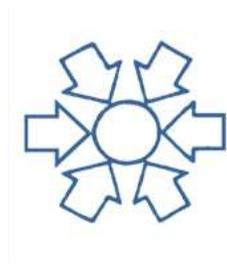


**The Future of Credit-Risk Insurance:
A Business Model at a Regulatory Precipice**



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Abstract

Federal Financial Analytics, Inc. here assesses the future of credit risk transfer (CRT), the process of moving credit risk from one entity to another by way of insurance – usually mortgage or financial-guarantee insurance – or through credit derivatives. Loan originators, asset securitizers and debt issuers cannot live without CRT – it is fundamental to the mortgage, small-business, municipal and sovereign markets – to name just a few. However, the CRT industry is in crisis, meaning that – absent development of new, robust CRT structures that remain viable under emerging regulatory standards – credit and securitization markets will shrink with costly sectoral and macroeconomic consequences.

In this paper we assess the prospects for each of these forms of credit risk transfer, analyzing the capital, rating-agency, securitization-reform and “shadow-banking” challenges that confront private mortgage insurance and financial guarantee insurance, challenges that create strong opportunities for credit derivatives offered by banks to replace these products. Direct bank entry into these sectors and/or offerings within banks of look-alike products is also, we conclude, a major strategic challenge for traditional credit-risk insurance providers, with this paper detailing the regulatory and market drivers promoting rapid bank entry.

However, traditional credit-risk insurers have significant advantages to offer both customers and regulators. As regulated, capitalized providers, mortgage and financial-guarantee insurance is structured to absorb even catastrophic risk without the vagaries of traded products or the conflicts of interest that can result when an institution is both originator and credit-risk mitigator. These advantages have, however, been sorely tested by failures in the current crisis that have devastated both private mortgage and municipal bond insurance in the United States.

This paper thus also assesses the reforms needed in these sectors if insurance is to remain a viable form of credit-risk transfer. We conclude that CRT providers need to reevaluate their business model, possibly by converting to bank charters, to come under credible federal regulation and, with it, the protection of powerful policy-makers. We note the vital importance of pending global regulatory-capital reform and the various initiatives designed to reduce or even eliminate the role of rating agencies, detailing ways CRT can enhance its position because of continuing demand for capital-efficient credit enhancement. Because of continued pressure on asset securitization, we believe CRT providers need to refocus on portfolio products and demonstrate value-added to banks and other investors holding large books of mortgages, state and local bonds and other assets suitable for CRT. Strategic options, including conversion into bank or BHC structures, should be carefully considered in crafting this new business model. For private mortgage insurance, winning a role in the new structures that replace Fannie Mae and Freddie Mac remains a top strategic priority.

Federal Financial Analytics, Inc. advises several major firms in this sector and has worked on financial transactions and M&A activity germane to it. The views expressed in this paper are solely those of the firm and do not reflect those of any clients. No confidential information is included in this report, with all of the public data on which it is based noted.

Executive Summary

The CRT industry is under acute stress due to catastrophic risk challenging mortgage insurers, speculative risk transfer decisions by bond insurers (who strayed outside their traditional municipal finance arena in the run-up to the financial crisis) and ongoing concerns that credit-derivative counterparties might not honor risk commitments. Complicating this outlook is the unusually large role government now plays in CRT, notably through insurance and guarantee programs like the U.S. government-sponsored enterprises now also under acute stress.

This paper analyzes CRT's prospects, taking a look first at the regulatory and market forces that affect all of these CRT providers and, then, assessing these strategic factors for each major CRT class to forecast the viability of its business model. We also assess the degree to which the crisis in CRT provided by regulated insurance companies will lead to entry into this sector by large banking organizations, a trend highlighted by the increasing use of credit default swaps in relevant asset classes and Goldman Sachs' recent plans to enter financial-guarantee insurance. In summary, Federal Financial Analytics concludes:

- **Private Mortgage Insurance (MI):** This CRT sector is bloodied up after the crisis, which took its worst toll on holders of residential-mortgage credit risk. However, despite the loss of several MI firms, the business remains viable and, on a forward-looking basis, profitable. The key strategic obstacle to resuscitating private MI is the uncertainty surrounding reform to the U.S. mortgage market. MIs are now dependent on the U.S. government-sponsored enterprises (GSEs), and the manner in which the GSEs are restructured is a critical driver, as is the role to be played by their main competitor, the Federal Housing Administration (FHA). Regulatory uncertainties (especially with regard to the U.S. bank-capital rules and a pending risk-retention rule for securitization) are also critical unknowns. Winning a favorable outcome on these policy drivers requires the industry to address deficiencies in its current regulatory model to persuade Congress, regulators and – perhaps most importantly – mortgage-risk holders that private mortgage insurance is a reliable form of CRT that can be counted upon under even catastrophic stress.
- **Financial Guarantee Insurance (FGI):** If MI is bloodied, then FGI is in intensive care. FGI is not advantaged by federal law such as the provisions in the GSE charters that designate MI as one of three forms of credit protection that must be used when a mortgage loan-to-value (LTV) ratio exceeds eighty percent. Instead, FGI has historically relied on rating-agency decisions to grant very high ratings to state and local debt issuances with FGI, easing the way for market penetration for small issuers and making higher-risk debt eligible for pension funds, retail investors and mutual-fund offerings. FGI enjoys capital benefits under various rules, but these are also ratings-dependent and thus under extreme stress. The sector has thus lost most of its U.S. firms. However, the fundamental business logic of FGI remains and,

indeed, is enhanced by capital constraints throughout financial markets and the need for municipal issuers to find new avenues to the capital market. As a result, large banks are contemplating entry into a sector where their regulatory status and large capital base, not ratings, are seen to offer an edge.

As these conclusions demonstrate, CRT is a sector uniquely defined by regulatory and policy decisions. Take these away, and the sector goes too. Strengthen regulatory recognition of the sector, and its use would dramatically increase, especially where regulatory-capital standards give financial institutions – most now severely capital constrained – benefit for CRT use. Because credit derivatives are offered by the most robust CRT players – very large banks – they are on the firmest footing as the surviving form of CRT positioned to take advantage of these capital and regulatory benefits.

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I. Introduction and Background

CRT has long been a focus of global regulators, but only in varied and often inconsistent ways. The general thrust of financial-sector regulation in the U.S. and, indeed, around the world, favors CRT, especially when provided by regulated, capitalized providers like MI and FGI. However, as the financial crisis began, the sector was already showing serious strain, leading regulators to reexamine how CRT is governed and relied upon.

