New York State Insurance Department Published Guidelines for Financial Guaranty Insurers of Collateralized-Debt Obligations

On September 22, 2008, the New York State Insurance Department (the "Department") issued Circular Letter No. 19 (the "Circular Letter") setting forth guidelines for "best practices" for financial guaranty insurers ("FGIs").[1] The guidelines are an after-the-fact effort by the Department to address what has become a significant issue in the present economic crisis — the largely unregulated utilization of credit default swaps ("CDS") as risk transfer devices. The guidelines address a variety of technical issues pertaining to the issuance of CDSs as a means of circumscribing market practices with the objective of carving out an area of insurance regulation for the CDS market. It is the Department's position that, under Section 1109 of the New York Insurance Law (the "Insurance Law"), 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" and thus the seller of the CDS should be subject to regulation by the Department.

Historically, CDSs have generally not been considered to be insurance contracts and have thus been sold by entities not subject to insurance regulation. The position taken by the Department in the Circular Letter would radically change the nature of the CDS market by requiring CDS sellers to comply with a strict regime of capital and other requirements imposed on FGIs that are intended to manage operational and financial risk. Prevailing market forces over the past year may have already started this process, but the Department's guidelines are an effort to address in concrete terms what it views as one of the contributors to the present illiquid state of the credit markets.

While the guidelines are not binding in the absence of the promulgation of Department regulations or the enactment of legislation, the guidelines put sellers of CDSs on notice that the Department intends to attempt to regulate the CDS market.[2] Whether or not the Department is successful in putting binding regulations in place (or convincing the New York legislature to enact relevant legislation), it can be anticipated that CDS issuers operating in New York State will come under increased scrutiny from the Department commencing January 1, 2009, the date the Department has stated that the guidelines will be given effect. Therefore, entities which are not presently subject to Department regulation should consider the impact of the Circular Letter on their existing CDS business and what modifications might be required should the Department make efforts to enforce the guidelines in some manner. The Circular Letter suggests that any party seeking to write a CDS (*i.e.,* the "protection seller") should seek an opinion from the Department's Office of General Counsel regarding whether the protection seller should be licensed as an insurer pursuant to Insurance Law § 1102.

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[1] Circular Letter No. 19 (2008), available at http://www.ins.state.ny.us/circltr/2008/cl08_19.pdf.

[2] Even absent future regulations or legislation, the Department of Insurance and the New York Attorney General would be able to take the position that a party (other than an FGI insurer licensed in New York) writing a CDS in New York of the type deemed to be "insurance" under the Circular Letter is engaging in an unlicensed insurance business in New York and subject to civil and/or criminal sanctions. Specifically, under §§ 109 and 1102(a) of the Insurance Law, engaging in an unlicensed insurance business is a misdemeanor and is subject to a $1000 fine for the first violation and a $2500 fine for each subsequent violation.

I. Background

Under a three-part plan announced in January 2008,[3] the Department set out to (1) attract more capital and increase capacity to protect policyholders and ensure continued availability of bond insurance, (2) facilitate solutions to current market challenges, and (3) develop stronger regulation for bond insurance. To the extent CDSs are the economic equivalent of bond insurance, the Circular Letter specifically addresses the third part of the plan and attempts to draw CDSs within the scope of Department regulation of bond insurance.

Briefly, the principal reason stated in the Circular Letter to justify doing so is as follows. The Circular Letter notes that one common structure for issuers of CDSs is to have an unregulated, minimally capitalized entity sell a CDS. That entity's obligation is then guaranteed by an insurance company. However, because the CDSs seller is not itself regulated, the terms of the CDS need not conform, and the CDS seller itself need not conform, to the provisions of the insurance law applicable to FGIs. Thus, under such a structure, CDSs the insurance company might not have been able to sell directly will have been sold and guaranteed by an insurance company. In the event the CDS seller is required to make payments under the CDS, it may not have the resources to do so and thus the payment obligation becomes that of the guaranteeing insurance company. In general, structures such as this, and the risks they expose insurance companies to, are sought to be eliminated by the guidelines.

II. The Guidelines Will Deem CDSs to Be Insurance Contracts

The guidelines take the position that under certain circumstances, which are prevalent in the CDS industry as it presently operates, CDSs will be considered by the Department to be insurance contracts. This position reverses a position taken by the Department a number of years ago.

