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Coping with the CDS Crisis:
Lessons Learned from the LMX Spiral

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Crowell & Moring LLP is an international, full-service law firm with nearly 500 lawyers representing major businesses, government, and other entities - both public and private - in high-stakes litigation, complex regulatory and administrative matters, and government and internal investigations. Crowell & Moring's Insurance/Reinsurance practice has attorneys located in Washington, D.C., New York, Orange County, and London and focuses on reinsurance arbitration and counseling, coverage litigation, and client counseling and negotiations for insurers and reinsurers in several lines of business including property and casualty, life, professional lines, and health care.

Abstract: The turmoil within the market for credit default swaps - a financial tool similar to credit insurance - is intimately tied to the widespread asset devaluation and de-leveraging process roaring through the transatlantic economy. It is also similar, on a much broader scale, to the Lloyd's LMX Spiral of the 1980's. In both crises, the problems were driven by misaligned incentives, intra-industry risk mitigation strategies that often pushed risks to new capital, underwriting models that caused some to view premiums as "free money," and a reverberation of losses due to collateral obligations and counterparty defaults. This turmoil has prompted U.S. state, federal, and European policymakers to seek regulatory solutions, including the creation of a central counterparty system. In designing such regulations, however, policymakers should consider the lessons previously learned by the reinsurance industry in the aftermath of the Lloyd's LMX Spiral for guidance.

I. <u>Introduction</u>

Some have called this the end of days for insurance and reinsurance markets, the next domino to fall in this economic meltdown.[i] Others have merely suggested a "restructuring."[ii] Insurance and reinsurance players, the thinking goes, are always last to the party, or perhaps, in this case, the wake. This view hinges on the downward spiral of deleveraging and seemingly unending, asset devaluation proceeding apace through the financial markets, and their impact on insurers and reinsurers alike. This devaluation and deleveraging is intimately tied to the unraveling of the credit markets and, in particular, the high-profile uncertainty surrounding the market for credit default swaps ("CDS"), a financial tool Warren Buffet once famously called "weapons of mass destruction" for what some perceive as their potential for cascading, harmful impacts on financial markets.[iii] Current estimates place the outstanding notional value of the CDS marketplace at $28 trillion.[iv]

Instead of being a final symptom of the underlying crisis, however, past experience in the insurance and reinsurance industry may be a guide for legislators and regulators who are seeking a credible, sustainable solution. In particular, the lessons of the Lloyd's/London Market LMX Spiral from the 1980's may provide some guidance to state and federal regulators attempting to arrest the turmoil within the CDS market and set forth a clear and sound regulatory scheme. After all, the predicament within the CDS market is arguably symptomatic of the issues central to the LMX Spiral: mitigating risk by spreading it among other market players, misaligned incentives for dealmakers who spread the risk, uncertain and opaque counterparty credit risk, an overabundance of new capital, crippling collateral obligations upon a "payment" event, and underwriting failures which plainly underestimated the risk of "payment" events. Before investigating this comparison further, however, it is useful to review what a CDS is, and the various domestic and international attempts to respond to the CDS market crisis.[v]

II. A Brief History of Credit Default Swap "Regulation"[vi]

A. An Overview of CDS

First, a brief history of the CDS marketplace. It has been suggested, although not necessarily accepted, that a CDS acts very much like an insurance contract.[vii] In fact, a CDS is a financial contract designed to offer protection for companies seeking to hedge or transfer credit risk. In practical terms, a CDS is a financial contract under which one party (the "protection buyer") pays a fee, usually in the form of a series of annual payments over five years, to another party (the "protection seller") in return for the protection seller's promise to pay the protection buyer if certain adverse credit events (such as bankruptcy, payment default, or restructuring) occur with respect to a particular obligor (the "reference entity") or certain of its debt obligations (the "reference obligations"), during the agreed-upon period. Thus, the protection buyer - typically a bank - transfers the risk of default of a borrower - the reference entity - to a protection seller. In that sense, a CDS is a financial derivative because its potential payoff is derived from the value of an underlying financial asset.[viii] Accordingly, CDSs function very much like a credit insurance product; if the protection buyer suffers an actual loss, the CDS becomes due, and the protection seller must compensate the buyer for such loss.

One notable - and controversial - distinction between CDS and true insurance is that the buyer of a CDS is not required to own the reference obligation for which the CDS protection is written, and thus does not have to suffer any actual loss on such reference obligation to collect on the CDS (i.e., the buyer has no "insurable interest"). This type of CDS is referred to as a "naked" CDS. If the protection-buyer does own the underlying security, the CDS is referred to as a "covered" CDS. Some commentators have likened buying a naked CDS to buying a fire insurance policy on an un-owned home.[ix] In both instances, the protection-buyer's economic interest runs counter to the long-term viability of the underlying asset - the security or the home - because the protection-buyer only collects if the underlying asset is impaired. In other words, because naked CDS permit buyers to "naked short"[x] the debt of an issuing company without restriction or downside risk, the incentive for buyers of naked CDSs is to seek the default or credit event of the issuer of the underlying security.[xi] This concern, which is analogous to the insurable interest dilemma in traditional insurance products, is central to all of the newly proposed regulatory programs addressing the CDS market.

