The National Conference of Insurance Legislators' Model CDS Bill

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Introduction

The National Conference of Insurance Legislators ("NCOIL") is drafting model legislation (the "Model Bill") that would subject credit default swaps ("CDS") to a state regulatory regime closely modeled on that regulating financial guaranty insurance in New York. This memorandum discusses NCOIL's plans for a state CDS regulatory regime and explores the implications of such a regime on the CDS market.

CDS and Insurance Law: The Current State of Play

In a typical credit default swap, one party (the "protection buyer") makes a stream of payments to the other (the "protection seller") so long as no negative credit event occurs with respect to one or more specified obligors. Negative credit events include a failure by the obligor to make payments on an underlying reference obligation (a "reference security") and bankruptcy. If a negative credit event occurs, the protection buyer ceases to make payments to the protection seller and receives a single payment from the protection seller.

Financial guaranty insurance protects buyers against certain financial events such as the failure of debt issuers to pay money owed to debtholders, changes in interest rates and changes in exchange rates (see sidebar on next page for an expanded definition). Like other forms of insurance, financial guaranty insurance is regulated by state law. In New York, for example, sellers of financial guaranty insurance must be licensed by the New York Insurance Department and must comply with New York Insurance Department rules, including capital adequacy requirements.

The potential similarities between CDS and financial guaranty insurance have led some to question whether CDS contracts constitute financial guaranty insurance subject to state law. The New York Insurance Department, for example, has considered the question in the context of the protection buyer's

Under Article 69 of the New York Insurance Law, Financial Guaranty Insurance Includes:

» **Contracts "under which loss is payable, upon proof of occurrence of financial loss" as a result of**
  - **a failure to pay monetary obligations due on investment grade instruments as a result of financial default or insolvency;**
  - **changes in interest rate levels;**
  - **changes in currency exchange rates;**
  - **changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general; or**
  - **similar events as determined by the superintendent,**

  but not as a result of
  - **a fortuitous physical event;**
  - **a failure of or deficiency in the operation of equipment; or**
  - **an inability to extract or recover a natural resource.**

» **In addition, certain contracts that are regulated under other insurance regimes are not included in the financial guaranty insurance definition even if they meet the above test.**

interest in the underlying security. In a 2000 opinion, the New York Insurance Department Office of General Counsel took the position that CDS are not insurance where "the seller will make payment to the buyer upon the happening of a negative credit event and such payment is not dependent upon the buyer having suffered a loss."[1] Under this opinion, so long as the CDS contract does not require the protection buyer to suffer an actual loss (regardless of whether the protection buyer actually holds or intends to hold a reference security), the CDS would not be insurance. "Naked CDS," those in which the protection buyer does not hold the reference security, are not financial guaranty insurance under such an interpretation and are not regulated by the New York Insurance Department. On September 22, 2008, the New York Insurance Department released Circular Letter No. 19, proposing to classify CDS as insurance if the protection buyer "*holds, or reasonably expects to hold,* a material interest in the referenced obligation."[2] On November 20, 2008, however, the New York Insurance Department announced in its First Supplement to Circular Letter No. 19 that "[i]n light of [the] progress made toward comprehensive federal regulation of CDS, New York will delay indefinitely its application of New York Insurance Law to CDS as described [in] Circular Letter No. 19."[3]

Overview of the NCOIL Model Bill

On March 4, 2009, NCOIL, an organization of state legislators whose main area of public policy concern is insurance legislation and regulation, charged its Task Force on Credit Default Swap Regulation (the "Task Force") with drafting model state legislation to regulate CDS. On May 13, 2009, the Task Force circulated to interested parties a preliminary draft of its Model Bill. A light mark-up of the New York statute on financial guaranty insurance (i.e., NY Insurance Law Article 69), the Model Bill in most places simply substitutes the phrase, "credit default insurance" for "financial guaranty insurance."

[1] New York Insurance Department General Counsel Opinion Re: Credit Default Option Facility, 2000 NY Insurance GC Opinions LEXIS 144 (June 16, 2000).

[2] New York Insurance Department Circular Letter No. 19 (Sep. 22, 2008) (emphasis added).

[3] New York Insurance Department First Supplement to Circular Letter No. 19 (Nov. 20, 2008).

