



Client Alert

Financial Markets Developments

Regulation of the Credit Default Swap Market by New York State Insurance Department

On September 22, 2008, the New York State Insurance Department (the "Department") issued Circular Letter No. 19 (2008) (the "Circular") outlining "best practices" for financial guaranty insurers. The Department expects financial guaranty insurance companies ("FGIs") to adhere, on a prospective basis, to the guidance starting January 1, 2009. As necessary, it also intends to promulgate regulations and seek legislation to formalize the proposed guidance. The impact of the Circular, however, could have far-reaching consequences on the credit default swap market beyond the regulation of FGIs. Depending on how certain portions the Circular are ultimately implemented, the rules may not be limited to FGIs. Without coordination of regulatory efforts, unintended consequences may result with market participants facing conflicting rules.

New FGI Regulation for an Evolving Credit Default Swap Market

Having considered the existing regulatory regime, the Department now seeks to impose more stringent requirements on FGIs. Historically, FGIs have provided insurance or "wraps" for municipal debt offerings. More recently, however, they have insured either directly or through transformer entities more complex securities supported by portfolios of assets; such securities are known as collateralized debt obligations ("CDOs"). The new standards have been developed in light of the recent economic turmoil which has affected FGIs particularly as a result of their involvement with these more complex markets.

FGIs will be prohibited from insuring pools of asset-backed securities ("ABS") that are comprised of other pools of ABS unless (a) the insurance policy is an unsubordinated, senior position and has an investment rating of at least single-A, (b) the ABS pool of assets are issued or guaranteed by a government-sponsored enterprise, (c) the ABS pool is made up entirely of assets already insured by the FGI (and hence no additional obligations are incurred) and (d) the superintendent of the Department has determined that the insurance is without undue risk to the FGI, its policyholders and the people of New York. In the Department's view, the successive layering of different pools of securities brings with it inherent risk and unpredictability. As FGIs become further removed and disintermediated from the underlying collateral, adequate modeling and risk measurement becomes difficult, if not impossible.

In addition, the Department outlines guidance for the issuance of financial guaranty policies covering payment obligations under credit default swaps ("CDS") of affiliated transformer entities. With the stated objective of limiting FGIs participation in the CDS market only to those transactions in which the risk is "roughly comparable to the amount and timing of risks assumed when directly insuring bonds," FGIs are now to limit their issuance of policies on CDS to transactions where (a) the FGI guarantees only the risks resulting from the failure to pay when the



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failure is the result of a financial default or insolvency, (b) neither the CDS agreement under which one counterparty sells protection to the other, nor the policy under which the insurer guarantees payment by the protection seller, defines a credit event, termination event, or event of default to include a change in the credit quality, rehabilitation, liquidation or insolvency of the FGI providing credit support and (c) neither the terms of the CDS agreement nor the policy under which the FGI provides its guaranty requires the insurer to post collateral. Moreover, the Department intends to promulgate regulation to limit the definition of “credit event or termination event” with respect to guarantees of credit default swaps.

A series of technical regulations which apply to FGIs and their business in the State of New York were also addressed under the Circular. The existing regulations impose minimum capital requirements, surplus contingency reserves, aggregate and single risk limitations and limitations on exposure to noninvestment grade securities. The changes include modifications to the approach used to calculate single entity risk limitations. These limitations are now revised by expanding the notion of “single entity” beyond simply the issuer of the debt to include the initial lender and servicer of each category of obligation as well. Also, exposure to noninvestment grade credit risk now applies to the entire portfolio of an insurer. An FGI will need to satisfy the 95 percent investment grade limitation on its whole portfolio, unless it can demonstrate that a lower standard is not detrimental to its policyholders and the people of the State of New York. Further, the technical regulations have been revised to impose additional disclosure and reporting, risk management, and capital and surplus requirements on FGIs.

Beyond FGI Regulation? The Potential Widespread Impact on the Credit Default Swap Market

Most interestingly, buried in the middle of the Circular is a paragraph with statements which potentially have far-reaching consequences. Their implication for the CDS market extends well beyond the world of FGIs and potentially reaching non-FGI protection sellers in the CDS Market.