Another concern is the lack of transparency within the CDS marketplace. Generally, CDS are privately-negotiated contracts between business entities sold and traded solely over-the-counter.[xii] The trades are generally documented on standard forms developed by the International Swaps and

Derivatives Association, Inc. ("ISDA") and negotiated directly by the parties as swaps.[xiii] However, because of the over-the-counter nature of the transactions, some protection buyers and sellers lack a full picture of the state of the CDS market at the time of the transaction, and are therefore not always able to accurately assess the credit risk of their counterparty.[xiv] According to one description:

> "For most investors, just getting default-swap prices is a chore. Unlike stock prices, which are readily available because they trade on a public exchange, swap prices are hard to find. Traders looking up prices on the Internet or on private trading systems see information that is hours or days old.... Banks send hedge funds, insurance companies and other institutional investors e-mails throughout the day with bid and offer prices....To find the price of a swap…even sophisticated investors might have to search through all of their daily e-mails."[xv]

B. The Regulatory Black Hole: New York Regulates "Financial Guaranty" Insurers, But State and Federal Governments Exempt CDS Issuers

The New York Insurance Department (the "Department") regulates financial guaranty insurance companies that are either domiciled in New York or licensed to issue such insurance in New York.[xvi] Also referred to as "monoline" insurers because they provide services to only one industry, only financial guaranty insurers licensed by the Department can write insurance policies which guarantee the timely repayment of bond principal and interest when an issuer defaults.[xvii] Multiline insurers (such as the large P&C insurers) are prohibited from issuing such coverage. However, New York law does permit multiline insurers to reinsure up to 50% of the risks written by any monoline insurer.[xviii]

In June 2000, the Department's Office of General Counsel issued an opinion suggesting that a CDS or similar instrument is not an insurance contract if, among other factors, any future payment under a CDS is not conditioned upon an actual pecuniary loss.[xix] This opinion, combined with the federal exemption from regulation granted to CDS under the Commodities Futures Modernization Act of 2000 (the "CFMA")[xx] and the private, over-the-counter nature of CDS contracts, resulted in an unregulated CDS marketplace. As a consequence, many different types of companies were permitted to issue CDS contracts, without becoming subject to the regulatory control of the Department or any federal agency.

Under Article 69 of the New York Insurance Law, monoline insurers were also permitted to create subsidiary, special-purpose vehicles (SPVs) to issue CDSs and to reinsure or guarantee such subsidiaries themselves.[xxi] Thus, although the CDS transactions themselves were exempted from regulatory scrutiny, the monoline insurers took on the risks of the CDS transactions all the same. Moreover, because the large, multiline insurers reinsured up to 50% of the entire book of business of the monoline issuers, the multiline insurers also ended up being exposed to the CDS risks of the monoline SPVs.

The reinsurance of these SPVs by the multiline insurers provides much of the ammunition for those who project that insurance and reinsurance markets are likely to bear the next brunt of the subprime/CDS crisis. Most analysts note that actual losses on these reinsurance contracts have just begun to hit, and that excess of loss treaties are not yet impacted.[xxii] In addition, much of this reinsurance is likely to be offshore, which limits the amount of information available regarding the extent of CDS reinsurance exposure with the multiline insurers.

III. <u>The Lloyd's LMX Spiral - Have We Been Through This Before?</u>

As some commentators have mentioned, the CDS crisis, although certainly different in scope, bears a strong resemblance to the Lloyd's/London Market LMX Spiral from the 1980's.[xxiii] Specifically, both the CDS and LMX markets expanded very quickly,[xxiv] based in part on flawed incentive structures which valued upfront fees over long-term profits. Both pursued risk mitigation by spreading risks to other market participants, in particular new capital and investors. Both presumed a risk variable so low, based in part on the cross-distribution of good and bad risks, that premiums or fees were seen as "free money." Consequently, once one counterparty failed, the failure reverberated into a spiral of losses among numerous market participants.[xxv]

The LMX Spiral began in the 1980's during a soft period in the reinsurance market. The 1980's was also a period of expansion within Lloyd's of London, which welcomed as new members thousands of new individual investors ("Names") prepared to invest their own private funds with the promise of extremely high returns in a short period.[xxvi] Many of these private investors were not sophisticated and knowledgeable about the insurance industry.[xxvii] To increase revenues and deal with the increase of new capital, Lloyd's expanded the use and issuance of London market excess of loss (LMX) policies, which reinsure the policies of another insurance/reinsurance company or Lloyd's syndicate for a share of the premium.[xxviii] LMX policies also offered large commissions - an incentive for brokers to push their sale.[xxix] Throughout this process, LMX reinsurers would issue LMX policies to provide cover from other LMX reinsurers (a process referred to as bundling or re-bundling).[xxx] This meant that LMX underwriters were ultimately covering both their own losses as well as the losses of others.[xxxi] The assumption was that aggregating exposures meant a reduction in risk, but the opacity of the Lloyd's market significantly reduced underwriters' actual knowledge regarding a members' exposure and, thus, the counterparty risk.[xxxii] Moreover, as Lloyd's did not, at that time, operate under a central controlling entity, no single participant could enforce underwriting or risk-management discipline among the other participating members.

Of course, the parade of "free money" lasted only so long as there were no immediate large losses.[xxxiii] However, after a series of catastrophic losses, including, among others, the large losses related to the Piper Alpha oil platform explosion in the North Sea, the LMX losses spiraled out of control, with claims echoing back and forth among participants, up, down and around the vertical exposure chain.[xxxiv] Moreover, because all of the exposure was entirely contained within the Lloyd's market, the default with any one member had the potential effect of unraveling each succeeding obligation. In all, Lloyd's members lost nearly £8 billion between 1988 and 1992, and as an institution nearly collapsed, with several individuals and companies filing for bankruptcy.[xxxv]

Since the LMX Spiral, the Lloyd's/London Market has changed significantly. First, there is now centralized, professional, and independent management of the London Market pool.[xxxvi] Second, Lloyd's is now regulated by the UK Financial Services Authority. Third, Lloyd's permitted corporate capital to invest in syndicates[xxxvii] and imposed new financial requirements on its individual members and syndicates, to prevent excess underwriting that was not backed by liquid assets.[xxxviii] Fourth, Central Lloyd's significantly increased market oversight, and expanded risk-management analysis of its members.[xxxix]

In addition, in partial response to the LMX Spiral, but also in response to the other very large liabilities that had developed due to environmental, asbestos, and other long-tail risks, Lloyd's formed Equitas, an entity organized in 1996 to segregate, reinsure, and run-off all of the pre-1993 Lloyd's insurance/reinsurance liabilities.[xl] As with all insurance and reinsurance run-offs, Equitas permitted Lloyd's to encapsulate all of its potential liabilities prior to 1993, manage the mitigation of potential liabilities to counterparties, and permit the value of time to discount the total amount of liabilities.[xli]

IV. Current Events: Developments in Regulation of CDS

The lessons learned from the LMX Spiral are widely applicable to the current crisis in the CDS market. Moreover, it appears that regulators and market participants are slowly accepting these lessons and moving towards an integrated solution to the CDS problems. This is a positive development because, just as reinsurance was a vital risk management tool for the insurance industry, CDS, if properly managed, are an important risk management tool for banks and other financial market participants. The key, as will be apparent, is reducing systemic risks through changes in the structure and operation of the marketplace. Current proposals for the regulation of the CDS marketplace address some of these changes, but out-standing issues remain.

