

STATEMENT OF THE
NATIONAL CONFERENCE OF INSURANCE LEGISLATORS (NCOIL)

BEFORE THE
COMMITTEE ON AGRICULTURE,
UNITED STATES HOUSE OF REPRESENTATIVES

HEARING ON
“DERIVATIVES MARKETS TRANSPARENCY AND ACCOUNTABILITY ACT OF 2009”

WEDNESDAY, FEBRUARY 4, 2009

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NEW YORK STATE ASSEMBLY
NCOIL FINANCIAL SERVICES & INVESTMENT PRODUCTS COMMITTEE
CHAIR, NEW YORK STATE ASSEMBLY STANDING COMMITTEE ON INSURANCE

INTRODUCTION

Good afternoon Chairman Peterson, Ranking Member Lucas, and Members of the Committee. Thank you for inviting me to testify before the Committee on a matter key to the stability and well-being not only of our nation's financial system, but, as we have learned, the U.S. economy as a whole.

I am New York State Assemblyman Joseph D. Morelle, testifying this morning on behalf of the National Conference of Insurance Legislators (NCOIL). I chair the New York State Assembly's Standing Committee on Insurance and serve as Chair of NCOIL's Financial Services & Investment Products Committee.

NCOIL is a multi-state organization comprising legislators whose main area of public policy concern is insurance. NCOIL legislators chair or serve on committees responsible for insurance legislation in their respective state houses.

I am pleased to be here today on behalf of NCOIL to discuss draft legislation titled the "Derivatives Markets Transparency and Accountability Act of 2009," and the greater question of whether and how to regulate this vast and yet somewhat obscure marketplace. On a point of interest, this is the third hearing in which I have participated regarding credit default swaps; I chaired the first two, one in my capacity as chairman of the Assembly's Insurance Committee and the other as chair of NCOIL's Financial Services and Investment Products Committee.

CREDIT DEFAULT SWAPS AS INSURANCE

I greatly appreciate the opportunity to offer testimony in this instance, and heartily congratulate the committee for its commitment to gain and provide a greater understanding of the importance of credit default swaps. Frankly, this discussion is not only appropriate but, perhaps, sadly overdue.

It is a discussion with implications beyond even the very broad horizons of its specific subject matter, for it relates to our fundamental notions of the free market system, a system that has produced wealth more prodigiously than any other but which, absent oversight, can result in the rapid destruction of institutional and personal assets and reverse the hard-won achievements of a generation of Americans.

In recognition of this, and particularly in the wake of the near collapse of American International Group, Inc. last September, NCOIL has turned its attention more closely than ever to the critical questions surrounding credit default swaps: namely, what manner of financial instrument are they and, once defined, how shall they be subject to the safeguards that are a fact of life for the buyers and sellers of other similar financial instruments?

Why NCOIL? Primarily because of a rising conviction on the part of many observers that credit default swaps constitute a species of insurance, and should be regulated as such. Certainly, I have come to strongly believe that they do indeed meet the standing definition of insurance, and

therefore, are best left to the regulatory purview of the states, whether acting collectively or individually.

On behalf of NCOIL, I would like to spend the few minutes that I have been allotted to make the following points: 1) credit default swaps are a species of insurance; 2) naked swaps are more akin to gaming than insurance since they lack “insurable interest”; and 3) that the states are best suited to regulate this type of financial guaranty.

Under New York State Insurance Law, § 1101: "Insurance contract" means any agreement or other transaction whereby one party, the "insurer," is obligated to confer 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 affected by the happening of such event.

What is a credit default swap? Simply put, a credit default swap is a financial guaranty against a negative credit event. A negative credit event triggering a credit default swap payment certainly meets the definition of a “fortuitous” event, one occurring by chance, under New York statute.

THE NCOIL PROCESS

In recognition of these facts, the NCOIL Financial Services and Investment Products Committee last November approved a 2009 Committee charge to “explore the role of credit default swaps

and other financial instruments, develop a position, and communicate to legislative colleagues regarding their public policy implications.”

And as I alluded to earlier in these remarks, the NCOIL Steering—Officers, Chairs, and Past Presidents—and Financial Services Committees convened a public hearing in New York City on January 24th to receive testimony from interested parties regarding proper marketplace regulation and the role of state lawmakers and NCOIL in that regulation. NCOIL was represented by legislators from Connecticut, Kentucky, New Mexico, North Dakota, and New York.

New York State Insurance Superintendent Eric Dinallo, and representatives of the International Swaps and Derivatives Association (ISDA), Assured Guaranty and the Association of Financial Guaranty Insurers (AFGI), AARP, the National Association of Mutual Insurance Companies (NAMIC), and the American Academy of Actuaries, among others, testified at the hearing. For your reference, electronic testimony is available on the NCOIL web site at www.ncoil.org.