Through a series of letters and opinions beginning in 1997, the Department had concluded that (1) an FGI may lawfully provide a financial guaranty policy with respect to the payment obligations of an affiliated special purpose vehicle ("SPV") under the terms of a CDS, (2) guarantees of "termination payments" under a CDS were not impermissible "acceleration payments" prohibited under Insurance Law § 6905, (3) pools of CDSs could be regarded as "asset backed securities" under Insurance Law § 6901(e) and, as such, were "permissible guarantees" under Insurance Law § 6904(b), and (4) a CDS is not an insurance contract if the payment to the protection buyer is not conditioned on actual pecuniary loss.[4] Additionally, Article 69 of the Insurance Law was amended in 2004 to specifically include CDSs or pools of CDSs in the definition of "asset-backed securities," provided that the CDSs does not constitute an insurance contract.

The Circular Letter states the Department's position that henceforth, under Insurance Law § 1101, a CDS will be considered to be an insurance contract when it is purchased by a party who, at the time at which the CDS is entered into, holds, or reasonably expects to hold, a "material interest" in the referenced obligation. In such cases, the Department expects FGIs to seek an opinion from the Department's Office of General Counsel to assess whether the protection seller should be licensed as an insurer pursuant to Insurance Law § 1102.

This position is a dramatic departure from existing law and practice, where it is common that parties writing CDSs are not licensed as insurance companies in any jurisdiction.[5] The one exception to this new position

[3] *See* Press Release, "New York Insurance Department Implementing Three-Point Plan on Bond Insurance," January 22, 2008, available at http://www.ins.state.ny.us/press/2008/p0801221.htm.

[4] Opinion of the Office of the General Counsel, June 16, 2000 (the "2000 Opinion").

[5] As the legal justification for the Department's position, the Circular Letter relies upon a proviso to Section 6901(j-1) of the New York Insurance Law which states that a CDS "does not constitute an insurance contract and the making of such

would be a CDS which contains a provision to the effect that it is a *condition to payment that the counterparty suffer a loss arising out of the triggering event in at least the amount of the amount due under the CDS* — which in practice is a very rare provision. In such an instance, the counterparty would in effect have to have an insurable interest, and the contract arguably would be one of insurance. CDSs typically are written providing that a payment in a determinable amount, and/or the posting of collateral to secure future payment obligations, be made upon the occurrence of a triggering event irrespective of whether the counterparty at the time of payment or at any other time has a loss. While it is frequently the case that CDSs are purchased to hedge risks, rather than as naked bets, so long as the documentation does not contain a provision conditioning payment upon an insurable interest, the general understanding and practice has been to regard CDSs as not being insurance.[6]

If the Circular Letter is taken to its logical extreme, the Department would appear to be seeking to assert regulatory jurisdiction over bank holding companies and other financial institutions which write or guarantee CDSs notwithstanding that they are subject to regulation under federal law or by other New York state regulators.[7] Moreover, the test articulated by the Department for whether a CDS is insurance such that the writer may fall within the ambit of the Department's jurisdiction does *not* address whether or not the material interest in the reference obligation must be held at the time a payment is triggered under the derivative. Thus, if a party holds the referenced obligation on the day the CDS is purchased but sells the referenced obligation the next day and retains its interest under the CDS, under the test articulated in the Circular Letter the CDS would be insurance although in economic fact it would be a naked bet (commonly understood to be a derivative, not insurance).

Query also what constitutes a "material interest" in a "referenced obligation." Consider for example a trade creditor of ACME, Inc. who purchases a CDS linked to default by ACME on its commercial paper as a legitimate, albeit imperfect, hedge for the trade receivables. Many derivatives in practice involve this sort of potential mismatch (or "basis risk"), and query at what point the mismatch becomes so attenuated that the hedge is no longer considered insurance.

III. Overview of Regulation of Financial Guaranty Insurers

Should the Department succeed in imposing the position taken in the guidelines with respect to CDSs, protection sellers who are not presently subject to Department regulation may find that to continue to do business they must conform to the regulations applicable to FGIs. Note that if this regulatory regime applies, it would apply to the entire entity and its capital structure, not just to the entity writing the CDS business.

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credit default swap does not constitute the doing of an insurance business." One could argue that the meaning of this proviso is to make clear that in permitting FGIs to write CDSs the statute did not preclude others, such as banks, from writing them as well. In contrast, the Circular Letter argues that the purpose of the proviso was to limit the use of special purpose vehicles guaranteed by FGIs to non-insurance situations. The Circular Letter then draws the negative inference that there are insurance CDSs and non-insurance CDSs such that the Department can regulate the former.