A. New York State Acts First

On September 22, 2008, after several of the monoline insurers suffered catastrophic losses related to their guarantee of CDSs issued by SPVs, the Department stepped into the

CDS regulatory breach and announced its intention to regulate part of the CDS market. Under the new proposal, issued within Circular Letter No. 19 (2008) ("Circular 19"), as of January 1, 2009, all CDSs issued to buyers who, at the time the agreement is executed, hold, or reasonably expect to hold a "material interest" in the reference obligation, would have been recognized as financial guaranty insurance contracts, and any protection seller issuing these covered CDSs would have been required to be a licensed as financial guarantee insurer.[xlii] In addition, the Department outlined a series of "best practices" to be followed by financial guaranty insurers issuing CDSs. These regulations capped financial guaranty insurers concentration of risks at 10% of aggregate surplus in any one risk, prohibited the issuance of CDSs on collateralized debt obligations that are comprised or include portion of other pools (with narrow exceptions), and eliminated the insurer's ability to issue CDSs that include a provision stating the credit quality or solvency of the financial guaranty insurer itself would trigger or accelerate liability.[xliii] As with traditional insurance regulation, the Department's intent was to protect CDS buyers by ensuring that the protection seller has both sufficient capital and surplus to pay claims under the CDSs.

Notably, the Department declined to regulate naked CDSs. As indicated previously, under such contracts the protection buyer does not own or maintain any interest in the underlying reference obligation. Accordingly, pursuant to the press release accompanying Circular 19, "naked" CDSs are not considered by the Department to constitute "insurance."[xliv]

The Department did, however, encourage the federal government to attempt to regulate naked CDSs.[xlv] In so doing, the Department outlined a short list of provisions that it urged as part of effective CDS regulation, including adequate capital and trading margins, a guaranty fund, market transparency and monitoring, non-voluntary regulatory oversight, and a clear and inclusive dispute resolution mechanism.[xlvi]

B. The U.S. Federal Government Steps In

Circular 19 was met with resistance from both the CDS industry and parties urging greater regulation of the CDS marketplace. The former urged that Circular 19 was unnecessary, and that CDS markets could find a non-regulatory solution. The latter sought more comprehensive CDS regulation from the federal government.

On November 14, 2008, both sides of the debate were heartened when the President's Working Group on Financial Markets (the "PWG"), which includes the Chairs of the Commodities Futures Trading Commission (the "CFTC"), the Securities and Exchange Commission (the "SEC"), and the Federal Reserve, issued an announcement setting forth a list of initiatives to strengthen the infrastructure and oversight of the over-the-counter derivatives market, including the CDS market.[xlvii] Central to the PWG's announcement was a plan for the CFTC, the SEC, and the Federal Reserve to work together to implement one or more central counterparties (a "CCP") for credit derivatives, including CDSs.[xlviii] According to the PWG, a CCP would effect an immediate reduction in the systemic risk associated with the CDS market by increasing transparency, and reducing the risk of counterparty default.[xlix] In addition, the PWG announced a "Memorandum of Understanding" among the three federal regulatory entities in which they agreed to work cooperatively in the oversight of the CCP, and towards a set of policy objectives for improving the functioning of the over-the-counter derivatives market.[l]

As a result of the PWG's announcement, on November 20, 2008, the Department delayed indefinitely the application of Circular 19's regulations regarding any treatment of covered CDSs as insurance.[li] The Department did not suspend application of the new "Best Practices" for monolines, and still "intends these limitations to confine [monoline] participation in the CDS market to those transactions in which the insurer's risk is roughly comparable to the amount and timing of risks assumed when directly insuring bonds," which means that the monoline insurers will not be able to guarantee policies or CDSs issued by SPVs that they could not write directly.[lii] Since then, the Committee on Agriculture in the U.S. House of Representatives has reported out "The Derivatives Markets Transparency and Accountability Act of 2009,"[liii] which, among other things, requires that prospective over-the-counter CDS transactions be settled and cleared through a derivative clearing organization regulated by the CFTC.[liv]

C. Operation of the CCP

Most parties now agree that the formation of one or more CCPs for credit derivatives, including CDS, is necessary to solve the current problems in the CDS marketplace.[lv] According to the PWG, a CCP may be a state-chartered bank, subject to examination by the Federal Reserve, a derivatives clearing organization under the jurisdiction of the CFTC, or a clearing agency regulated by the SEC.[lvi] No matter the form, however, functionally, the CCP would interpose itself between each of the counterparties to a CDS (the protection seller and the protection buyer), and bear the credit risk of each party by agreeing to make any required payments when due under standardized CDS contracts.[lvii] The CCP does not take an economic interest in the CDS contract, but tracks the identity of both counterparties to a CDS and then "clears and settles" CDS trades, and claims in a timely manner.[lviii]

Importantly, since the CCP bears all counterparty risk, the clearinghouse would be available only to those market participants that satisfy and maintain the CCP's criteria for financial resources and operational capacity. Member participants would be required to meet minimum capital requirements, margin requirements, and operational requirements to ensure the efficient functioning of the CDS trading desk. In addition, member participants would be required to post collateral to the CCP based on daily tallies of their CDS positions, and contribute funds as surplus to protect the CCP in the event of a counterparty default. (The CCP would maintain a guaranty fund in addition to its own capital and reserves.) Finally, the CCP would likely put in place risk management systems applicable to all market participants.

