President's Working Group Takes Lead on CDS Regulation, NY Insurance Department Steps Aside

It has been widely asserted by the financial community, regulators and politicians that credit default swaps ("CDSs") have played a significant role in the financial meltdown that has befallen the financial system. However, despite the financial harm some have attributed to these instruments, it is also widely acknowledged that CDSs can provide value to the financial system as risk transfer devices and by enhancing the market liquidity of financial instruments. As a result, in the past several months there have been calls for a new and comprehensive regulatory structure for the CDS market.[1]

The New York State Insurance Department (the "Insurance Department") was the first to answer the call when, on September 22, 2008, it issued Circular Letter No. 19 (the "Circular Letter") setting forth guidelines for "best practices" for financial guaranty insurers ("FGIs").[2] The Circular Letter addressed 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. In essence, it was the Insurance Department's position that, under Section 1109 of the New York Insurance Law (the "Insurance Law"), a CDS is an insurance contract when the purchaser holds a "material interest" in the "referenced obligation." The position taken by the Insurance Department in the Circular Letter, and the legislation that would have been sought to effect the same, would have radically changed 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.

After the Insurance Department's announcement, the President's Working Group on Financial Markets (the "PWG"), composed of the Secretary of the Treasury and the Chairs of the Federal Reserve Board (the "Board"), the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC"), began to actively develop policy objectives for the over-the-counter ("OTC") derivatives market, with a primary focus on CDSs. As a culmination of their efforts, on November 14, 2008, the PWG announced certain initiatives to strengthen oversight and infrastructure of the OTC derivative markets.[3] Specifically, the PWG will oversee the implementation of central counter party ("CCP") services for CDSs traded in the OTC derivatives market. Such services could benefit the OTC derivative market by reducing systemic risk associated with counterparty credit exposures. To facilitate the regulatory aspect of the CCP services, the Board, the SEC and the CFTC entered into a nonbinding Memorandum of Understanding (the "MOU") which provides a framework for consultation and information sharing on issues related to CCPs. Finally, the PWG announced a broad set of policy objectives (the "Policy Objectives") to guide efforts to address the full range of challenges associated with OTC derivative markets.

In response to the PWG's initiatives, the Insurance Department announced that it would delay indefinitely its plan to regulate part of the CDS market.[4] The Insurance Department justified its policy reversal by noting that

---

[1] However, some commentators have claimed that the CDS market is one of the few bright spots in the failing economy and that "there's no reason to fix what's not broken." Crovitz, L. Gordon, *When Even Good News Worsens a Panic,* The Wall Street Journal, November 24, 2008 at A17.

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

[3] Press Release, *PWG Announces Initiatives to Strengthen OTC Derivatives Oversight and Infrastructure* (November 14, 2008) available at http://www.ustreas.gov/press/releases/hp1272.htm.

[4] *See* Press Release, *Recognizing Progress by Federal Government in Developing Oversight Framework for Credit*

"the best solution for a healthy market in credit default swaps is a single market. That won't happen if New York regulates some transactions under the insurance law, while the rest of the market is either unregulated or regulated under other laws." The Insurance Department made clear that it will revisit the issue of regulating those CDSs which it considers insurance at the time when Congress and the other relevant federal agencies have completed their efforts to fully regulate the CDS market. However, even in delaying its own specific plans to regulate the CDS market, the Insurance Department offered five principles that must be part of any effective regulatory scheme:

1. All sellers must maintain adequate capital and post sufficient trading margins to minimize counterparty risk;
2. A guaranty fund should be created that ensures that a failure of one seller will not create a cascade of failures in the market;
3. There must be clear and inclusive dispute resolution mechanisms;
4. To ensure transparency and permit monitoring, comprehensive market data should be collected and available;
5. The market must have comprehensive regulatory oversight, and regulation cannot be voluntary.

This memorandum will discuss and analyze the PWG's initiatives relating to the regulation of the CDS market, especially in light of the structure initially proposed by the Insurance Department.

I. The New York Insurance Department's Plan

Historically, CDSs have generally not been considered to be insurance contracts and have thus been sold by entities not subject to insurance regulation.[5] However, in the Circular Letter, the Insurance Department took the position that 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.[6]

Default Swaps, New York Will Stay Plan to Regulate Some Credit Default Swaps, November 20, 2008, available at http://www.ins.state.ny.us/press/2008/p0811201.htm. *See also* Testimony by Superintendent Eric Dinallo of the New York State Insurance Department to the US House of Representatives Committee on Agriculture, November 20, 2008, available at http://www.ins.state.ny.us/speeches/pdf/sp0811201.pdf.

5 Through a series of letters and opinions beginning in 1997, the Insurance 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. Opinion of the Office of the General Counsel, June 16, 2000 (the "2000 Opinion"). 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 CDSs do not constitute an insurance contract.

