

Credit Default Swaps: A Brief Insurance Primer

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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 – particularly, in what ways CDS are like or unlike insurance. In brief, a CDS is like insurance insofar as the buyer collects when an underlying security defaults or loses value in some other way defined by the contract. It is unlike insurance, however, in that the buyer need not have an “insurable interest” in the underlying security.

Defined as Similar to Insurance

A CDS appears a lot like insurance on an investment, in particular a debt obligation. 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”—usually, though not always, defined to involve a default on the underlying security. 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.

Despite the differences between a CDS and insurance outlined below, pursuing recovery under both can be quite similar. The language of the agreement is very important. Although standardized forms exist and are commonly used, very often much of the controlling language will be drafted specifically for each swap.

Yet Not Quite Insurance

Yet although courts and other reference sources almost invariably describe CDS as similar to insurance, there is a broad consensus that, on the whole, 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.

CDS also differ from insurance contracts with regard to tax, accounting, bankruptcy and in regulatory jurisdiction. To date, for example, CDS have not been subject to state insurance regulations – although this might soon change. New York State has begun 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 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 believe they will be able to assert their powers over this part of the market.

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