Thus, the CCP would undertake three distinct operational roles, each of which serves clear policy purposes. First, the CCP records information regarding the CDS transactions, including the counterparties and details of each contract. These records would dramatically increase the transparency in the CDS market, particularly regarding the prices for CDS, trading volumes, and open interest positions, thereby reducing the negative operational and risk-assessment impacts of misinformation among market participants. Second, the CCP enforces uniform and vigorous risk controls on market participants, including limitations on risk concentrations, and the aforementioned required capital and surplus margins for participants. These risk-management measures would reduce both the risk of default by any one market participant and the broader systemic risks amplified by cascading defaults or capital/collateral requirements. Finally, the CCP clears and settles all eligible CDSs among market participants, including the "netting" of counterparty positions in similar CDS contracts. The timely settling of CDS contracts reduces the necessity of collateral swings among market participants, and, most importantly, vastly improves the ability of the CDS market to contain the destabilizing effects of the failure of any one major market participant.

D. Outstanding Questions: Is the CCP Mandatory and Is it Trans-Atlantic?

Two important questions, however, remain unanswered regarding the formation and implementation of a CCP for the CDS market.

i. Is the CCP Mandatory?

The first is whether CDS market participants will be required to participate in the CCP. As noted by Patrick M. Parkinson, Deputy Director of the Board of Governors of the U.S. Federal Reserve System, in his November 20th testimony before the U.S. House of Representatives Committee on Agriculture, "[t]he degree of [market] transparency…depends on participation in the CCP," and "to the extent that participation in a CCP is voluntary, its value as a device to prevent and detect manipulation and other fraud and abuse in the CDS market may be limited."[lix] On the other hand, many of the outstanding CDS contracts are on non-standardized forms, for which the CCP may not be available. As such, implementation of the CCP may not wholly resolve the current, systemic problems in the CDS market, nor clarify future regulatory or operational issues, unless and until settlement of CDSs through the CCP becomes the sole market standard.

ii. Is the CCP Trans-Atlantic?

The second, and broader question regarding the implementation of the CCP is whether the clearinghouse will be open to non-U.S. CDS market participants, specifically, market participants from Europe. Many European banks and other financial entities were, and still are, heavily involved in the CDS market and have suffered significant CDS losses. Indeed, by some accounts, the volume and scope of over-the-counter CDS transactions was greater in London than in New York. At this time, the European Commission ("the Commission"), and the European Central

Bank support the creation of a European CCP. But, while European banks in principle agree that establishment of a CCP for CDS clearing is the way forward, these banks also prefer a global, or at least Trans-Atlantic, CCP solution as opposed to separate CCPs in Europe and the US.[lx] The Commission, aware that it may have no jurisdiction to intervene, supervise, or influence regulation of a single, US-based CCP, has argued that it would be beneficial to have a separate European solution, in order to maintain control over the CCP regulatory regime, to promote competition between transatlantic CCPs, and to manage the risk of having only one global clearinghouse.

Regardless, there has been interest from a number of clearing-houses that are prepared to act as CCP for the CDS market, both in the US and in Europe, including:

- ICE Trust, created by Intercontinental/Exchange and The Clearing Corporation, a consortium of dealer banks
- Credit Market Derivatives Exchange, to be set up by the Chicago Mercantile Exchange and Chicago-based hedge fund Citadel
- NYSE Euronext through its subsidiary Liffe, which launched its CCP initiative in Europe
- Eurex Clearing, a subsidiary of Deutsche Börse

Given that there is also an ongoing battle within the U.S. Congress and government regarding which regulatory agency - the SEC, CFTC, or the Federal Reserve - should have ultimate authority over the CCP,[lxi] it is not likely that this issue will be resolved until the U.S. Congress and the Obama Administration present the promised regulatory overhaul of the financial markets.

V. What Does The CDS Crisis Mean For Reinsurance?

Insurance and reinsurance losses related to the subprime/CDS market disruption are currently estimated to be nearly $10 billion. However, estimates of losses related to systemic risks are often low and any estimate of ultimate losses is dependent upon the extent of further economic deterioration, the development of evidence of fraud or abuse, and the success of future regulatory regimes and structures, such as the CCP. Accordingly, this figure is likely to be much higher when the losses are finally played out.

A. Impact on Directors & Officers /Errors & Omissions Insurers and Reinsurers

Although it is difficult to tell at this point how the CDS turmoil will develop into insurance losses, the claims arising out of the subprime mortgage collapse are illustrative. At this point, underwriters of professional liability policies (both D&O and E&O), are likely to feel the strain in the coming months as a result of the collapse of both the subprime mortgage market, and the global financial credit crisis. Advisen, Ltd., an insurance consultancy, predicts that D&O/E&O losses relating to the subprime mortgage crisis may be in the region of $5.9 billion for D&O insurers and $3.7 billion for E&O insurers.[lxii]

In 2007, 278 civil litigation cases were filed before the US courts relating to subprime issues, and directors and officers were named as defendants in 97% of the class action cases.[lxiii] This is an unprecedented increase given that class action losses had been on the decline for the three prior years. A number of analysts also expect that a large proportion of defendants will be making claims against their D&O and E&O policies once the litigation has been resolved.

The subprime mortgage situation represents a significant risk especially to those insurers who, like AIG, were considered leaders in large account market position for D&O liability insurance as well as property insurance, employment practices liability insurance and umbrella and excess liability insurances. Investors in companies that have experienced subprime losses are likely to lay the blame for such losses at the feet of the directors and officers of such companies. Litigation flowing from the financial crisis may come in the form of shareholder derivative actions against the corporate officers and directors. Shareholders may claim that directors/officers breached their fiduciary duties by failing to be vigilant and failing to control the risks associated with subprime investments. Other allegations may include the inducement of shareholders by company directors/officers to enter into contracts on facts that were misrepresented to them, breach of contract, or claims arising from the reliance on certain investment advice. Regulators have also expanded their monitoring and are working with their overseas counterparts to ensure all avenues that are open for potential actions are reviewed.

