



## Credit Default Swaps – Insurance or Not?

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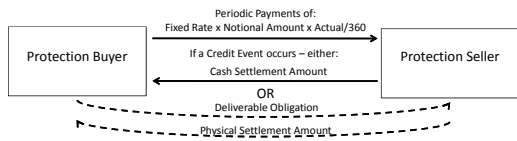
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## What is a Credit Default Swap?



Reference Entity = Debt Issuer  
Reference Obligation = Specific Debt  
Credit Event = Failure to Pay  
Bankruptcy  
Notional Amount = \$ amount

Cash Settlement vs. Physical Settlement

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## History of CDS

- CDS market started in early 1990s
  - Created by banks seeking to reduce credit risk exposure
  - ISDA published first CDS definitions in 1999
- 2000-2001 was turning point in CDS market
  - Global economic concern and uncertainty drove default concerns
  - ISDA published new CDS definitions in 2003
- Significant growth in products and volume during 2000s

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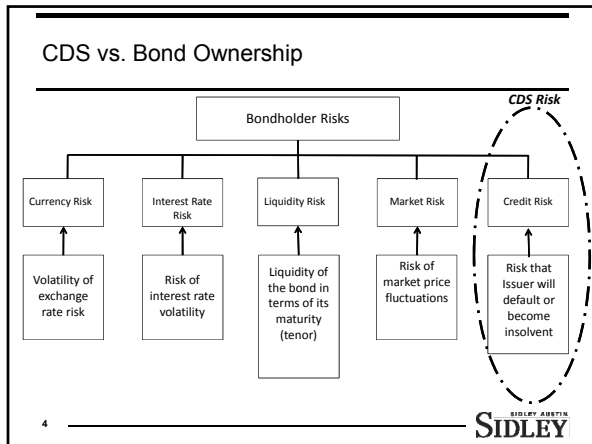
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### The Distinction Between CDS and Insurance

- Because CDS provides protection with respect to credit default risk, the instrument has drawn attention from insurance regulators
- If CDS falls under the state law definition of “insurance”, dealer-counterparties (who sell protection) could be viewed as “conducting an insurance business”, subject to state regulation as insurers
  - Categorization as “financial guaranty” insurance
- Analysis begins with the applicable state law definition of “insurance”

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### Elements of Insurance

- While “insurance” is defined under the insurance laws of each state, there are common definitional components that are present in all states (and English law)
- 3 key elements of insurance:
  - (1) the applicable agreement must confer upon the insured or beneficiary a pecuniary benefit;
  - (2) the pecuniary benefit is payable upon the occurrence of a fortuitous event; and
  - (3) the insured or beneficiary has a material interest that may be adversely affected by such fortuitous event.
    - Often presented as the “insurable interest” or “indemnity” requirement

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## CDS Characteristics

- CDS have the first two elements of the classic state law definition of insurance:
  - Conferring a pecuniary benefit
  - Payable upon occurrence of a fortuitous event
- CDS lacks the element of a requirement of insurable interest or indemnity
  - Protection buyer not required to own or have exposure to reference entity or reference obligation
  - Payment obligation is triggered upon a credit event, regardless of any loss
  - Amount payable under CDS (e.g. cash settlement amount or physical settlement amount) is determined without regard to any loss

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## Interpretations of Applicable Insurance Law

- UK Law – Robin Potts opinion
  - Requisitioned by ISDA, in response to the creation of CDS
- U.S. Law – Limited interpretative precedent under U.S. state law regarding CDS
- U.S. Law – New York Insurance Department OGC Opinions providing guidance regarding other financial instruments:
  - May 31, 1995 Opinion from Rochelle Katz regarding Guaranty of Mutual Fund Performance
  - February 29, 1996 Opinion from Rochelle Katz regarding Mutual Fund Offering with "Redemption Right"
  - June 25, 1998 Opinion from Paul F. Altruda regarding Catastrophe Options
  - June 26, 1998 Opinion from Michael J. Moriarty regarding Index Swap Transaction
  - February 15, 2000 Informal Opinion regarding Weather Financial Instruments

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## Recent Regulatory Attention to CDS

- New York – Circular Letter No. 19 (2008) "best practices" for financial guaranty insurers (September, 2008), September 12, 2008 and First Supplement to Circular Letter No. 19 (2008), November 20, 2008
  - Initially suggested that 'covered' credit default swaps may be 'insurance' within NY Insurance Code
  - First Supplement delayed 'indefinitely' interpretation by Department
- State of Missouri Insurance Department – Insurance Bulletin 08-12: Covered Credit Default Swaps (November 19, 2008)
  - Subjects 'covered' credit default swaps to regulation under Missouri insurance law

