

NCOIL Adopts Model Law Regulating Credit Default Swaps as Insurance

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Insurance legislators have taken a first step towards state regulation of credit default swaps (“CDSs”) as insurance. On November 22, 2009, the National Conference of Insurance Legislators (“NCOIL”), an organization of state legislators whose main area of public policy concern is insurance legislation and regulation, adopted the Credit Default Insurance Model Legislation (the “Model Law”).¹ Its adoption is set against the backdrop of various federal proposals to regulate CDSs. Market participants are concerned that state regulation of CDSs would create multiple, inconsistent regimes that would be overly burdensome to comply with, and prefer uniform federal legislation. It is now up to each state to decide whether or not to adopt the Model Law.

Summary of Model Law

The Model Law requires sellers of CDSs to be licensed by the state insurance department. Licensed CDS dealers are required to comply with certain financial requirements, including a \$150 million minimum surplus to policyholders, and can only engage in certain types of permissible CDSs. They are not permitted to sell naked CDSs (defined below) and violation of this and any other requirement of the Model Law will result in civil and criminal penalties. They are also subject to regulation as property/casualty insurers to the extent not inconsistent with the Model Law.

Credit Default Swaps as Insurance

The Model Law is based on the premise that CDSs are insurance and should therefore be regulated by state insurance departments. While there are many similarities between CDSs and traditional insurance products, industry groups are quick to point out their fundamental differences.

A CDS is similar to insurance in that the buyer receives a payment only upon the occurrence of certain events. The fee for such risk protection is based on the probability of those events occurring. Under a CDS, the seller agrees to pay the buyer a settlement amount upon the occurrence of agreed-upon credit events (such as bankruptcy, payment failure or

¹ The text of the Model Law can be found at <http://ncoil.org/schedule/200930Day/Annual30Day/CDIModel.pdf>.

restructuring) with respect to a reference entity. The settlement amount is based on the difference between the par and the market value of a referenced debt obligation of the reference entity, and may be settled by payment of par by the seller against delivery of the referenced debt obligation by the buyer.

The buyer may have purchased the CDS because it owns an interest in the referenced debt obligation, and the CDS is intended to hedge its risk that the reference entity may default on such obligation. A CDS where the buyer owns the referenced debt obligation is often referred to as a “covered” CDS. However, unlike insurance, the buyer is not required to hold an “insurable interest” in order to enter into, or collect payment under, a CDS. It can also enter into a CDS for speculative or other purposes without owning any interest in the referenced debt obligation or any securities of the reference entity. In contrast, these CDSs are often referred to as “naked” CDSs and constitute the vast majority of outstanding CDSs. The Model Law bans naked CDSs.

In a letter to the Chairman of the NCOIL Task Force on Credit Default Swap Regulation dated May 22, 2009 (the “ISDA/SIFMA Letter”), the International Swaps and Derivatives Association, Inc. (“ISDA”) and the Securities Industry and Financial Markets Association (“SIFMA”) point out a number of differences between CDSs and insurance. First, as mentioned above, the CDS buyer does not have to hold an “insurable interest.” Second, the buyer can be paid after the occurrence of a credit event even without suffering actual losses due to such credit event. Third, whereas insurance contracts are usually bought and held until termination, there is robust trading in CDSs.

Main Points of Model Law

The Model Law is based on Article 69 of the New York Insurance Law (the “NYIL”), which is the statute on financial guaranty insurance, and replaces the term “financial guaranty insurance” with “credit default insurance.” It is also based on Circular Letter No. 19 issued by the New York State Insurance Department (the “NYID”) on September 22, 2008 (the “NYID Letter”).²

² See Dewey & LeBoeuf’s Client Alerts, “New Regulation of Credit Default Swaps by the New York Insurance Department; New ‘Best Practices’ for Financial Guaranty Insurers,” dated September 25, 2008, and “Credit Default Swap Central Counterparties and the Regulation of CDS,” dated November 26, 2008, for a description of the NYID Letter.

License Required to Sell Credit Default Insurance

Before an entity can “transact the business of credit default insurance” (*i.e.* sell CDSs) in a state that has adopted the Model Law, it is required to be licensed as a “credit default insurance corporation.”³ It is clear that a CDS dealer has to be licensed in its domestic jurisdiction, but it is less clear from the language of the Model Law whether it must also be licensed in the state where the CDS buyer is located. The answer will depend on whether a CDS dealer can be deemed to be “transact[ing] the business of credit default insurance” in that state.