The most extensive review of CRT dates to a 2008 paper by the Joint Forum,¹ a global organization of banking, securities and insurance regulators aimed at identifying regulatory challenges that, like CRT, cross traditional boundaries between banking, insurance and securities products. The Joint Forum paper focused particularly on financial guarantee insurance (often called bond insurance in the U.S.) and credit derivatives, due to the role these instruments played in the financial crisis already beginning to grip the global market when the paper was released. However, it also addressed private mortgage insurance, to some degree differentiating favorably this CRT sector. Although the Joint Forum paper recommended reforms, few have been substantively addressed to date outside the credit-derivative arena, where reforms are being implemented in concert with more general regulatory changes in the over-the-counter (OTC) derivative arena.²

However, the crisis of course did not end with the Joint Forum paper. As a result, regulators have recently returned to CRT, this time in concert with a broader assessment of “shadow banking.” The Financial Stability Board (FSB) in 2011 issued final recommendations on shadow banking³ that outlined various financial-market sectors that, it argues, pose systemic risk because they “transform” maturities and/or liquidity in a manner like regulated banks without comparable prudential regulation. Non-traditional insurance – most notably MI and FGI – are cited in the FSB paper, as well as in a following consultation from the European Union seeking a new regulatory framework governing, among other entities, providers of “imperfect” CRT.⁴

¹ The Joint Forum, *Credit Risk Transfer - Developments from 2005 to 2007* (July 31, 2008), available at <http://www.bis.org/publ/joint21.htm>.

² See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010), Title VII; see also OTC derivatives, central counterparties and trade repositories, Eur. Parl. Doc. (COM(2010)0484 – C7-0265/2010 – 2010/0250(COD)) 1 (2012), available at <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fTEXT%2bTA%2b20120329%2bTOC%2bDOC%2bXML%2bV0%2f%2fEN&language=EN>.

³ Financial Stability Board (FSB), *Shadow Banking: Strengthening Oversight and Regulation: Recommendations of the Financial Stability Board* (Oct. 27 2011), available at http://www.financialstabilityboard.org/publications/r_111027a.pdf.

⁴ European Commission, *Green Paper: Shadow Banking*, COM(12)102 final (2012), available at http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf.

If CRT comes to be defined as systemic or shadowy, the basic business of CRT providers will be wholly redefined. Although these aspects of the U.S. and global regulatory regimes are incomplete, it is already clear that systemic/shadow firms will be subject to the following constraints:

- sharp restrictions on the degree to which banks may rely upon them (restrictions imposed by higher capital requirements or even express product bans);
- new capital requirements applied to the CRT provider designed to mimic bank capital requirements;
- specific product/activity restrictions to control operations deemed by regulators to mimic those of regulated financial intermediaries; and
- additional possible standards – e.g., systemic capital “surcharges.”

II. Regulatory and Policy Landscape

Here, Federal Financial Analytics assesses the key policy drivers that redefine CRT, highlighting emerging U.S. and global actions and assessing their strategic impact. References provide ready access to the details of documents on which this assessment is based, with the firm also having our own in-depth analytics on many of these official releases (available upon request).

Capital

These requirements are key drivers of financial-institution value both to customers and shareholders. In CRT, this two-way equation is particularly important, since capital credit for use of CRT is at least as much a franchise driver as the capital standards applied by functional regulation or, now, possibly under systemic and/or shadow standards.

In general, CRT capital drivers are those focused on the “banking book” – that is, the regulatory-capital standards governing loans, asset-backed securities (ABS) or similar portfolio holdings at regulated financial institutions. However, the standards affecting the “trading book” – that is, available-for-sale (AFS) holdings – are critical to credit derivatives, which are often used as hedges for trading-book positions. The Basel II.5 standards⁵ now include new requirements governing credit risk in the trading book based on the realization following the crisis that, despite expectations of liquid markets that can quickly absorb ABS holdings, ratings

⁵ Basel Committee on Banking Supervision (BCBS), *Enhancements to the Basel II Framework* (July 2009), available at <http://www.bis.org/publ/bcbs157.pdf>; BCBS, *Revisions to the Basel II Market Risk Framework* (July 2009), available at <http://www.bis.org/publ/bcbs158.pdf>; BCBS, *Guidelines for Computing Capital for Incremental Risk in the Trading Book* (July 2009), available at <http://www.bis.org/publ/bcbs159.pdf>; BCBS, *Changes to the Revisions to the Basel II Market Risk Framework* (June 2010), available at <http://www.bis.org/press/p100618/annex.pdf>.

downgrades or other market phenomena can quickly add credit risk to the market-risk criteria on which the trading-book capital standards were previously based. Since the Basel II.5 rules were finalized in the Basel Committee and some national frameworks (but not yet in the U.S.), global regulators have moved on to refine them further with respect to risk specifically related to monoline credit insurance.

These additional capital requirements mandate an additional capital charge for “credit valuation adjustments” (CVA). The point here is to force banks to calculate the real credit risk related to positions so that, in the event market liquidity turns problematic, the bank holds enough regulatory capital to prevent solvency risk related to trading assets that must be held for longer-than-anticipated periods. Although intended to offset undue reliance on CRT, the CVA charges may in fact support its use if, independent of ratings (see below), bank CVA judgments based on use of CRT are robust enough to limit the CVA capital charges that would otherwise apply.

The importance of capital efficiency is heightened by the broader context of both the banking- and trading-book capital standards. In general, these have been significantly increased, not just due to the Basel II.5 rules, but also to the Basel III global standards⁶ (which expressly mandate CVA across the board) and to the stringent Federal Reserve stress tests that judge large-bank capital adequacy on a tough, forward-looking basis. Late last year, the Basel Committee further refined the entire corpus of its capital rules by stipulating concern about “high-cost” CRT.⁷ Under this statement, CRT structured to provide regulatory-capital benefit that does not in fact reflect a real transfer of credit risk will not be recognized for favorable capital treatment.

To the degree that CRT reduces capital requirements, it provides significant added value to banks under these stringent capital standards. And, with the guidance noted above, this benefit will be limited to capitalized CRT if regulators in fact enforce the standards laid out by the Basel Committee. Measuring the specific net present value of this benefit depends on the price of the CRT, the cost of equity to the bank and the amount of actual equity offset for use of CRT. However, when CRT is paid by borrowers for MI and issuers for FGI, it provides straightforward value-added to investing banking organizations – they do not pay for protection while they enjoy its benefit in tandem with reduced regulatory capital. In fact, under current stringent capital conditions, capital credit for CRT is in most cases a criterion for use because, without it, pricing is too high and capital costs otherwise too onerous to warrant an additional expenditure related to a whole loan, debt obligation or ABS.

As noted, the other feature driving capital analysis for CRT is the standard applicable to the CRT provider itself. The higher these are, the higher the price needed for offer and, of course, the more resilient the resulting claims-paying capacity. In the U.S., the capital standards governing

⁶ BCBS, *Basel III: A Global Regulatory Framework For More Resilient Banks And Banking Systems* (Dec. 16, 2010), available at <http://www.bis.org/publ/bcbs189.htm>.

⁷ BCBS, *High Cost Credit Protection* (Dec. 2011), at http://www.bis.org/publ/bcbs_n116.htm.

