



To: The NCOIL Task Force on Credit Default Swaps Regulation  
Assem. Joseph Morelle, NY (Chair) Sen. Carroll Leavell, NM  
Sen. Joseph Crisco, CT Sen. Neil Breslin, NY  
Sen. Ralph Hudgens, GA Sen. James Seward, NY  
Sen. Vi Simpson, IN Rep. Hubert Vo, TX  
Rep. Robert Damron, KY Sen. Mike Hall, WV  
Rep. George Keiser, ND

From: Michael and Constance Erlanger, Managing Principals  
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Subject: Comments on NCOIL Credit Default Insurance Model Legislation

Thank you for this opportunity to comment on NCOIL's proposed draft model legislation regarding credit default insurance. NCOIL has requested that interested parties limit all comments to specifically address the language of the draft model legislation, and also advises that interested parties, other than insurance industry trade groups, will be given time to participate in the June 18<sup>th</sup> call, only if time allows. Given that all previous NCOIL conference calls have not allowed sufficient time for non-insurance-industry interested parties to offer comments, we thought it would be more respectful of your time if we simply submit our comments in writing.

### **Background and Key Questions**

The most widely used form of credit default insurance is credit default swaps. The model bill clarifies the financial requirements for corporations to be licensed to participate in the business of credit default insurance of any kind. However, the proposed model bill raises several broad questions, and we offer them here for your review.

1. Do the legislators intend to address solely covered swaps?
2. Does the model bill establish a means by which one could ensure that a transaction is covered? How is that information collected and tracked? How does that happen? How is a covered risk described?
3. With regard to covered swaps, how does this draft legislation allow for the transferability of credit default insurance? For example, if a bond is covered with credit default insurance, and the owner sells the bond, does this legislation address whether or not the credit default insurance is sold with the bond, or sold separately, or if the seller of the bond may sell the credit default insurance back to its issuer?
4. Where does this legislation establish a clear link between the covered risk, and the credit default insurance itself in a manner that a regulator can observe and track?

Importantly, the model bill does not address a critically important element of establishing comprehensive reform and regulation of credit default insurance. There has been general agreement in the financial market that, with respect to the CDS sector, at least three factors contributed to the current financial debacle:

1. Gaps in regulatory oversight, with many market participants seeking to profit by taking advantage of those gaps; and
2. Over-reliance on credit rating agencies to accurately identify and assess risk, systemically, a subsequent failure; and,
3. Dangerous absence of access to critically important information necessary for the timely identification and evaluation of risk (lack of access to this type of information is called "opacity").

The definitions that are included in the proposed legislation will help to close many of those regulatory gaps. However, the reliance on credit rating agencies and their flawed structure and methodologies is adopted and perpetuated in the model legislation. For example, when referring to the definitions in Section I, 5M "insurable risk", and 5N "investment grade", "insurable risk" -- with respect to asset-backed securities -- is defined as being of investment grade. "Investment Grade", in turn, is defined as being in the top four generic lettered rating classifications by a securities rating agency, or a rating in category 1 or 2 by the Securities Valuation Office of the NAIC.

The NAIC's valuation methodology, and those of the leading rating agencies, have been widely acknowledged as extremely inadequate. Therefore, continued reliance on the old rating valuation methodologies, which have just failed, is unlikely to yield better results going forward.

### **Option for Improvement**

To make this model legislation truly effective in the marketplace, there should be a different means by which "insurable risk" and "investment grade" are determined. In order for economic regulatory reform to bring discipline to the credit insurance markets in the 21<sup>st</sup> century, state legislators must recognize that unfettered access to information is critical and needed in near- or real-time. This information must include: (1) the definition of risks, as expressed in the underwriting standards of the financial contracts themselves, and (2) the clear expression of the value of the contracts themselves, especially in derivative financial products (most notably credit default swaps), as measured by clear and currently updating per contract financial performance measures.

One seems to follow the other as the notion of appropriate oversight without data and analytics seems impossible.

Arguably, it has become apparent to most market participants that that access to information in financial markets is essential to creating confidence and growth so that financial markets may properly function -- i.e., clear risks. Opacity within the financial markets has the exact opposite effect, and does not serve the interests of the regulatory system or its market participants.

We hope to have the opportunity to discuss with you these questions and what we and numerous other authorities believe are our correct and appropriate answers and solutions.