6 *See* 2000 Opinion.

7 The distinction being made by the Department could lead to the perverse result that banks, financial institutions and other parties writing CDSs could do so for counterparties which are simply gambling on the credit quality of the issuer of the referenced obligation but could not write CDSs (without getting an financial guarantee insurance license) for counterparties with a real exposure to hedge. From the point of view of the writer of the CDS, the CDS is no more or less potentially toxic in one situation versus the other; from the point of view of the purchaser, one would think that the regulatory authorities would want to encourage (and facilitate broad and deep markets for) legitimate hedging and the spreading of risk and discourage pure speculative bets.

The regulation of FGIs in New York is governed by Article 69 of the Insurance Law, which applies exclusively to such companies. The current requirements, designed to safeguard FGIs against insolvency, include:

- Minimum Capital: FGIs must have a minimum initial capital and surplus of $75 million and must thereafter maintain a policyholders' surplus of at least $65 million.[8]
- Contingency Reserves: FGIs must maintain reserves based on the greater of 50% of premiums written for each category of security guaranteed or a sum arrived at by multiplying specific factors, including the relative risk of each class of security guaranteed, by the principal amount of each class of security guaranteed.[9]
- Aggregate Risk Limitations: Based on contingency reserves and policyholders' surplus, FGI's are limited in amount and type of securities that they may insure.[10]
- Single Risk Limitations: FGIs must limit their exposure to any one risk to a percentage of the aggregate of the policyholders' surplus and contingency reserve.[11]
- Limitation on Non-Investment Grade Securities: 95% of the municipal obligation bonds, special revenue bonds and industrial development bonds insured by an FGI must be investment grade.[12]

IV. Department Guidelines for Best Practices

The "best practices" outlined in the Circular Letter cover eight categories:

- Insurance for collateralized-debt obligations ("CDOs") of asset-backed securities ("ABS")
- Credit Protection for CDSs
- Concentration of Risk

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8 Insurance Law § 6902(b). In this context, "Capital" means the aggregate par value of all classes of shares of capital stock issued and outstanding and "Surplus" means the excess of total admitted assets over the liabilities of the insurer, which is the sum of all capital and surplus accounts minus any impairment thereof. *Id*. at § 107(a)(12), (42). "Admitted Assets" are assets of an insurer that conform to the requirements of Insurance Law § 1301. *Id*. at § 107(a)(3).

9 Insurance Law § 6903(a).

10 *Id.* at § 6904(c).

11 *Id.* at § 6904(d).

12 *Id.* at § 6904(b)(2). In this context, "Investment Grade" includes:

(1) obligations that are in one of the top four generic lettered rating classifications by a securities rating agency acceptable to the Superintendent of Insurance;
(2) obligations that have been identified in writing by such rating agency to be of investment grade; or
(3) if the obligation has not been submitted to any such rating agency, the obligation is determined to be investment grade by the Securities Valuation Office of the National Association of Insurance Commissioners.

See Id. at § 6901(n).

- Non-Investment Grade Credit Risk and Monitoring
- Restatement of Appropriate Underwriting and Risk Management Standards
- Increased Capital and Surplus Requirements
- Increased Capital for Insurance that Includes Operating Leverage
- Additional Regulatory and Reporting Requirements

A. Additional Limitations on FGI's Writing CDSs

The Circular Letter advises that FGIs should limit the issuance of policies on CDS to those where:

- The FGI only guarantees failures to pay obligations when due or payable when the failure is the result of a financial default or insolvency, as specified in Insurance Law § 6901(a)(1)(A);
- Neither the definitions of credit event, termination event, nor event of default in the CDS agreement or the financial guaranty insurance policy include a change in credit quality, rehabilitation, liquidation, or insolvency of the FGI providing credit support; and
- Neither the CDS agreement nor the financial guaranty insurance policy requires the FGI to post collateral.

B. Insurance for CDOs of ABS

FGIs should restrict significantly the issuance of policies that back pools of ABS that are comprised or include portions of other pools of ABS, such as CDOs or CDO-squareds.[13] Accordingly, FGIs should not insure these types of obligations unless:

- The FGI holds an unsubordinated, senior position with an investment rating of single-A or above;
- The underlying assets are issued or guaranteed by a government-sponsored entity;
- The pool consists entirely of the portion of other pools of ABS that are already insured by the FGI; or
- The Superintendent has determined that the insurance is without undue risk to the FGI, its policyholders, and the people of the State of New York.

