MAYER • BROWN
JSM

STRUCTURED FINANCE UPDATE

Revisited: Credit Default Swaps - Are They Contracts of Insurance?

8 October 2008

Is a credit default swap ("CDS") a contract of insurance? This question was resolved in the negative some ten years ago in both London and New York, and most other financial centers have followed these leads. The 19th May 1997 opinion of Robin Potts, QC and the 16th June 2000 opinion of the New York State Insurance Department have been oft-cited as the benchmark legal positions on this issue. These legal opinions paved the way for the blooming of a multi-trillion dollar CDS industry over the past decade. Given the recent unprecedented global credit crisis, however, this question is now being revisited by financial regulators.

New York

In a major departure from prior precedent, New York Governor David A. Paterson announced on September 22, 2008, that the New York State Insurance Department (the "Department") would start regulating certain types of credit default swaps as insurance. Beginning on January 1, 2009, if the protection buyer under a CDS owns the underlying security on which it is buying protection, then the CDS will be treated as an insurance contract. Among other things, this means that only licensed financial guaranty insurance companies will be authorized to issue that type of CDS.

The Governor's announcement did not, however, address a host of important issues. For example: Can federal preemption of state regulation for national banks in the banking sector be properly extended to the insurance sector when it comes to national banks' CDS activities? Will banks be exempted from insurance licensing on the premise that they are already otherwise adequately regulated? How does one distinguish between "actually owning", "required to own" and "expected to own" when describing the reference obligations in documentation? If a CDS is treated as an insurance contract, will a protection buyer be permitted to receive a payment from the protection seller exceeding its "insurable interest" or "actual loss"? Will the new regulatory regime also cover other credit derivatives such as total return swaps?

These and other important issues can only be clarified as the legal / regulatory process develops in the United States. Mayer Brown will be happy to keep you informed of these developments on a regular basis. A Legal Update is attached herewith that further discusses these issues.

London

The traditional analysis in England has focused, in the case of a CDS, on the absence of an "insurable interest" and consideration of whether the payment obligation arises irrespective of whether the payee suffers "loss" or was subject to the "risk of loss". Contracts of insurance, on the other hand, require these elements. In order for an "insurable interest" to exist, the insured party must be able to show that it will suffer a "loss" upon the occurrence of a particular event which is adverse to the interests of the insured. To avoid this characterisation, CDSs have been drafted to achieve a disconnect between a Credit Event and such "loss". For example, a CDS typically does not require the buyer of protection to own any reference obligation.

The analysis is far free from doubt - not least because of: (i) the major regulatory developments in the UK during the last decade and regulatory oversight which has greatly increased; (ii) recent proposals for insurance contract law reform in the UK have proposed the abolition or severe curtailment of the "insurable interest" qualification for insurance contracts; and (iii) the absence of any relevant case law fully on point, during the last decade, analysing the question, in the context of the use of sophisticated credit derivative structures, testing the aforementioned leading counsel's opinion.

It appears to us that the trend in England may be gravitating toward greater regulation of the CDS market by the Financial Services Authority under the Financial Services and Markets Act 2000 and related legislation. Mayer Brown will be happy to keep you informed of relevant legal/regulatory developments in England in this area.

Hong Kong

Hong Kong legal analysis on the question of CDS vs. insurance appears to largely follow English law (although since 1997 Hong Kong does have its own common law). This is based not on any Hong Kong court precedent, but on at least one privately-issued Hong Kong QC opinion which we are knowledgeable about, which analyses the question under the provisions of Part II of the Insurance Companies Ordinance, Cap 41. That opinion, however, leaves open the question of whether a Hong Kong court, in characterising the CDS contract as a whole, might not consider a CDS a contract of insurance if (i) the protection buyer does in fact own the reference obligations, (ii) the Credit Event is defined in such a way that it will occur only if the protection buyer suffers a loss or (iii) the settlement payment does in fact represent the loss which the protection buyer suffers.

Furthermore, the licencing regime under Hong Kong law is such that an entity that is engaged in (or is deemed to engage in) any class of insurance business in or from Hong Kong is required to obtain an insurance licence from the Commissioner of Insurance irrespective of any other financial licencing which it may possess (e.g. any banking licence granted by the Monetary Authority under the Banking Ordinance or any securities dealing or advisory licence granted by the Securities and Futures Commission under the Securities and Futures Ordinance).

It seems to us that Hong Kong financial regulators, as they become aware of regulatory developments in other jurisdictions, may consider whether CDSs should be regulated more closely in Hong Kong. Mayer Brown JSM will also be happy to keep you informed of relevant legal/regulatory developments in Hong Kong in this area.

FOR FURTHER INQUIRIES PLEASE CONTACT:

Lawrence R. Hamilton (Chicago)
Mayer Brown LLP
Tel: +1 312 701 7055
Email: lhamilton@mayerbrown.com

Joel S. Telpner (New York)
Mayer Brown LLP
Tel: +1 212 506 2590
Email: jtelpner@mayerbrown.com

Peter Schwartz (London)
Mayer Brown International LLP
Tel: +44 20 7398 4678
Email: pschwartz@mayerbrown.com

Edmund Parker (London)
Mayer Brown International LLP
Tel: +44 20 7782 8922
Email: eparker@mayerbrown.com

Sara S.M. Or (Hong Kong)
JSM
Tel: +852 2843 2268
Email: sara.or@mayerbrownjsm.com

Jeffrey H. Chen (Hong Kong)
Mayer Brown LLP
Tel: +852 2843 2209
Email: jchen@mayerbrown.com