TESTIMONY

TO THE UNITED STATES
SENATE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

HEARING ON
"THE ROLE OF FINANCIAL DERIVATIVES IN THE CURRENT FINANCIAL CRISIS"

BY SUPERINTENDENT ERIC DINALLO

NEW YORK STATE INSURANCE DEPARTMENT

TUESDAY, OCTOBER 14, 2008

DIRKSEN SENATE OFFICE BUILDING, ROOM 106

I would like to thank Chairman Tom Harkin, Ranking Member Saxby Chambliss and the members of the Senate Committee on Agriculture, Nutrition, and Forestry for inviting me to testify today at this hearing on the role of financial derivatives in the current financial crisis.

My name is Eric Dinallo and I am Insurance Superintendent for New York State.

I have been asked to discuss with you today one particular kind of derivative--credit default swaps--which have played a major role in the financial problems we now face.

Let me first establish why the New York State Insurance Department is a relevant authority on credit default swaps. I will expand on theses issues at greater length, but to provide a context, I will start with a brief summary.

As credit default swaps were developed, there was a question about whether or not they were insurance. Since initially they were used by owners of bonds to hedge their risk or seek protection or insurance in the case of a default by the issuer of the bonds, this was a reasonable question. In 2000, under a prior administration, the New York Insurance Department was asked to determine if certain credit default swaps were insurance and said no. That is a decision we have since revisited and reversed as incomplete. I will provide more detail on these important decisions shortly.

In addition, since I took office in January 2007, the impact of credit default swaps has been one of the major issues we have had to confront. First, we tackled the problems of the financial guaranty companies, also known as bond insurers or monolines. Credit default swaps were a major factor in their problems. More recently, we have been involved in the bailout of AIG. Again, management of credit default swaps was the biggest source of that company's problems.

Through these experiences, we have needed to carefully study the history and issues surrounding credit default swaps. And we have learned the hard way about their impact on markets and companies.

I am honored to have this opportunity to share with you what we have learned from this experience.

First, let's discuss what a credit default swap is and the different kinds of credit default swaps. A credit default swap is a contract under which the seller, for a fee, agrees to make a payment to the protection buyer in the event that the referenced entity, usually a company or other issuer of some kind of bond, experiences any number of various "credit events", such as bankruptcy, default, or reorganization. If something goes wrong with the referenced entity, the protection buyer can put the bond to the protection seller and be made whole, or a net payment can be made by the seller to the buyer.

Originally, credit default swaps were used to transfer and thus reduce or mitigate risk for the owners of bonds. If you owned a bond in company X and were concerned that the

company might default, you bought the swap to protect yourself. Literally the buyer "swaps" risk of default with someone else. That is why it is called a credit default swap. The swaps could also be used by banks who loaned money to a company. This type of swap is still used for hedging purposes.

Over time, however, swaps came to be used not to reduce risk, but to create or assume it. This second type of swap is little more than a gamble on the value of a particular reference obligation. Institutions that did not own the obligation bought and sold credit default swaps to place a directional bet on a company's credit worthiness. In early May, we began to use the term "naked credit default swaps" to describe swaps bought by speculators because in that case the swap purchasers do not own the underlying obligation. The protection becomes more valuable as the company becomes less creditworthy. This is similar to naked shorting of stocks.

I have argued that these naked credit default swaps should not be called swaps because there is no transfer or swap of risk. Instead, risk is created by the transaction. Indeed, you have no risk on the outcome of the day's third race at Belmont until you place a bet on horse number five to win.

We believe that the first type of swap, let's call it the covered or "sartorial" swap, is insurance. The essence of an insurance contract is that the buyer has to have a material interest in the asset or obligation that is the subject of the contract. That means the buyer owns property or a security and can suffer a loss from damage to or the loss of value of that property. With insurance, the buyer only has a claim after actually suffering a loss.

With the covered swaps, if the issuer of a bond defaults, then the owner of the bond has suffered a loss and the swap provides some recovery for that loss. The second type of swap contains none of these features.

