SIMPSON
THACHER

New York State to Regulate Certain Credit Default Swaps as Insurance

September 25, 2008

On September 22, 2008, the New York State Insurance Department issued Circular Letter No. 19. The Circular Letter expresses the Insurance Department's intention to regulate certain credit default swaps as insurance contracts, effective January 1, 2009. As a result, after that date those credit default swaps may be issued in New York only by licensed financial guaranty insurance companies.

The credit default swaps to be regulated as insurance contracts are "covered swaps" – i.e., where the purchaser of the swap holds a material interest in the underlying security and is seeking to hedge its exposure. So called "naked swaps," where the purchaser does not hold a material interest in the underlying security, will not be deemed insurance and will not be regulated by the Insurance Department.

Under the Circular Letter, covered swaps are to be regulated like other forms of financial guaranty insurance. Financial guaranty insurance can be written only by financial guaranty insurers, also known as "monoline insurers" because they are not permitted to write other kinds of insurance.

Financial guaranty insurers are regulated in New York under Article 69 of the New York Insurance Law. In addition to the regulatory requirements generally applicable to all insurance companies (such as limitations on dividends, restrictions on inter-company transactions, and scrutiny of company directors and officers), Article 69 sets forth a number of detailed requirements applicable to financial guaranty insurers, including:

- <u>Minimum Capital and Surplus Requirements</u>: The Insurance Department intends to seek changes in the Insurance Law to increase the amount of paid-in capital from $2,500,000 to at least $15,000,000, paid-in surplus from $72,500,000 to at least $165,000,000, and minimum surplus to policyholders from $65,000,000 to a figure in excess of $150,000,000.

- <u>Contingency Reserves</u>: Financial guaranty insurers are required to maintain an additional liability reserve to protect policyholders against the effects of adverse economic developments or cycles or other unforeseen circumstances. The reserve is equal to the greater of 50% of premiums written for each category of security guaranteed or a sum arrived at by multiplying specific factors by the principal amount of each class of security guaranteed.[1] The amounts are based upon both the principal guaranteed and the relative risk of the type of security.

---

1 "Premiums" on a credit default swap are typically paid over the life of the swap in the form of periodic "fixed payments". Since such payments cease when the swap terminates (including upon the occurrence of a "credit event" that triggers early termination of the swap), it is not clear how the contingency reserve in this context would be calculated.

- Aggregate and Single Risk Limitations: A financial guaranty insurer is limited in the amount and type of securities that it may insure, based upon its surplus to policyholders and contingency reserves. Exposure on any one risk is further limited. Obligations with respect to a "single entity"-- a single revenue source, a particular category or obligation, or some combination thereof -- cannot exceed ten percent of the aggregate surplus and contingency reserves, using debt service and principal as a measure. Financial guaranty insurers are also to consider the initial lender, servicer, seller or sponsor of a security, and the year in which the obligation originated ("vintage"), in determining its exposure to a "single entity."

- Limitations on Non-Investment Grade Securities: The Insurance Department will require 95% of a financial guaranty insurer's portfolio to be investment grade, unless the insurer receives an exemption on the basis that a lower standard is not detrimental to its policyholders and the public.

The Circular Letter would impose additional restrictions on the covered swaps:

- Limitation on Credit Events: The credit default swap can only have credit events consisting of failure to pay or bankruptcy of the reference obligor.

- Limitation on Swap Termination Events: The credit default swap cannot terminate based upon a credit deterioration or bankruptcy of the protection seller (i.e., the insurer).

- Limitation on Collateral: The insurer cannot be required to post collateral to secure its obligations under the credit default swap.

This proposal, if implemented, we believe will significantly alter the way in which participants in the credit default swap market conduct that business (at least insofar as such activity is conducted in the State of New York).

While Circular Letters express the Insurance Department's current thinking on a particular subject, they do not have the force of law. However, the Insurance Department is in the process of developing regulations based on Circular Letter 19 that will have legal effect. Any such regulations will be subject to the State Administrative Procedure Act and be subject to a public comment period before taking effect.

Please direct any questions about this memorandum to David M. Eisenberg (deisenberg@stblaw.com; 212-455-7103), Gary I. Horowitz (ghorowitz@stblaw.com; 212-455-7113), Michael D. Nathan (mnathan@stblaw.com; 212-455-2538), or Steven R. DeLott (sdelott@stblaw.com; 212-455-3426).