SIFMA
Securities Industry and
Financial Markets Association

ISDA®
International Swaps and Derivatives Association, Inc.

May 22, 2009

The Honorable Joseph Morelle
Chairman
Task Force on Credit Default Swaps Regulation
National Conference of Insurance Legislators
601 Pennsylvania Ave. N.W.
Suite 900, South Building
Washington, D.C. 20004

Re: NCOIL Model Legislation

Dear Chairman Morelle:

The Securities Industry and Financial Markets Association ("SIFMA") and the International Swaps and Derivatives Association ("ISDA") appreciate the opportunity to comment on NCOIL's proposed model legislation to regulate credit default swaps ("CDS") under provisions patterned on New York's current regulation of financial guaranty insurance, set forth in Article 69 of the New York Insurance Law. While we appreciate NCOIL's concern about the regulation of financial products, we believe NCOIL's proposal, if enacted into law by one or more states in its present form, would adversely affect commercial, industrial, and other companies that benefit from CDS, as well as banks and other financial firms that act as CDS dealers, and might cause financial institutions to move their CDS businesses out of state or offshore. These consequences are likely and they would harm local economies.

SIFMA and ISDA agree it is important to bring increased regulatory oversight to the CDS market to reduce systemic risk in the financial system and increase transparency and liquidity of the markets. But applying the capital regimes, concentration limits and the other specific requirements borrowed from the New York financial guaranty insurance law would create regulatory ambiguity and inconsistency with respect to other state and federal regulatory regimes, such as banking regulation, already applicable to CDS providers. Broadly drafted legislation such as this also might have unintended consequences such as applying to financial instruments or transactions that were not meant to be captured.

Credit default swaps benefit our economy by facilitating lending and corporate finance activity, which is particularly important in today's tight credit environment. CDS have remained the only credit product consistently available to allow companies and investors to transfer credit risk and express a view on creditworthiness. Illiquidity in the financial markets would likely be worse if CDS were not available. Ultimately, CDS increase liquidity in the banking industry because they enable lenders to manage the credit risk inherent in lending, thereby allowing them to lend more money at lower cost to many more businesses.

CDS also serve a valuable signaling function. CDS prices produce better and timelier information about the companies for whom a CDS market develops because CDS prices, unlike the credit ratings published by rating agencies, rely on market-based information about a company's financial health.

The proposed model legislation contains various elements that could have an adverse effect on the financial system. In particular, the legislation would effectively prohibit non-hedging CDS transactions as falling outside the scope of permissible credit default insurance. Those transactions provide liquidity in CDS markets and thus facilitate the availability of CDS for risk-hedging purposes.

In addition, whether or not adopted, the promulgation of the model legislation threatens to undermine the approach to the regulation of over-the-counter derivatives articulated in the recent proposals by the Obama Administration. The Treasury Department has proposed to deal with systemic risk, liquidity, counterparty credit risk, and transparency in over-the-counter derivatives with increased standardization, clearing through centralized counterparties, robust collateral requirements, reporting requirements and increased federal regulatory oversight. It is likely that this effort will form part of a comprehensive solution to the regulation of our financial markets. Treasury's proposal addresses the concerns raised by NCOIL and also provides a framework for effective use of CDS, thus maintaining the benefits highlighted above. In contrast, the NCOIL model legislation risks effectively eliminating the domestic CDS market or, at best, creating a patchwork of legislation with state-based variations. These competing approaches to derivatives regulation could well lead to regulatory turf battles at a time when cooperation between state and federal regulators is essential.

We also question the wisdom of replacing a market where CDS are actively traded with a non-transparent, illiquid market limited to insurance companies as sellers of protection. These insurance companies could amass large CDS positions, which would not be marked to market. They would not post collateral to their counterparties, and a decline in their CDS positions would likely be highly correlated with declines in their investment portfolios. This does not seem like the best way to address any deficiencies in the current CDS market. Moreover, given the market's adverse experience with this model in purchasing CDS from the monolines, we think it unlikely that market participants will be willing to purchase protection from these newly created insurers.

Additionally, we must note that we disagree with a fundamental premise of the NCOIL model legislation, specifically that credit default swaps constitute insurance. There are a number of characteristics that distinguish the two. Whereas insurance requires an insurable interest, credit default swaps are often purchased by protection buyers that are not hedging a specific underlying risk. Insurance contracts generally are purchased and held by the buyer, whereas CDS are frequently bought and sold. And finally, insurance contracts only pay out when the insured party actually incurs a loss. CDS provide for payments to protection buyers upon the occurrence of a credit event, which frequently occurs before any loss is incurred. We believe each of these factors marks a significant difference between CDS and insurance.

Although SIFMA and ISDA agree that it is important to bring increased regulatory oversight to the CDS market, we are deeply concerned that the model legislation would face significant obstacles to achieving the regulatory benefits it seeks while threatening adopting states with a potential loss of financial business, jobs and revenue and having a detrimental effect on end users of financial products. For these reasons, we take the view that it is not appropriate to proceed with the model legislation, particularly in light of the steps proposed by the Obama Administration to pursue these issues at the federal level. We urge NCOIL to reconsider the direction of its efforts in this important area.

Thank you again for soliciting the comments of interested parties. If you have any questions or would like additional information, please do not hesitate to contact us.

Respectfully submitted,

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SIFMA

Katherine Darras, General Counsel, Americas
ISDA

CC: Sen. James Seward, President, National Conference of Insurance Legislators