



# Credit Enhancement, Financial Guarantees, and Financial Ratings:

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*When Capital Markets and Insurance Worlds Collide*

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- I. Credit Enhancements – Capital Market Terminology**
  - II. Financial Guarantees – Insurance**
  - III. Developments**



# Credit Enhancements – Capital Market Terminology

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- A. General Definition – Credit Enhancements support payment obligations arising from the under-performance or non-performance of specified assets, cash flows or counterparties.



# Credit Enhancements – Capital Market Terminology

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1. Examples – Wraps, bonds guaranteeing payment, letters of credit supporting counterparty payment obligations.
2. Purpose of credit enhancement products is to improve acceptability of product as an investment, improve perception of rate of return and in cases of loans or securitizations to reduce the interest rate applicable to the transaction.



# Credit Enhancements – Capital Market Terminology

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## B. Hallmarks of credit enhancements

1. absolute and unconditional liability
2. “pay first” – fight later”
3. liability runs to institutional investors



# Financial Guarantees – Insurance

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- A. Traditional insurance – reimburses for injury and loss of property due to a fortuitous event.
  - 1. property/casualty insurance



# Financial Guarantees – Insurance

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## B. Surety

### 1. Traditional Form

- a. Hybrid – guarantees third party (obligee) that performance will occur and pays either to complete project or to reimburse for loss due to delay or failure to complete.
- b. typically pays for additional costs to complete project, does not pay for lost opportunity cost.
- c. (1) often the obligee is a bank or lender



# Financial Guarantees – Insurance

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## 2. Commercial Bonds

- a. originally guaranteed rent payments and bank deposits
- b. 80's and 90's began to branch out to more complex bonds – output guarantees on power projects, savings guarantees for large HVAC projects, guarantees of delivery in forward gas sales
  - 1) damages were tied directly or closely to lost opportunity cost
  - 2) (2) became very complex – securitizations, derivatives



# Financial Guarantees – Insurance

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## c. Financial Guarantees

1. Guarantees are not of property loss from a fortuitous event, but financial loss of a financial obligor.
2. Became very prevalent in 80's and 90's during periods of competitive premium pricing (soft markets).
3. Property and casualty companies with little or no capital markets experience became involved in complex capital markets transactions and provided guarantees of structural payment programs.
4. Programs tend to be larger and sellers were drawn to insurance companies as guarantors because they typically charged smaller fees but had equivalent credit ratings.



# Financial Guarantees – Insurance

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## D. Legal Prohibitions

1. 80's – Insurance Departments saw some insolvencies due to losses from financial guarantees. Also, saw solvent companies lose good credit ratings that threatened coverage of insureds for traditional offerings – auto, property and casualty, etc.
  - a. Mutual Fire – had \$50 million program that guaranteed investors would pay initial capital into partnerships.
2. Several states have enacted laws that prohibit multiline insurance companies from issuing financial guarantees.
  - a. New York, California and Florida most notable
  - b. New York statute the most restrictive

E. New York – often called the “Appleton Law”

1. Found in N.Y. Insurance Law § 1113(16)(5)(ii)(6) (consol. 2007); N.Y. Insurance Law § 6901 (consol. 2007).
2. Prohibits multiline insurance companies from writing financial guarantees.
  - a. some exceptions:
    - (1) Fidelity and Surety
    - (2) credit insurance
    - (3) Guarantees of higher education loans
    - (4) residual value insurance



# Financial Guarantees – Insurance

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3. General Rule – if policy or bond guarantees largely performance it is probably not a financial guarantee.
  - a. True even if some part /guarantee involves payment of financial obligation – e.g. sub-contractor’s bond.
4. If policy or bond guarantees payment of financial obligation is likely a financial guarantee – unless it falls onto exceptions.
5. New York purports to apply to any insurance company licensed in New York.
  - a. purports to apply to any bond written in any state.

6. Penalties can include fines, imprisonment and in extreme cases – cancellation of license.
7. Letter rulings by Office of Attorney General and sometimes by the Insurance Department.

F. California and Florida similar

1. Both, however, allow lease bonds, which are prohibited in New York.



# Financial Guarantees – Insurance

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- G. New York – allows multi-line companies to reinsure financial guaranty risks that they cannot write directly.
  - 1. Statute allows credit up to 50% of risk.



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That concludes today's presentation.  
Thank you for your time.

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