

Insolvency Treatment of Derivatives

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Current US Bankruptcy Treatment

▶ Two Places to Look

- Title IX of the US Bankruptcy Code – for treatment of derivatives transactions where debtor is a non-bank or commercial company
- Federal Deposit Insurance Act – for treatment of derivatives where debtor is a bank

Concerns of US insolvency law

- ▶ Legal Certainty for counterparties and market
- ▶ Reduce Systemic Risk which **supposedly** arises in the derivatives context because of the likelihood that financial institutions are non-defaulting counterparties
- ▶ Reduce Counterparty Exposures
- ▶ Ability of Non-defaulting Counterparty to calculate its position (gains or losses) and value of collateral, close out positions, retrieve collateral, hedge, enter into new positions

Mechanisms for addressing Concerns

- ▶ Netting or Set Off (preferably across affiliates and products)
- ▶ Close Out netting (preferably across affiliates and products)
- ▶ Collateral Requirements and Segregation

The foregoing must be provided for in contracts (master agreement, schedules of counterparty preferences, trade confirmations, collateralization via credit support annex) and supported by law of the jurisdiction.

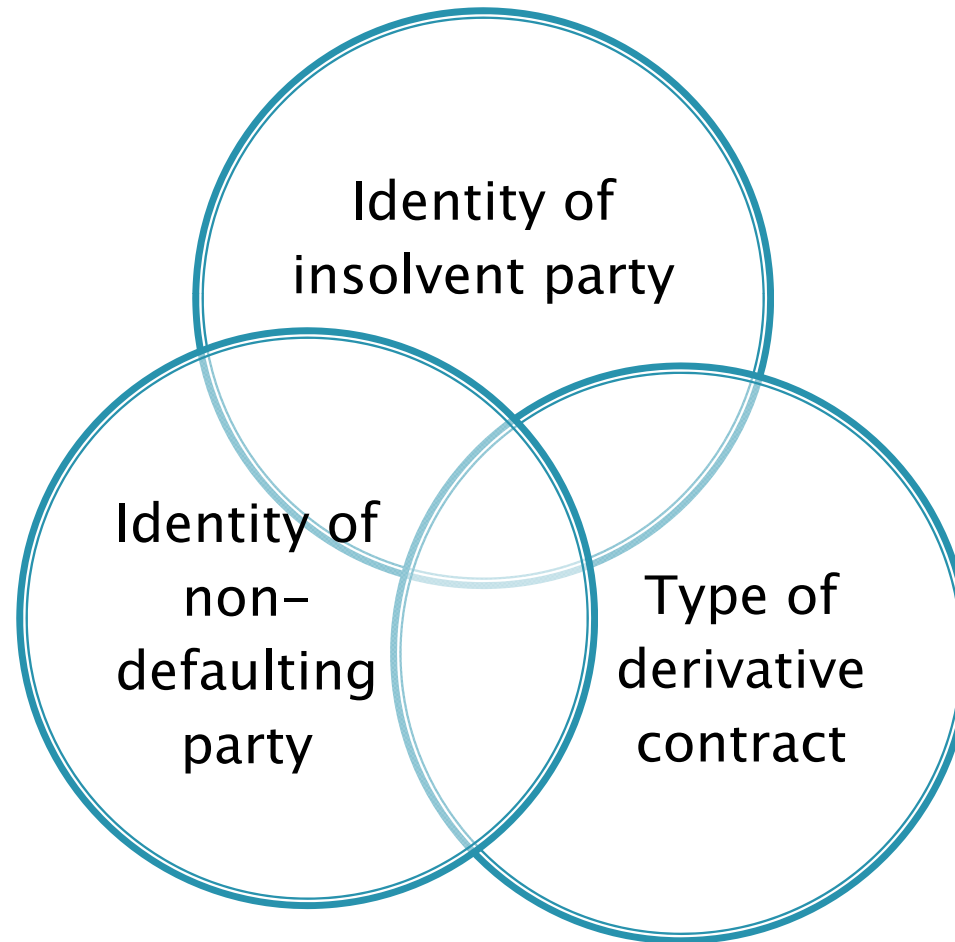
Mechanisms for addressing concerns

- ▶ Applicability of Contracts and Laws to **appropriate** range of derivatives (called covered contracts, qualifying contracts, swap agreements, at various times **and various laws**), range of defaulting parties and range of non-defaulting parties

Creditor Favorable System for derivatives

- ▶ Differs from usual US bankruptcy approach to allow debtor time, another chance, ability to choose which executory contracts to enforce.
- ▶ US insolvency treatment for derivatives eliminates ability for bankrupt estate/trustee to:
 - Apply an automatic stay to avoid immediate enforcement of contracts
 - Choose which executory contracts to enforce

