STATE OF MISSOURI

DEPARTMENT OF INSURANCE, FINANCIAL INSTITUTIONS AND PROFESSIONAL REGISTRATION

P.O. Box 690, Jefferson City, Mo. 65102-0690

INSURANCE BULLETIN 08-12: Covered Credit Default Swaps

ISSUED November 19, 2008

To: Buyers and Sellers of Covered Credit Default Swaps
From: Linda Bohrer, Acting Director
Re: Application of Requirement for Certificate of Authority to Transact Insurance Business to Covered Credit Default Swaps

Section 375.786.1, RSMo 2000 (2007 Cum. Supp.), states in relevant part: "It is unlawful for any insurance company[1] to transact insurance business in this state… without a certificate of authority from the director [of the department of insurance, financial institutions and professional registration]…"[2] Engaging in the business of issuing a covered credit default swap is an insurance business that requires a certificate of authority from the director when such business is done in the state of Missouri.[3]

The National Association of Insurance Commissioners (NAIC) has recently described credit default swaps ("CDS"): "A credit default swap can be broadly described as a contract under which the seller promises to pay the buyer upon the occurrence of a credit event with respect to a reference entity. A credit event may include a failure to pay but can also include restructuring and other events that change the entity's credit quality. For example, bond owners seeking protection on a bond issuer's interest and/or principle defaults can use credit default swaps. These types of swaps are generally referred to as 'covered' swaps; and though they have been

[1] "Unless otherwise indicated, the term 'insurance company' as used in sections 375.786 to 375.790 includes all corporations, associations, partnerships and individuals engaged as principals in the business of insurance and also includes interinsurance exchanges and mutual benefit societies." Section 375.786.2, RSMo 2000 (2007 Cum. Supp.).

[2] The statutory term "insurance business" is not defined in the insurance laws. Nor has the General Assembly provided any indication that the director of this department has discretion to make a statement of interpretation of or to set substantive standards for the term "insurance business." Rather, the term "insurance business" is a pure term of law. Accordingly, statements in this bulletin regarding the application of section 375.786 to covered credit default swaps represent statements of position that the director will take in courts of competent jurisdiction, as well as the positions that the director believes such courts will adopt when applying section 375.786 to covered credit default swaps.

[3] The acts in this state effected by mail or otherwise that constitute transacting an insurance business in this state are described in subdivisions (1) through (8) of subsection two of section 375.786, RSMo 2000 (2007 Cum. Supp.).

viewed historically as non-insurance financial products, they are analogous to insurance contracts. The swap buyer is like a homeowner insuring a home."[4]

Likewise, courts have described credit default swaps as similar or akin to insurance. "A credit default swap is an arrangement similar to an insurance contract. The buyer of protection… pays a periodic fee, like an insurance premium, to the seller of protection… in exchange for compensation in the event that the insured security experiences default."[5]

"Credit derivatives are akin to insurance policies for holders of corporate bonds or other securities against downgrades in the credit of the issuing companies. They do this by transferring credit risk from a 'protection buyer' to a 'protection seller'... A CDS is a common type of credit derivative in which the protection buyer makes a fixed payment to the protection seller in return for a payment that is contingent upon a 'credit event'-such as a bankruptcy-occurring to the company that issued the security (the 'reference entity') or the security itself (the 'reference obligation')."[6]

A CDS may be referred to as "covered" where the protection buyer has a present legal interest in the reference entity or reference obligation that is the subject of the credit event of the CDS. If a CDS generally is "similar to an insurance contract" and "akin to insurance policies," a covered CDS *is* an insurance contract or an insurance policy and the business of issuing a covered CDS is an insurance business. In a covered CDS, the protection buyer has transferred the risk of financial loss to a third party – namely, the protection seller – who otherwise would not bear the risk of loss and does not control the risk of loss, in exchange for consideration. The issuance of a covered CDS would constitute an insurance transaction.

Accordingly, the issuer of a covered CDS must obtain a certificate of authority from the director in order to avoid the consequences of the unlawful activity described in section 375.786.1.[7] The regulations of this department describe the processes for obtaining such a certificate.[8] Because a covered credit default swap protects against the risk of losses associated with or related to default on a debt security, it is a form of surety as described in section 379.010.1(3), RSMo. Among other requirements for a certificate of authority, an applicant must demonstrate that it maintains a minimum of $1,600,000 in capital and surplus if it is a monoline insurer or $2,400,000 if it is a multi-line insurer.[9] In addition, the applicant must maintain loss reserves, which are actuarially determined.[10]

Based on the foregoing, the insurance laws provide a present basis for enforcement of the requirement for a certificate of authority to issue covered credit default swaps. The director is, however, aware that such swaps are only a subset of the total credit default swap market and that creating a segmented credit default market is not the ideal solution. The director and the NAIC

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[4] NAIC Members' Response to A. M. Best Survey, response to question 1 (October 24, 2008).
[5] **Merrill Lynch International v. XL Capital Assurance Inc.**, 564 F.Supp.2d 298, 300 (S.D.N.Y. 2008).
[6] **Deutsche Bank AG v. AMBAC Credit Products, LLC**, 2006 WL 1867497, 2 (S.D.N.Y 2006).
[7] Pursuant to subsections 4 and 5 of section 375.786, a violation of this section is a level four violation under section 374.049. In addition, subsection 6 of section 375.786 makes the transaction of insurance business without a certificate of authority, as described in this section, a class C felony.
[8] See 20 CSR 200-17.100 ("Procedure for Forming a Missouri Domestic Insurance Company") and 20 CSR 200-17.200 ("Procedure for Foreign Insurer to Obtain a Certificate of Authority to Transact the Business of Insurance").
[9] See section 379.010.2, RSMo 2000.
[10] See section 379.102, RSMo 2000.

in general "support a comprehensive solution to regulating the entire market."[11] At the present time, federal regulators are discussing such a comprehensive solution.[12]

Enforcement of the insurance regulatory scheme on the issuance of covered credit default swaps would be premature at the present, given these discussions and the likelihood that a comprehensive regulatory scheme will be adopted soon. However, the director will not tolerate a total lack of oversight over an important part of the business of insurance in this state.

Therefore, the director will begin regulatory enforcement on January 1, 2009. However, the director will exercise discretion in enforcement of the insurance laws in regard to covered credit default swaps, in order to allow an opportunity for the enactment of comprehensive federal regulation. If a comprehensive federal regulatory scheme regarding credit default swaps, including covered credit default swaps is adopted prior to January 1, 2009, or appears significantly likely to be adopted soon after that date, the director may defer or suspend any or all department enforcement actions.

[11] NAIC Members' Response to A. M. Best Survey, response to question 4 (October 24, 2008).
[12] NAIC Members' Response to A. M. Best Survey, response to question 4 (October 24, 2008).