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**Recent Regulatory Attention to CDS (cont'd)**

- National Conference of Insurance Legislators (NCOIL) Model Credit Default Insurance Legislation (adopted, November, 2009)
  - Legislative intent to ban 'naked' credit default swaps
  - Requires 'covered' credit default swap providers to be licensed as a "Credit Default Insurer"
  - Closely tracks New York Article 69 for Financial Guaranty Insurers
    - Limits types of reference obligations that can be the subject of CDS protection provided by Credit Default Insurers
    - Requires minimum capital to be maintained
    - Limits substantive terms of Credit Default Insurance:
      - Credit Default Insurers cannot post collateral;
      - Insurance is not transferable; and
      - Obligations are not subject to acceleration upon a default or insolvency of the Credit Default Insurer.

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**Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)**

- Regulates all "Swaps" and "Security Based Swaps"
  - Broadly defines "Swaps" and "Security Based Swaps" to include virtually all traditional over-the-counter derivative products, including credit default swaps (CDS), as well as many other financial arrangements
- CDS falls within the "Security Based Swap" definition if it involves between 1 and 9 reference obligations that are "securities" and falls within the "Swap" definition if it involves 10 or more reference obligations that are "securities," or any reference obligation that is not a "security" (e.g. loans)
- CFTC has jurisdiction to regulate "Swaps"
- SEC has jurisdiction to regulation "Security Based Swaps"
- Dodd-Frank Act expressly provides that "Swaps" and "Security Based Swaps" may not be regulated by states as insurance

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**Insurance Companies are Logical Users of CDS to:**

- Buyers of credit protection to hedge credit risk of existing investments and exposures
- Sellers of credit protection to replicate credit risk by "synthetically" investing in credits
- Use of derivatives – including CDS – by insurers are subject to regulatory limitations
  - State investment law limitations
    - Quantitative limits
      - Instruments
      - Strategies
      - Counterparty exposure
    - Qualitative limitations
      - Derivatives Use Plans (DUPs)

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### Implications of CDS Counterparty Bankruptcy

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### Termination Value/Payments

- 1992 ISDA Master Agreement:
  - Market Quotation or Loss
  - First Method or Second Method
- 2002 ISDA Master Agreement:
  - Close Out Amount
  - Second Method

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### U.S. Bankruptcy Code

- Preferential treatment of derivatives contracts
  - Not subject to automatic stay
  - Ability to terminate and close out contract
  - Ability to foreclose on collateral
  - Pledging of collateral and marking-to market not subject to voidable preference

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## State Insurance Laws

- Insurance Companies (domestic) are **NOT** Bankruptcy Code eligible debtors
  - Insolvency governed by state insurance company insolvency laws
  - Ten states have adopted a version of the specialized Bankruptcy Code-like provisions of the NAIC Insurer Receivership Model Act (IRMA)
- Model Act States:
  - Slight variations from state-to-state
    - Ability to terminate and close out contract
    - Ability to foreclose on collateral
- Non-Model Act States:
  - Implications and remedies vary from state-to-state

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## Section 711: Qualified Financial Contracts of the Insurer Receivership Model Act

Notwithstanding any other provision of this Act, including any other provision of this Act permitting the modification of contracts, or other law of a state, no person shall be stayed or prohibited from exercising:

- (1) A contractual right to cause the termination, liquidation, acceleration or close out of obligations under or in connection with any netting agreement or qualified financial contract with an insurer because of:
  - (a) The insolvency, financial condition or default of the insurer at any time, provided that the right is enforceable under applicable law other than this Act; or
  - (b) The commencement of a formal delinquency proceeding under this Act;
- (2) Any right under a pledge, security, collateral, reimbursement or guarantee agreement or arrangement or any other similar security arrangement or arrangement or other credit enhancement relating to one or more netting agreements or qualified financial contracts;
- (3) Subject to any provision of Subsection 609B [(providing certain restrictions to set-off)], any right to set off or net out any termination value, payment amount, or other transfer obligation arising under or in connection with one or more qualified financial contracts where the counterparty or its guarantor is organized under the laws of the United States or a state or a foreign jurisdiction approved by the Securities Valuation Office (SVO) of the NAIC as eligible for netting

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## Contact Information

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