Because the credit default swap market is not regulated, we do not have valid data on the number of swaps outstanding, how many are naked, who bought, who sold and on which issuers they have been written. Estimates of the market were as high as $62 trillion, though lately the market has been reduced to an estimated $55 trillion. By comparison, as of the second half of this year, there was only about $6 trillion in corporate debt outstanding, $7.5 trillion in mortgage-backed debt and $2.5 trillion in asset-backed debt, according to data from the Securities Industry and Financial Markets Association. That's a total of about $16 trillion in private sector debt. So it appears that swaps on that debt could total at least three times as much as the actual debt outstanding.

When we were dealing with finding a solution for AIG, we knew the company had written almost half a trillion dollars in swaps, but we had no idea how much in swaps had been written on AIG itself or by whom. That meant we did not know what the broader effect of an AIG bankruptcy would be. Also, in our work on the bond insurers, we could not determine the total credit default swaps written on companies such as MBIA and Ambac.

As one of the efforts to stop the current financial crisis, the SEC suspended shorting the stock of 700 companies and all naked shorting of stocks. But nothing was done about the shorting of credit through credit default swaps, though there are much larger numbers involved.

Now, I think it would be useful for your purposes to go into some of the history, including important legislative decisions.

Gambling, betting or speculating on movements in securities or commodities prices without actually owning the referenced security or commodity is nothing new. As early as 1829, "stock jobbing", an early version of short selling, was outlawed in New York. The Stock Jobbing Act was ultimately repealed in 1858 because it was overly broad and captured legitimate forms of speculation. However, the question of whether to allow bets on security and commodity prices outside of organized exchanges continued to be an issue.

"Bucket shops" arose in the late nineteenth century. Customers "bought" securities or commodities on these unauthorized exchanges, but in reality the bucket shop was simply booking the customer's order without executing on an exchange. In fact, they were simply throwing the trade ticket in the bucket, which is where the name comes from, and tearing it up when an opposite trade came in. The bucket shop would agree to take the other side of the customer's "bet" on the performance of the security or commodity. Bucket shops sometimes survived for a time by balancing their books, but were wiped out by extreme bull or bear markets. When their books failed, the bucketeers simply closed up shop and left town, leaving the "investors" holding worthless tickets.

The Bank Panic of 1907 is famous for J.P Morgan, the leading banker of the time, calling all the other bankers to a meeting and keeping them there until they agreed to form a consortium of bankers to create an emergency backstop for the banking system. At the time there was no Federal Reserve. But a more lasting result was passage of New York's anti-bucket shop law in 1909. The law, General Business Law Section 351, made it a felony to operate or be connected with a bucket shop or "fake exchange." Because of the specificity and severity of the much-anticipated legislation virtually all bucket shops shut down before the law came into effect, and little enforcement was necessary. Other states passed similar gaming or bucket shop laws. Interestingly, to this day, companies wishing to use the world "exchange" must receive permission from New York State.

Thus, the various bucket shop laws essentially prohibit the making or offering of a purchase or sale of security, commodity, debt, property, options, bonds, etc., upon credit or margin, without intending a bona fide purchase or sale of the security, commodity, debt, property, options, bonds, etc. If you think that sounds exactly like a naked credit default swap, you are right. What this tells us is that back in 1909, 100 years ago, people understood the risks and potential instability that comes from gambling on securities prices.

With the growth of various kinds of derivatives in the late 20th Century, there was legal uncertainty as to whether certain derivatives, including credit default swaps, violated state bucket shop and gambling laws.

The Commodity Futures Modernization Act of 2000 ("CFMA"), signed by President Clinton on December 21, 2000, therefore created a "safe harbor" by (1) preempting state and local gaming and bucket shop laws except for general antifraud provisions, and (2) exempting certain derivative transaction on commodities and swap agreements, including credit default swaps, from CFTC regulation.

Thus CFMA stated: "This Act shall supersede and preempt the application of any state or local law that prohibits or regulates gaming or the operation of bucket shops."

