CDS & Indemnity INSURANCE

Dr. I. Rokas*

1. From a legal point of view the private **insurance contract** in particular in indemnity insurances, and the contract of **C**redit **D**efault **S**waps (**CDS**) have a **common essential characteristic**: **"the transfer of risk"** from one person to another in return of a consideration.

2. CDS buyer agrees to pay a preset amount (**premium, also called CDS spread**) and CDS seller agrees to pay to the CDS holder the loss of the nominal value of an underlying debt obligation, such as a **C**ollateral **D**ebt **O**bligation (**CDOs**) or other titles **in case a default** as determined in the CDS contract ("**credit event")** occurs, in other words in case of materialization of the **credit risk**, which is the loss of some or all of the value of the underlying. The default/ credit event typically includes payment default, downgrade, any kind of restructuring or bankruptcy of the underlying obligation or its issuer. It is to be noted that CDS can be traded **O**ver **T**he **C**ounter (**OTC**) and that the value (price) is primarily determined by the probability of default (of the underlying obligation at the time of trading). For example if on January 1st 2010 the probability of default or the credit rating of the issuer (of the underlying obligation) is AA the price (spread) of the CDS is 100.000 € and on March 1st the credit rating is lowered to BBB the price of this CDS will be 400.000 €. The CDS holder can then either sell it with a profit of 400.000 – 100.000 = 300.000 € or hold it to maintain his protection against the credit event of the underlying.

3. Similarly, credit risk can be transferred to an insurer as far as such risk can be marketed within the insurance industry (other forms of financial loss of class 16 "miscellaneous financial loss" of the non-life insurances). However there exist also **important differences** in other **essential characteristics** between the two financial products, which make the **analogical application of insurance rules to CDS not possible**.

4. So, not only does the CDS buyer pay the CDS premium to the seller, but also he bears the risk of CDS devaluation in case the value of the underlying increases, which however is not usual in our days ("counter-function"). The "counter function" of the CDS is contrary to the nature of the coverage of risks by indemnity insurance, which refers only to losses incurred when the risk materializes (coverage of damages).

5. Further, the transfer of risk via a policy is realized by **spreading it among the "community of the insureds"**, while in CDS the risk is transferred to one entity only. A known test to be followed in order to find out if a contract of transfer of risk is an insurance and thus should be regulated by the insurance legislation or not, is the involvement of the community of the insureds.

6. Moreover, a CDS can be also acquired without the buyer undertaking the underlying debt obligation. This structure is called **"naked CDS"** contract (similar to this is **naked short selling**). The holder of such CDS is entitled to collect from its issuer the amount corresponding to the devaluation or non-payment of the underlying debt obligation, which he does not possess; thus, he makes a **pure profit** and does

* Professor of Commercial & Business Law at the Athens University of Economic & Business (i.rokas@rokas.com)

not cover own damages. An insurer, for instance against fire of a building, compensates damages in case of fire but to the extent of the costs necessary to repair damages and in addition he will have to check that the insurance money is going to be paid out to the damaged person indeed. The insured against fire of a building who has no interest at all if the building is damaged by the fire, is **neither entitled to collect insurance money for his own benefit nor to conclude such an insurance on his own name and for the benefit of himself**. The obvious main reason is to avoid giving motivation to a policyholder to provoke the materialization of the risk.

7. Is the function of naked CDS really so different from that of the policy in this particular point that the core principle of insurance, the insurance interest, is absolute irrelevant? In allowing **without restrictions** somebody to bet on the collapse of a debt obligation, perhaps moral hazard is created, in particular if the naked CDS holder is a powerful entity and has the financial tools to harm the credibility of the underlying issuer and thus the credibility of the titles. Is it sufficient that the contracting parties of CDS are sophisticated professionals and is it correct that the "counter function" of this financial instrument equalizes the position of the seller and buyer? The answer some eight years ago was "yes".

