Testimony on Regulation of Financial Guaranty Industry

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Financial Security Assurance Holdings Ltd.

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Government Sponsored Enterprises

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Chairman Kanjorski, ranking member Garrett and members of the subcommittee, we respectfully submit this white paper, which I will summarize in my testimony today. I am Séan McCarthy and I am President and Chief Operating Office of Financial Security Assurance (FSA). Today, I am testifying on behalf of FSA and Assured Guaranty Corp. (Assured). Our two companies are coming together after Assured completes their acquisition of FSA on July 1. In the new company, I will be President and Chief Operating Officer.

We appreciate the opportunity to testify at the hearing to improve oversight of the insurance industry and a restructuring of the federal government's role with regard to insurance products.

Pertinent background on the U.S. municipal bond insurance industry

I had the honor to testify before the full Committee just a few weeks ago about the state of the municipal bond market and what the Congress and the Administration could do in the short term to provide targeted assistance. Our companies have been involved in helping states and localities access the municipal bond market in the most cost efficient manner, saving billions of dollars for taxpayers.

I am here today because it is not just the market conditions and the credit crisis that is making it more difficult for our companies to offer the best value to our municipal and other customers.

As monoline insurance companies, we provide, in the case of FSA, bond insurance for the U.S. municipal and global infrastructure markets, and, in the case of Assured Guaranty Corp., bond insurance for U.S. municipal, global infrastructure and structured financings. We are in the business of guaranteeing bonds and related products only, and do not provide other types of insurance products.

The industry's basic guaranty insurance policy ensures that if the issuer of an insured bond fails to make any scheduled principal or interest payment, the bond insurer will make the scheduled payment on time and in full. This unconditional, irrevocable guaranty covers all types of risk, including fraud. The guaranty bridges differences between the needs of investors and debt issuers and offers significant benefits to both sides.

We also provide significant benefits that go beyond the guaranty. These include analysis and structuring of municipal transactions, on-going surveillance, and remediation of the issues we insure. We believe that we have had a significant role in making municipal bonds safe for investors, not only because we have insured them, but particularly because the monitoring and remediation of the bonds we insure allows us to identify issues before they grow into problems that could result in default.

The bond insurance industry occupies a unique space in the insurance industry and requires the consistency of standards and oversight that a Federal regulator can provide.

Financial guaranty insurance is utilized only in the financial markets. It is a very different product from that of property and casualty, life and health insurance companies, and we desire and require regulatory differentiation. Article 69 was enacted by New York State to segregate financial guaranty insurance from multiline products and the risks those entail. While it was a good step, it was not strong enough. Therefore, we believe we require mandatory federal regulation that is closer to that of banks, that being centralized and encompassing all aspects of regulation, including required capital. Most states do not have the resources to properly regulate such a specialized industry.

The current decentralized regulatory regime for monolines is aimed at specifying what types of business they can insure rather than a high level of capital. There are no uniform, consistent credit, capital and financial strength standards. The states have limited tools and have done their best to focus on companies whose solvency is tested but they are not in a position to focus on stronger capitalized companies that market participants rely on. New York State Insurance Commissioner Eric Dinallo, who recently announced that he was leaving office, has stated the potential need for Federal regulation of bond insurers. Due to the lack of a single consistent regulator, the rating agencies have become the de facto regulators of our industry, all with different requirements and models that are not transparent and do not result in consistent outcomes, which are necessary for regulation and oversight.

While we will continue to strive to achieve the highest possible ratings, we believe that credit rating agency views currently play too singular a role in the evaluation of our financial strength. Ratings are based on criteria that vary and include many subjective characteristics and employ methodologies that are not readily transparent. Additionally, all three rating agencies have different sets of guidelines, which present conflicting goals that make it impossible to manage a stable company. Importantly, investors cannot easily evaluate rating agency conclusions. Due to the impact of ratings on the trading value of the securities monolines insure, investors are forced to accept the impact of ratings with respect to the financial guarantors.

The end result of this de facto "regulation by rating" has been to destabilize markets and reduce municipal issuers' cost-effective access to the capital markets. This has negatively affected smaller municipal issuers particularly and municipal issuers of complex bonds—where bond insurance homogenizes the credits and provides market liquidity. Additionally, bond insurers have become the primary source for credit enhancement in today's municipal market. Bond insurance penetration for the first five months of 2009 was 13%. Market penetration for LOCs for the first five months of this year was down to about 6%.

What happened and where is the industry headed?

There is no question that several financial guarantors took large, concentrated risks in the most volatile and risky mortgage-backed securities that severely underperformed, which in turn led to the downgrades or failures of five of the original seven primary bond insurers. Notably, many of these now problematic transactions were rated triple-A by the rating agencies at the time those securities were issued.

The financial guaranty industry is currently in a rebuilding phase with a number of potential new entrants to the market. FSA, Assured Guaranty and Berkshire Hathaway are established and participating in the market.

FSA and Assured Guaranty, which were established in 1985 and 1988, respectively, have come through this unprecedented period of turmoil in strong capital positions, and despite the understandable concerns that the market has expressed about the financial guaranty model, we are confident that investors will continue to see value in guarantors that combine capital strength with diligent, experienced credit selection skills. The ultimate beneficiary of the investor seeing continued value in bond insurance is the issuer of the bond and the consumer of what is financed. In the case of municipal bonds, those consumers are state and local citizens and taxpayers.

Rationale for Federal Regulation

We would like to see federal oversight of our industry that would provide regulation by design, rather than default. Uniform federal regulation of the financial guaranty industry would increase investor confidence and provide much needed transparency and stability to the capital markets.

We believe that licensing requirements should be stringent and require high but predictable capitalization levels; guarantors should provide detailed disclosure on risks to all constituencies (e.g., issuers and policyholders); and should be subject to an annual stress test that would be applied equally to all companies.

Our industry would benefit from federal regulation because:

It would be objective and fact-based and made without conflicts of interest;

It would allow for uniform standards and regulation across the entire country; and

It would be transparent and understandable.

Importantly, investors would rely on the balance sheet of the financial guaranty company rather than an arbitrary and volatile rating.

In conclusion, uniform federal regulation of the financial guaranty industry would bolster investor confidence, which would increase market liquidity for municipal bonds, and that in turn, would help issuers to gain greater access to the capital markets at lower funding costs. Bond insurance has for decades played this important role in the U.S. municipal market, and today, as states and cities face declining tax bases and increasing public infrastructure needs, we believe our role has taken on even greater currency.

As long as bond insurers are able to provide value to state and local municipal bond issuers by reducing their cost of borrowing, saving taxpayers money and attracting a broader based of investors, issuers will continue to utilize insurance. Providing consistent, transparent requirements, standards and oversight by a single Federal regulator will ensure that all active monoline insurers have the financial standing and capability to carry through on their insurance commitments.

Thank you for giving us the opportunity to state the case for federal regulation of the bond insurance industry.