The same applies to E&O liability policies that are likely to be called upon to provide coverage in situations where underwriters, property valuers, rating agencies, promoters and other participants in the CDS market are exposed to liability claims based on negligent advice, which in retrospect, did not accurately reflect current market conditions. The potential claimants include shareholders, institutional investors, lenders, borrowers and other entities that relied on the advice. The potential targets of litigation include accountants, valuers, analysts, lawyers, underwriters and other professionals who provided advice relating to the value of CDSs.

B. Subprime/CDS Related Litigation

As a result of the meltdown of the subprime mortgage industry and related credit crunch, the insurance industry as a whole is predicting a huge volume of litigation regarding refusal of coverage under D&O and E&O policies. One of the cases testing policy coverage was the recent case *JP Morgan Chase & Co Shareholder Derivative Litigation*,[lxiv] in which shareholders of JP Morgan Chase brought suit against the company's directors and officers of corporation, alleging that a number of officers and directors of the bank "breached their fiduciary duty to JP Morgan, wasted corporate assets, and unjustly enriched themselves at the expense of JP Morgan and its shareholders" through their actions relating to subprime mortgages.[lxv] In the UK, a similar case, *HSH Nordbank*,[lxvi] is currently being argued on forum/jurisdictional grounds, but if accepted by the UK courts, will be the first piece of subprime litigation that England has seen.

Potential claims on D&O policies may also arise out of the high profile "grillings" of former directors of UK banks Royal Bank of Scotland ("RBS") and HBOS at the hearing of the Treasury Select Committee on February 10, 2008. There, the former chairmen and former chief executives of both banks were accused of misleading investors at the time of a 2007 rights issue for RBS, of failing to disclose properly their banks' exposure to the subprime mortgage market, and of the perceived excessive risk taking at both banks.[lxvii] The RBS executives have also been named in class action lawsuits filed in New York relating to the accusations surrounding the 2007 rights issue.[lxviii] Their contrition may be seen as an admission to specific mistakes over governance or risk management issues and may lead to further litigation.

Despite the potential for significant claims, insurer and reinsurer responsibilities in connection with a number of these claims may be in dispute, as exclusions may apply. The majority of D&O and E&O policies contain exclusions relating to dishonest/fraudulent/criminal acts, breach of contract, and violations of securities laws. Examination of the result of such litigation may not be likely for some time, but it is expected that insurance companies will closely scrutinize the facts surrounding policyholder claims going forward.

VI. Applying Lessons Learned from the LMX Spiral

A. Dealing with "Spirals of Risk"

Each of the regulatory or quasi-regulatory proposals currently under consideration in both the U.S. and Europe appear designed to mitigate the destabilizing and systemic "spirals of risk" associated with counterparty defaults within the CDS marketplace. The CCP, for its case, focuses on transparency and collateral swing reductions through a strengthened infrastructure and "netting" counterparty transactions, financial standards and risk-management controls for member participants, and a wholesale shift of the counterparty risk to the CCP. While the more regulatory-oriented aspects of the CCP may have the effect of reducing the number of CDS protection sellers, they would also quite clearly increase the participating members' creditworthiness and sophistication, which should encourage capital formation among the CDS market. In addition, exposures among all participants, both buyers and sellers, would be tracked and measured on a real-time basis, allowing regulators with oversight of the CCP to identify any potential risk concentration or credit issues before they amalgamate into significant problems.

Other proposals, including the Department's effort to regulate issuers of covered CDS, accomplish many of the same policy goals, albeit through the more explicit means of traditional government insurance regulation. Of course, the Department's efforts would not address the issues and problems related to the "naked" CDS market.

B. Lessons Learned?

The regulatory and CCP proposals involving the CDS market appear to heed several of the lessons learned through the LMX Spiral. First, a central party must be created to set capital and operational standards applicable to all market participants.

Second, the central party must create transparency throughout the marketplace. Third, the market participants must reorient incentives and improve risk-management standards (and models) by eradicating the brokering and underwriting ethic which focuses on upfront commissions or premium income to the exclusion of true risk exposure. Fourth, market participants must recognize the threat of risk aggregation, or mitigating risk by spreading it to other market participants, which can lead to the destabilizing spiral of collateral swings and cascading counterparty defaults.

Two issues from the LMX Spiral, however, appear to remain unaddressed by the current proposals, one operational and one practical. First, any solution that is not comprehensive may not be a satisfactory solution. As the LMX Spiral demonstrates, systemic problems demand comprehensive solutions that encompass all market participants. For example, the transparency benefits of the CCP, as noted above, are limited to the extent that participation in the CCP is voluntary. In addition, since the systemic risks are just as great in non-standardized CDS contracts as in standardized ones (and perhaps greater), until settlement through the CCP becomes the market standard, the mitigation effects of the CCP as it relates to system-wide financial risks is limited. [lxix]

The second issue is more practical - what can regulators do to address the inherent limitations of the CCP regulatory model? The London insurance and reinsurance market solved this problem both by mandating adherence to the new regulatory and management structure of Lloyd's, and, in part, by its formation of the Equitas facility, with the resulting encapsulation of all of the losses of all of the participants from 1930 to 1993, including all of the LMX Spiral years.

Therefore, the questions facing the new U.S. administration and the European Union are two-fold: whether to require CDS market participants to become CCP members on a forward-looking basis, and, perhaps more importantly, whether to attempt to isolate as much of the risks and losses related to non-standardized, naked, outstanding CDSs as possible, through the formation of a federally-managed "bad bank," similar to Equitas or the Resolution Trust Corporation formed after the US savings and loan crisis. This entity could act as a stand-alone CCP, with access to federal funding - thus, the government is the counter-party to both sides of the transaction, addressing the issue of the "Damocles sword" - in order to assure the resolution of previously-issued CDSs that cannot be managed through the newly recognized CCP, and would only exist long enough to clear and settle these legacy, non-standard CDS contracts.