CFMA also amended the Securities and Exchange Acts of 1933 and 1934 to make it clear that the definition of "security" does not include certain swap agreements, including credit default swaps, and that the SEC is prohibited from regulating those swap agreements, except for its anti-fraud enforcement authority.

Therefore, by ruling that credit default swaps were not gaming and not a security, the way was cleared for the growth of the market. But there was one other issue. If some swaps—covered swaps—were considered insurance, then they would be regulated by state insurance departments. The capital and underwriting limits in insurance regulation could have threatened the rapid growth in the market for these derivatives.

So at the same time, in 2000, the New York Insurance Department was asked a very carefully crafted question. "Does a credit default swap transaction, wherein the seller will make payment to the buyer upon the happening of a negative credit event and such payment is not dependent upon the buyer having suffered a loss, constitute a contract of insurance under the insurance law?"

Clearly, the question was framed to ask only about naked credit default swaps with no proof of loss. Under the facts we were given, the swap was not "a contract of insurance", because the buyer had no material interest and the filing of claim does not require a loss. But the entities involved were careful not to ask about covered credit default swaps. Nonetheless, the market took the Department's opinion on a subset of credit default swaps as a ruling on all swaps and, to be fair, the Department did nothing to the contrary.

In sum, in 2000 as a society we chose not to regulate credit default swaps, whether as insurance, as a security or gaming.

Why did that matter? As we have seen, the financial system has been placed in peril because there was no comprehensive management of counterparty risk. Deals were made privately between two parties. These bilateral arrangements mean that there are no standards for the solvency of counterparties, who can assign the credit default swaps to other parties. The buyer does not know how much risk the seller is taking on. There are no requirements for the seller to hold reserves or capital against the risks it is taking on

by selling swaps. And no one knows who owns or where the credit default swaps ultimately reside.

None of this was a problem as long as the value of everything was going up and defaults were rare. But the problem with this sort of unregulated protection scheme is that when everyone needs to be paid at once, the market is not strong enough to provide the protection everyone suddenly needs.

Unlike insurance, credit default swaps are marked to market. That means, the value of the swap reflects the current market value, which can swing sharply and suddenly. Value changes require the sellers to post collateral. Sudden and sharp changes in the credit rating of the issuer of the bonds or of the bonds themselves can produce large swings in the value of the swaps and thus the need to post large and increasing amounts of collateral. That capital strain can produce sudden liquidity problems for sellers. The seller may own enough assets to provide collateral, but the assets may not be liquid and thus not immediately accessible. When many sellers are forced to sell assets, the price of those assets falls and sellers are faced with taking large losses just to meet collateral requirements. As the prices of the assets are driven down by forced sales, mark-to-market losses increase and the collateral posting cycle continues. Meanwhile, the underlying assets may continue to perform--paying interest and principal in full.

The above was a substantial part of the problem at AIG. A ratings downgrade on September 15 produced immediate collateral calls. The company did not have sufficient liquid assets.

In addition, chains of counterparty exposures mean that if any one link in the chain—any one counterparty—fails, others with exposure to that counterparty may also fail setting off a chain reaction. Many financial institutions bought protection from AIG, and there was great uncertainty as to whether all of these institutions could survive AIG's failure.

Was the AIG bailout necessary? I believe it was. Thanks to the protective moat created by state regulation, AIG's insurance operations were insulated from the problems in other AIG subsidiaries and are solid, profitable companies. Many of AIG's companies are leaders in their markets. They have substantial value. But that value could not be realized over a weekend. The bailout will provide time for an orderly restructuring of AIG's operations. It is possible that AIG will survive, as a smaller but much stronger insurance-focused enterprise. At least some of its operations will be sold.

Some argue that the company should have been filed for bankruptcy, as Lehman did. AIG has business relations with just about every major bank in the world. At a time when the financial system and in particular the credit markets are already deeply troubled, the risks of allowing AIG to file for bankruptcy were, in my opinion, just too great. The New York Federal Reserve Bank and the Treasury appear to share that view.