[13] "CDO-squareds" is a term which refers to pools of CDOs.

C. Concentrations of Risk

Currently, under Insurance Law § 6904(d), FGIs must limit their exposure to obligations with respect to a "single entity" to 10% of their aggregate surplus and contingency reserves. The Circular Letter now requires that the definition of "single entity" include not only the issuer of debt, but also the initial lender and servicer of each category of obligation, regardless of the type of underlying collateral. In addition, the Department now expects to be promptly notified in writing if the "single entity" limits are exceeded, which notice shall include an explanation of the intended actions to reduce exposure.

D. Non-Investment Grade Credit Risk and Monitoring

As discussed above, currently, 95% of the municipal obligation bonds, special revenue bonds and industrial development bonds insured by an FGI must be investment grade. The Department will now require that 95% of an FGI's entire investment portfolio, including structured finance investments, must be investment grade, unless the FGI can demonstrate that a lower standard is not detrimental to its policyholders or the people of the State of New York. The Department also expects to be promptly notified in writing if the 95% minimum requirement is not met for at least 30 days, which notice shall include an explanation of the actions which the FGI intends to take to meet the standard.

E. Restatement of Appropriate Underwriting and Risk Management Standards

In addition to the current requirement that new FGIs submit a plan of operation to the Department[14] and that they adhere to the bright line capital, surplus, and contingency reserve requirements discussed above, which are proposed to be enhanced as set forth below, the Department now expect FGIs to maintain:

- Sufficient liquidity to pay claims, including extreme stress scenarios;
- Appropriate risk underwriting policies, criteria, and procedures to ensure sufficiently low levels of risk of default or severity of loss, to ensure appropriate pricing and accurate estimate of anticipated losses, and to use dynamic risk modeling and management thereafter; and
- Sufficient control and remediation rights to mitigate the potential severity of any loss.

F. Increased Capital and Surplus Requirements

The Department intends to seek legislation to (1) increase the minimum initial capital and surplus from $75 million to $180 million, comprised of $15 million in paid-in capital and $165 million in paid-in surplus, and (2) increase the amount an FGI must maintain in policyholders' surplus from least $65 million to at least $150 million. Pending the actual increase, the Department expects all FGIs to maintain the higher levels.

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[14] Insurance Law § 6902(a)(3) requires that the plan detail:

> [T]he types and projected diversification of financial guaranty insurance policies that will be issued, the underwriting procedures that will be followed, managerial oversight methods, investment policies, and such other matters as may be prescribed by the Superintendent.

G. Increased Capital for Insurance that Includes Operating Leverage

The Department views financial guaranty insurance policies issued with respect to specific tranches (other than the senior-most tranche) of an obligation to be "leveraged" (in contrast to policies which insure an entire instrument). The Department expects FGIs to maintain capital and contingency reserves no less that the greater of 300% of the amount required for that tranche, or the capital and contingency reserves for all tranches senior to and including that tranche that are not already insured by that insurer. This requirement does not apply to the super-senior tranche of any obligation (or any junior tranches for which the insurer also insures all the senior tranches of that obligation).

H. Additional Regulatory and Reporting

FGIs are required to report any failures to comply with the standards set forth in the Circular Letter and to report:

- The basis for material declines in policyholder surplus;[15]
- When the notional value of an FGI's aggregate liabilities on its guaranteed obligations rise above multiples of policyholders' surplus and contingency reserve;
- On a periodic basis, all guaranteed obligations with data sufficiently transparent to be properly evaluated by the Department for degree of risk; and
- All guarantees and insurance contracts entered into between insurers and SPVs.

Whether the Department will be successful in effecting the fundamental changes in the CDS industry signaled by the Circular Letter remains to be seem. The guidelines as drafted raise a number of significant interpretative issues as to their intended scope and how they might be applied in practice. These sorts of issues will have to be worked through in the event regulations or legislation is proposed — or may be litigated if the Department seeks to enforce adherence to the guidelines themselves. However, as the current credit market crisis continues, the likelihood of some regulatory or legislative action on the subject of CDSs seems almost inevitable.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Thorn Rosenthal at 212.701.3823 or trosenthal@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; Charles Gilman at 212.701.3403 or cgilman@cahill.com; or Banks Bruce at 212.701.3052 or bbruce@cahill.com.

15 In this context, "material" means declines in policyholder surplus of 5% or more for insurers with less than $500 million, and 20% or more for insurers with more than $500 million, based on the end of the previous quarter.

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