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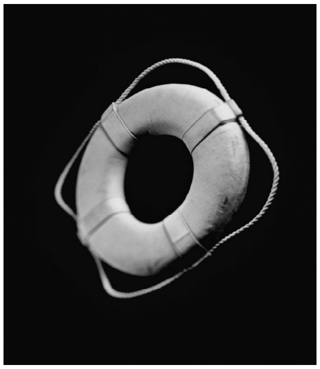

"Good Bank-Bad Bank" for Insurance Companies: Is MBIA Just CIGNA Redux, Plus CDSs?

"Good Bank-Bad Bank" in the Current Financial Crisis

In the early days of the financial crisis in late 2007 and early 2008, monoline financial guaranty insurers began to experience rating agency downgrades due, in part, to their wrapping of structured financial products such as collateralized debt obligations and asset-backed securities. Securities that are guaranteed by monolines are rated at the higher of the rating of the wrapping insurer or the published underlying rating of the security. Historically, this business required a "AAA" rating. In order to maintain the rating, monolines typically write to a "no-loss" or "remote loss" standard and limit their business to investment grade bonds.

With a loss of their top ratings, the monolines effectively lost their ability to write new business. Insurers such as Financial Guaranty Insurance Co. ("FGIC") announced plans to divide their businesses into legally distinct entities, one to house the troubled structured finance business and the other to hold their healthy traditional municipal bond business. At the time, a number of issues were raised as to the structure of "good bank-bad bank" reorganizations and the consequences of such restructurings. In particular, capital markets participants were particularly focused on the treatment of credit default swaps ("CDSs") written on or referencing, and by, these restructured monolines. Ultimately, no restructurings were consummated.

With the deepening of the financial crisis in 2008 and the enactment of various federal initiatives to mitigate the cascading effects,[1] a number of proposals were considered to restore financial stability and investor confidence, including a government-sponsored good bank-bad bank model. This approach is intended to isolate troubled assets and insulate healthy operations from the detrimental drag of future losses and adverse public perception arising from the "toxic" business. On February 10, 2009, Treasury Secretary Geithner announced a plan to establish a Public-Private Investment Fund to remove troubled assets from the balance sheets of financial institutions. The details of Geithner's new Financial Stability Plan are still not public, but removing "bad" or troubled assets from core financial institutions appears to be part of the solution.[2]

MBIA Restructuring in 2009

Although MBIA Insurance Corp. ("MBIA") applied to receive funds from the government's Troubled Assets Relief Program, on February 18, 2009, independent of any federal government rescue program, MBIA announced that it would separate its risky structured product business from its healthy municipal bond business. The reorganization was intended to generate market confidence and increase liquidity in the municipal bond market.

[1] For additional information on the government intervention efforts in response to the financial crisis, please see our Client Alerts and resources at Financial Crisis Legal Updates and News.
[2] For additional discussion of "good bank-bad bank" issues, please see our Client Alert: "Good Bank-Bad Bank: A Clean Break and a Fresh Start."

To effect this reorganization, MBIA Insurance Corp. of Illinois ("MBIA Illinois"), an existing subsidiary of MBIA which will be renamed National Public Finance Guarantee Corp. and redomesticated to New York ("National"), reinsured $537 billion in outstanding public finance policies on the books of MBIA as of September 30, 2008, and assumed MBIA's obligations to reinsure policies originally issued by FGIC and reinsured by MBIA. By virtue of cut-through provisions in the reinsurance provisions, existing policyholders will have the right to claim directly against National as well as against MBIA. As additional protection, National also issued second-to-pay policies for the benefit of policyholders covered by the reinsurance and the assumption. If either MBIA or FGIC fails to pay on the transferred policies, policyholders will have a right to make a direct claim against National under the second-to-pay policies. National will also underwrite new policies to guarantee public finance debt. As payment for the reinsurance and assignment, MBIA paid National approximately $2.89 billion, equal to the net unearned premium and loss and loss adjustment expense reserves, net of ceding commission. To bolster its claims paying ability, National received an addition $2.09 billion of equity from MBIA. Following the restructuring, Standard & Poor's downgraded the rating of National from "AA" to "AA-" "to reflect uncertain business prospects" and placed the insurer on credit watch. The lowered rating is three notches below the "AAA" typically expected of a financial guarantor.

MBIA will retain its existing structured finance and international operations but will no longer insure credit default swaps. In the future, these operations will not be able to rely on the profits of the municipal bond business for support. The structured finance and international businesses will have $10.1 billion in claims paying resources for net par outstanding obligations of $240 billion. MBIA intends to resume the structured finance and international businesses when ratings and market conditions warrant. Currently, the S&P rating for that business was dropped to "BBB+" due to remaining exposures on residential mortgage-backed securities and guarantees on collateralized debt obligations. Moody's has assigned the business a "B3" or junk rating. Both ratings are significantly below the "AAA" required of a financial guarantor.