The Task Force

- **Most of the Task Force approaches the CDS regulation debate from a perspective grounded in insurance lines rather than one that incorporates the nuances of the CDS market.**
- **The Task Force has consulted extensively with the New York Insurance Department, led in this effort by Assistant Deputy Superintendent & Counsel Paul Zuckerman, for legal guidance and drafting input.**

The Model Bill is still being drafted. However, on an open Task Force conference call on Thursday, May 14 (the "May 14 Conference Call"), the Task Force discussed their plans to:

- make the Model Bill broadly applicable to require all CDS protection sellers to register with state insurance departments as providers of "credit default insurance;"
- make "naked" CDS illegal by requiring CDS protection buyers to have a "material interest" in the reference security;
- subject providers of credit default insurance to capital adequacy requirements identical to those applicable under New York financial guaranty insurance law;
- subject providers of credit default insurance to concentration restrictions;
- require providers of credit default insurance to file "policy forms" with state insurance regulators; and
- require all credit default insurance to operate on a "pay-as-you-go" basis under which the credit default insurer would "step into the shoes" of the defaulting obligor and continue scheduled payments for the duration of the obligation of the reference security.[4]

Analysis of the Model Bill

Licensing Requirements

Under the Model Bill, CDS dealers would be required to be licensed as "credit default insurance corporation[s]" with state departments of insurance. The Model Bill thus would give these departments direct regulatory power over CDS dealers, many of whom are already subject to oversight by other state and federal regulators on the basis of other activities. For example, many banks that write CDS are subject to oversight by the Office of the Comptroller of the Currency ("OCC").

[4] Unlike Article 69's "pay-as-you-go" provision, the current draft of the Model Bill does not allow for acceleration at the sole option of the insurer.

Members of the Task Force

- Assem. Joseph Morelle, NY
- Sen. Joseph Crisco, CT
- Sen. Ralph Hudgens, GA
- Sen. Vi Simpson, IN
- Rep. Robert Damron, KY
- Rep. George Keiser, ND
- Sen. Carroll Leavell, NM
- Sen. Neil Breslin, NY
- Sen. James Seward, NY
- Rep. Hubert Vo, TX
- Sen. Mike Hall, WV

Requirement of a "Material Interest" in the Reference Security

The current draft of the Model Bill provides that, for a CDS contract to constitute permissible "credit default insurance," the protection buyer must have a "material interest" in a reference security of the CDS. On the May 14 Conference Call, the Task Force expressed its intention to make CDS in which the protection buyer has no "material interest" illegal rather than simply excepting such "naked" CDS from insurance regulation as New York law currently does. The term "material interest" is a reference to Section 1101(a)(1) of the New York Insurance Law which requires that, for a contract to be insurance, the beneficiary must have a "material interest" in the subject of a fortuitous event for which the beneficiary is paid by the insurer. The term is not defined in the New York Insurance Law nor is it defined in the Model Bill. This leaves open questions of how to determine whether a protection buyer "holds" or "reasonably expects to hold" such an interest and who would be responsible for making such a determination.

On the May 14 Conference Call, some Task Force members, including North Dakota State Representative George Keiser, asked for a precise definition of the term, "material interest." Some suggested the use of the term "insurable interest" instead of "material interest." This was explicitly rejected and was not included in a revised Model Bill circulated May 27, 2009. In addition, the Task Force suggested that credit default insurers would be responsible for policing the requirement that insureds are not entering into "naked" CDS. The New York Insurance Department staff, which participated in the May 14 Conference Call, also suggested that protection buyers be responsible for verifying their own "material interest."

Capital Requirements

The Model Bill would apply to credit default insurers the same capital requirements applicable to financial guaranty insurers under Article 69. While the drafters of the Model Bill stated that they are considering increasing the dollar amounts of the minimum total capital requirements for CDS protection sellers, the Task Force did not discuss capital charges related to specific risks or how the policy concerns underlying Article 69 would apply to the CDS market.

Moreover, unlike financial guaranty insurers, which historically have not engaged in any other businesses, CDS dealers typically have been organized as banks or broker-dealers engaged in a variety of financial services and subject to

federal regulatory capital regimes. It is unclear how the capital requirements under the Model Bill would interact with these other capital requirements and whether credit default insurers ultimately will be permitted under state legislation to engage in other businesses. However, if this Model Bill were adopted as law, the CDS dealers would likely establish separate insurance companies to transact CDS business.

Financial Guaranty Insurance Payout Method Versus Acceleration

The Model Bill applies the financial guaranty method for payments upon default of the reference security obligation. Under this method, the guarantor steps into the shoes of the issuer and makes payments in accordance with the terms of the original reference security's payment schedule on a timely basis. In contrast, CDS typically provides that following a credit event, the protection seller makes a single lump sum payment.

Applicability of Other Insurance Law

The model legislation states that credit default insurers will be subject to regulation as property/casualty insurers on all issues not specifically covered by the model legislation itself. This imposes further requirements on parties wishing to sell protection via CDS.

