News Bulletin

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Credit Default Swaps as Insurance: One Regulator or Many?

The unregulated nature of credit default swaps has been blamed for playing a major role in the recent abrupt demise of Bear Stearns, the dramatic bankruptcy filing of Lehman Brothers, the federal rescue of American International Group and Bank of America's acquisition of Merrill Lynch. Although the instruments are designed to offer legitimate protection to those seeking to hedge or transfer credit risk, some argue that manipulative practices in the credit default swap market have contributed to the demise of these entities, as well as to the general market turmoil.

On September 22, 2008, New York's Governor David Paterson made what proved to be the first in a series of regulatory pronouncements on the topic of credit default swaps. Governor Paterson announced that the state would reverse its prior position and begin, effective January 1, 2009, to regulate credit default swaps or CDSs as financial guarantee insurance in those instances when the buyer of the CDS owns the underlying security for which the CDS provides protection. On the following day, Christopher Cox, Chairman of the Securities and Exchange Commission, called for federal regulation of CDSs.

In Cox's brief statement, he noted that a buyer of a CDS does not need to own the underlying security for which the CDS provides protection and that such buyers can "naked short" the debt of the issuing companies without restriction. The Chairman concluded that the unregulated nature of CDSs and the potential incentive for such buyers to seek the default or other credit event of the issuer of the underlying security raised great concerns. As a consequence, Cox urged Congress to provide the SEC with the authority to regulate such products in order to provide investor protection and market stability.

Cox's proposal is, of course, not the first effort to regulate CDSs on a uniform basis. However, after efforts by the Commodity Futures Trading Commission to assert control over the regulation of credit default swaps a decade ago, the passage of the Commodity Futures Modernization Act in 2000 definitively established that the CFTC did not have such regulatory oversight. SEC authority is also limited in this area, and industry groups such as the International Swaps and Derivatives Association, Inc. ("ISDA") have taken a strong position against treating CDSs as securities. In support of this "hands-off" approach, some have argued that CDSs are privately negotiated contracts between highly sophisticated parties and therefore the protection offered by the securities law regime is not needed for that marketplace.

A credit default swap is a financial contract under which the seller promises to pay the buyer if certain adverse credit events (such as bankruptcy, payment default or restructuring) occur with respect to a specified obligor or certain of its debt obligations. The swap functions like insurance for the buyer if the buyer suffers an actual loss, but pursuant to the prior position of the New York Insurance Department, was not classified as insurance, in part because no insurable interest (or actual loss or indemnity) was required, and in part because the Department relied on such trades being documented on standard forms developed by ISDA and negotiated by the parties as standard swaps.

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As a consequence of New York State's new regulatory approach, all sellers of CDSs to buyers who, at the time an agreement is executed, hold, or reasonably expect to hold, a "material interest" in the reference obligation, will be required to be licensed as financial guarantee insurers and only financial guarantee insurers will be permitted to issue such CDSs. It is estimated that this will result in New York regulating approximately one fifth of the huge $62 trillion market. The purpose of the regulation is to assure that the protection seller has both sufficient capital and surplus to pay claims under the CDSs and adequate risk management policies to protect the buyers of the CDSs, who are effectively policyholders. Under the prior New York position, AIG and the monoline financial guarantee insurers issued credit default swaps out of non-insurance subsidiaries that were not required to hold sufficient reserves against future claims but nevertheless enjoyed financial guarantee protection issued by the parent. The subsidiaries were required to pay under the CDSs when the parent insurer could not pay directly under the financial guarantee.

CDS buyers, however, are not required to hold the underlying security, and the larger part of the CDS market may consist of such buyers who, many contend, are using CDSs for speculative purposes, similar to that of naked short sellers of equity securities. It is this portion of the market that would remain unregulated as insurance under the New York regulation. In his announcement, Paterson called on the federal government to regulate this "non-insurance" portion of the market involving so-called "naked credit default swaps".