MI and FGI are determined under state capital requirements that differ markedly from those that would govern capital for comparable risk positions at banking organizations. Key factors here are:

- MI and FGI requirements under applicable state-insurance standards include catastrophic-risk reserves intended to ensure the ability to pay claims under even severely-adverse conditions. However, these catastrophic-risk reserves have not proved adequate for most MIs and FGIs in the current crisis.
- MI and FGI requirements are more stringent than comparable Basel or U.S. capital standards for comparable guarantees because these commitments are capitalized at origination and over the life of the insurance contract, including through the catastrophic-risk reserves noted above. In contrast, comparable bank commitments are risk-weighted as off-balance sheet obligations and carry no regulatory capital if structured as guarantees for less than one year. When capital charges do apply, they are generally lower than those applied for comparable on-balance sheet credit-risk positions held by banks, although these analytics are complicated by different risk tranches in different credit-risk backstops and the varying definition of capital applicable across the banking and insurance sectors.
- CDS and similar credit-derivative capital standards vary widely but often are far less than applicable in insurance or bank-guarantee structures. If a regulated bank is the credit-derivative counterparty, then it holds capital to honor CDS calls. However, because CDS and, to a lesser degree, other credit derivatives are readily traded instruments, the actual counterparty called upon to honor a claim may be a hedge fund or similar investor with limited capital capacity. This problem is being addressed in the Dodd-Frank Act reforms referenced above and in recent European Union efforts to reform OTC derivatives.⁸ However, none of these rules yet bans “naked CDS,” meaning that at any point in time a CDS counterparty could in fact be unable to pay a claim. It is in part for this reason that regulators around the world have sought the use of central counterparties (CCPs) for credit derivatives, along with other OTC instruments, as CCPs can ensure that counterparties are eligible claims-paying entities.

Rating-Agency Reform

Although credit rating agencies (CRAs) had significant critics before the financial crisis, they were roundly attacked in its wake. Of most concern was the degree to which the highest CRA designations (which we will call AAA despite the fact that these symbols vary by CRA) were granted with seeming impunity to actual credit risk related to subprime mortgages or

⁸ OTC derivatives, central counterparties and trade repositories, Eur. Parl. Doc. (COM(2010)0484 – C7-0265/2010 – 2010/0250(COD)) 1 (2012), available at <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fTEXT%2bTA%2b20120329%2bTOC%2bDOC%2bXML%2bV0%2f%2fEN&language=EN>.

mortgage-backed securities (MBS). CRAs were also, however, attacked for conflicts of interest and lax internal controls which, many said, led rating agencies not just to make analytical errors, but also to be all too willing to grant AAAs because of broader CRA business considerations. Regulators also found that “cliff effects” created systemic risk because CRA downgrades resulted in sharp market swings due to increased regulatory-capital requirements tied to ratings, higher collateral demands or even prohibitions on asset holdings that, when ratings fell, led to fire sales that created serious capital and liquidity stresses across global financial markets (a risk also called “herding”).

Many of these cliff-effect and other adverse consequences resulted from the dependence of MI and FGI on ratings determinations. Indeed, FGI has often been described as a “ratings arbitrage” business model because municipal issuers depended on the ability of an FGI policy to make a debt issue AAA regardless of the issuer’s actual credit risk. MI has also been ratings dependent because GSE “eligibility” standards that made them suitable providers of credit-enhancement services to the MIs’ largest customers were in part ratings dependent, as were many other eligibility criteria used by Federal Home Loan Banks and other customers.

Perhaps most importantly, all CRT used to enhance the credit quality of securitizations or debt issuances have been ratings dependent because global capital rules are dictated by CRA determinations. This is, though, now about to change, most dramatically in the U.S. The Dodd-Frank Act expressly bars references to CRAs in bank and securities regulation, forcing the banking agencies, Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) to undertake various efforts to find alternative credit-risk criteria that are objective, transparent and not dependent on the CRAs.⁹ The most significant of these efforts is a pending initiative from the banking agencies outlining rating-agency replacements in the capital standards governing trading activities, although the SEC has also issued critical rules in this area.¹⁰

Rating-agency elimination from the capital rules offers a major opportunity for CRT providers, especially regulated, capitalized ones like MI and FGI. Arguably, use of such third-party credit enhancement is a clear guide to credit risk because with it, risk is reduced and, without it, it is increased. Regulators often refer to this as the “double-default” benefit – that is, an investor is

⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010), § 939A.

¹⁰ Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), Notice of Proposed Rulemaking, *Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions* (Dec. 2011), available at <http://fdic.gov/news/news/press/2011/pr11189a.pdf>; Securities and Exchange Commission (SEC), Proposed Rule, *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934* (Apr. 2011), available at <http://www.sec.gov/rules/proposed/2011/34-64352.pdf>; SEC, Proposed Rule, *References to Credit Ratings in Certain Investment Company Act Rules and Forms* (Mar. 2011), available at <http://www.sec.gov/rules/proposed/2011/33-9193.pdf>.

at risk only if both the issuer and, then, the MI or FGI defaults, insulating it from the risk of the single default of the actual obligation.

Given the difficulty of finding CRA alternatives and the recognized benefit of double-default protection, reliance on CRT would seem an obvious option for U.S. and global regulators. However, the ongoing problems in key CRT sectors have led regulators to seek other rating replacements, a search that has so far led to no clear alternative due to the complexities of all of those now under active consideration.

Changing Asset Securitization Standards

Secondary markets are critical strategic drivers for CRT, especially private MI. Because of the capital benefits resulting from CRT use outlined above, ABS issuers benefit from CRT because regulated entities can hold the security in a more capital-efficient fashion. The rating's benefit from CRT use also enhances ABS demand by virtue not only of increased capital efficiency, but also greater asset eligibility for investors such as pension funds. However, these advantages created part of the global financial crisis, where AAA-rated, but still high-risk securitizations were sold into financial markets without appropriate due diligence by CRT providers, rating agencies and/or investors. As a result, securitization reform is a major part of the FSB shadow-bank reform effort noted above, with global regulators contemplating an array of sweeping changes to this arena.¹¹

In the U.S. changes to securitization markets are not theoretical, as the Dodd-Frank Act mandates numerous reforms in this area. These include numerous new securities-law changes to enhance investor understanding of ABS risk.¹² But, from a CRT perspective, the most significant change in U.S. law requires risk retention.¹³ That is, issuers and/or originators of all ABS would need "skin in the game" – to hold at least five percent of the credit risk in the pool of assets sent into the secondary market. The goal of this requirement is incentive alignment; the law is premised on the view that the problems ABS caused during the financial crisis largely resulted from the failure of securitizers to retain risk in obligations sold to sometimes hapless investors. Even though the law puts new burden on investors to understand their risk and gives them more information with which to do so, Dodd-Frank goes on also to mandate significant risk retention that undermines the capital and liquidity premises of asset securitization in the United States.