Look for overlap of covered parties and covered contracts



Title IX of Bankruptcy Abuse Prevention and Consumer Protection Act

- ▶ Harmonized laws relating to treatment of financial contracts in the insolvency of a financial market participant (except see next slide)
- ▶ Included New Products and Transactions
- ▶ Expanded the Cross Product Netting (no cross entity netting in Title IX)
 - Cross entity netting does exist when banks are insolvent and receiver decides to repudiate all or none of insolvent bank contracts with a counterparty must include all contracts with counterparty affiliates
- ▶ Specified kinds of non-defaulting entities eligible for safe harbor protections under the insolvency laws

Difference between Bank and non-bank US insolvency regime

- ▶ FDIC has power to transfer derivatives contracts from a failing financial institution to a healthy one or to disallow the contract altogether subject to payment of law defined damages to limit disruption caused by bank or thrift failure
- ▶ Bankruptcy Trustee for insolvent non-banks does not have such power
- ▶ (Consider how this changes if there is a new resolution framework for entities like broker dealers)
- ▶ FDIC has power to expand definition of qualified financial contract. Congress would have to change definition of swap agreement.

Title IX and FDIA Coverage of Derivatives Contracts

- ▶ Swaps, repos, commodities contracts, securities contracts (including purchase or sale of loan), equity swaps, total return swaps, weather swaps, spot agreements or new products similar to swaps, futures, forwards, and options (**although you still need to check to be sure**)
- ▶ Repos under Title IX include reverse repos, repos on mortgage related securities, certain non-US government securities and interests in mortgage related securities and loans of less than a year, master agreements, security agreements and combinations of repos and options on repos
- ▶ As a result one can also net related guarantees, collateral pledges, credit enhancement, etc.

Products covered

- ▶ CDS and Pay as you go CDS on asset backed securities (where there are floating payments during the term of the protection coverage and additional fixed payments by the buyer to the seller)

Products not covered by Title IX

- ▶ Repos on corporate debt or equity securities, repos on interests in loans of more than one year
- ▶ Assets transferred for securitization purposes so that the transactions would be **conclusively** treated as true sales and not treatable as secured financings that the bankruptcy trustee may claw back into the estate at times.
- ▶ To the extent such contracts involve future sales of receivables they can be treated by the trustee as executory contracts subject to acceptance or rejection– abandoned language would have excluded from bankruptcy estate certain defined assets and their proceeds

Products not covered by Title IX

- ▶ Covered repos excludes participation in a commercial mortgage loan but not repo in a participation in a commercial mortgage loan

Covered Participants

- ▶ Generally, **non-defaulting** counterparties may terminate a contract upon the insolvency of a bank or non-bank, avoid automatic stay, use netting and close out netting if the **non-defaulting** party is:
 - Under FDIA
 - Any person (check this)
 - Any financial institution
 - Under Title IX
 - A financial participant – includes financial clearing organizations, or entities with large notional or actual outstandings or large market to market
 - Master netting agreement participant

Distinct Treatment for Insolvent Banks

- ▶ FDIC remains the receiver to transfer or repudiate financial contracts of an insolvent debtor bank to a wide range of viable parties
- ▶ Goal is to avoid disruption of deposit insurance fund to protect depositors
- ▶ Counterparties ability to walk away from a payment obligation is limited

Other Issues

- ▶ Do CDS or naked CDS create incentives for protection buyers or sellers to encourage the failure of the reference entity? Look at anti-disruption sections of Senate bill.
- ▶ How should the proposed resolution framework for non-bank financial institutions work and how will that affect counterparties and the market?
- ▶ What are the cross border issues to consider – where is a bank or financial institution based?
- ▶ How to deal with universal vs. territorial (ring-fencing) financial institution resolution?
- ▶ How to deal with cross affiliate netting? How to deal with affiliates and “Volcker rule”? For example, if derivatives are pushed out of government insured or liquidity supported banks, cross affiliate netting might defeat purpose of Volcker rule.

Other Issues

- ▶ How do deal with extraterritorial impact of the bankruptcy and financial regulation rules? What entities are included in the estate of the bankrupt financial company, what contracts, what do you do when there are intercompany transactions?
- ▶ In asset securitizations, in the case of the insolvency of the vehicle originator, how to make certain that the off balance sheet vehicles meets the expectations of its creditors and counterparties and the creditors and counterparties of the originator of the vehicle? How do the new FASB, SEC, Basle capital and FDIC proposals/rules affect that?
- ▶ In synthetic securitizations, are there special issues involved including the difficulty to pierce through the layers of risk and have sufficient access?

Other Issues

- ▶ In the context of CCPs, how should collateral be segregated – collateral posted between the counterparty and the clearing member and the clearing member and the CCP? See the proposed legislation. How was this an issue in the case of Lehman?