While NCOIL took no formal action at the hearing—the Financial Services Committee will chart a policy course for the organization during the NCOIL Spring Meeting, which will be held here later this month—members generally agreed on a few broad principles, including that:

- credit default swaps have many of the characteristics of insurance transactions
- so-called “covered” swaps closely resemble financial guaranty insurance
- “naked” swaps are very troubling because they lack insurable interest and more closely resemble directional bets than insurance

- state legislators and regulators should be responsible for regulating the credit default swap market
- by preventing states from enforcing long-standing regulatory statutes, the *Commodities Futures Modernization Act* played an unexpected and negative role in the proper and necessary regulation of swaps.

STATES AS INSURANCE REGULATORS

This final point, in reference to state primacy in insurance regulation, is rooted in decades of established law. As the distinguished members of the committee know, the McCarran-Ferguson Act of 1945 established the state preeminence in the area of insurance regulation. If we conclude that credit default swaps are a species of insurance, and I would strongly argue that they are, then authority in relation to CDS must accrue to state legislatures and state insurance regulators.

It is NCOIL's position that state regulators, with their extensive experience at regulating insurance products, are extremely qualified to regulate covered CDS as insurance products. They are best able to ensure that the standards set for the insurance industry at large – such as identification of insurable interests, institutional solvency and the other elements essential to indemnification – are met by CDS providers as well.

Thus, respectfully, it is also NCOIL's position that Congress erred when it preempted the states from regulating CDS under our gaming and bucket shop laws when it passed the Commodities Futures Modernization Act of 2000 (CFMA). The CFMA permitted so-called “naked swaps” - those CDS contracts that are speculative in nature and are merely directional bets on market

outcomes - to proliferate to the point where they now constitute 80 percent of the CDS market, which has a notional value of around \$54 trillion, with no regulatory framework.

Let me state clearly that as a matter of philosophy, the members of NCOIL believe that this committee is on the right track in banning “naked” swaps. We believe that naked CDS pose a dangerous threat to global financial stability.

DEFINING NAKED SWAPS

Section 16 of the draft bill makes it a violation of the Commodity Exchange Act to enter into a “naked” credit default swap. The language establishes that a party could not enter into such a contract unless it has a direct exposure to financial loss should the referenced credit event occur. Furthermore, it defines the term “credit default swap” as a contract which *insures* a party to the contract against the risk that an entity may experience a loss of value as a result of an event specified in the contract, such as a default or credit downgrade.

Again, NCOIL agrees that credit default swaps are insurance, and with the direction and spirit of the legislation now before you, even as we again, respectfully, aver that the actual implementation of CDS regulatory mechanism should be at the state rather than federal level.

Speaking for myself, however, I would respectfully suggest a broadening of the definition of clothed or covered swaps to include those that provide a legitimate hedge against negative credit events. In the domain of naked swaps, there is a critical need to delineate between those that are purely speculative and those in which some “stream of commerce” ties the buyer to the insured

asset. In other words, if a CDS were used for hedging rather than speculative purposes, we should consider that the economic utility of such transactions as more than mere speculative activity. For example, an owner or investor of Ford dealerships may want to hedge their exposure to a negative credit event by purchasing a credit default swap on Ford.

The point of demarcation, then, is not so much one of “clothed” v. “naked” swaps, but rather “speculative” v. “hedged.”

Although CDS used for hedging activity may not contain as direct an exposure as owning an underlying bond covered by a CDS, an insurable interest exists which can be identified through GAAP accounting - which requires that CDS be listed as used for hedging or speculative purposes.

Thus, any prohibition of speculative CDS contracts, in my view, must make this distinction between the clear differences that exist in the inherent intent and nature of contracts that are purely speculative and those in which there is an arguable “stream of commerce” related to the contract buyer and, therefore, whether legitimate and beneficial economic stimulus is derived by permitting such contracts to occur.

CONCLUSION

In closing, NCOIL urges that the committee and Congress consider the question of whether the goals of the transparency and accountability draft would be best realized and enacted by the states; whether the CFMA of 2000 was overbroad in its intent and application; and whether the

powers removed from state government in relation to that act might be restored as an avenue to establish what President Obama in his inaugural address called the “watchful eye” of oversight, necessary to ensure that freedom in the financial markets does not degenerate into simple and destructive anarchy.

It has been my pleasure, privilege and distinct honor to appear before you today on behalf of NCOIL and all those whose interests are impacted by this committee’s deliberations. We look forward to working with the Committee as it proceeds in its review of credit default swap regulation.

I certainly stand ready at this time to answer any questions you may have. Thank you.

ASSEMBLYMAN
JOSEPH D. MORELLE
132ND ASSEMBLY DISTRICT, NEW YORK

BIOGRAPHY

Since his election to the New York State Assembly in 1990, Joseph D. Morelle has authored more than 100 laws and established himself as a leader on the issues that matter most to New Yorkers: economic growth and job creation, crime prevention, and ensuring the health and safety of our most vulnerable citizens.