The impact of this change is most acute in the residential-mortgage sector, which in recent years has been almost wholly dependent on government and private securitization. In the course of the financial crisis, private-label mortgage securitization died as a result of losses in

¹¹ See *supra* note 3, at 21-22.

¹² See *supra* note 9, § 942.

¹³ *Id.*, § 941.

these holdings that led investors to avoid new issuances. As the crisis somewhat abates, there is considerable U.S. interest in renewed private-label MBS, but the prospect of the risk-retention provision has blocked all but a few new issuances. Included in Dodd-Frank's risk-retention language is an express requirement for regulators to structure a special standard for "qualified residential mortgages" (QRMs) to be exempted from the risk-retention requirement.¹⁴ Depending on how this QRM is defined and, especially, on whether or not it permits private MI to make a loan QRM-eligible is among the most significant strategic uncertainties confronting the future of private MI. Since FHA and GSE loans will almost surely be exempted from risk retention, all mortgages intended for the secondary market – likely to be the vast majority of U.S. loans going forward – will go through these agencies if private MI is not similarly advantaged.

The pending proposal¹⁵ on the QRM in fact puts MI at this disadvantage, although the overall proposal is so controversial that it may well be revisited, opening the MI question for further review. The risk-retention proposal is far more favorably inclined to CDS than to MI. Thus, if finalized as proposed – another ongoing uncertainty – this form of CRT could gain a significant new edge in mortgage securitization and, perhaps, in other ABS arenas where private CRT is not viable under the final U.S. securitization standards.

Systemic Regulation

The framework for systemic designation and regulation is sharply divergent on both a national and sectoral basis. In the U.S., the Dodd-Frank Act requires designation of nonbank financial companies that may pose systemic risk, with the Financial Stability Oversight Council (FSOC) in early April finalizing the standards for doing so.¹⁶

The law¹⁷ also permits designation by FSOC of a systemic "activity or practice," broad authority that would permit designation of CRT sectors as systemic even if firms that provide MI, FGI or credit derivatives do not themselves trigger systemic designation. U.S. law treats any BHC with assets over \$50 billion as systemic.

¹⁴ *Id.*

¹⁵ OCC, FRB, FDIC, SEC, Federal Housing Finance Agency (FHFA), Department of Housing and Urban Development (HUD), Proposed Rule, *Credit Risk Retention*, 76 Fed. Reg. 24090 (Apr. 29, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-04-29/pdf/2011-8364.pdf>.

¹⁶ Financial Stability Oversight Council (FSOC), Final Rule, *Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies* 77 FR 21637 (Apr. 11 2012), available at: <https://www.federalregister.gov/articles/2012/04/11/2012-8627/authority-to-require-supervision-and-regulation-of-certain-nonbank-financial-companies>.

¹⁷ See *supra* note 9, § 120.

The Basel Committee has also finalized criteria for designating global systemically-important banks (G-SIBs).¹⁸ However, outside the U.S., cross-sectoral standards and those to implement the Basel ones for G-SIBs remain incomplete. Pending non-U.S. actions with CRT implications include a longstanding effort by the International Association of Insurance Supervisors (IAIS) to craft a methodology to determine global systemically-important insurers (G-SIIs). This provisional methodology was released in 2011¹⁹ but has yet to be finalized, with IAIS now planning action by June 2012.²⁰ In general, IAIS is resisting G-SII designation and, then, the capital surcharges, resolution provisions and other rules that would apply. However, IAIS has specifically cited CRT provided in insurance as a possible source of systemic risk because of CRT's function as a form of credit-risk intermediary. Thus, despite ongoing disputes over G-SIIs, CRT designation as a systemic risk is possible both through the U.S. nonbank designation process and/or through the IAIS.

Given the divergence between U.S. and global SIFI standards, the strategic implications for CRT are clear to date only in the United States. There, systemic regulation will have profound implications for CRT, imposing a regulatory framework likely at considerable odds from that currently imposed by state insurance regulators for MI and FGI. This new framework could be very costly, especially in terms of capital and other prudential requirements. However, as discussed in more detail below, it could also provide troubled insurers with a federal regulatory framework from which to persuade regulators, legislators and investors to continue or even enhance current policy advantages accorded loans, debt or asset-backed securities bearing CRT.

Of particular interest here would be federal action to address the "resolvability" of CRT insurance providers. Neither MI nor FGI is covered by the state guaranty associations that protect policy-holders in several other insurance sectors. These guaranty associations, largely proven under stress, are funds provided by insurers held under state regulation to provide a backstop to ensure that claims are paid until policy-holders find a replacement insurance provider. Both MI and FGI are exempt from these resolution structures and are unlikely to be suitable for them going forward because of the concentrated nature of providers in these sectors and their still-weak condition. Thus, in resolution (i.e., run-off), MIs have had sharply to reduce claims payments and FGIs were forced to restructure to protect claims-paying capacity in their previous core business (municipal finance) even as claims payments on other obligations (e.g., MBS) were rejected. While it is possible that state insurance regulation could develop a resolution protocol for CRT providers, none to date has emerged. Absent one, federal policy reliance on CRT regulated by the states will remain uncertain unless, within the systemic-regulatory framework, a federal solution to resolvability emerges.

¹⁸ BCBS, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement* (Nov. 2011), available at <http://www.bis.org/publ/bcbs207.pdf>.

¹⁹ International Association of Insurance Supervisors (IAIS), *Insurance and Financial Stability* (Oct. 1, 2011), available at http://www.iaisweb.org/_temp/Insurance_and_financial_stability.pdf.

²⁰ Jaime Caruana, Address at the Morgan Stanley European Financials Conference (Mar. 27, 2012), available at <http://www.bis.org/speeches/sp120403.pdf>.

Government Competitors

In part because of the challenges under state insurance regulation noted above, government and bank entry (see below) are the most critical unknown factors confronting MI and, to a lesser extent, FGI. Indeed, for MI, government competitors are the most significant competitive uncertainty. Systemic regulation, MI recognition in capital regulation and even the future of securitization are vital unknowns, but favorable resolution of each of these and the other challenges confronting private MI will still not be sufficient to sustain a revitalized industry if the U.S. Government decides to expand its role in this arena or create alternatives to private MI.

MI is now most importantly protected by provisions that require use of one of three forms of credit enhancement for mortgages purchased by the GSEs with LTVs over eighty percent.²¹ These three forms of credit enhancement include recourse to the originating lender, a ten percent loan participation with the lender or use of “qualified insurance,” a term to date that covers only eligible private MIs. Recourse and participations have been used from time to time, but require capital backing from the lender and thus have not been widely used as an MI substitute. Going forward, it is possible that this will occur because risk retention under the rules noted above might be read to include either recourse or participation, thus negating the MI requirement if risk retention is required for GSE-guaranteed mortgages (not now currently proposed). However, the capital constraints noted above will still apply to recourse or participation unless it substitutes for another capital requirement, making MI the most favored form of credit enhancement under the GSE charter if the industry is deemed to offer “qualified insurance.”