Many economists have proposed a similar model and new U.S. Treasury Secretary Timothy Geithner appears to at least be considering a similar public-private model.[lxx] Although undoubtedly costly, the best asset the government has in this crisis is time; in particular, the time to allow many of the CDSs to be run-off or unwound, as necessary. If the experience of the insurance and reinsurance industry is any guide, the resulting regulatory and operational certainty suggests that it just may work.

Endnotes:

[i] *See, e.g.*, Iain Dey, "Insurers Next for State Bailout," *The Sunday Times*, Oct. 26, 2008, *available at:* http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5014576.ece ("Fears are mounting that rapidly falling stock markets, coupled with losses from the collapse of institutions such as Lehman Brothers and Washington Mutual, could put insurers around the world under pressure.").

[ii] Christian Wells, "Credit Crunch or Solvency Stricture?," *Reinsurance*, Dec. 1, 2008, *available at*: http://www.reinsurancemagazine.com/public/showPage.html?page=831398.

[iii] 2002 Annual Report to the Shareholders of Berkshire Hathaway, Inc., p. 15, *available at*: http://www.berkshirehathaway.com/2002ar/2002ar.pdf. Buffet's prescient statement reads in full: "[D]erivatives are financial weapons of mass destruction, carrying damages that, while now latent, are potentially lethal."

[iv] Matthew Leising, "U.S., Europe May Jointly Regulate Credit Derivatives," *Bloomberg*, Feb. 19, 2008, *available at*: http://www.bloomberg.com/app/news?pid=20601087878&sid=aU3t3vi4lmfI&refer=home.

[v] Since the U.S. and European governments are working quickly to resolve the CDS crisis, the issues and topics discussed herein continue to develop and, as such, this article may not address any legal or regulatory changes which occur after the date of publication.

[vi] CDS have not to date been regulated by any authority.

[vii] *See*, *e.g.*, "Regulating Credit Default Swaps: Less Deference, More Deterrence," Westlaw Business Currents, Jan. 13, 2009 (describing CDS as "quite insurance-like") (hereinafter "Business Currents Article").

[viii] Rene M. Stulz, "Should We Fear Derivatives?," 18 *Journal of Economic Perspectives* 3, p. 173 (Summer 2004).

[ix] *See* Business Currents Article, supra ("To get a general idea, imaging buying fire insurance on your neighbor's house - if it burns down, you get the payout."); David Evans, "Hedge Funds in Swaps Face Peril With Rising Junk Bond Defaults," *Bloomberg*, May 20, 2008, *available at*: http://www.bloomberg.com/apps/news?sid=206011 &sid=aCFGw7GYxY14

&refer=home (stating "It's as if many investors could buy insurance on the same multimillion-dollar home they didn't own and then collect on its full value if the house burned down.") (hereinafter "Evans Article").

[x] "Naked short selling," or "naked shorting," is the practice of selling a stock short, without first borrowing the shares or ensuring that the shares can be borrowed as is done in a conventional short sale.

[xi] *See* Testimony of Erik Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission, before the Committee on Agriculture, U.S. House of Representatives, Nov. 20, 2008 (hereinafter "Sirri Testimony") (stating that securities markets "are directly affected by CDS due to the interrelationship between the CDS market and the securities that compose the capital structure of the underlying issuers on which protection is written" and that "[i]n addition to the risks that CDS pose systemically to financial stability, CDS also present the risk of manipulation").

[xii] As they are unregulated, CDS contracts can theoretically be entered into by any two entities. Generally speaking, the biggest issuers and buyers of CDSs are banks, insurance companies, hedge funds, and institutional investors.

[xiii] The ISDA's website can be found at: http://www.isda.org.

[xiv] In May of 2008, George Soros described the issue of counterparty risk in the CDS market as "a Damocles sword waiting to fall." Evans Article, *supra*.

[xv] Evans Article, *supra*.

[xvi] N.Y. Ins. L. § 6901 *et seq*. Due to its status as a financial center, the overwhelming majority of financial guaranty insurers are either domiciled or licensed in New York.

[xvii] *Id.* at § 6901(a)-(b) (defining "financial guaranty insurance" and "financial guaranty insurance corporation").

[xviii] In fact, the multiline insurers are permitted to reinsure 100% of the monoline insurers, N.Y. Ins. L. § 6906, but since monoline insurers can only receive a credit for 50% of reinsurance, the practical effect is to limit reinsurance cessions to 50%.

[xix] Opinion of General Counsel of New York Insurance Department, "Re: Credit Insurance Policy Issued to Financial Institution," June 16, 2000, *available at*: http://www.ins.state.ny.us/ogco2000/rg006161.htm; see also New York Insurance Department Circular No. 19 (2008), p. 7, issued Sept. 22, 2008, *available* at http://www.ins.state.ny.us/circltr/2008/cl08_19.htm (hereinafter "Circular 19") (discussing the June 2000 opinion).

[xx] The CFMA was enacted into law on January 21, 2000 as part of H.R. 4577, the Consolidated Appropriations Act 2001, an omnibus spending bill, became P.L. 106-554, §1(a)(5), and is codified within 7 U.S.C. § 1 et seq. Under 7 U.S.C.§ 27e: "No provision of the Commodity Exchange Act … with respect to the clearing of covered swap agreements) shall apply to, and the Commodity Futures Trading Commission shall not exercise regulatory authority with respect to, a covered swap agreement offered, entered into, or provided by a bank."

[xxi] Circular 19, p. 3 ("Many of the policies that [monolines] sold in the structured finance marketplace backed commitments by affiliated special purpose vehicles…that entered into credit default swaps…with banks and securities firms."); N.Y. Ins. L. § 6901.

[xxii] James S. Gkonos, "The Ripple Effects of Subprime Lending and the Capital Markets Crisis on the Insurance Industry," Presentation, The Insurance Industry's Top 10 Risks and Opportunities Conference, Dec. 8, 2008.

[xxiii] *See, e.g.*, Joy A. Schwartzman, "The Game of 'Pass the Risk': *Then and Now," Risk Management: The Current Financial Crisis*, *Lessons Learned and Future Implications,* e-book, published by Society of Actuaries, *available at*: http://www.soa.org/library/essays/rm-essay-2008-schwartzman.pdf (hereinafter "Schwartzman Article").