But that systemic risk does underline the need for us to heed New York Governor David Paterson's call to regulate the credit default swap market. In a recent statement, Governor

Paterson said, "The absence of regulatory oversight is the principal cause of the Wall Street meltdown we are currently witnessing. This is why New York took the crucial next step of planning to regulate an area of the market which had previously lacked appropriate oversight, but that is indisputably as regulatable as insurance. I strongly encourage the federal government to follow our approach and bring stronger regulatory oversight to these markets. New York stands ready to work expeditiously with all concerned to find a workable solution to this problem."

In an interview with the New York Times, Governor Paterson called credit default swaps "gambling" and noted that they were a major cause of AIG's problems. He told the paper that "when we peeled back the onion, we found out that AIG had so many credit default swaps that we couldn't calculate how much money they probably had" lost.

On September 22, Governor Paterson announced that New York State is prepared, beginning in January, to regulate part of the credit default swap market which has to date been unregulated. The State is prepared to provide clear regulatory guidance where credit default swaps are used as "insurance" to protect or "hedge" the value of investments held by the purchaser. These transactions are, both functionally and legally, financial guaranty insurance policies.

As I noted, the 2000 decision by the Insurance Department only considered naked credit default swaps. Last month, we determined that covered credit default swaps are insurance and therefore potentially subject to state regulation.

What would be the benefit of treating covered credit default swaps as insurance? Insurers must hold capital and reserves against risks. Insurers are subject to underwriting restrictions that ensure diversification. Insurers are not permitted to write policies with acceleration events, downgrade triggers or collateral calls. While financial guaranty insurance companies have been downgraded, they have maintained their solvency and liquidity. In short, if they were regulated as insurance, buyers of covered credit default swaps would be assured that they could actually have protection when they need it.

What New York State is doing fits our role as insurance regulators. We are providing an appropriate way for those with an insurable interest to protect themselves. Our goal is to ensure the terms of credit default swaps are written as a mechanism for protecting buyers against actual losses and not for betting on the credit quality of a third party. We will also ensure that whoever sells protection is solvent, in other words, can actually pay the claims. There is currently no such protection for parties to credit default swaps that use them as insurance.

The primary goal of insurance regulation is to protect policyholders by ensuring that providers of insurance are solvent and able to pay claims on policies they issue. The goal of regulating these swaps is not to stop sensible economic transactions, but to ensure that sellers have sufficient capital and risk management policies in place to protect the buyers, who are in effect policyholders and to ensure stable markets.

However, we recognize that carving up the credit default swap market is not the ideal solution. And we recognize that there are some valid uses of naked swaps to provide liquidity in the market for risk transfer. There may be different valid ways of having a material interest besides directly owning a bond, such as being long a stock, owning part of a syndicated loan or having a receivable. Also, it may be valid to use the swaps for various sophisticated trading strategies.

Governor Paterson's announcement that New York was ready to regulate part of the market starting January 1 framed the dialogue and pushed forward the discussion of regulating the entire market. The day after Governor Paterson's announcement, SEC Chairman Cox asked for the power to regulate the credit default swap market. And shortly afterward, the New York Federal Reserve began a series of meetings to discuss how to proceed.

There are a number of possible effective means of regulating the entire market, including an exchange, a clearing corporation or a centralized counterparty. Properly designed and operated, any solution would include margin requirements to ensure that there is sufficient capital and liquidity. There should be security funds and other mechanisms to manage counterparty default equitably and predictably. It should provide transparency, both with regard to prices and with regard to the amount of exposure by all counterparties. These measures would ensure that credit default swaps could be a tool for managing risk, without becoming a risk to the entire financial system. We support this effort to find and implement an effective holistic solution.

Credit default swaps played a major role in the financial problems at AIG, Bear Stearns, Lehman and the bond insurance companies. One of the major causes of this financial crisis was not how lax or tight we regulated or how easy or hard we enforced, but what we chose not to regulate. Clearly, it is time to start regulating credit default swaps.

As Governor Paterson said on September 22, New York stands ready to work expeditiously with all concerned to find a workable solution to the problem of how to regulate credit default swaps.

Thank you and I would be happy to answer any questions.