STATE OF NEW YORK
INSURANCE DEPARTMENT
25 BEAVER STREET
NEW YORK, NEW YORK 10004

June 16, 2000

Bertil Lundqvist, Esq.
Skadden, Arps, Slate, Meagher & Flom, LLP
Four Times Square
New York, NY 10036

Re: Credit Default Option Facility

Dear Mr. Lundqvist:

I am writing in response to your June 8, 2000 correspondence concerning the above referenced topic.

QUESTION PRESENTED

Does a credit default swap transaction, wherein the counterparty ("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?

CONCLUSION

No, 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, does not constitute a contract of insurance.

FACTS

You describe the proposed transaction in the following manner:

> An affiliate of a U.S. investment bank ("Buyer") will enter into a Credit Default Swap with a swap counterparty ("Seller"). The reference obligations underlying the Credit Default Swap is a

> portfolio of corporate bonds rated triple-B and maturing within five years. The seller will receive premium payments from the Buyer in return for making payments contingent upon a negative credit event. A negative credit event is one or more of the following: bankruptcy, failure to pay, obligation acceleration, or restructuring. Settlement is cash. The Seller pays the Buyer the difference between the par amount and the market value of the reference obligation (upon the happening of a negative credit event). The Seller will pay the amount regardless of whether the Buyer has suffered an actual loss or not.

ANALYSIS

The credit default swap which you have described does not meet the definition of Insurance contract in N.Y. Ins. Law Section 1101(a)(1)(McKinney 1985)[1] because, under the terms of the transaction, 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.

In the past, the Department has opined (Op. Letter 6/26/98, copy enclosed), that an index swap transaction did not constitute an insurance contract because the index swap did not obligate the index payer to indemnify the losses of the fixed rate payment payer. Rather, the index payer was obligated to pay the fixed rate payment payer whether or not the fixed rate payment payer suffered a loss. That letter stated:

> In order for an Index Swap (or other derivative) to constitute an insurance contract, it must obligate the index payer (as insurer) to indemnify the fixed rate payment payer (as insured) for actual losses incurred by the fixed rate payment payer. Indemnification of loss is an essential indicia of an insurance contract which courts have relied upon in the analysis of whether a particular agreement is an insurance contract under New York law. Absent such a contractual provision the instrument is not an insurance contract.

Please contact me if you have any questions regarding this matter.

Very truly yours,

Rochelle Katz
Associate Attorney
(212) 480-5266

[1] N.Y. Ins. Law Section 1101(a)(1)(McKinney 1985) defines an insurance contract as, any agreement or other transaction whereby one party, the "insurer", is obligated to confer a benefit of pecuniary value upon another party, the "insured or beneficiary", dependent upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely effected by the happening of such event.