However, the analysis presented above considers only GSE securitizations under the current charter. Fannie Mae and Freddie Mac are now in a conservatorship established in September of 2008. This conservatorship preserves the charter requirements for high-LTV mortgages that cites qualified insurance, but does not alleviate the strains on the GSEs or the need to develop a long-term solution to mortgage securitization. The Obama Administration in 2011 issued a white paper that suggested a possible role for MI²² and subsequent statements from the acting head of the Federal Housing Finance Agency (FHFA) have suggested an even greater role for MI.²³ However, until the Administration and Congress settle the role of the GSEs and, then, the degree to which MI plays a part, a critical element driving the future of private MI is uncertain.

²¹ See Federal National Mortgage Association Charter Act, Title III of the National Housing Act, § 302(b)(2), codified as amended at 12 U.S.C. § 1717(b)(2)(C) (2011); Federal Home Loan Mortgage Corporation Act, Pub. L. No. 91-351 (1970), § 305(a)(2)(C), codified as amended at 12 U.S.C. § 1454(a)(2)(C) (2011).

²² Department of Treasury and Department of Housing and Urban Development, *Reforming America's Housing Finance Market* (Feb. 2011), available at: <http://portal.hud.gov/hudportal/documents/huddoc?id=housingfinmarketreform.pdf>.

²³ FHFA, *A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending* (Feb. 2012), available at <http://www.fhfa.gov/webfiles/23344/StrategicPlanConservatorshipsFINAL.pdf>.

At the same time, the FHA is providing credit enhancement for high-LTV mortgages, pricing coverage and underwriting risk without regard to the same criteria that govern private MIs. Additionally, the GSEs have imposed their own loan-level fees that augment the cost of a high-LTV loan for many borrowers. As a result, many high-LTV borrowers see FHA as a lower cost option, further reducing private MI market share and increasing pressure on the sector. FHA is under considerable stress as a result of these risky pricing and underwriting practices. But, as long as it operates with the full faith and credit of the U.S. Government behind it, private MIs will face a profound competitive threat. Under all of the capital rules noted above, U.S. obligations like those backed by the FHA have a zero percent risk-based capital requirement, giving them a major advantage over privately-guaranteed mortgages and even an edge over GSE-backed ones.

For FGI, the only public competitors are the Federal Home Loan Banks, but their ability to offer letters of credit and other CRT to supplant FGI is limited by several statutory considerations, as well as by the weakened condition of the Home Loan Banks System. Congress has from time to time since the financial crisis considered developing another mechanism for backing municipal finance, most notably an “infrastructure bank” that would provide a federal guarantee for revenue bonds related to infrastructure that would compete directly with FGI.²⁴ However, this legislation remains moribund and will not pass in the foreseeable future.

In the European Union, proposals have been floated to create a national guarantee for sovereign debt obligations.²⁵ However, any such proposal would only back the obligations of the European Union, with active consideration of the concept on hold as the EU instead constructs a “firewall” to protect sovereign obligors and banks holders of their debt with a direct backstop.

Bank Entry

CRT has two major forms of competition from large banks: credit derivatives and direct entry through insurance or similar products. To date, credit derivatives have been the sole CRT bank offering, but this may not be true going forward as an array of capital and strategic factors create strong incentives for direct bank entry. Given the weakened condition of MI and FGI, bank competition poses a formidable long-term strategic challenge, in part because banks –

²⁴ See, e.g., Building and Upgrading Infrastructure for Long-Term Development, S. 652, 112th Cong. (2011); American Infrastructure Investment Fund Act, S. 936, 112th Cong. (2011); National Infrastructure Development Bank Act, H.R. 402, 112th Cong. (2011).

²⁵ Michael Mackenzie, *Non-profit credit rating agency challenge*, Financial Times, Apr. 17, 2011, at http://www.ft.com/cms/s/0/302e5b38-84ab-11e1-b6f5-00144feab49a.html?ftcamp=published_links/rss/markets_capital-markets/feed//product.

despite all the new rules governing them – are not seen as problematic “shadow” entities and have significant credit-risk experience in relevant asset classes.

Credit derivatives, principally CDS, have recently emerged as significant CRT players. Traditionally used directly only for large debt issuances by single obligors (i.e., corporates or sovereigns), several recent changes in CDS have enhanced their role in asset classes previously the sole province of insurance CRT providers. In the European Union, CDS have recently enhanced their role as backstops for covered bonds.²⁶ Covered bonds are instruments that mimic ABS in numerous respects, although the assets backing the debt issue remain on a bank’s balance sheet (in contrast to true securitization). CDS for covered bonds are analogous to an ABS guarantee in that the structure provides credit-risk mitigation across a dynamic set of assets in a pool, replacing pool CRT and potentially supplanting the need for loan-level CRT such as MI. CDS have also begun to play a significant role in the U.S. municipal bond arena,²⁷ seeking to replace FGI both to standardize bond markets and reduce trading volatility in this sector.

Perhaps the most important U.S. drivers of bank entry into CRT are limits on expansion through traditional merger-and-acquisition (M&A) strategies and the capital constraints frequently noted in this analysis. The Dodd-Frank Act builds on prior limits now to bar large U.S. banking organizations from any non-emergency acquisition of another entity if this increases their share of all U.S. financial company liabilities above ten percent.²⁸ Given this, the largest banking organizations cannot acquire other banks or large financial companies – the usual path to earnings growth in prior years. Large banks that are not clearly systemic may not transgress this ten-percent limit, but still find M&A of other insured depositories highly problematic. Earlier this year, the Federal Reserve finally approved the acquisition of a mid-sized deposit base by Capital One,²⁹ but only agreed to this otherwise-routine transaction after high-profile controversies sparked by accusations that it would create another “too-big-to-fail” bank. As a result, even routine transactions for large regional banks are uncertain.

In contrast, acquisition of permissible non-bank activities or *de novo* entry into them is not marred by these political obstacles. Because MI and FGI do not hold large liability positions (including insured deposits), the liability caps noted above almost surely will not apply and the political obstacles recently observed in traditional bank-to-bank acquisitions are also considerably less problematic. Current leverage capital standards for U.S. banks measure only direct asset holdings and thus do not impose any capital requirement for CRT exposures. Risk-

²⁶ Laurie Carver, *Dealers Draw Up Contract for Covered Bond CDSs*, Risk.net, Apr. 13, 2012, at <http://www.risk.net/risk-magazine/news/2166323/dealers-draw-contract-covered-bond-cdss>.

²⁷ Katy Burne, *Standardization of Default-Protection Contracts is Aimed at Attracting Investors*, Wall Street Journal, Apr. 17, 2012, at http://online.wsj.com/article/SB10001424052702304818404577349993810437480.html?mod=googlenews_wsj.