Prior to the Circular, the Department’s position had been notably different. In an opinion by the Department’s Office of General Counsel (“OGC”) dated June 16, 2000, the Department stated that a CDS is not an insurance contract as long as the payment by the protection buyer is not conditioned upon an actual pecuniary loss. With this opinion and revisions to the insurance laws, FGIs were permitted to write financial insurance guaranty policies covering the obligations of affiliated entities (i.e. transformer entities) under credit default swaps as long as the CDS itself “does not constitute an insurance contract and the making of such credit default swap does not constitute the doing of an insurance business.” On the basis of this position, FGIs became important players in the CDS market.

It seems that a change in course is proposed in the Circular. The Department clarifies that if the making of the CDS itself may constitute “the doing of an insurance business” within the meaning of Insurance Law Section 1101, then the seller of protection should consider obtaining an opinion from the Department’s OGC to determine whether the protection seller should be licensed as an insurer under Insurance Law Section 1102. The Circular goes on to say, notwithstanding the OGC’s June 16, 2000 opinion letter, that the question still remains as to whether under Insurance Law Section 1101 a “CDS is an insurance contract when it is purchased by a party who, at the time at which the agreement is entered into, holds, or reasonably expects to hold, a ‘material interest’ in the referenced obligation.” It adds that this question will be addressed in a yet to be issued opinion of the OGC.

A great deal has been made of CDS and its role in the current financial crisis. Eric Dinallo, the Insurance Superintendent of the State of New York, said: “The severity of this crisis was substantially increased by what the government chose not to regulate, principally credit default swaps.” Many in the market suggest that increased oversight of CDS will likely follow in the months ahead; what is not certain is what form such oversight will take.

The focus of the New York State insurance regulators is on transactions where the buyers of protection “hold, or reasonably expects to hold, a ‘material interest’ in the reference obligation.” Transactions such as basis trades and capital relief structures, such as balance sheet CDOs, will therefore fall within the regulatory net cast by the insurance regulators. In these transactions the buyers hold the underlying reference obligation. According to the Department’s press release, most credit default swaps, which are so-called “naked swaps”—swaps held by speculators who do not own the underlying security or other obligation and therefore have no insurable interest—will remain unregulated. It is their view that naked swaps have no insurable interest and therefore are not deemed insurance contracts.

The Department’s efforts somewhat fail to address the fundamental concerns commentators raise regarding the involvement of CDS in the current financial crisis: lack of transparency, leverage and counterparty risk. Although perhaps counterparty risk would be addressed to the extent a seller of protection is regulated by insurance regulators and is required to comply with the capital standard and reporting requirements applicable to insurance companies. A central clearing mechanism and the requirement to publicize positions, and perhaps mandated position limits, more effectively address risk commonly pointed to as being at the heart of the financial system’s current issues.

The Impact of Widespread Regulation of the Credit Default Swap Market

In addition, there is some uncertainty and apprehension in the market when considering what the OGC’s opinion might address. Robert Pickel, Executive Director and Chief Executive Officer of the International Swaps and Derivatives Association, is quoted in a press release of the association as urging that “[t]he State of New York should proceed very cautiously and in consultation with Federal regulators before acting in a way that may ultimately cause more harm than good.”

For one, unless legislative changes are implemented, there are potentially drastic tax consequences which result from treating CDS as insurance. Offshore funds with investment managers located in the United States would be subject to federal income tax. We would likely see a flight away from domestic investment managers as many fund managers would move their operations outside of the United States. Also, periodic payments by the buyers of protection based in the United States would be subject to federal withholding and excise tax.

As different regulators focus on credit default swap market and seek to flex their regulatory muscle, the Department’s Circular will likely not be the last word on regulation. The Securities and Exchange Commission Chairman Christopher Cox has pressed Congress to authorize the regulation of these products in order to improve investor protection and ensure the proper operation of the markets. Similarly, the Commodity Futures Trading Commission has called for regulation. Without suggesting which regulator should be responsible or, indeed, whether regulation is the answer, a patchwork of regulation would likely have unintended consequences and harm the markets. As New York State’s insurance regulators have taken the first step, it unfortunately seems that we are heading towards a world in which CDS market participants will be forced to navigate varying regulatory regimes imposed by multiple regulators. We can only hope the rules do not conflict.

The Circular is available at www.ins.state.ny.us/press/2008/p0809224.pdf.

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