[xxiv] It is estimated that the CDS market "has doubled in size every year since 2000" to over $60 trillion (notional) in May 2008. It is "larger in dollar value than the New York Stock Exchange." Evans Article, supra.

[xxv] *See* Schwartzman Article, supra at 73-74 (comparing the LMX Spiral and the subprime/CDS crisis); see also Michael Wade, "Lloyd's of London's Collapse Has Lessons For Today's Crisis," *The Daily Telegraph*, Feb. 13, 2009, *available at:* http://www.telegraph.co.uk./finance/news by sector/bank and finance/insurance/461337/Lloyds-of-Londons-Collaps-

has-Lessons-for-Todays-Crisis.html (describing the similarities between the LMX Spiral and the CDS crisis) (hereinafter "Wade Article"). Of note, Mr. Wade was a Member of the Council of Lloyd's and of the McKinsey & Co. Taskforce commissioned to address the issues facing Lloyd's in the 1990s.

xxvi Schwartzman Article, *surpa*, at 73.

xxvii *Id*. As an example, one prominent new "Name" was famous English golf star Tony Jacklin. *See* Patrick Tooher, "Is America's Tragedy a Risk Too Far for Lloyds' Names?," *The Independent*, Sept. 26, 2001, *available at*: http://www.independent.co.uk/news/business/analysis-and-features/is-americas-tragedy-a-risk-too-far-for-lloyds-names-670765.html (describing the sports stars, politicians, and aristocracy who became Lloyds' Names in the 1970s) (hereinafter "Tooher Article").

xxviii Schwartzman Article, *supra* at 73; Tooher Article, *supra* ("Too much money was chasing too few risks, driving premiums down too low. What's more, a number of syndicates raised the risks they took on by reinsuring other syndicates in what one judge later likened to a dangerous game of pass the parcel, where the parcel was the underlying risk that was being moved around.").

xxix Schwartzman Article, *surpa*, at 73 ("LMX deals also offered commissions to brokers as high as 10 percent, thereby making them an attractive sell[.]").

xxx Anthony Hilton, "Leveraging Up Lehman Losses," *Evening Standard*, Oct. 9, 2008, *available at*: http://www.thisislondon.co.uk/standard-business/article-2359554-details/leveraging +up + Lehman + Losses/article.do (describing the practices of the LMX Spiral as follows: "The point about the LMX spiral at Lloyd's was that underwriters took on business they knew was dangerous, because they could pass the risk on to someone else. The recipients took a fee and passed it on.") (hereinafter "Hilton Article").

xxxi *Id*. ("[T]he reinsurers who thought they had passed on risk found out that it had come back to them without their noticing. Far from dispersing risk, it had become more concentrated."); *see also* Wade Article, *supra*,. ("[W]hen the underlying losses did occur, there was systemic collapse of the Lloyd's market not just because the losses went around in an impossibly complicated spiral, but because many members of Lloyd's were also members of other reinsurance syndicates and the losses came back to them in another cycle of contracts.").

[xxxii] Hilton Article, *supra* ("[The reinsurers] had no real idea who was good for the money, because it was all just too opaque. The market froze[.]").

[xxxiii] Wade Article, *supra*, (stating "The consequence with the excess capital was that underlying risks could be underpriced as they were being passed to the new specialist reinsurance syndicates. In turn, they could not measure the correct pricing as they appeared to be hugely profitable.")

[xxxiv] *Id.* ("[W]hen the underlying losses did occur, there was systemic collapse of the Lloyd's market not just because the loses went around in an impossibly complicated spiral, but because many members of Lloyd's were also members of other reinsurance syndicates and the losses came back to them in another cycle of contracts.").

[xxxv] Schwartzman Article, *supra*, at 73; *see also* Tooher Article, *supra* (Lloyds' racked up "staggering losses of £8bn between 1988 and 1992").

[xxxvi] Lloyd's is now managed by the Council of Lloyd's, akin to a Board of Directors, and the Lloyd's Franchise Board, as well as independent senior management, and a series of corporate departments with oversight of operations in North America and internationally, as well as a risk management department which provides assistance and advice to syndicates in developing risk management practice and associated systems and controls.

[xxxvii] Corporate capital now provides over 85% of Lloyd's capacity. Charles E. Boyle, "Lloyd's of London Finds its 21st Century Form," *Insurance Journal*, Sept. 5, 2005, *available at*: http:// www.insurancejournal.com/magazines/east/2005/09/05/features/59961.html

[xxxviii] The Lloyd's corporate risk management office also monitors the reserves and capital adequacy of the syndicates, and to determine the levels of these for the market as a whole.

[xxxix] The Lloyd's Franchise Board is responsible for risk management and lays down guidelines for all syndicates and operates a business planning and monitoring process to safeguard high standards of underwriting and risk management.

[xl] Schwartzman Article, *supra*, at 74.

[xli] Wade Article, supra ("In essence, the Lloyd's solution was to centralise liabilities and discount them by creating Equitas[.]").

[xlii] *See* Circular 19, p. 7, *available at:* http://www.ins.state.ny.us/cir-cltr/2008/cl08_19.htm

[xliii] *Id*. at p. 5-12.

[xliv] *See* "Governor Patterson Announces Plan to Limit Harm to Markets From Damaging Speculation," Press Release from Office of New York Governor David Patterson, Sept. 22, 2008, *available at*: http://www.ins.state.ny.us/press/2008/p0809224.pdf (statement of Eric Dinallo, New York State Insurance Superintendent that "we are not regulating naked credit default swaps").

[xlv] *Id*. (statement of Governor Patterson that "I urge the federal government to follow New York's lead once again by regulating the rest of the credit default swap market[.]").

[xlvi] *Id*.