²⁸ See *supra* note 9, § 622.

²⁹ FRB, *Federal Reserve Board Announces Approval of the Notice by Capital One to Acquire ING Bank* (Feb. 14, 2012), available at <http://www.federalreserve.gov/newsevents/press/orders/20120214a.htm>.

based capital rules for off-balance sheet obligations like MI and FGI do not impose requirements comparable to those for direct holdings of mortgages, municipal bonds or other assets, although this could change if bank regulators recognize that CRT poses first-loss risk not now well captured in the current risk-based or leverage capital requirements. Still, current bank-capital standards and those to come under Basel III provide banks a strong capital incentive for taking on CRT.

Large banks believe they have considerable expertise in CRT because their traditional credit-underwriting standards track the same risks traditionally backed by monoline MI and FGI. Banks are of course major holders of residential-mortgage risk and are also allowed to hold large volumes of state and local obligations. Recent enhancements to stress-testing have improved these credit-risk analytics on a forward-looking basis that takes far better account of seriously-adverse scenarios than banks traditionally have done, better aligning these credit-risk analytics with those of traditional CRT providers and reducing entry cost. Finally, various rules noted above that create stronger demand for CRT create incentives outside the current monoline asset classes in traditional CRT, providing banks market opportunity to leverage CRT structures outside mortgages and municipal finance to asset classes like small business loans, where a large provider of CRT that commoditizes credit offerings could open capital markets to obligations otherwise too small to warrant separate credit-risk analytics.

An unanswered regulatory question here is whether any bank offering CRT “look-alike” products would be allowed by its regulators to do so outside traditional insurance structures. The Gramm-Leach-Bliley Act (GLBA) bars national banks from offering any insurance product in which they were not engaged as of the enactment date in 1999,³⁰ but nothing in GLBA bars a financial holding company (FHC) from engaging in insurance through a state-regulated subsidiary. To be sure, any such FHC subsidiary must operate under terms and conditions comparable to those of insurance companies in the same sector, standards made tougher for FHCs by the overlay of Federal Reserve regulation at the parent level and, for SIFIs, all of the additional capital, liquidity and prudential standards noted above. However, it is possible that banks could circumvent these GLBA requirements were the Office of the Comptroller of the Currency (OCC) to deem CRT-like products analogous to traditional banking ones, not to the new insurance products barred by GLBA. The OCC has signaled its willingness to do so for FGI. To date, however, no interpretations granting this power have been made public, although press coverage suggesting that Goldman Sachs plans to enter FGI indicates that this may be under active consideration if these plans contemplate this activity in the United States through a national bank.³¹ Regulation K of the Federal Reserve³² permits U.S. banks to offer a wide array of services otherwise regulated or barred in the U.S., making clear that Goldman Sachs or

³⁰ Gramm-Leach-Bliley, Pub. L. No. 106-102 (1999), § 102.

³¹ Tracy Alloway, *Goldman Looks to Monoline Insurance*, Financial Times, Mar. 18, 2012, at <http://www.ft.com/intl/cms/s/0/a1684756-6f79-11e1-9c57-00144feab49a.html#axzz1ss2UiYhX>.

³² 12 C.F.R. pt. 211 (2012).

other large U.S. banking organizations could offer MI, FGI and other CRT products outside the U.S. without regulatory barriers (other than the usual capital and prudential standards applicable at the parent discussed above).

CRT Charter Conversion

The flip side of bank entry into CRT is CRT entry into banking, a strategic option made increasingly compelling by all of the strains on CRT discussed above caused by regulatory and investor doubts about the degree to which CRT promises are kept when claims are made. Regulatory certainty on key issues – e.g., the future of MI in the GSEs to come and the capital credit accorded FGI for new municipal issuances – would bolster CRT and, in several cases, essentially resurrect the CRT business model. But, resolution of many of the most critical issues remains unlikely in the near term even as market strains on CRT providers continue unabated. Charter conversions provide an option to leap-frog many of these regulatory impediments, albeit an option that comes at no small cost in terms of restructuring, capital and – sometimes most daunting for CRT – a far more intrusive regulatory model that imposes new constraints on senior management and the board of directors.

As discussed above, there are no statutory limits on an FHC owning both a CRT structured as a regulated insurer in a separate holding-company subsidiary in tandem with one or more insured-depository institutions. CRT can thus be acquired by an existing FHC or have a parent that converts into an FHC, establishing a bank de novo or acquiring one if the firm has sufficient capital to do so. No current CRT provider is large enough to encounter the liability constraints on big-BHC M&A discussed above and most firms would also skirt the \$50 billion threshold for BHCs that now triggers systemic regulation. As “regional” BHCs, these firms would thus have less onerous regulation than the largest BHCs, but still gain the “cover” of Federal Reserve regulation at the parent level likely to persuade other U.S. and global regulators about the strength of the resulting firm. Liquidity strains could be considerably reduced through access to insured deposits and Home Loan Bank advances, although the degree to which a separate CRT subsidiary could make use of these funds would need careful attention.

Significant structuring issues would also need to be confronted, but the CRT issuer could also achieve capital efficiencies (e.g., through lack of a catastrophic-risk reserve requirement) depending upon how CRT is housed within the FHC. These liquidity and capital-efficiency issues are less complex if the CRT itself is restructured into a banking organization. In such cases, the potential advantages resulting to banks that enter CRT would adhere to the restructured CRT.

However, either as an FHC or through direct bank conversion, CRT firms will face an additional strategic challenge: the cultural differences when operating in a banking organization. Federal Financial Analytics has confronted these in numerous cases, where CRT management and/or boards are hesitant to consider conversion out of fear that laws like the Community

Reinvestment Act (CRA)³³ would force them into high-risk activities. We do not believe this to be a substantive impediment, based on the limited risks CRA has so far posed to banks, although the law does create numerous political and M&A hurdles that require careful attention.

The more substantive cultural change resulting from bank conversion for CRT is, we have found, the presence of supervisors in a day-to-day fashion at banking organizations. This is a wholly alien concept even to CRT firms used to state insurance regulation. The bank-examination model involves regulatory personnel often in residence at banks or at the least, in very frequent contact throughout a banking organization to assess ongoing compliance with a wide array of requirements promulgated in an extensive body of examination manuals, interpretations, guidance and rule. Failure to comply with any of these can create significant legal and reputational risk, especially in the current, stringent mood gripping regulators following the financial crisis. Of even more concern to many nonbanks is the requirement that bank examiners meet with the board and that boards of most banking organizations have demonstrable risk-management capacity among their independent directors.

III. The Future of Private MI

The MI industry has been under acute stress in recent years, unsurprising given its concentrated exposure to residential mortgages with high LTV ratios – among the riskiest in this deeply-stressed sector. The MI industry survived largely intact after the savings-and-loan crisis of the late 1980s, in large part due to the catastrophic-risk premium retention requirements mandated under state insurance rules after the industry was resuscitated in the late 1950s following its collapse in the Great Depression. This catastrophic-risk structure is intended to ensure resilience under even acute stress by requiring MIs to retain fifty percent of each premium dollar for ten years, and it in fact protected MIs far better than other large holders of similar risk.