The New York Insurance Department provided further detail to the state's position by issuing Circular Letter No. 19 (2008), also dated September 22, 2008, setting forth "best practices" for financial guarantee insurers licensed by the Department, which include most of those operating in the U.S. The Department cited a prior opinion that stated that a CDS is not an insurance contract if the payment by the protection seller is not conditioned upon a pecuniary loss by the protection buyer. The language of the Circular Letter, similarly, does not seem to require the protection buyer to actually suffer a loss for payment under covered CDSs. In addition, the Department advises that protection sellers seek an opinion from the Department as to whether the seller is required to be licensed as a financial guarantee insurer. The best practices set forth in the Circular Letter:

1. Impose strict limits on such insurers when guaranteeing risky collateralized debt obligations ("CDOs") that are based on successive pools of asset-backed securities, including those often referred to as CDOs-squared, by imposing certain risk-limiting conditions. The CDOs-squared structure, which has the effect of placing the guarantor more than one layer from the underlying obligation, has been viewed as one of the principal causes of the recent credit volatility in the commercial and investment banking sector;

2. Limit financial guarantee insurers to guaranteeing CDSs only when the underlying risk is consistent with those permitted to be insured directly by the financial guarantee insurer and prohibits the underlying CDS and the financial guarantee from requiring the insurer to post collateral (thus covering guarantees of CDSs issued by special purpose affiliates of financial guarantee insurers);

3. Require measures to limit sources of risk for such insurers arising from pools of asset-backed securities such as concentration risk relating to originators and servicers of debt;

4. Extend to its structured finance portfolios an existing requirement for a financial guarantee insurer's municipal bond portfolio that the portfolio be 95% investment grade;

5. Require new entrants to financial guarantee insurance to provide, and existing insurers, if necessary, to revise existing, written risk control and underwriting policies to reflect extreme stress scenarios and sufficiently low levels of loss;

6. Increase the required minimum statutory capital and reserves for such insurers pending changes in statutory requirements; and

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7. Increase reporting requirements to allow the Department to better oversee the activities of financial guarantee insurers.

The guidelines become effective January 1, 2009 but will not apply to existing CDSs.

If certain CDSs are regulated as insurance, further questions will need to be reviewed. Should the Department eliminate indemnity as the principal defining criterion for insurance? If so, what would be the consequential effects on other "non-insurance" instruments? How onerous will the Department's requirement be that each protection seller seek an opinion from the Department as to whether it would require licensing? How onerous will the reporting requirements be for the financial guarantee insurers compared to non-regulated issuers of CDSs? How much of a competitive disadvantage will the required capital and surplus charges be? How will the financial guarantee insurers obtain balance sheet reinsurance relief? What will that reinsurance look like? Will sales of covered CDSs be restricted to licensed insurance agents? Will current issuers be shut out of this portion of the market or consent to be regulated as financial guarantee insurers? Under the insurance CDS regime, will issuers, and therefore buyers, of insurance CDSs be so adversely disadvantaged from issuers of non-insurance CDSs that this market will no longer be viable? Is federal regulation and a uniform playing field the logical way to go?

The New York position has predictably triggered multiple responses. ISDA has met with the New York Insurance Department, the New York Federal Reserve Bank and the Treasury Department to discuss possible responses to the New York position. ISDA representatives indicated that a broad consensus may be necessary to satisfy the various regulatory regimes while preserving the market function provided by such instruments. It was also reported that Superintendent Dinallo reiterated Governor Paterson's position that the problem extended far beyond financial guarantee insurers and required intervention on a broader scale. ISDA staff are scheduled to meet again next week with the New York Insurance Department.

The New York Circular Letter has drawn a similar response from the banking community. On October 2, the Institution of International Bankers issued a memorandum to member institutions commenting that consonant with legal precedent, credit default swaps issued, sold or transacted by banking institutions, including those issued by U.S. branches or agencies of international banks, qualify under New York laws as banking products and should not be regulated as insurance products. In particular, such products should not be subject to the Circular Letter and such bank issuers should not be required to be licensed as insurance companies. The memorandum cites prior New York Insurance Department determinations that instruments issued by banks such as letters of credits that might otherwise be deemed to be insurance are not insurance because they are issued by banks and thus represent the business of banking.

In light of recent serious disruptions suffered by the capital markets, there appears to be a growing sentiment, particularly within the regulatory community, that the CDS market must be regulated. The fundamental question, however, is whether the market should be segmented from a regulatory point of view, with a portion subject to one or more state insurance regulators and the remainder subject to federal or industry regulation or rather, as proposed by Chairman Cox, subject to a single regulator. The New York approach would artificially distinguish one form of instrument from another depending upon the market position held by the protection buyer. The Institute of International Bankers approach will base regulation on the nature of the protection seller. The alternative of supervising the entire market by a single federal regulator or having self-regulation by the industry would of course provide uniformity to the complex market and avoid adding yet another element of confusion to an already opaque area. A federal regulatory scheme, however, may not be achievable and self-regulation may already be discredited.

We will continue to provide updates regarding relevant proposals as additional information is made available.

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