One of the Assembly's most senior members, Assemblyman Morelle chairs the standing Committee on Insurance and is a member of the powerful Rules and Ways and Means committees. He also holds assignments on the standing committees for Economic Development, Job Creation, Commerce and Industry, and Higher Education.

Assemblyman Morelle is particularly recognized for his efforts to improve New York's business climate. That is especially true in Upstate New York, which has experienced severe job and population losses since the early 1990s. Born in Utica, raised in the Rochester suburb of Irondequoit and a former small business owner himself, Assemblyman Morelle is a lifelong Upstate resident who understands the region's unique challenges.

LEADER ON ECONOMIC DEVELOPMENT

In 2005, Assemblyman Morelle addressed those challenges in a report entitled *Creating A State of Innovation: Unleashing the Power of New York's Entrepreneurial Economy* that detailed the decline of New York as an economic power and offered numerous policy prescriptions for reversing that decades-long trend. *Creating A State of Innovation* has been widely praised by business and academic leaders, other elected officials and editorial boards across the state.

Assemblyman Morelle's report was the culmination of years of advocacy for new economic and tax policies. His passion for job creation and making New York more competitive stems in part from his own experience as founder and president of MMI Technologies Inc., a software development firm. He knows first-hand the difficulties small businesses face when attempting to make a profit while meeting the demands of the state's high tax burden.

At the assemblyman's request, the Speaker of the Assembly created the Subcommittee on Manufacturing, with Assemblyman Morelle as chairman, as a means of providing New York's manufacturing community a greater voice in state government. He also served on the Speaker's Task Force on Budget Reform and the Workers' Compensation Reform Task Force, and co-chaired the Assembly's Welfare Reform Task Force.

In June 2006, Assemblyman Morelle also announced major legislation aimed at reforming New York's debt practices in order to reduce the annual cost of the state's \$49 billion public debt and spare future generations those costs as well.

INSURANCE

Few sectors regulated by government have a degree of impact on individuals and the economy as great as insurance. Families need and deserve adequate health care; parents and spouses naturally wish to protect their loved ones and property in the event of personal tragedy or natural disaster; businesses need to insure against the liabilities inherent in their operations while maintaining a strong bottom line.

Hence, the work of the Committee on Insurance is of critical importance to the fiscal and economic well being of our private and commercial citizens. From the cost of health care premiums to the status of the insurers operating in the troubled bond markets of 2008, Assemblyman Morelle is committed to bringing issues of long-term importance before the committee for discussion and resolution.

Most recently, the assemblyman was named the chairman of the Financial Services & Investment Products Committee of the National Conference of Insurance Legislators. He is also a recognized leader in the effort to establish regulatory controls over the so-called “credit default swaps” market, linked by many economic experts to the financial crisis of 2008.

TOURISM AS AN ECONOMIC ENGINE

Assemblyman Morelle’s commitment to New York’s economic rebirth also defined his chairmanship of the Assembly’s Standing Committee on Tourism, Arts and Sports Development, a position held from 2001 until 2007. Tourism is the state’s No. 2 industry, and Assemblyman

Morelle has consistently worked hard to make sure that the New York's vast cultural and natural resources are promoted and enjoyed by people around the world.

In 2004, Assemblyman Morelle created the film production tax credit to encourage the making of motion pictures in New York. This has created thousands of jobs and billions of dollars in added economic activity, and in fact the tax credit has proved so successful that a five-year, \$250 million extension was included in the 2006-2007 state budget.

ADDITIONAL LEGISLATIVE PRIORITIES

Aside from economic issues, Assemblyman Morelle's recent legislative priorities include a broad range of consumer protection bills in the area of health care, initiatives to improve the business climate for insurance carriers in New York State, and anti-crime measures, including mandatory background checks for nursing home and home-health care workers, civil confinement for dangerous sexual predators even after release from prison, and the elimination of the statute of limitations in felony rape and sexual assault cases.

Assemblyman Morelle is also a strong supporter of military veterans, authoring a bill earlier this year making it easier for former members of the armed forces to receive added exam credits when applying for civil service positions. In the past, Assemblyman Morelle has also successfully fought to exempt veterans from certain licensing fees and to protect military gravesites from vandalism.

PERSONAL & PROFESSIONAL HISTORY

Assemblyman Morelle's career in the Assembly is the latest phase in a long history of public service. In 1983, he was elected to the Monroe County Legislature, where he eventually served as vice president and assistant majority leader. He served there until his successful bid for the Assembly's 132nd District seat in 1990. The district today comprises the Charlotte, Maplewood and North Winton Village sections of the City of Rochester and the towns of Irondequoit and Brighton.

Assemblyman Morelle, 51, is a graduate of Eastridge High School and received his bachelor's degree in political science from SUNY Geneseo. He is an inductee of the Eastridge High School Hall of Fame and the State University of New York Alumni Honor Roll.

Assemblyman Morelle and his wife, Mary Beth, live in Irondequoit and have three children. Mary Beth teaches in the East Irondequoit School District, which all three Morelle children have attended.