However, the industry still experienced severe strain. This is in part because the U.S. residential sector has remained under stress beyond that anticipated even under the catastrophic-risk provision. The MI industry relies on new premiums to rebuild capital under stress, premium revenue not at desired levels due to the combination of competition from the FHA (which generally charges lower premiums than private MIs for comparable risk), the higher loan amounts the FHA now insures, higher fees charged by the GSEs that drive business to the FHA, remaining regulatory uncertainties resulting from the factors discussed above and investor fears that MIs may not honor claims in full.

³³ Community Reinvestment Act, Pub. L. No. 95-128 (1977), § 2901.

The first private MI failure during the current crisis came in 2008 when the smallest firm at the time, Triad Guaranty Insurance Corporation (Triad), collapsed. Although it initially paid its claims in full, it subsequently was able only partially to do so. Another large MI, United Guaranty Corporation (UGC), as a relatively small subsidiary of the American International Group, Inc. (AIG), became an indirect beneficiary of one of the largest bail-outs in U.S. history when AIG was rescued in 2008. Other MIs held on, but began to falter in 2011. Late last year, Private Mortgage Insurance Co. (PMI) was seized by the Arizona state insurance regulator, forcing the parent firm into bankruptcy. Thereafter, Republic Mortgage Insurance Company was severed from its parent, Old Republic International Corporation (Old Republic), and also was placed into run-off by its state regulator. Since then, the regulator for each of these insurers has determined that it may not be able to pay claims in full.

Even as this occurred, however, there have been new entrants to the private MI industry. These de novo entrants into the MI industry are Essent Guaranty, Inc. (Essent), which began in 2010, and National Mortgage Insurance which completed its capital funding in April, 2012.³⁴ As of year-end 2011, the total MI industry in the U.S. had \$723 billion of insurance in force,³⁵ representing about 41 percent of the total insured mortgage market share,³⁶ and covered 7.23 percent of total outstanding mortgage debt on one-to-four family residences.³⁷

Use of MI is clouded not only by these problems and partial claims payments at the firms in run-off, but also by larger questions about the industry's willingness and ability to honor claims under stress. MI contractual agreements and policies include "rescission" rights – that is, the right of the MI to put back the insured risk to the lender if fraud or other misrepresentations are found upon foreclosure and presentation of a claim. Before the financial crisis, many shortcuts in loan underwriting occurred that have sparked MI rescissions that are the subject of some lender disputes. These have led some investors to question the value of MI on a going-forward basis. The Federal Reserve has recently reflected these fears in the capital treatment accorded MI under the 2011 big-BHC stress test,³⁸ where the Board noted that it did not provide capital recognition for MI in part due to fears about rescission.

Historically, global and U.S. regulators have favored reliance on private MI, for example by providing favorable treatment for MI in the Basel II capital rules unchanged by the 2010 final

³⁴ See Jody Shenn, *FBR Raises \$550 Million for New Mortgage Insurer*, Bloomberg, April 26, 2012, at <http://www.bloomberg.com/news/2012-04-26/fbr-raises-550-million-for-new-mortgage-insurer.html>.

³⁵ Inside Mortgage Finance, Feb. 10, 2012, at 3.

³⁶ FHA accounts for the rest of the market with over \$1.05 trillion of insurance in force. Federal Housing Administration, *Single Family Outlook*, Feb. 2012, at 3.

³⁷ See FRB, *Mortgage Debt Outstanding* (Mar. 2012) (showing approximately \$10 trillion of mortgage debt on 1-to-4 family residences), at <http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm>.

³⁸ FRB, *Frequently Asked Questions: Supervisory Methodologies in CCAR 2012* (Apr. 20, 2012), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120420a1.pdf>.

Basel III rewrite of global risk-based capital standards.³⁹ The Joint Forum in January of 2010⁴⁰ urged nations to ensure that greater use of MI is part of their mortgage-reform efforts. The Joint Forum paper does, however, state the need to ensure that capital credit and regulatory recognition are provided only when private MI is in fact well regulated and capitalized, noting the significant problems that result from reliance on products such as credit derivatives. Building on the Joint Forum work, new global standards from the FSB for mortgage origination⁴¹ also call for reliance on “prudent” MI for high-LTV loans.

IV. The Future of Financial Guarantee Insurance

Since 1971, municipal-bond issuers have turned to FGIs to enhance the credit profile of their bond offerings by guaranteeing scheduled payments of interest and principal in the event that the issuer defaults before the security matures. In exchange, FGIs collect premiums based on their analysis of an issuer’s credit risk. In general, insured debt allows issuers to pay lower yields to investors than comparable uninsured-debt based on the additional claims-paying ability of the insurer and the discipline provided by a second layer of due diligence performed by the insurer on top of credit rating agency reviews. Between 2000 and 2007, issuers insured nearly half of their municipal-bond offerings, and in 2006, FGIs insured \$1.3 trillion of all municipal securities.⁴² During this same period, however, U.S. FGI companies went well beyond their initial municipal-finance business to provide financial guarantees for a wide array of instruments, mainly highly-structured mortgage instruments in which the firms also invested. This resulted in acute correlated risk not captured in FGI capital or prudential regulation.

By year-end 2006, FGIs collectively insured over \$800 billion of structured finance instruments.⁴³ With the downturn in the housing market in 2007 and the onset of the financial crisis, FGIs came under enormous pressure due to their guarantees of these structured instruments. Their exposure to the subprime mortgage market, directly through MBS and indirectly through CDOs of ABS, led to significant downgrades of their once sterling credit

³⁹ BCBS, *Basel III: A Global Regulatory Framework For More Resilient Banks And Banking Systems* (Dec. 16, 2010), available at <http://www.bis.org/publ/bcbs189.htm>.

⁴⁰ The Joint Forum, *Review of the Differentiated Nature and Scope of Financial Regulation - Key Issues and Recommendations*, (Jan. 8, 2010), available at <http://www.bis.org/publ/joint24.pdf>.

⁴¹ FSB, *FSB Principles for Sound Residential Mortgage Underwriting Practices* (Apr. 2012), available at http://www.financialstabilityboard.org/publications/r_120418.pdf.

⁴² Daniel Bergstresser et al., American Finance Association 2011 Denver Meetings Paper, *Financial Guarantors and the 2007-2009 Credit Crisis* (Nov. 2010) at 7, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1571627.

