintended consequences. Those consequences could be particularly harmful for companies that could otherwise use CDS to reduce troubling CDS exposures they currently hold.

Finally, inasmuch as AFGI, and I personally, have been involved in the evolution of Article 69 over twenty years, I would be happy to provide any background information or additional assistance.

AFGI believes it is essential for NCOIL to take the time necessary to understand the complex and highly technical subject matter at hand. It is particularly important to ensure that the model bill not have unintended consequences.

For example, discussion indicated that there are several provisions of the draft model that need to be more fully understood by legislators.

- The former section 1(a)(2), shown as deleted in the current draft, was described as relating to “transformers.” The provision relates to synthetic CDS.
- Bill section 1(g)(5) was also described as relating to “transformers” and no longer necessary. The provision provides for using credit protection available under a CDS as collateral.
- With regard to capital and surplus requirements and contingency reserves, the numbers are not fine-tuned, and adjustments to these numbers would probably not have prevented the recent crisis. The core problems in the financial markets were not related to the CDS form itself, but to the failure of rating agencies and others to correctly analyze and identify risks, particularly in certain sectors. This point was noted in AFGI’s testimony before the hearing of the NCOIL Financial Series Committee on January 24 . The problem you seek to address would not be addressed by capital, surplus, and contingency reserve requirements, because calculation of those requirements would be based on an erroneous understanding of the risks involved.

I hope this summary is helpful to you and your colleagues at NCOIL.

Let me close by restating AFGI’s willingness to answer any questions and offer any assistance with regard to development of this model legislation.

Thank you.

Bruce Stern
General Counsel, Financial Security Assurance Inc.
Chair, Association of Financial Guaranty Insurers (AFGI) Government Affairs
Committee