6 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 CDS's 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

This position was 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.[7] If that position was taken to its logical extreme, the Insurance Department appeared 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.[8]

The Proposed Regulation of the CDS Market by the New York Insurance Department

The Insurance Department's scheme would have required protection sellers who are not presently subject to Insurance Department regulation to conform their entire capital structure to the regulations applicable to FGIs.[9] In addition, the Insurance Department offered "best practices" that an FGI would be expected to follow with respect to CDSs. The key aspects of these additional regulations are as follows:

- *The Terms of the CDS:* The CDS shall only become due or payable after the occurrence of a financial default or insolvency, as specified in Insurance Law § 6901(a)(1)(A). The CDS shall not have credit events, termination events, or events of default that include a change in credit quality, rehabilitation, liquidation, or insolvency of the FGI providing credit support. The CDS shall not require the FGI to post collateral.

- *CDS on collateralized-debt obligations ("CDOs") of asset backed securities ("ABS"):* CDSs shall not reference pools of asset-backed securities ("ABS") that are comprised or include portions of other pools of ABS, such as collateralized-debt obligations ("CDOs") or CDO-squareds[10] unless (1) the FGI

---

to, were the impetus behind the Insurance Department's proposal.

7 For a more detailed discussion of the Circular Letter and the proposed regulations thereunder, see *New York State Insurance Department Published Guidelines for Financial Guaranty Insurers of Collateralized-Debt Obligations*, Cahill Gordon & Reindel LLP Firm Memorandum (September 30, 2008) available at http://www.cahill.com/news/memoranda/000112.

8 The distinction made by the Insurance Department could have 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.

9 The current requirements under Article 69 of the Insurance Law, 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. Insurance Law § 6902(b).
- 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. *Id.* at § 6903(a).
- Aggregate Risk Limitations: Based on contingency reserves and policyholders' surplus, FGI's are limited in amount and type of securities that they may insure. *Id.* at § 6904(c).
- 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. *Id.* at § 6904(d).
- 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. *Id.* at § 6904(b)(2).

10 "CDO-squareds" is a term which refers to pools of CDOs.

holds an unsubordinated, senior position with an investment rating of single-A or above (2) the underlying assets are issued or guaranteed by a government-sponsored entity or (3) the pool consists entirely of the portion of other pools of ABS that are already insured by the FGI. The Superintendent would have the authority to make exceptions to these rules if the proposed CDS is without undue risk.

- *Concentrations of Risk:* FGIs would be required to limit their exposure to obligations with respect to a "single entity" to 10% of their aggregate surplus and contingency reserves. "Single entity" would 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. If the limitation is exceeded, the FGI must promptly provide a notification including the intended actions to alleviate the excess.

- *Non-Investment Grade Credit Risk and Monitoring:* The Insurance Department would 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. If the minimum requirement is not met for at least 30 days, the FGI must promptly provide a notification including the intended actions to alleviate the violation.

- *Restatement of Appropriate Underwriting and Risk Management Standards:* New FGIs would be required to submit a plan of operation to the Insurance Department[11] and the Insurance Department would expect all FGIs to maintain (1) sufficient liquidity to pay claims, including extreme stress scenarios, (2) 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 (3) sufficient control and remediation rights to mitigate the potential severity of any loss.

- *Increased Capital and Surplus Requirements:* The Insurance Department would require minimum initial capital and surplus of $180 million, comprised of $15 million in paid-in capital and $165 million in paid-in surplus, and minimum policyholders' surplus of at least $150 million.

- *Increased Capital for Insurance that Includes Operating Leverage:* The Insurance Department would view 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 Insurance Department would expect 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.

- *Additional Regulatory and Reporting:* FGIs would be required to report any failures to comply with the standards set forth in the Circular Letter and to report (1) the basis for material declines in policyholder surplus,[12] (2) when the notional value of an FGI's aggregate liabilities on its guaranteed obligations rise above multiples of policyholders' surplus and contingency reserve, (3) on a periodic

[11] 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.

[12] 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.

basis, all guaranteed obligations with data sufficiently transparent to be properly evaluated by the Insurance Department for degree of risk and (4) all guarantees and insurance contracts entered into between insurers and special purpose vehicles.

II. The Federal Government's Plan

The PWG's approach to regulating the CDS market is quite different from the approach proposed by the Insurance Department. While the Insurance Department's Circular Letter contemplated specific regulations relating to capital requirements and risk management standards, the PWG's approach focuses more on creating an OTC market infrastructure which minimizes systemic risk by making use of CCP arrangements. Under the PWG's plan, a CCP for CDSs would be (1) a state-charted bank that is a member of the Federal Reserve, (2) a derivatives clearing organization as defined in Section 1a(9) of the Commodity Exchange Act and a member of the CFTC, or (3) or a clearing agency as defined in the Securities Exchange Act of 1934.

A. Policy Objectives

To further its goal of successfully implementing CCP services for CDSs, the PWG has laid out the following policy objectives:

- *Improve Market Transparency and Integrity for CDSs:* The CCP arrangements should allow for the public reporting of OTC market data, including prices and trading volumes. In addition, regulators should have access to trade and position information for the purpose of monitoring market trends, identifying potential issues, and preventing market manipulation and insider trading.

