New York Tries Taming Credit-Default Swaps

State to Regulate Certain CDS Pacts As Insurance Deals

BY SERENA NG AND LIZ RAPPAPORT

New York regulators are attempting to tame parts of the unregulated credit-default-swaps market by requiring some sellers of these contracts to become insurance companies.

On Monday, the New York Insurance Department under Eric Dinallo reversed a previous position and issued guidelines that declared some CDS contracts are "insurance and therefore subject to state regulation," it said in a statement.

Credit-default swaps are privately negotiated contracts that act like insurance and protect investors against a default on bonds and loans that they own. Swap buyers make regular payments to sellers, which in turn agree to make large payouts if defaults take place.

Eric Dinallo

The rules, which are supposed to take effect in January 2009, would cover swaps bought by investors that also own the actual bonds or loans referenced by the swaps. The regulations involve New York buyers and sellers, but they account for a large chunk of the market. And the state's action could inspire other regulators elsewhere.

Since the New York State Insurance Department ruled in 2000 that these contracts were not a form of insurance, the regulators have effectively ignored the market, which has grown to about $62 trillion of contracts and has been criticized recently as contributing to massive stock and credit-market volatility.

Because these are derivatives tied to bonds, swap buyers can profit if the protection they bought increases in value. That has made many people come to view buying CDS as akin to making bearish, or "short," bets against companies.

Many derivative traders and analysts were baffled by New York regulators' move.

"To suddenly decree that 'covered' credit-default swaps are insurance products suggests to me that regulators haven't thought through the details of how this market works," said Leslie Rahl, president of Capital Market Risk Advisors, a risk-management consultancy in New York. She noted many sellers of CDS are banks, hedge funds and other institutions that aren't set up as insurance companies but are perfectly able to meet their obligations under the contracts.

The planned regulation means banks or institutions that sell CDS to investors that want to protect their bonds or loans would have to apply for a license to be an insurance company, said David Neustadt, spokesman for the State of New York's Insurance Department, adding the office is prepared to turn around those licenses quickly.

Regulators, including the Federal Reserve, have been looking for ways to rein in the CDS market, where elevated swap prices are believed to have played a role in the demise of Bear Stearns and **Lehman Brothers Holdings** Inc. and amplified worries about the solvency of **American International Group** Inc. and the bond insurers. Wall Street has long said that the swaps aren't securities or insurance contracts and don't fall under the jurisdiction of securities or insurance regulators.