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## Insurance on Lehman Debt Is the Industry's Next Test

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First the house of Lehman fell. Now the insurance bill is coming due.

Nearly three weeks after the Wall Street bank sank into bankruptcy, financial companies and investment funds that wrote what are effectively insurance policies on Lehman Brothers' debts are being called on to pay hundreds of billions of dollars in claims.

Whether those claims can or will be paid, and the financial repercussions that could follow if they are not, will signify the biggest test yet for the vast, unregulated market in credit-default swaps.

The danger is that the claims on the Lehman default are so large — they are estimated at \$400 billion to \$600 billion — that settling them could leave some companies with large, perhaps even crippling, losses and heighten the turmoil in the financial markets.

The magnitude of the exposure came into focus on Friday, when the price of Lehman's bonds was set via a closely watched auction on Wall Street. The debt was priced at a little above 8 cents on the dollar, leaving companies and funds that insured these debts against default on the hook for the remainder.

The price determined the amount that sellers of bond-default protection would have to pay those who bought their protection, called counterparties. The lower the bonds' price fell, the higher the payouts were going to be.

But even now, the total amount coming due is unknown because the market for credit-default swaps is not regulated or tracked through any clearinghouse of data. "The huge value of credit-default swaps on Lehman Brothers, and the low price obtained in this auction, mean there are billions of dollars in obligations," said Eric R. Dinallo, the New York State insurance superintendent. "No one knows who owes this money, how much each counterparty owes, or whether any of these counterparties will now be in trouble themselves, with further potential problems for the financial markets."

Some of those on the hook will quietly settle their trades as they come due, mostly within the next two weeks, and keep doing business as usual. To the extent there are problems, the world may find out about it only when another financial services company discloses its exposure or perhaps even collapses.

Mr. Dinallo and Gov. David A. Paterson have said that New York State should regulate credit-default swaps to some extent, because they are similar to insurance, which is regulated at the state level. The regulators pay attention to how much coverage insurers write and how much they charge, to make sure they do not get in over their heads and collapse.

Swaps, on the other hand, are private contracts between two counterparties, so no regulator keeps track of who is promising coverage to whom, or whether the swap seller can really afford the coverage being promised.

Complicating things further, it is possible to buy and sell credit-default swaps without owning the underlying bonds. One trader can both buy and sell protection on the same bonds, too. These complexities make it hard to know exactly how much risk lies in the Lehman Brothers default.

Separately on Friday, the Federal Reserve Bank of New York met with representatives of the derivatives industry to review proposals for the creation of a credit-default swaps clearinghouse. The Fed asked for more information about how competing proposals would work, and had not made any decisions as of Friday.

Officials say they believe that if the swaps were traded through a central body, the volume of trading could be tracked and prices would become clear. Investors would stand a better chance of noticing when a company was taking on too much risk, and could dump its stock before disaster struck. That kind of market discipline might force traders to manage their risks more carefully.

But the clearinghouse will only help the swaps market in the future. In the meantime, the financial markets do not know where the next disaster might be.

Market participants were expressing particular concern about the amount of money that the American International Group, the insurance giant that was effectively nationalized, would have to pay as it settled its swap positions on Lehman Brothers' debt. A.I.G.'s financial products unit was a major issuer of credit-default swaps.

A spokesman for A.I.G., Nicholas J. Ashooh, said on Friday that the big insurer was not able to provide a figure. It was billion-dollar obligations falling due under the terms of A.I.G.'s swaps contracts on other issuers' debt that led to the company's collapse in mid-September.

Julie A. Grandstaff, a managing director of StanCorp Investment Advisers, said the outcome of Friday's auction was "really extraordinary, in that it's a large bankruptcy and a small recovery value."

She was concerned that some counterparties might have to make payments big enough to deplete their capital, which could lead to possible ratings downgrades. Capital depletion is a serious problem at the moment because the capital markets are largely frozen and companies cannot easily raise new money if they need it.

"If you exhaust it all in one event, that will cause the ratings agencies to think about whether to downgrade you," Ms. Grandstaff said.