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Credit Default Swaps: A Brief Insurance Primer

Credit Default Swaps ("CDS") are part of a $62 trillion market that have gone from obscure to infamous in a matter of months, if not weeks. Yet along the way, many people were left without a clear understanding of what CDS are or how they compare to – or differ from – insurance.


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Defined as Similar to Insurance

A CDS appears a lot like insurance on an investment, in particular on debt obligations. As one court explained,"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."

Merrill Lynch International v. XL Capital Assurance, Inc. (S.D.N.Y.). The triggering event that causes the Seller to pay is usually called a "Credit Event." Upon the occurrence of a Credit Event, the Buyer and Seller settle up in one of two methods. Under both methods, the Seller will pay to the Buyer the face value of the underlying debt security. In return, under a "physical settlement," the Buyer will deliver the underlying debt security to the Seller, and under a "cash settlement," the Buyer will offset the Seller's face value payment by the actual market value of the underlying security, sometimes determined through an auction. The Credit Event will often, but not always, be defined to involve a default on the underlying security.

Because of these offsets, the actual cumulative exposure – after cancelling out the offsetting liabilities – is only about 3% of the total CDS market, which is still about $1.6 trillion, according to the International Swaps and Derivatives Association (ISDA).

Despite the differences between a CDS and insurance, pursuing recovery under both can be quite similar. Although much of the language of CDS contracts has been standardized under forms supplied by the ISDA, the key terms that define the trigger of payment obligations is specific to each CDS. Careful attention is required when (1) drafting the CDS, (2) drafting the terms of the underlying obligation, and (3) presenting the claim. Poor planning has left parties without the protection they thought they had. For example, in *Aon Financial Products, Inc. v. Societe Generale*, Aon was both a Seller and a Buyer on separate CDS contracts relating to the same underlying debt. In separate litigations, Aon was required to pay as a Seller, but could not collect on the other CDS as a Buyer. The definitions of Credit Event did not match, and Aon lost on both ends.

Yet Not Quite Insurance

Although courts and other sources almost invariably describe CDS as similar to insurance, there is a broad consensus that CDS are not the equivalent of insurance policies.

The two main reasons most often given to support the conclusion that CDS are not insurance products are that (1) the Buyer does not have to own the underlying security, or otherwise have any insurable interest in that security, and (2) the Buyer does not in fact have to suffer any loss in order to recover on the CDS. As noted, under some CDS terms, a "Credit Event" can take place that does not involve an actual default for the underlying security, and, of course, if the CDS Buyer does not own the underlying security, it will not suffer a loss even if there is a loss for actual bondholders. In addition, a Credit Event could cause the Buyer who does hold the underlying debt to recover an amount that is greater than, or less than, any actual loss it suffers. The Buyer's recovery is determined by the contract terms – the amount of any loss it suffers is irrelevant. As noted by the court in the *Aon Financial Products case*:

> CDS agreements are thus significantly different from insurance contracts . . . they [CDS contracts] "do not, and are not meant to, indemnify the buyer of protection against loss. Rather, CDS contracts allow parties to 'hedge' risk by buying and selling risks at different prices and with varying degrees of correlation."

Because of an imperfect correlation, the CDS that Aon purchased to hedge a particular risk did not actually match that risk. The result was that Aon could not collect even though it suffered an actual loss.

Another key difference between a CDS and an insurance policy is that the seller of a CDS is not currently subject to regulatory capital requirements. Some analysts have suggested that this needs to be changed. Others note that the CDS market has developed its own form of capital requirements, in that the seller is usually required to post collateral when the market moves against it. In fact, it was the need to comply with such collateral requirements that caused many of the liquidity problems that recently confronted AIG and other major financial institutions. AIG's collateral obligations were triggered when its credit rating slipped below AAA. It is not clear that a regulated capital requirement – of any somewhat similar stringency – would have provided buyers with the requisite protection while causing less damage to the financial industry and markets as a whole.

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In addition to these differences between the CDS market and insurance, there are other differences in tax, accounting, bankruptcy and in regulatory jurisdiction. To date, for example, CDS have not been subject to state insurance regulations. New York State recently began issuing guidelines to regulate that portion of the CDS market where the Buyer **does** own the underlying asset, **does** therefore have an insurable interest, and **does** suffer a loss upon default. CDS contracts that share these characteristics do not support the two main reasons that CDS are generally considered not to be insurance, and New York insurance regulators believed they will be able to assert their powers over this part of the market. Even more recently, however, on November 20, New York Insurance Superintendent Eric Dinallo announced that his department would hold off in implementing its CDS regulations while awaiting the result of potentially more comprehensive federal regulation.

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