

September 24, 2008

New York Moves to Place Covered Credit Default Swaps under State Insurance Regulation; SEC Asks Congress for Immediate Authority over Credit Default Swaps

An old debate as to whether unregulated Credit Default Swaps constitute insurance for purposes of regulation by the states has come back to life with New York's announcement that starting next year it intends to begin regulating covered Credit Default Swaps – those in which the party to be paid on default owns the underlying bond or obligation – as a form of financial guaranty insurance. The announcement is not self-implementing; there will be a forthcoming Opinion of the insurance department's Office of General Counsel formalizing the interpretation of the definition of "insurance" to include covered Credit Default Swaps, and there may well need to be new implementing regulations promulgated before the plan comes into effect.

Beginning on January 1, 2009, no one other than financial guaranty insurers will be able to issue covered Credit Default Swaps in New York or to New York purchasers. The New York decision will have market-wide effect because the market for these instruments is highly concentrated in New York. It is generally impractical for a provider to eschew doing business in New York, and other states often follow New York on matters relating to financial guaranty insurance. The new regime will not affect any swaps in existence prior to January 1, 2009. It is not clear what effect the New York announcement will have on ongoing efforts to create a central clearing house for Credit Default Swaps.

So-called "naked" Credit Default Swaps will not be included. Because the protection buyer does not own the underlying bond or obligation, the Insurance Department's position is that a naked Swap is not an insurance contract because it does not "confer a benefit of pecuniary value" on the purchaser of the security upon the "happening of a fortuitous event in which the purchaser "has, or is expected to have, a pecuniary interest which will be adversely effected by the event" (see Insurance Law section 1101(a)). The entire market for Credit Default Swaps is some \$62 trillion, and an unknown percentage of that is naked Swaps. Since naked Swaps are used for speculation rather than protection, it would be anomalous, in the view of New York regulators, to leave them unregulated. Hence, in announcing the state's decision, Governor Paterson called on the federal government to step in and initiate regulation of the rest of the huge Credit Default Swaps market.

On September 23, the day after the New York announcement, SEC Chairman Cox, testifying before the House banking committee, asked Congress "immediately" to give the SEC authority to regulate Credit Default Swaps. It was not clear, however, if Cox was asking for SEC authority over all Credit Default Swaps (thus conflicting with New York) or over only naked credit default swaps (thus supplementing New York).

Please click here to view [Governor Paterson's September 22 press release](#) and the [New York Insurance Department's simultaneous Circular Letter to the insurance industry](#).



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