ASSURED GUARANTY®

December 6, 2018

Douglas Poms
International Tax Counsel
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Brett York
Associate International Tax Counsel
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Lindsay Kitzinger
Attorney-Advisor
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Angela Walitt
Attorney-Advisor
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Peter Merkel
Branch Chief, Branch 5 (CC:INTL:B05)
1111 Constitution Ave., NW
Washington, DC 20224

Azeka Abramoff
Attorney-Advisor, Branch 5 (CC:INTL:B05)
1111 Constitution Ave., NW
Washington, DC 20224

Josephine Firehock
Attorney-Advisor, Branch 5 (CC:INTL:B05)
1111 Constitution Ave., NW
Washington, DC 20224

Re: Insurance Business Exception to Passive Foreign Investment Company Rules

Dear Mr. Poms, Mr. York, Ms. Kitzinger, Ms. Walitt, Mr. Merkel, Ms. Abramoff, and Ms. Firehock:

Thank you for taking time to meet with us regarding the qualifying insurance corporation exception to the passive foreign investment company ("PFIC") rules under section 1297(f) of the Internal Revenue Code (the "Code"), as amended by section 14501 of P.L. 115-97 (the "Act"). This letter responds to your request at our meeting for additional detail regarding our request for guidance

Assured Guaranty Ltd.

30 Woodbourne Avenue, 5th Floor
Hamilton HM 08
Bermuda

main 1 441 279 5700
fax 1 441 279 5701

info@agltd.com

AssuredGuaranty.com

clarifying the circumstances in which a financial guaranty insurance company's failure to satisfy the percentage of applicable insurance liabilities test is due to rating-related circumstances. In particular, this letter explains why the suggestions in the letter from Eversheds Sutherland dated September 5, 2018 (the "Eversheds Sutherland Letter"), with which we generally agree, should be supplemented with provisions specific to financial guaranty insurers given the unique nature of financial guaranty insurance.

About Assured Guaranty and Financial Guaranty Insurance

Assured Guaranty Ltd. ("AGL") is the holding company for the Assured Guaranty group of companies. AGL is organized under the laws of Bermuda and its common shares are publicly traded on the New York Stock Exchange. AGL, through its insurance subsidiaries, provides credit protection products to the United States and international public finance and structured finance markets, including insurance coverage with respect to bond issuances by U.S. municipalities, infrastructure projects in the U.S. and abroad, and structured finance vehicles.

The Assured Guaranty group includes three U.S. incorporated financial guaranty insurance companies, a United Kingdom domiciled financial guaranty insurer, and a Bermuda-based financial guaranty reinsurer, Assured Guaranty Re Ltd. ("AG Re"). AG Re is the largest financial guaranty reinsurer globally; it underwrites business as a reinsurer of third-party primary insurance companies and of certain insurance company affiliates within the Assured Guaranty group.

Financial guaranty insurance, also known as bond insurance, is a line of insurance business whereby an insurance company guarantees scheduled payments of interest and principal on a bond or other debt security in the event of a payment default by the issuer of such bond or debt security over its life. Thus, financial guaranty policies are typically long-term, often issued with terms of 30 years or more, in order to match the maturity dates of the insured securities. Bond insurance is a form of credit enhancement that generally results in the rating of the insured security being the higher of (1) the financial strength rating of the insurer, and (2) the rating the bond would have without insurance. Financial guaranty insurers are limited from entering other lines of insurance business and, accordingly, are often called "monolines."

Financial guaranty insurers typically experience a lower frequency of losses than property and casualty insurers, but when financial guaranty insurers do experience losses, they often have a high severity. For example, financial guaranty insurers (and their reinsurers) have paid billions of dollars in aggregate, cumulative claims on insured U.S. residential mortgage-backed securities that first defaulted during the 2008-2009 financial crisis. More recently, such insurers (again, with their reinsurers) have paid substantial losses in connection with certain high profile U.S. municipal bankruptcies, e.g., Jefferson County, Alabama, Detroit, Michigan, and Puerto Rico.