- *Enhance Risk Management of OTC Derivatives:* Market participants are encouraged to adopt best practices including netting and collateral agreements, public reporting, liquidity management, senior management oversight and counterparty credit risk management. Regulators should establish policy standards and risk management expectations for CCPs and regulated entities that transact in OTC derivative instruments.

- *Strengthen OTC Derivatives Market Infrastructure:* Regulators should require market participants to clear all eligible contracts through the CCPs, which may also require strengthening the legal framework governing the bankruptcy regime to ensure adequate protection. Additionally, regulators must encourage the use of exchange platforms which provide pre-trade transparency for trades in standardized CDS contracts. For those CDSs which are not cleared through a CCP, details should be retained in central contract repositories.

- *Continue Cooperation among Regulatory Authorities:* Regulators should review their enforcement authority and capability to ensure adequate coverage of fraud and market manipulation. Existing OTC derivatives activities should be expanded to include cooperation, coordination and information sharing.

B. Memorandum of Understanding

The MOU documents the understanding among the Board, the SEC and the CFTC (collectively, the "Parties") with respect to their shared responsibilities in overseeing certain systemically important payment, clearing, and settlement activities for the CCPs for CDSs. The focus of the MOU is to provide a framework for sharing information between the Parties and, in so doing, enhance the ability of the Parties to effectively carry out their respective statutory responsibilities and minimize duplicative efforts. It should be noted, however, that the MOU, by its terms, does not create any legally binding obligations or any enforceable rights. Key aspects of the

MOU are as follows:

- *Sharing Information:* The Parties will share information in connection with their respective supervisory and regulatory responsibilities for CCPs. The information to be shared may include (1) the review and approval of any proposed CCP, (2) any proposed changes to the rules, policies, or procedures of a CCP regarding the CCP's risk management systems, internal controls, liquidity and financial resources, operations, or governance, (3) examination reports or results with respect to the same, and (4) CDS market data and any assessments of the conditions in such market. To effect the sharing of information each Party agrees to designate an individual to serve as its primary regulatory liaison.

- *Maintaining Confidentiality:* To the extent permitted by applicable laws, the Parties will maintain the confidentiality of all non-public information obtained pursuant to the MOU. This includes (1) establishing and maintaining necessary and appropriate safeguards, (2) notifying another Party of any legally enforceable demand for non-public information provided by such Party and giving such Party the reasonable opportunity to respond, (3) refraining from making public any portion of such non-public information without the prior written consent of the Party providing such information, and (4) allowing a Party that provided information to intervene in any related action solely to protect the confidentiality of such information.

- *Use of Information:* The information received under the MOU must be used in accordance with the terms of the MOU. If information received reflects the judgment, analysis, opinion or findings of the Party that provided such information (in the judgment of such Party), then any other Party may not use such information in any enforcement investigation, proceeding or civil action without the written consent of such providing Party. Any other non-public information can be used for such purposes by a receiving Party if such receiving Party could have independently obtained such information through its regular regulatory functions. However, any disclosure to a third party would require consent of the Party that provided such information.

III. Comparison and Conclusion

In comparing the two approaches, the most notable difference is the level of specificity proposed by the Insurance Department with the objective of regulating a smaller universe of "insurance-like" CDS transactions compared to the more ambitious and more comprehensive OTC market structure the PWG has proposed, which leaves many of the specifics to be decided by a group of regulators with overlapping responsibilities. In other words, the Insurance Department proposed to carve out a portion of the CDS market and apply a regulatory regime based on an existing and functioning body of law. The PWG, on the other hand, has articulated several broad policy objectives which aim to create an OTC market with central counterparties where standardized CDS contracts can be traded with minimum exposure to systemic or counterparty risk. In addition, the PWG has facilitated an understanding between the relevant regulatory bodies as to how information relating to the CCP can be shared and used. The question remains, however, how many CCPs will exist and under what regulatory regime will they operate: the SEC, the CFTC or the Federal Reserve.

Moreover, it is not clear from the PWG announcement that the type of CDS contracts most troublesome in the eyes of the Insurance Department, that is, privately negotiated contracts under which financial institutions buy protection from large insurance companies, are even contemplated by the PWG's approach. Unlike so-called "naked" swaps,[13] the types of CDS contracts focused on by the Insurance Department are not normally traded at

[13] A "naked" swap, similar to a "naked" short, refers to a CDS contract where the buyer has no actual exposure to the

all, but instead are held to maturity by the seller. Therefore, an OTC marketplace with CCPs standing in the middle of all transactions may overlook a significant portion of the CDS market.

As the current financial crisis continues to develop, it is reasonably certain that CDSs, and their inter-relationship to other facets of the financial system, will receive intense focus. Whether the PWG's plan will have the desired remedial effect on the CDS market, or whether New York State will feel compelled to revive its regulatory proposal, remains to be seen.

* * *

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 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; Thorn Rosenthal at 212.701.3823 or trosenthal@cahill.com; or Banks Bruce at 212.701.3052 or bbruce@cahill.com.

underlying obligations.

This memorandum is for general information purposes only and is not intended to advertise our services, solicit clients or represent our legal advice.