8. **Alan Greenspan**, the former Chairman of the U.S. Federal Reserve, wrote in September 2002: "*By design, this [credit default swap] market, presumed to involve dealing among sophisticated professionals, has been largely exempt from government regulation […] But regulation is not only unnecessary in these markets, it is potentially damaging, because regulation presupposes disclosure and forced disclosure of proprietary information can undercut innovations in financial markets just as it would in real estate markets*".

Two years ago, **Greenspan** said in October 2008: "*Credit default swaps, I think, have serious problems associated with them*".

Few days ago, President **Obama** in a speech at the Cooper Union College at the New York financial center said: *"A free market was never meant to be a free license to take whatever you can get however you get it. That has happened too often in the years leading up to the crisis"*. His criticism obviously includes financial companies which among others bet via naked CDS on the collapse of, for instance, CDOs designed and issued by their company or affiliated companies.

9. If naked CDS are more similar to betting on the outcome of the football mach, the implications are much more severe. This is due to the relationship between the price of a naked CDS and the "price" (cost/ interest rate) of refinancing/ renewal of the underlying debt obligation. **Common logic of the insurance rule**, which prohibits the payment of insurance money if the **risk is realized deliberately** by the insured and in many cases also by its gross negligence, is included in the insurance contract laws worldwide. The insurance against the **risk of death** of a third person is null and void without the written approval of the third party. The acquisition of a naked CDS against the risk of "**credit death**" of a third entity does not presuppose a written approval by the "victim"! In practice not only is it possible for somebody to buy naked CDSs, but at the same time he can be the **financial advisor** of the issuer of the underlying titles and in addition be **the same person who has designed the titles or be member of the Board of the issuer**. Does this situation open up the doors to the possibility to **provoke the harm** of the credibility of the issuer of these titles and transform those titles to junk? Or is it not the case as long as there is a proper disclosure to all parties?

©*IKRP* (Athens) Law Firm

10. Further, the risk of credit default can be partially realized by incomplete opinions in targeting a specific issuer of CDOs or countries, in particular, if we consider that in the globalized markets a **small group of powerful financial advisors, rating agencies and mass media is dominant**. It is to be noted that three rating agencies covering 95% of the world market significantly impact the prices of the underlying and therefore the prices of the CDS. Therefore an error can lead to notable losses/ damages.

11. The yield of a credit (price) depends at least partially on the **market belief** about the creditworthiness of the issuer. A small but extremely powerful group can affect this belief.

12. The question why we don't apply to naked CDS the core of the common logic inherent to the insurance rule which prevents disasters and frauds is often answered as follows: **indemnity insurance is not an investment product as is the CDS**! But simply the given name and the characterization of a financial product does not legalize a product which motivates disasters for the same reason that indemnity insurance without insurable interest at all is not legalized. We could say that the possibilities to provoke credit default are much larger than the possibilities to provoke a fire in a building. It is not necessary to give to the naked CDS the name of insurance in order to apply the common logic which avoids similar situations in insurance in the last centuries! For the same reason it's **not necessary to prohibit the issue of naked CDS unless there is no other way to avoid the deliberate efforts to lead to a credit default event**. Regulation for naked CDS could be for instance strict conflict of interest rules as well as **information** rules regarding issues on the status and on transactions of the seller of CDS and the position of the seller at the concluding of the contracts as well as during its life.

13. The very poor regulation on CDS activities in contrast to the heavy regulation of insurance activities is partially due to the fact that the international legislator **has not yet responded to the recent pathology** of these new financial products and their evolution in our days. This should not be a surprise. We are witnesses of situations which were considered in the past legal but in our days are considered illegal! It is to be noted that the recent developments make it clear that **the EU Directive on market abuse** is insufficient to solve this pathology.

14. The **lesson,** taking into consideration the capacity of CDS as a tool of transfer of risks from the buyer to the seller, is the following. There is no reason not to introduce rules and regulations which limit the possibility to deliberately cause the risk, as is the case with the **insurance,** to CDS transactions. These rules, as in insurance, will be a halt to those who take advantage of the insufficient supervising rules and bet huge amounts not for the good but for the collapse of companies or whole countries and thus they will do everything possible to contribute to this collapse.

©*IKRP* (Athens) Law Firm