Financial Requirements

The Model Law imposes financial requirements on credit default insurance corporations, consistent with those imposed on financial guaranty insurers under Article 69 of the NYIL and the NYID Letter. Credit default insurance corporations are required to:

- maintain at least \$15 million in paid-in capital, \$165 million in paid-in surplus and \$150 million in minimum surplus to policyholders;
- establish and maintain contingency, loss and unearned premium reserves; and
- comply with aggregate and single risk limitations based on the type of referenced debt obligation.

The single risk limitations present a challenge to the CDS market and would change the way CDS dealers operate. The Model Law provides exposure limitations to loss on any one risk covered by credit default insurance, net of collateral and reinsurance, for various types of referenced debt obligations. These limitations restrict the amount of credit default insurance a CDS dealer can sell with respect to any single reference entity in order to prevent a concentration of risk on one or more reference entities. As a result, CDS dealers may be forced to diversify more and to change their hedging strategy. CDS dealers frequently hedge their exposure by entering into offsetting CDSs, so as to end up at a risk-neutral position. However, the terms that are required to be in an agreement in order to receive credit for reinsurance are not typically contained in CDS agreements. Therefore, CDS dealers may have regulatory incentives to restructure their hedging activities so as to obtain credit for reinsurance, and to satisfy the single risk limitations.

³ Model Law, Sections 1(b) and 4(a).

Investment Limitations

The Model Law provides that a credit default insurance corporation may not invest in any reference entity on which it provides credit default insurance in excess of 4% of its admitted assets as of the last year-end. However, this investment limitation does not apply to investments payable or guaranteed by a U.S. federal or state governmental entity and rated in one of the top two rating classifications by a rating agency acceptable to the insurance department superintendent. This requirement will cause CDS dealers to further diversify their investments.

Permissible Credit Default Insurance

“Credit default insurance” is defined broadly to include both covered and naked CDSs, as well as other types of contracts and guarantees in which payment is triggered by the occurrence of a payment failure arising from a financial default, insolvency or other credit event. In addition, the insurance department superintendent is permitted to designate other substantially similar products as credit default insurance.

The Model Law lists the categories of obligations that can serve as referenced debt obligations for credit default insurance, including asset-backed securities (“ABS”). It places significant limitations on ABS which may be reference debt obligations. Such ABS must be secured by first mortgages on real property or by a pool of ABS. ABS secured by first mortgages on real property are required to either (1) have mortgages with a loan-to-value ratio in excess of 80 percent and (a) be insured by an authorized mortgage guaranty insurer or (b) satisfy a 10 percent single risk limitation; or (2) be supported by additional mortgages, other collateral or excess spread in an amount at least equal to the coverage that would have been provided by an authorized mortgage guaranty insurer. ABS secured by a pool of ABS are required to satisfy one of five conditions: (1) none of such ABS are subordinated to any other security of the issuer; (2) the credit default insurance corporation possesses control and remediation rights equivalent to those held by the most senior class of securities; (3) all such ABS are issued or guaranteed by a government unit or certain agencies; (4) all such ABS are insured by the credit default insurance corporation; or (5) the superintendent has determined that insuring the ABS does not present undue risk. These requirements and conditions significantly limit the types of ABS that can be referenced by CDSs.

In addition, these limitations require a level of information about the underlying collateral that is not commonly reviewed by CDS dealers, such

as the loan-to-value ratio of each underlying mortgage. This level of due diligence would increase the cost of credit default insurance on these types of ABS. It is unclear whether credit default insurance corporations would be required to monitor this information on an ongoing basis in order to ensure that the requirements are met. If so, this would further increase the cost of business for credit default insurance corporations.

Ban on Naked CDSs

The Model Law requires the buyer of credit default insurance to have, or expect to have, at the time of the credit event, a “material interest”⁴ in such credit event⁵ – in effect, banning naked CDSs. “Material interest” is not defined in the Model Law and it is unclear how a credit default insurance corporation is to determine whether this requirement is met.

Terms of Credit Default Insurance

The Model Law specifies certain terms of the credit default insurance. For example, upon the occurrence of a credit event, the credit default insurance corporation has the option to make scheduled payments due under the terms of the referenced debt obligation similar to financial guaranty insurance, rather than a lump sum payment as is typical under CDSs written with respect to corporate debt (as opposed to ABS).⁶ A rehabilitation, liquidation, conservatorship, bankruptcy or similar proceeding with respect to the buyer or seller will not in itself, without the occurrence of a credit event, trigger a payment, but may permit either party to terminate the CDS, so long as the termination does not require the insurer to make an early termination payment. Rates cannot be “excessive, inadequate, unfairly discriminatory, destructive, detrimental to the solvency of the insurer, or otherwise unreasonable.”⁷ Further, the superintendent is permitted to prescribe other terms of the credit default insurance that he/she determines to be necessary or appropriate.

