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GOVERNOR PATERSON ANNOUNCES PLAN TO LIMIT HARM TO MARKETS FROM DAMAGING SPECULATION

S.E.C. Limited "Short Selling" of Stock, New York Will Now Regulate Portion of Market for "Short Selling" Bonds

For First Time New York Will Regulate Part of $62 Trillion Credit Default Swap Market

Paterson Calls on Federal Government to Regulate Rest of Swap Market, Citing it as Major Contributor to Nation's Financial Distress

Governor David A. Paterson today announced that New York State will, beginning in January, regulate part of the credit default swap market which has to date been unregulated and has been a major contributor to the emerging financial crisis on Wall Street. Governor Paterson also called on the federal government to regulate the rest of the massive $62 trillion market.

This action is similar to one recently taken by the federal government that tightly restricts "short selling," or profiting from falling stock prices. The state action applies to credit default swaps which are a means of profiting from falling values of bonds. Under the direction of Governor Paterson, the New York Insurance Department today issued new guidelines that, for the first time, establish that some credit swaps are insurance and therefore subject to state regulation.

"The absence of regulatory oversight is the principle cause of the Wall Street meltdown we are currently witnessing. While I applaud the recent federal intervention to stabilize the market – and thus our entire economy – it is important we also take the next step as a nation by regulating areas of the market which have previously lacked appropriate oversight," said Governor Paterson. "Earlier this year, New York was the first state in the nation to mandate certain regulatory control of the subprime lending market, and today's action is just the next step. I urge the federal government to follow New York's lead once again by regulating the rest of the credit default swap market, which will have a positive impact on our collective efforts to get the national economy back on track."

Eric Dinallo, New York State Insurance Superintendent, said: "The severity of this crisis was substantially increased by what the government chose not to regulate, principally credit default swaps. This is primarily a credit crisis, not an equity crisis, and that is where the focus should be now. 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 and we are going to ensure that whoever sells them that protection is solvent, in other words, can actually pay the claims. There is currently no such protection for policyholders. However, we are not regulating naked credit default swaps."

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. At AIG, for example, insurance companies regulated by the state are required to hold substantial reserves and as a result those companies are solvent and able to pay claims. However, a major part of AIG's problems were created when credit default swaps were issued by a non-insurance unit that did not hold sufficient reserves.

A credit default swap is similar to a short sale of a stock. In both cases, an investor profits when the value of the security, either a bond or a stock, declines. As part of efforts to contain the current financial crisis, the federal government has temporarily limited some short sales of some stock to prevent destructive speculation that was damaging the health of targeted companies.

Credit default swaps played a major role in the financial problems at AIG, Bear Stearns and the bond insurance companies. A credit default swap is a contract under which the seller promises to pay the buyer if the insurance provider of the bond cannot pay principal and interest. Credit default swaps can be used by the owners of bonds who want to protect themselves if the company that issued the bonds is unable to pay interest and principal. In those cases, the swap is insurance, because the swap buyer is like a homeowner insuring a home. But, just as with short selling of stock, most swaps are now used by speculators who do not own the bonds and the value of swaps outstanding are generally much more than the value of a company's debt. Swaps bought by speculators are known as "naked swaps" because the swap purchasers do not own the underlying bond. Speculation in a company's bonds can under some circumstances hurt that company's ability to borrow.

The new guidelines establish that when the buyer owns the underlying security on which he is buying protection then the swap is an insurance contract. Under these new regulations, such swaps would be subject to regulation for the first time and can thus only be issued by entities licensed to conduct insurance business. So called "naked swaps" are not insurance and cannot be regulated by the State.

The Insurance Department today issued Circular Letter No. 19 (2008), which sets forth best practices for financial guarantee insurers, also known as bond insurance companies or monolines. In the fall of 2007, the Department developed a three-part plan to address the serious challenges recently faced by the financial guarantee industry. Under that plan, the Department has:

1. Encouraged the entry of additional, well-capitalized insurers into the financial guarantee market and facilitated capital raising by existing insurers.

2. Protected policyholders and the public by helping financially distressed bond insurers to develop workable solutions.

3. Developed new standards to which the financial guarantee business should adhere.

Today's circular letter is part of developing the third point, new standards. The Department will continue to encourage new players to enter the financial guarantee industry to ensure a healthy competitive market for those who need these products.

The new best practices:

1. Strictly limit financial guarantee insurers from guaranteeing collateralized debt obligations or "CDOs"—securities based on the payments from many mortgages. These CDOs, often based on subprime mortgages, have caused substantial financial difficulties for many commercial and investment banks. Credit default swaps on CDOs are the source of a large part of AIG's financial troubles.

2. Institute a number of measures to limit risks for financial guarantee insurers. For example, the rules better define concentration risk, which is the risk from insuring too many bonds from a single source. The new rules include originators and servicers of debt as sources to consider.

3. Require written risk control and underwriting policies.

4. Increase the minimum amount of capital and reserves a financial guarantee insurer must maintain.

5. Expand reporting requirements.

Circular letters provide regulated insurance companies with direction from the Insurance Department. The Department also plans to propose regulations and legislation to implement reforms. The Department is prepared to answer questions and provide guidance about its views with regard to complicated credit default swap issues.

The new guidelines will not affect any existing credit default swaps. Financial guarantee companies were very active in selling credit default swaps, but are conducting little if any business currently. The new guideline provides a means for current and new companies to more prudently provide this type of insurance.

To avoid market disruptions, the guidelines as regards to credit default swaps will not take effect until January 1, 2009.

New York regulates most of the nation's financial guarantee companies and Article 69 of the New York Insurance Law, which governs financial guarantee insurance, generally serves as the model for the laws governing financial guarantee insurance in other states. In 2000, the Department ruled that all credit default swaps were not insurance. Today's circular letter effectively reverses that decision only to the extent that certain swaps are insurance under New York Insurance Law.

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