Financial guaranty insurers are subject to unique accounting rules under Generally Accepted Accounting Principles ("GAAP") that do not apply to other insurance companies. Statement of Financial Accounting Standards No. 163, *Accounting for Financial Guaranty Insurance Contracts*, provides that a financial guaranty insurer cannot establish loss reserves for a policy until the insurer's expected loss on the policy exceeds its unearned premium reserves on the policy. Therefore, while a financial guaranty insurer's current loss reserves might be modest relative to its overall capital (particularly if those loss reserves have been paid out as claims), the insurer would still hold and seek to maintain a substantial amount of assets in order to meet potential high severity claims in its portfolio in the future.

In light of the unique characteristics of financial guaranty insurance described above, financial guarantors (and the reinsurers like AG Re that support them) must be backed by a very strong claims-paying ability that is rigorously reviewed by major rating agencies and regulators and can be relied upon by the issuers and investors who benefit from financial guaranty insurance. For this reason, financial guaranty insurers are subject to a unique set of rating agency and regulatory requirements that do not apply to property and casualty or life insurance companies. In particular, the rating agencies have developed capital adequacy models and requirements that are specific to financial guaranty insurance companies. Under these models, both Moody's Investors Service Inc. ("Moody's") and S&P Global Ratings, a division of Standard and Poor's Financial Services LLC ("S&P"), assess a financial guaranty insurer's total claims paying resources. These constitute what we would consider a financial guaranty insurer's "rating agency capital" and consist, for the most part, of the insurer's GAAP equity, plus various additional claims paying assets (which vary depending on the particular rating agency). As such, rating agency capital exceeds GAAP equity and, based upon our prior experience with the rating agency models, for purposes of this test we believe that 150% of GAAP equity would be an appropriate proxy for the required rating agency capital of a financial guaranty insurer.

The rating agency models, moreover, are not static, but may change as the rating agencies see fit. For instance, Assured Guaranty and other financial guaranty insurers have been required to hold an increased amount of capital since the financial crisis, as compared to the pre-crisis period, as both S&P and Moody's revised their financial guarantor rating methodologies following the crisis. And, just this past week, S&P requested comments on proposed revisions to its current criteria for analyzing the capital adequacy of bond insurers.

Exception for Rating-Related Circumstances

To qualify for the insurance corporation exception to PFIC designation, an insurance corporation must demonstrate that its "applicable insurance liabilities" constitute more than 25 percent of its total assets, as reported on the corporation's applicable financial statement. If the company cannot do so, then the PFIC provisions provide for an alternative facts and circumstances test under which a corporation that fails to qualify for the insurance corporation exception solely by reason of its failure to meet such 25-percent threshold may still qualify for such exception if: (1) its ratio of loss reserves to assets is at least 10 percent, (2) the corporation is predominantly engaged in an insurance business, and (3) its failure to meet the 25-percent threshold is *due solely* to runoff-related or *rating-related circumstances* involving such insurance business.[1]

Because of the potential for claims with a high severity of loss, rating agencies require financial guaranty insurers to hold a substantial amount of assets. This results in the denominator of the applicable insurance liability ratio being large. At the same time, the special accounting treatment for financial guarantors described above excludes unearned premium reserves from applicable insurance liabilities and, therefore, keeps the numerator of the ratio low. Thus, compliance with rating agency

[1] Code § 1297(f)(2) (emphasis added).

capital requirements, when coupled with accounting rules applicable to financial guarantors, leads to an inability of financial guarantors to satisfy the 25-percent threshold.

The Eversheds Sutherland Letter proposes the following two-part test for establishing when the failure to meet the 25-percent threshold would be considered due solely to rating-related circumstances:

(1) The insurance corporation's ability to write insurance business is in whole or part based on having a specified credit rating; and

(2) The insurance corporation's applicable insurance liabilities are greater than or equal to 25 percent of the insurance corporation's total assets after (a) the insurance corporation's total assets are reduced by (b) the amount of capital required by an approved rating agency that provides the specified rating.

We generally support this methodology, but believe it does not go far enough when it comes to financial guaranty insurers. In particular, we believe this methodology does not sufficiently take into account the critical importance of a high credit rating to the business of a financial guaranty insurer and of the need, therefore, for such insurers to hold substantial assets and claims paying resources to ensure the availability of capital that may be required by a rating agency in the future.