The New York State Insurance Department, MBIA's domicile state regulator, issued the required approvals after a finding that both MBIA and National would have sufficient statutory capital to meet policyholder claims as they become due.

MBIA share prices increased by up to 41% following the announcement of the restructuring. Ambac Financial Group, another major bond insurer that has also suffered ratings downgrades, is similarly seeking to protect its business by reestablishing a pre-existing dedicated municipal bond insurer. We note that these true "good bank-bad bank" restructurings involving the transfer of bad assets and/or liabilities and associated valuation issues to an affiliated entity are distinguishable from the restructurings proposed by, for example, AIG, in which corporate entities are transferred into new holding companies.

Division of CIGNA in 1996

Despite the fact that Jay Brown, chairman and chief executive officer of MBIA, has adamantly rejected the characterization of the restructuring as a "good bank-bad bank" type of split, an inevitable parallel is drawn with the CIGNA Corp. restructuring of 1996. Faced with market concerns over its more than $4.5 billion of potential asbestos and environmental liabilities, CIGNA "divided" its domestic property and casualty operations into its ongoing businesses, housed in INA Holdings, and established a run-off entity, Brandywine Holdings Ltd. ("Brandywine"), in order to hold its asbestos and environmental liabilities. The transfer of the business to Brandywine was effected through assumption reinsurance – that is, through novation of CIGNA's insurance obligations to Brandywine. CIGNA also relied on a Pennsylvania "division" statute, applicable only to companies domiciled within the state, that allowed a firewall between distinct pools of the assets and liabilities of the company. Even though, as a contract matter, novation typically requires the consent of the obligee, pursuant to applicable insurance law and the division statute, CIGNA was able to restructure without obtaining affected policyholder approval. Policyholders with asbestos or environmental claims were limited to the assets of the run-off entity, Brandywine, rather than the ongoing operating companies of INA Holdings.

In the division, in order to protect policyholder interests, CIGNA contributed more than $4 billion in capital, obtained $800 million in reinsurance and established a $50 million dedicated fund to allow Brandywine to satisfy actuarial stress test standards. The company received required regulatory approval for the transaction, including Pennsylvania insurance department approval. Policyholders whose policies were transferred to Brandywine contested the split, fearful that without the support of the profits generated by the ongoing businesses, there would be insufficient assets to meet policyholder claims relating to asbestos and environmental liabilities. Competitor insurance companies also asserted that policyholders would be forced to accept a lower credit rating for Brandywine than what they bargained for when contracting with INA Holdings companies. Because the transfer of the asbestos/environmental policies was effected through assumption reinsurance, the legal challenge was founded, in part, upon the lack of policyholder consent and upon alleged infirmities in the applicable assumption reinsurance statutes.

CIGNA was immediately beset by legal challenges, primarily instigated by industry competitors fearful of the perceived advantage afforded by the restructuring. After the company prevailed in an initial court action, the Pennsylvania insurance department order approving the reorganization was overturned on appeal. Ultimately the Pennsylvania Supreme Court upheld the reorganization.

Although in 1999, CIGNA eventually sold all of its property and casualty businesses to ACE Ltd., including both INA Holdings and Brandywine, to focus on its health, life and pension operations, the company continued to face litigation arising from the division. Competitors American International Group, Inc. and Chubb Corporation, among others, convinced lower courts in California to hear the issue as to whether the reorganization violated the state's unfair competition law. CIGNA appealed that action.

Upon acquisition of the CIGNA property and casualty business, in addition to the funds CIGNA had contributed, ACE applied $1.25 billion of Brandywine's capital to acquire $2.5 billion in reinsurance. ACE, in turn, became subject to legal challenges from competitors as it sought to assert its right to limit its exposures to asbestos and environmental claims to the assets of Brandywine. AIG and Chubb continued to bring legal actions, attempting to force INA Holdings to be liable for any shortfalls in Brandywine's payments to policyholders. Absent a backstop from the sister company, policyholders would be entitled to rely upon state insurance guaranty funds, and ultimately, licensed insurance companies, including competitors, would be required to bear the costs of the shortfalls. The efforts were presumably also designed to limit INA Holdings's effectiveness in the marketplace.

Competitors continued to challenge ACE even with respect to its sale in 2005 of Brandywine to run-off specialists Randall & Quilter Investment Holdings Ltd. Challengers claimed, among other things, that the sale would have a "significantly unfair and unreasonable effect" on policyholders and reinsurance cedants and would establish an unfortunate precedent in which a financially strong company could walk away from potentially underfunded liabilities. Randall & Quilter had less than 20% of the capital of ACE. In addition, concern was voiced that the proposed purchaser was a foreign entity and beyond the scope of U.S. insurance law requirements. The sale was ultimately approved.