⁴ This term is a reference to Section 1101(a)(1) of the NYIL, under which a beneficiary of an insurance contract is required to have a “material interest” which will be adversely affected by the occurrence of a fortuitous event.

⁵ Model Law, Section 4(b)(1). This probably means a material interest in the referenced debt obligation that is the subject of the credit event.

⁶ CDSs on corporate debt are typically written on a category of debt obligations, such as all loans and bonds of the reference entity. In contrast, CDSs on ABS are typically written on a specific debt obligation. CDSs on ABS typically provide for pay-as-you-go settlement, under which the seller can make multiple payments that track the performance of the referenced debt obligation, following the occurrence of an interest or principal shortfall or a writedown of that referenced debt obligation.

⁷ Model Law, Section 5(f).

Filing Requirements

Credit default insurance corporations are required to file criteria and guidelines utilized to establish rating categories and ranges of rates to be utilized prior to their use, and to file policy forms and amendments within 30 days of their use, in each case with the insurance department superintendent.

Criminal and Civil Penalties for Violations

The Model Law imposes criminal and civil penalties for violations of the Model Law. In addition, any credit default insurance corporation that sells impermissible credit default insurance will have its license revoked for a period of time.

Subject to Property/Casualty Insurance Laws

Similar to financial guaranty insurers under Article 69 of the NYIL, credit default insurance corporations are also subject to the laws applicable to property/casualty insurers to the extent such laws are not inconsistent with the Model Law.

Transition Period

The Model Law proposes a ten-year transition period, after which all entities engaged in credit default insurance are required to comply with the paid-in-capital and surplus requirements, the minimum surplus to policyholders and the aggregate and single risk limitations under the Model Law. The superintendent may extend this period for an additional six months.

Any entity licensed as a financial guaranty insurer on the effective date of the Model Law is required to apply for a license under the Model Law within a year of the effective date, and until such license is provided, may transact in credit default insurance so long as it meets all the requirements of the Model Law as of the effective date. However, any policy that was in compliance with the financial guaranty insurance laws of the insurer's state of domicile at the time of issuance is not required to comply with the Model Law during this interim period; provided that such policy is not amended or replaced on or after the effective date to extend its term, unless such amendment or replacement was executed in good faith to mitigate losses or reduce exposure to future losses (such as in a workout situation) and the superintendent is notified of such amendment or replacement within ten days.

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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Any entity not licensed as a financial guaranty insurer on the effective date of the Model Law is not permitted to transact in credit default insurance until it has been licensed as a credit default insurance corporation under the Model Law.

What's Next?

Each state must now decide whether or not to adopt the Model Law and whether to make any amendments to the Model Law before adoption. Many states will likely wait until federal legislation on CDSs is enacted, since it is possible that the Model Law may be preempted by federal legislation. Derivatives participants have been lobbying for explicit language stating that federal regulation of CDSs will preempt any state regulation of CDSs. However, none of the three federal bills that will form the basis of any enacted federal legislation⁸ currently clearly preempts state regulation of CDSs.

If federal legislation is passed that does not preempt state regulation of CDSs, some states may adopt the Model Law. According to the ISDA/SIFMA Letter, this could lead to ambiguity and inconsistency among state and federal regulatory regimes and "a patchwork of legislation with state-based variations," as each adopting state could make amendments to the Model Law. In addition, ISDA and SIFMA believe the Model Law would create an illiquid CDS market as many entities will not be able to qualify as credit default insurance corporations. This may financially harm adopting states as CDS dealers move out of state and/or fewer end users located in those states enter into CDSs. Each state must determine whether these potential adverse consequences outweigh the benefits of the Model Act.

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⁸ "Over-the-Counter Derivatives Markets Transparency and Accountability Act of 2009" introduced by House Agriculture Committee Chairman Collin Peterson; "Over-the-Counter Derivatives Markets Act of 2009" introduced by House Financial Services Committee Chairman Barney Frank; and "Restoring American Financial Stability Act" introduced by Senate Committee on Banking, Housing and Urban Affairs Chairman Christopher Dodd.