[xlvii] Policy Objectives for the OTC Derivatives Market, President's Working Group on Financial Markets, Nov. 14, 2008, *available at*: http://www.ustreas.gov/press/releases/reports/policyobjectives.pdf. The PWG identified four overarching objectives: 1. Improve Market Transparency and Integrity for Credit Default Swaps; 2. Enhance Risk Management of OTC Derivatives; 3. Strengthen OTC Derivatives Market Infrastructure; and 4. Continue Cooperation Among Regulatory Authorities.

[xlviii] *Id*. The PWG stated that "Regulators should have access to trade and position information housed at central counterparties (CCPs) and central trade repositories for the purpose of monitoring market trends."

[xlix] *Id*. According to the PWG, "Regulators and prudential supervisors should require participants in a central counterparty arrangement to clear all eligible contracts through that CCP," and that "[d]etails of all credit default swaps that are not cleared through a CCP should be retained in a central contract repository."

[l] Memorandum of Understanding Between the Board of Governors of the Federal Reserve System, The U.S. Commodity Futures Trading

Commission, and The U.S. Securities and Exchange Commission Regarding Central Counterparties for Credit Default Swaps, *available at*: http://www.ustreas.gov/press/releases/reports/finalmou.pdf (hereinafter "Memorandum of Understanding" or "MOU").

[li] *See* First Supplement to Circular Letter No. 19, New York Insurance Department, Nov. 20, 2008 ("In light of [the] progress made toward comprehensive federal regulation of CDS, New York will delay indefinitely its application of New York Insurance Law to CDS as described on pages 6 and 7 of Circular Letter No. 19[.]"). The Department did not suspend application of the "Best Practices" for monolines, and still "intends these limitations to confine [monoline] participation in the CDS market to those transactions in which the insurer's risk is roughly comparable to the amount and timing of risks assumed when directly insuring bonds," which means that the monoline insurers will not be able to guarantee policies or CDSs issued by SPVs that the they could not write directly.

[lii] Circular 19, p. 8.

[liii] H.R. 977.

[liv] The likelihood of passage of H.R. 977 by the U.S. House of Representatives is unclear at this time given the continuing negotiations regarding which agency and committee should have regulatory and oversight authority over the CDS market, respectively. *See infra*, note 58.

[lv] *See*, *e.g*., Adam Bradbery, "The European Commission Calls for a CDS Clearinghouse," *Wall Street Journal Europe*, Feb. 4., 2009, *available at*: http://online.wsj.com/article/SB123370034868545223.html ; Stephen Labaton, "Obama Plans Fast Action to Tighten Financial Rules," *New York Times*, Jan. 24, 2009, *available at*: http://www.iht.com/articles/2009/01/25/america/25regulate.php ("The administration is also preparing to require that derivatives like credit default swaps...be traded through a central clearinghouse[.]").

[lvi] Memorandum of Understanding, *supra*.

[lvii] *Id.* (the MOU defines a CCP as "[A]ny entity that is engaged in the business of interposing itself, either through a guarantee or as a principal, between counterparties in providing clearing and settlement facilities for the post-trade processing of OTC credit default swap transactions or both

OTC and exchange-traded credit default swap transactions.").

lviii *Id.*

lix Testimony of Patrick M. Parkinson, Deputy Director, Board of Governors, U.S. Federal Reserve System, before the Committee on Agriculture, U.S. House of Representatives, Nov. 20, 2008.

lx *See* Nikki Tait, "New Move on CDS Clearer for Europe," Financial Times, Feb. 13, 2009, *available at:*http://www.ft.com/cms/s/0/f115dbbe-f930-11dd-90c1-000077b07658.html?nclick_check=1 (stating "the International Swap and Derivatives Association, whose members include many of the big investment banks, [want] one 'global' clearer[.]").

lxi Kara Scannell, "Derivatives Oversight Spurs House Turf Battle," *Wall Street Journal*, Feb. 13, 2009, *available at*: http://online.wsj.com/article/SB123449113017080599.html.

lxii Advisen's E&O report is *available at*: http://corner.advisen.com/Subprime_E_O_final_3.pdf; the D&O report is *available at*: http://corner.advisen.com/The_Global_Credit_Crisis_and_D_O_final_2.pdf.

lxiii Nicholas Remmel, "Sub-prime Related Lawsuits Clogging the Courts" *Financial Week*, April 25, 2008.

lxiv 2008 WL 4298588 (S.D.N.Y. Sept. 19, 2008).

lxv *Id*. at *1. The case was ultimately dismissed on procedural grounds.

lxvi *UBS Securities LLC v. HSH Nordbank AG*, [2008] EWHC 1529 (Comm).

lxvii Steve Slater, "UK Ex-Bank Chiefs Face Grilling as Backlash Builds," Reuters, Feb. 10, 2009, *available at*: http://wwww.forbes.com/feeds/reuters/2009/02/10/2009-0210T0817972_01_LA177211_RTRIDST_0_Britian-Banks-Hearing-Update-1.html ; Alex Barker and Jim Packard, "Lawyers Helped to Phrase Apologies," Financial Times, Feb. 10, 2009, available at: http://www.ft.com/cms/s/0/c/33a5b8c-f7ca-11dd-a284-000077b07658, dwp-uuid=bfce0fae-de0b-11dk-9de3-0000779fd2ac.html? nclick_check=1

lxviii Sean Farrell, "RBS Faces Class Action on $10bn Share Offering," *The Independent*, Jan. 29, 2009, *available at:* http://www.independent.co.uk./news/business/news/rbs-faces-class-action-on-10bn-share-offering-1519098.html lxix *See, e.g.*, Matthew Leising, "Credit Swaps Clearing Stalls on Pricing, ICE Says," Bloomberg, Feb. 10, 2009, available at: http://www.bloomberg.com/apps/news?pid=206010878&sid=ajj6IligF1UQ&refer-home.

LXX Edmund L. Andrews and Stephen Labaton, "Geithner Sets Out Sweeping Overhaul to Bank Bailout," New York Times, Feb. 11, 2009, available at: http://www.iht.com/article/2009/02/10/business/bailout.4-427207.php ("A central piece of the plan... would create one or more so-called bad banks that would rely on taxpayer and private money to purchase and hold banks' bad assets.").