Treatment of CDSs where MBIA is the Reference Entity

To complicate the picture, unlike the capital markets environment of 1996, the MBIA reorganization is taking place in the midst of a massive global financial crisis, and there are significant questions as to the effect of the restructuring on credit default swaps where MBIA is the Reference Entity.

In analyzing the effect of the reorganization on any particular CDS transaction, one must review both the terms of that transaction, as well as the specific definitions and provisions published by the International Swaps and Derivatives Association, Inc. ("ISDA") that have been incorporated into that transaction. The vast majority of CDS transactions incorporate the 2003 ISDA Credit Derivatives Definitions (the "2003 Definitions").[3] Depending on a

[3] To the extent that a CDS transaction incorporates the 1999 ISDA Credit Derivatives Definitions instead of the 2003 Definitions, differences between the two sets of definitions may lead to different results.

CDS transaction's trade date, the parties may have also incorporated the Additional Provisions for Physically Settled Default Swaps – Monoline Insurer as Reference Entity (published by ISDA on May 9, 2003) (the "2003 Monoline Provisions") or the Additional Provisions for Physically Settled Default Swaps – Monoline Insurer as Reference Entity (published by ISDA on January 21, 2005) (the "2005 Monoline Supplement").[4]

Regardless of which particular ISDA provisions have been incorporated into a CDS transaction, certain common elements are likely to be present in virtually all single-name and index CDS transactions where monoline financial guaranty insurers have been selected as the Reference Entity.

- First, Bankruptcy and Failure to Pay will have been specified as the Credit Events. In a minority of transactions, Restructuring will also be specified as a Credit Event.
- Second, either the 2003 Monoline Provisions or the 2005 Monoline Supplement will have been incorporated into most, though not all, outstanding CDS transactions.
- Third, the Successor provisions of the 2003 Definitions, in most cases, will apply. These provisions will be further modified if either the 2003 Monoline Provisions or the 2005 Monoline Supplement has been incorporated.

Did a Credit Event Occur for Purposes of CDS Transactions in which MBIA is the Reference Entity?

It does not appear that the MBIA restructuring resulted in the occurrence of either a Bankruptcy or Failure to Pay.

For CDS transactions where Restructuring is specified as a Credit Event, one of two definitions will apply: either the standard Restructuring definition in the 2003 Definitions (the "Basic Restructuring Provision") or the Basic Restructuring Provision, as modified by the 2005 Monoline Supplement (the "Modified Restructuring Provision"). The 2003 Monoline Provisions do not include a modification of the Basic Restructuring Provision.

In the case of either the Basic Restructuring Provision or the Modified Restructuring Provision, the determination as to whether MBIA's reorganization will qualify as a Restructuring appears to depend on whether the reorganization results in the "Subordination" of a sufficient principal amount of MBIA's obligations. "Subordination" with respect to an obligation and another obligation to which it is being compared (the "Senior Obligation") means the existence of a contractual, trust or similar arrangement providing that (i) on the liquidation, dissolution, reorganization or winding up of the Reference Entity, claims of holders of the Senior Obligation will be met prior to claims of holders of the Subordinated obligation or (ii) holders of the Subordinated obligation are not entitled to receive or retain payments in respect of claims against the Reference Entity at any time that the Reference Entity is in payment arrears or is otherwise in default under the Senior Obligation.

The MBIA reorganization would not appear, on its face, to result in a Subordination of any obligation of MBIA. However, it is conceivable that parties could, through an aggressive reading of the applicable ISDA provisions, assert that the reorganization has caused a Restructuring. For example, it might be argued that moving the municipal business into National effectively ringfences the assets and the future profits of that business away from the structured finance business, supporting an argument that holders of structured finance obligations were effectively Subordinated. Similarly, it might be argued that if MBIA were in fact placed into run-off, such a plan might constitute a "winding up" or "dissolution" of MBIA. MBIA's stated plans, however, are to continue its operations as soon as its ratings and market conditions warrant.

There are additional ISDA provisions that may limit the scope of Restructuring. For example, the 2003 Definitions provide that preferences among creditors arising by operation of law or the existence of collateral, credit support or other credit enhancement arrangements are not to be taken into account in determining whether

[4] Capitalized terms used but not defined in this Client Alert have the meanings given to them in the 2003 Definitions, the 2003 Monoline Provisions, or the 2005 Monoline Supplement, as applicable.

an obligation has been Subordinated. In addition, the Modified Restructuring Provision explicitly provides that an event is not a Restructuring if, in the case of a Qualifying Policy and an Insured Instrument, (i) the Qualifying Policy continues to guarantee or insure the same Instrument Payments on the same dates and (ii) there is no change in the priority of payment ranking of the Qualifying Policy.[5]

How to Determine a "Successor" to MBIA

The 2003 Definitions contain certain rules governing how Succession Events affect existing CDS transactions and the Reference Entity under those transactions. The 2003 Monoline Provisions and the 2005 Monoline Supplement modify those rules to account more precisely for various aspects of the monoline business.

