

CREDIT DERIVATIVES AND INSURANCE COMPANIES

What are Credit Derivatives?

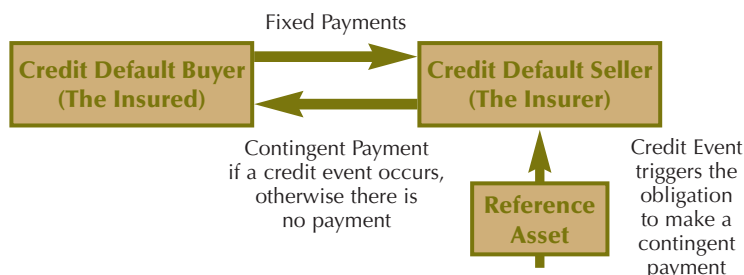
Credit derivatives are bilateral financial contracts that isolate specific aspects of credit risk from an underlying instrument and transfer that risk between two parties. In so doing, credit derivatives separate the ownership and management of credit risk from other qualitative and quantitative aspects of ownership of financial assets. By separating specific aspects of credit risk from other risks, credit derivatives allow users to reduce credit exposure without physically removing assets from their balance sheet.

How are insurance companies involved?

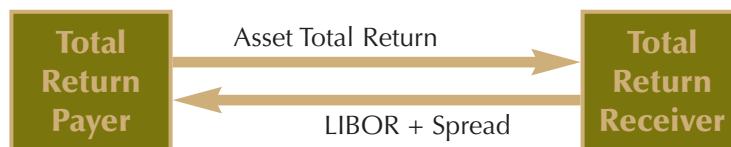
The use of credit derivatives has grown exponentially since the early 1990s, with banks as the most active participants. Today it is a \$500 billion market in the U.S. and it includes the active participation of insurance companies. Insurance and reinsurance companies, particularly financial guarantee companies, view credit derivatives as a product extension of their core business. They have become active players in this market in the past 1-2 years, particularly as sellers of credit protection in credit default swap transactions.

The Basics – Three Types of Credit Derivatives

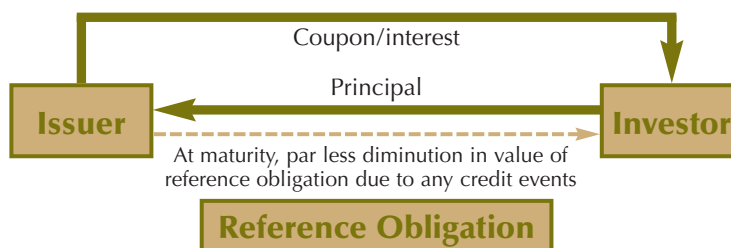
1. **Credit Default Swaps** – are considered the classic credit derivatives and 95% of all credit derivatives are credit default swaps. The protection buyer pays a periodic fee, based upon the notional amount, in return for a contingent payment by the protection seller following a credit event with respect to a reference entity or asset.



2. **Total Return Swaps** – an exchange of the total economic performance of a specified asset for another cash flow. The payments between the two parties to the swap are based upon changes in the market valuation of a specific credit instrument, irrespective of whether a credit event has occurred.



3. **Credit Linked Notes** – a form of structured note with an embedded credit derivative. The coupon on the note is linked both to the credit quality of the issuer and an obligation of a third party. On maturity, the issuer will redeem the credit-linked note at par provided there have not been any credit events.



Uses of Credit Derivatives

• Protection Buyers

- Hedge credit risk through the transfer of the risk associated with a credit instrument without selling the asset and without the knowledge of the borrower.
- Diversify credit risk through the purchase and sale of credit protection to change a company's geographic, customer, or industrial risk profile.

- Obtain banking regulatory capital relief by substituting a credit risk exposure to a non-bank obligor with an OECD bank exposure.
- **Protection Sellers**
 - By selling protection on a credit instrument using a credit derivative, an institution can assume the underlying credit risk and associated rewards as if it had purchased the bond or originated the loan directly.
 - Provides access to returns on new asset classes.

What are the Challenges?

Insurance and reinsurance companies face many challenges in this relatively new marketplace. Among them are:

- **Legal documentation and structuring:** Credit default swap documentation has been standardized by the International Swaps and Derivatives Association (ISDA). However, to achieve insurance accounting treatment as opposed to derivative accounting treatment in financial statements, the documentation will require very specific tailoring.
- **GAAP and Statutory accounting:** In their standardized form credit derivatives are accounted for under FAS 133 on a GAAP basis, assuming the insurance scope exception under FAS 133 is not obtained, and under SSAP No. 31 on a statutory basis. Insurance companies are faced with the challenge of presenting and analyzing their derivative activity in their financial statements in the most favorable manner.
- **Valuation and Risk Management:** Determining fair values for credit derivatives is more difficult than for other types of derivative instruments for many reasons, specifically:
 - (a) Companies often have insufficient resources and expertise in the pricing and valuation of these products.
 - (b) Typically, current market prices are not readily available.
 - (c) There are no standardized methods of valuation and variations exist in the methodologies and techniques used.
 - (d) The inputs required by valuation models vary from product to product.
 - (e) Products can be highly structured and can involve multiple credit exposures, adding to their complexity.

How PricewaterhouseCoopers can help

- **Documentation and structuring:** We can assist insurance companies in the tailoring of the standard documentation to achieve insurance accounting treatment as opposed to derivative accounting treatment in financial statements. We can also provide advice on the structuring and accounting for Special Purpose Vehicles (SPVs) that have been established to facilitate participation in this marketplace.
- **GAAP and Statutory accounting:** We can assist insurance companies in accounting for credit derivatives under the relevant GAAP and Statutory guidance and in providing guidance on the alternatives available in terms of presentation in financial statements.
- **Valuation and Risk Management:** PwC's Financial Risk Management team can assist in the review of pricing and valuation methodologies.

Who to call

- **Documentation, Structuring, and Accounting:**
 - Colette Cribbin, Insurance Senior Manager, (646) 471-8194
 - Paul Medini, Insurance Partner, (646) 471-7860
 - John Rossello, Insurance Partner, (646) 471-7800
- **Valuation and Risk Management:**
 - Richard Reynolds, Financial Risk Management Partner, (646) 471-8559
 - Douglas Summa, Financial Risk Management Director, (646) 471-8596