As explained above, the financial strength ratings assigned by rating agencies to a financial guaranty insurer or reinsurer represent the rating agencies' opinions of the insurance company's financial strength and ability to meet ongoing obligations to policyholders and reinsureds in accordance with the terms of the financial guaranties it has issued or reinsured. Because of the credit enhancement nature of bond insurance, issuers, investors, underwriters, ceding companies, and others consider a financial guarantor's financial strength ratings a critical factor when deciding whether or not to utilize a financial guaranty or purchase reinsurance from that insurance company. For this reason, a downgrade of a financial guarantor's financial strength rating by a rating agency is likely to have a very detrimental impact on the financial guarantor's new business production, in addition to negatively impacting its results of operations and financial condition. For example, S&P recently downgraded a financial guaranty insurer from 'AA-' to 'A' (a very respectable S&P rating for most other types of insurers). This caused the insurer to effectively stop writing new business soon after the downgrade and the insurer is now in runoff. A financial guarantor, thus, must strive to maintain the highest possible credit rating. Accordingly, prudent management of its business requires that it hold some excess capital and assets to protect against the possibility of a future rating downgrade.

In recognition of the critical importance of a financial guarantor's rating to its business franchise, the formula suggested in the Eversheds Sutherland Letter should be modified to permit a certain amount of excess capital specifically for financial guarantors.[2] We suggest a rule that provides that, in the case

---

[2] A rule specific to financial guarantors is appropriate given the specialized nature of their business and has ample precedent. Among other examples, (1) section 832(e) and related Treasury regulations allow financial guaranty insurers to deduct an amount set aside as contingency reserves for statutory accounting purposes to the extent the insurer purchases tax and loss bonds; (2) section 832(b)(7)(B) provides for a different discount rate applicable to unearned premium reserves in the case of financial guaranty insurers; (3) several U.S. states have sections of their insurance codes expressly devoted to the

of a financial guaranty insurance corporation, such corporation's failure to meet the requirement of section 1297(f)(1)(B) would be considered solely due to rating-related circumstances involving the corporation's insurance business if the corporation's applicable insurance liabilities are greater than or equal to 25 percent of the corporation's total assets after the insurance corporation's total assets are reduced by 150 percent of such corporation's existing equity capital (as such amount is reported on the corporation's applicable financial statement for the last year ending with or within the taxable year). In light of the rating methodology applied to financial guarantors by rating agencies, such as the inclusion in rating agency capital models of more than a financial guarantor's GAAP equity, based upon our prior experience, we believe such amount of excess capital would be appropriate for the financial guaranty insurance industry.

For this purpose, a financial guaranty insurance corporation could be defined as a corporation licensed under, and compliant with, a U.S. state law that specifically governs the licensing and regulation of financial guaranty insurance companies or a corporation whose sole business is to reinsure only the type of business written by, or that would be permitted to be written by, such a corporation. Alternatively, the special rule could be based on a functional test measuring the insurer's net debt service outstanding; for example, the rule could require that the principal and interest of bonds insured or reinsured by the corporation divided by its total assets be at least 15-to-1. Both debt service outstanding and total assets could be determined for purposes of such test as reported on the corporation's applicable financial statement for the last year ending with or within the taxable year. Additionally, the amount of any insured or reinsured net debt service outstanding that relates to the portion of any financial guaranty insurance business that exceeds single risk limits set forth in the Financial Guaranty Insurance Guideline adopted by the National Association of Insurance Commissioners could be excluded from the calculation of net debt service outstanding.

Deferral of Effective Date

The amendment made by the Act to the definition of qualifying insurance corporation in section 1297(f) is effective for taxable years beginning after December 31, 2017. For the reasons detailed above, financial guaranty insurers may be unable to satisfy the 25 percent threshold and must rely on the alternative facts and circumstances test if they are going to avoid PFIC status. Because failure to meet the qualified insurance corporation exception for one year effectively results in being treated as a PFIC for future years, it is critical that the alternative test be implemented after a notice and comment period before taxpayers are subject to the new rules. Therefore, we request guidance that, until final regulations are issued to implement the alternative test, taxpayers who are unable to satisfy the 25-percent threshold be able to rely on prior law.

---

licensing and regulation of financial guaranty insurers; (4) such insurers are subject to unique accounting rules under GAAP that do not apply to other insurance companies; and (5) the National Association of Insurance Commissioners exempts the financial guaranty insurance industry from complying with risk-based capital requirements.

Thank you for your consideration of this matter. Please let us know if you have any questions.

Sincerely,

Robert A. Bailenson
Chief Financial Officer