⁴³ *Id.*

ratings within a single year.⁴⁴ Of the seven major FGIs, five had their AAA-ratings downgraded in 2008, with three (CIFG Assurance North America, Inc., Financial Guaranty Insurance Company, and XL Capital Assurance, Inc.) substantially downgraded to speculative grade, *i.e.*, B and below.⁴⁵ Furthermore, as a direct result of these rating downgrades, insured-municipal bond yields surpassed those of equivalent uninsured ones.⁴⁶ In 2005, for instance, insured bonds averaged yields were 20 basis points lower than uninsured bonds; however, beginning in August 2008, insured bond yields were 40 basis points higher, and this yield inversion was still apparent in October 2010 (the last date for reliable public information on this sector).⁴⁷ This yield inversion, in conjunction with FGI downgrades, have significantly reduced the volume of municipal-bond insurance coverage. In 2009, only about 22 percent of municipal-bond offerings were insured, and dollar-coverage amounts were even lower at 7.7 percent.⁴⁸

In the post-crisis period, the FGI industry faces an uncertain future. All the major FGIs, except for Assured Guaranty Corp. (Assured Guaranty), are restructuring, in bankruptcy and/or lack the capital to underwrite new insurance policies. One of the largest FGIs, Financial Guaranty Insurance Company (FGIC), ceased writing financial guaranty policies in January 2008 and is currently negotiating a rehabilitation plan with its creditors under the supervision of the New York State Department of Financial Services (NYSDFS); its parent company, FGIC Corp., has already filed for Chapter 11 reorganization.⁴⁹ Ambac Assurance Corp. (Ambac), another troubled FGI, was seized by the Wisconsin Insurance Commissioner in 2010, and MBIA Insurance Corp. (MBIA) was effectively rescued by the NYSDFS in 2009 when it approved MBIA's restructuring.⁵⁰ Even Berkshire Hathaway's 2007 foray into the FGI industry has stalled, with distressed state and local governments forcing premium rates downward or foregoing insurance altogether on their debt offerings.⁵¹ The FGIs are also locked in lawsuits with several

⁴⁴ See, e.g., Disclosure Statement for the Chapter 11 Plan of Reorganization of FGIC Corporation at 11, *In re* FGIC Corp., No. 10-14215 (SMB) (Bankr. S.D.N.Y. Mar. 15, 2012), available at <http://www.fgic.com/aboutfgiccorp/finaldisclosurestatement.pdf>.

⁴⁵ *Supra* note 42, at 37.

⁴⁶ *Id.*, at 2.

⁴⁷ *Id.*, at 4-5.

⁴⁸ *Id.*, at 35.

⁴⁹ See *supra* note 44.

⁵⁰ Wisconsin Office of the Commissioner of Insurance, Wisconsin Insurance Report Business of 2010, *Companies in Liquidation or Rehabilitation, Ambac Assurance Corporation Segregated Account, in Rehabilitation* (2010), available at http://www.oci.wi.gov/ann_rpt/bus_2010/rehab_liquid2010.pdf.

⁵¹ See Warren Buffett, *Annual Letter to Shareholders* (2009), 13-15, available at: <http://www.berkshirehathaway.com/letters/2008ltr.pdf>; Jonathan R. Laing, *The Two Trillion Dollar Hole*, *Barron's*, Mar. 15, 2010, at http://online.barrons.com/article/SB126843815871861303.html#articleTabs_panel_article%3D1; Penelope Lemov, *Is Municipal Bond Insurance Dead?*, *Governing*, Dec. 31, 2009, at <http://www.governing.com/topics/finance/Is-Municipal-Bond-Insurance.html>.

MBS issuers, mainly large banking entities, whom the insurers claim fraudulently structured their products to incorporate loans that violated the representations and warranties found in the securitization agreements.⁵² The industry is sustaining claims in much of this litigation, but it raises questions similar to those confronting MI regarding reliable claims-payment capacity under stress.

The industry's current prospects are further clouded not only by the strain of prior non-municipal business, but also by ongoing doubts about its claims-paying capacity. In the nation's largest municipal bankruptcy in recent years, that of Jefferson County in Alabama, the FGI provider is Syncora Guarantee, Inc., a company so small and so concentrated in bonds issued by this municipality that its ability to honor the obligations now that the issuer has defaulted is, at best, uncertain.⁵³ However, not all FGIs have been similarly affected by the financial crisis. Assured Guaranty and Financial Security Assurance Inc. (FSA) retained their AAA ratings through 2009, and merged that same year to form Assured Guaranty Municipal Corp.⁵⁴ This merged entity now dominates the (much diminished) municipal-bond insurance market as it is the only one actively underwriting insurance policies. It is now contesting a possible ratings downgrade that, should it occur, will further challenge the role of FGI.

However, despite all of these challenges, the fundamental FGI business model is not only sound, but also even more urgently needed under current state and local fiscal constraints. As Jefferson County is joined by other bankruptcies in municipal revenue and general-obligation offerings, CRT is a valuable risk mitigant for skeptical investors and a buffer against punitive capital charges when these obligations are held by regulated financial institutions. Thus, new entries – possibly those contemplated by large banks – appear a certainty as financial markets begin to stabilize and investors seek new financial-industry opportunities in the revised regulatory framework discussed above.

V. Conclusion

The above analysis demonstrates that regulatory developments and underlying market needs promote robust CRT, with the combination of capital constraints on banking organizations, market demand for higher-yielding assets and the dependence of national economies on CRT-supported sectors all combining to create a sound business model with strong forward-looking

⁵² See, e.g., Letter from the Association of Financial Guaranty Insurers to Brady W. Dougan, CEO, Credit Suisse Group, AG (Jan. 13, 2012), available at http://www.afgi.org/resources/AFGI_January_2012_Letter_CreditSuisse.pdf.

⁵³ Katy Stech, *Jefferson County Bankruptcy Opens Muni-Bond Insurer*, Wall St. J., Feb. 15, 2012, at <http://online.wsj.com/article/SB10001424052970204880404577225280156326416.html>

⁵⁴ Dan Seymour, *Assured/FSA: One Standing*, The Bond Buyer, Oct. 16, 2009, at http://www.bondbuyer.com/issues/118_199/assured-fsa-1002586-1.html.

prospects. The challenge lies in the word “robust.” In the lead-up to and, then, in the course of the current financial-market crisis, MI, FGI and credit derivatives proved wanting in their most vital function: serving as a reliable way to transfer credit risk with assured claims-paying capacity even under acute stress. CRT providers are rebuilding their business models, licking their wounds, developing capacity for new business and otherwise repositioning for recovery, but regulatory skepticism and continuing policy uncertainties make the ability of CRT to prosper going forward at best dubious, despite the strong business fundamentals noted above.

To date, most CRT providers have acknowledged the vital role policy decisions play not just in forward-looking franchise value, but also in their very survival. Some have also invested in policy advocacy to urge desired change. None, though, has determined which of the regulatory options noted above – bank entry, charter conversion, federal regulation, etc. – would be a near-term game-changer that could be accomplished under current law and pending rule. For the industry truly to break out of its current malaise, one or more surviving companies will need to craft their own future, not wait to read about it in the papers.