Under the 2003 Definitions, the portion of Relevant Obligations of the Reference Entity to which one or more entities "succeeds" determines the number of Successors, if any.[6] Whether an entity "succeeds" with respect to a Reference Entity and its Relevant Obligations depends on whether the Reference Entity is no longer an obligor (primarily or secondarily) or guarantor [or insurer][7] with respect to those Relevant Obligations. Because MBIA remains liable under its financial guarantee insurance policies, National did not succeed to those policies and is thus likely not a Successor.[8]

Lessons from the Past for the Future

From MBIA's point of view, its reorganization avoids many of the pitfalls of the CIGNA division. As a threshold matter, because it relied on reinsurance rather than novation to effect the transfer of policy liabilities, MBIA should not be subject to claims that it transferred policies without policyholder consent. More importantly, because, unlike CIGNA, the "good bank" rather than the "bad bank" was transferred into the new entity, affected policyholders are less likely to object, especially in light of the protections afforded by the cut-through reinsurance provisions and the second-to-pay policy. Also, unlike CIGNA, it is likely that competitors of MBIA may want to emulate MBIA and may have broad regulatory support to do so. As a consequence, it appears less likely that MBIA will be subject to claims of unfair competitive advantage from the industry.

MBIA, of course, remains potentially subject to claims that the structured finance policyholders are now at greater risk of insufficient funds and a less credit-worthy insurer, in part because they are not supported by the profits of the ongoing municipal bond business and in part because the extent of future liabilities cannot be accurately estimated.

Will the MBIA reorganization be replicated? As of December 31, 2007 there were seven major monoline financial guaranty insurers carrying a "AAA" rating. All except Assured Guaranty Ltd. (and FSA Holdings) lost the required top ratings. Currently, Assured Guaranty is actively writing in the new primary municipal bond market. FSA Holdings, which is also issuing policies in that market, is in the process of being acquired by Assured Guaranty.

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[5] Under the 2005 Monoline Supplement, the term "Qualifying Policy" is defined to mean, in pertinent part, a financial guaranty insurance policy under which a Reference Entity irrevocably guarantees or insures the Instrument Payments of an "Insured Instrument." Instrument Payments include (x) in the case of pass-through certificates or other funded beneficial interests, (i) the specified periodic distributions in respect of interest or other return on the certificate balance on or prior to the ultimate distribution of the certificate balance and (ii) the ultimate distribution of the certificate balance on or prior to a specified date, and (y) for other Insured Instruments, the scheduled payment of principal and interest.

[6] The Relevant Obligations under a CDS transaction are the Obligations of the Reference Entity constituting bonds and loans outstanding immediately prior to, in our case, the reorganization of MBIA, excluding debt obligations between MBIA and its affiliates.

[7] This bracketed text was added in the 2003 Monoline Provisions and the 2005 Monoline Supplement.

[8] Separately, we note that there is a question whether financial guarantee insurance policies qualify as Obligations (and thus as Relevant Obligations) at all under the 2003 Definitions, absent modification. An Obligation, among other things, is any obligation of a Reference Entity (either directly or as provider of a Qualifying Affiliate Guarantee or, if All Guarantees is specified as applicable in the related Confirmation, as provider of any Qualifying Guarantee) determined pursuant to the method described in Section 2.19 (but excluding any Excluded Obligation) of the 2003 Definitions. "Qualifying Affiliate Guarantees" and "Qualifying Guarantees" do not include financial guarantee insurance policies under the 2003 Definitions. However, parties may expressly specify any financial guarantee insurance policy as an Obligation in the confirmation evidencing a CDS transaction.

Berkshire Hathaway Assurance Corp. ("BHAC"), a newly formed financial guaranty insurer, has received a "AAA" rating, but only from S&P and awaits a similar rating from another rating agency before it is able to write primary business. BHAC did obtain an "Aaa" rating from Moody's for secondary market insurance, allowing it to write indirect business backed by a contingent payment insurance policy from a "Aaa" rated affiliate. The downgrades suffered by the monolines were ascribed to negative performance of their structured finance businesses. The recapitalization and restructuring efforts taken at the end of 2007 and during 2008 have not yet proven to be successful in restoring the coveted, and to date necessary, "AAA" rating. Will MBIA's peer companies follow in its footsteps? Only time will tell.

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