Additional Questions Raised by the Model Bill

Jurisdictional Reach

The Model Bill's impact on the CDS market may depend on the jurisdictional reach asserted by state regulators in states that adopt the Model Bill. Under the Model Bill, "credit default insurance may be transacted in [a] state only by a corporation licensed for such purpose" in that state.[4] Thus, an important consideration will be how state regulators interpret the phrase "transacted in [a] state." For example, an approach based on the location of the credit default insurer or the situs of the credit default insurance contract might lead to the relocation of CDS businesses to non-adopting states or offshore. In contrast, an approach based on the location of the credit default insurance buyer might result in a significant reduction of the size of the CDS market. Finally, an unclear standard could lead to regulatory arbitrage.

[4] Model Bill, Section 4(a).

Highlights of the Obama Administration OTC Derivative Plan

» **The Obama Administration released a proposal on May 13, 2009, to provide oversight on the OTC derivative market.**

» **The proposal would:**

- **Require all standardized OTC derivatives trades to clear through a central clearinghouse**
- **Provide broad powers to the CFTC and SEC to require recordkeeping and reporting requirements for OTC derivatives trades**
- **Move the standardized part of derivatives markets onto regulated exchanges and regulated transparent electronic trade execution systems for OTC derivatives**
- **Provide the CFTC and SEC policing powers over the derivative markets**
- **Protect less sophisticated customers by restricting market participation or requiring increased OTC derivatives disclosure**

» **For more information on the proposal, please see our Client Newsflash, Obama Administration Proposes Regulatory Reform for OTC Derivatives.**

The Task Force's Next Steps

- On the May 14 Conference Call, the Task Force expressed an intent to use the current draft legislation as the basis of the Model Bill going forward.
- The Task Force also plans to begin a public information campaign that will include the creation of a number of documents including press releases and Q&A documents.
- The Task Force will be holding its next open conference call on Friday, June 5, at 1:00PM EDT. On the agenda is a brief discussion with a representative of SIFMA and ISDA to discuss their joint comment letter. In preparation for the June 5 call, NCOIL distributed an edited version of the Model Bill on May 27, 2009.

The Possibility of Federal Preemption

State regulation of CDS could face arguments of federal preemption. Under the McCarran-Ferguson Act of 1945, if the federal government wishes to regulate insurance, it must do so explicitly. Federal regulators could argue, however, that CDS are not "the business of insurance" and therefore are not covered by the McCarran-Ferguson Act.

The OCC, the principal federal regulator of national banks and federally-licensed branches of foreign banks, could seek to preempt the Model Bill with respect to its charges by arguing that credit derivatives are authorized banking products under its regulatory jurisdiction. United States Supreme Court precedent interprets the OCC's preemption powers broadly. It is less likely that federal law would preempt application of the Model Bill to state banks or state-licensed branches of foreign banks. As a result, it is possible that state banks and state-licensed branches of foreign banks could opt into federal regulation to avoid the Model Bill's regulation of their CDS businesses.

In the current political environment, the NCOIL Model Bill is particularly vulnerable to federal preemption because it adopts an approach to regulating CDS that is at odds with that articulated by the Obama administration. The focus at the federal level is to increase transparency, reduce systemic risk and increase liquidity in the OTC derivatives markets by forcing transactions on to central clearing and exchange trading platforms.

References

- » NCOIL Model Bill Draft (May 27, 2009)
- » Statement of Assemblyman Joseph P. Morelle on Behalf of the National Conference of Insurance Legislators Before the House Committee on Agriculture (February 4, 2009)

This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice.

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Appendix A: NCOIL, Financial Guaranty Insurance and CDS—A Timeline

- ***June 16, 2000.*** An opinion of the New York Insurance Department's Office of General Counsel finds that CDS are not financial guaranty insurance contracts as long as payment is made "upon the happening of a negative credit event and such payment is not dependent upon the buyer having suffered a loss."

- ***September 22, 2008.*** The New York Insurance Department releases Circular Letter No. 19, which argues that if a CDS buyer "holds, or reasonably expects to hold, a 'material interest' in the referenced obligation," the CDS should be deemed an insurance contract. The New York Insurance Department says it will take this view effective January 1, 2009.

- ***November 20, 2008.*** The First Supplement to Circular Letter No. 19 announces that "[i]n light of th[e] progress made toward comprehensive federal regulation of CDS, New York will delay indefinitely its application of New York Insurance Law to CDS as described [in] Circular Letter No. 19."

- ***March 4, 2009.*** NCOIL announces the formation of a "Task Force on Credit Default Swap Regulation" charged with "hold[ing] interim conference calls to work toward appropriate oversight of the previously unregulated insurance segment." Assem. Joseph Morelle of NY is chosen to head the Task Force.

- ***April 8, 2009.*** NCOIL announces that the Task Force will "draft model legislation establishing strong solvency and disclosure requirements for CDS."