An echo from the past

*Derivatives offer excellent potential for spreading insurance risks across a wide base of investors. However, **David Rowe** argues that legal uncertainty represents a potential obstacle to traditional insurance companies' efforts to realise these benefits*

A stable and predictable legal environment, administered by an independent judiciary, is a prerequisite for the development of fully effective competitive markets. A lack of such conditions arises most often in the context of emerging market countries with fragile legal systems. The economic impact of an uncertain legal system usually relates to whether the power of the state can be invoked in a fair and balanced way to enforce the obligations undertaken in voluntary contracts. It also relates, however, to how rights and obligations will be treated in a bankruptcy proceeding.

Any bankruptcy implies the existence of an unavoidable economic injustice. The failed entity has undertaken enforceable legal obligations in excess of its ability to meet them. In effect, a bankruptcy proceeding is a judicially supervised political process designed to allocate the unavoidable injustice among the full range of claimants. Since the inability of the bankrupt entity to meet all its commitments is at the heart of the issue, the status of the surviving parties' claims cannot be determined in advance by the contracting parties alone. While the contractual language is relevant, the structure of applicable bankruptcy law is crucial to how a claim will be treated.

The prolonged struggle for netting

Those over 35 years old will remember the prolonged struggle to establish legal recognition of close-out netting across multiple derivatives transactions that have been booked at different times. It took an extended period of lobbying both in the US and in Europe to establish recognition of netting language as an accepted feature of bankruptcy law. In the US, this was effectively accomplished by 1991.[1] In English law, it had been held previously that application of the liquidation and set-off rule was mandatory and that derivatives netting was merely a special case of this general rule. Progress was slower in other European countries, but today close-out netting of derivatives is widely viewed as the accepted convention for properly booked transactions with most types of institutions.

Notable exceptions

Despite the generally established recognition of close-out netting, important exceptions still exist. For certain types of legal entity, a bankruptcy proceeding unfolds in a environment different from that applicable to regular corporations or financial institutions. Lacking a statutory confirmation of the right to net, counterparties must assume that the administrator of a liquidation would cherry-pick the portfolio, forcing a surviving counterparty to perform on those transactions where it has sustained a loss yet thwarting its ability to collect on those transactions where it has a gain. This limits the willingness of derivatives market-makers to deal with such entities, since the current and potential future credit exposure will generally be greater if close-out netting is not enforceable.

Insurance companies are among the most important types of legal entity where application of close-out netting is open to question. In the US, an insurance company's bankruptcy is generally conducted under the authority of the insurance commissioner in the state of its incorporation. Only a handful of states have incorporated netting provisions into their legal codes. In the absence of legal certainty, it doesn't take a great deal of imagination to visualise the tabloid headlines contrasting the claims of 'widows and orphans' with those of 'greedy financial institutions'.

A recent report from Fitch Ratings raises this as a concern. The report argues that lack of legal clarity in this area makes it more difficult and more expensive for insurance companies to use derivatives effectively in managing their risks. Such uncertainty may also be an obstacle to insurance companies' efforts to remain competitive in the long run.

The growing overlap of insurance and financial markets has been evident for some time. The development of catastrophe swaps and catastrophe bonds are good examples. Cat swaps allow the exchange of risks in different locations, providing valuable diversification in an efficient manner. Cat bonds actually transfer risk to external investors, broadening the sources of capital ready to accept and absorb such risks at a market-determined price. The proliferation of such innovations seems certain to alter the nature of the insurance industry as we know it. It would be ironic indeed if obsolete legal provisions that fail to clarify how derivatives will be treated in bankruptcy hamper the ability of traditional insurers to participate fully in this unfolding revolution. ■

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[1] *The key milestones in establishing netting in US law were the 1990 amendment to the Federal Bankruptcy Code and the 1991 Federal Deposit Insurance Corporation Improvement Act*