

INSURANCE DAY



LEGAL FOCUS

How can insurers keep control of credit derivative exposures?

NICK MILES investigates the history and underlying mechanics of the financial instruments

LEHMAN BROTHER'S filing for Chapter 11 protection, the Fannie Mae and Freddie Mac conservatorship and the fall-out from "Meltdown Monday" all placed terrific strain on the \$62trn credit derivatives market.

Insurers with exposure to these instruments will now be carefully considering their rights. They must ascertain whether recent events trigger credit protection obligations or entitle them to "close out" transactions.

Nick Miles, of the London office of law firm Sedgwick Detert Moran & Arnold LLP, looks at the mechanics of credit derivatives, some historic legal issues and key factors for parties seeking to manage their exposure.

Credit derivatives

Credit derivatives have features in common with credit insurance, although there are significant differences as well. The "protection buyer" makes regular payments, akin to premium, to the "protection seller".

The protection seller assumes the risk of diminution in value of an underlying obligation (a bond, or other asset) as a result of a change in the creditworthiness of the obligor (the "reference entity").

Upon occurrence of a credit event affecting the reference entity, the seller pays the notional value of the obligation to the protection buyer. The buyer in return delivers the obligation to the seller, or allows the seller to offset the current trading value of the obligation.

Some buyers purchase protection to hedge exposure to an underlying asset. But a vast number just seek to arbitrage. This reveals the key point of contrast with insurance: the protection buyer need not suffer any loss to acquire a claim.

In the past, disagreements have emerged over what kind of obligation the buyer may deliver to the seller. This issue can have a significant impact on the amount of credit protection due. The International Swaps and Derivatives Association (ISDA) recently quelled an incipient controversy of this nature in relation to Fannie Mae and Freddie Mac.

In the wake of the bursting of the dot.com bubble, ISDA definitions fell under the microscope in court and arbitration proceedings. Disputes focused on certain kinds of credit event (restructuring – the definition of which has since been amended – and bankruptcy) and polarised a stand-off between monoline insurers and the banks.

The latest tsunami arising from the credit crunch has the potential to elicit a similar

volume of disputes. A number of insurers now have significant exposure to credit derivatives, whether through their treasury activities or by the sale of insurance wraps.

Entities with exposure under credit derivatives, or through policies insuring them, should review their contracts carefully. In addition to consideration of credit event and obligation definitions, it is important to be aware of rights to exit transactions. Express rights are set out in the ISDA master agreement, which sets much of the contractual backdrop before which individual transactions are confirmed.

The 1992 and 2002 ISDA masters include conditions precedent as to the absence of any event of default or potential event of default (hard insolvency or events or equivalent) affecting a counterparty.

How useful these provisions are in practice is not entirely clear. There is a lingering question mark hanging over its potential to bind a liquidator. To date, no English judicial authority has addressed this issue directly.

Additionally, a party may be entitled to terminate a master upon the occurrence of an event of default. However, judgment may be required in determining whether a right to terminate has arisen.

Disputes sometimes flare up over whether quasi-insolvency or related procedures amount to events of default. For example, in *Merrill Lynch v Winterthur Swiss*, Winterthur denied (in the context of a credit indemnity insurance) that French safeguard proceedings applying to Eurotunnel financing vehicles amounted to an event of default under the 1992 ISDA master. Wrongful termination may amount to repudiatory breach.

Close-out

Termination of a master agreement "closes out" all transactions which have been confirmed under the master. Close-out involves a mutual netting procedure, according to which the prospective value of the parties' mutual obligations under the transactions are valued – frequently by seeking a market quotation – and then set off against one another.

Where a large bundle of transactions is concerned, it may be difficult for a party to predict whether the netting procedure will leave it "out of the money". For this reason, a non-defaulting party may contemplate the prospect of close-out with some trepidation.

Close-out is similar to reaching a global commutation. The significant difference is that, in quantifying future obligations, the parties expose themselves to the immediate vicissitudes of the market. This is a key concern in the current climate.

In some cases, termination will be automatic; the precise terms of the master agreement should be consulted in this regard.

Finally, parties may have additional rights at common law, which should be cumulative with those under express termination provisions.

Because credit derivatives have been such a monumental source of wealth, disputes have been (comparatively) infrequent. In spite of the careful drafting of the complex standard documentation, there may be latent pressure points in the wordings yet to be resolved.

When a business ceases to be profitable, participants often begin to think seriously about stress-testing contractual language in formal proceedings. At that stage, latent problems may emerge.

Angus Rodger, a partner of Steptoe & Johnson, added that insurers are counting the cost of last week's financial turmoil. For example, Swiss Re last week announced a potential exposure to AIG of SFy200m (\$184.6m).

The most obvious exposure is the loss in value of shares held in the insurers' investments. Axa, for example, owns around half-a-million shares in American International Group (AIG): the drop in share price from \$24 two weeks ago to \$5 (Tuesday) represents a loss of \$10m.

Rodger said: "Credit derivative exposures are more complex. Under the terms of standardised ISDA swap contracts, Lehman Brothers is in bankruptcy and this gives its counterparties a right to terminate and claim a termination payment."

"In relation to AIG, the position is more complicated. The Federal Reserve's emergency funding of AIG seems to have staved off bankruptcy but other grounds for termination might arise: for example, if the rescue arrangements put AIG in breach of commitments in other agreements, then there could be an event of 'cross default'."

Termination payment

"Whether an insurer should terminate its swaps will depend on the value of any termination payment and the prospects of receiving any further scheduled payments. Usually, the termination payment would be based on market quotations. But the markets are not working as efficiently as the ISDA master agreements assume they would, and this complicates the valuation process."

Financial turmoil in the industry has ramifications for other types of contracts. For example, recent arrangements may accelerate loans (although recent US court rulings have ordered a stay of certain consequences in relation to Lehman Brothers).

As regards insurance contracts, in recent years it has become common for high-value insurance contracts to contain a downgrade clause, under which an insurer must post collateral if its credit rating is downgraded. Some insurers objected to these clauses, predicting that they could create a vicious circle. Their prediction could be tested soon.



Emergency funding of AIG may have staved off bankruptcy, but grounds for termination might arise

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