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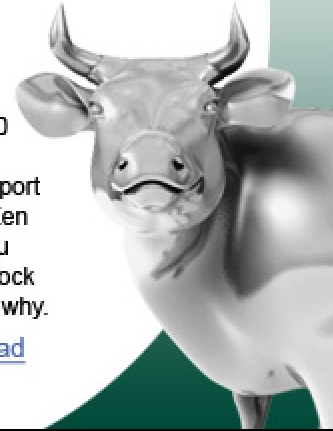
How the Exxon Valdez Spill Created the Credit Default Swap

JUSTIN ROHRLICH MAY 27, 2010 8:00 AM

When Exxon Mobil borrowed billions from JPMorgan to pay damages in the case, the risk needed be managed somehow.



It was reported yesterday that the Associated Press obtained a witness statement from one Truitt Crawford, an employee of **Transocean** (RIG) -- the company that leased the now-infamous Deepwater Horizon drilling platform to **BP** (BP).

"I overheard upper management talking saying that BP was taking shortcuts by displacing the well with saltwater instead of mud without sealing the well with cement plugs, this is why it blew out," Crawford told Coast Guard investigators.

Eleven people died on April 20. The various methods BP has tried in its increasingly desperate attempt to stanch the gusher of oil currently turning the Gulf of Mexico toxic -- the "Top Hat," the "Top Kill," and so forth -- haven't worked. What we don't yet know is the extent of the contamination caused.

Trial attorney W. Mark Lanier, founder and lead litigation counsel at The Lanier Law Firm, who has extensive expertise in maritime law and has filed a class action suit on behalf of Louisiana residents affected by the spill, wrote that "some estimates of the flow of oil exploding from the sea floor put the volume equal to the Exxon Valdez spill -- every four days."

Lanier noted that "It is sobering to realize that oil still remains from the Exxon Valdez spill, a spill that occurred over 20 years ago."

While the Exxon Valdez spill created environmental havoc, it also ended up inadvertently creating something else that, years later, created a bit of havoc in the financial markets:
the credit default swap.

After a jury ruled that **Exxon Mobil** (XOM) was responsible for paying $5 billion in punitive damages -- equivalent to one year's worth of Exxon profits at the time -- the US Court of Appeals for the 9th Circuit later reduced the amount to

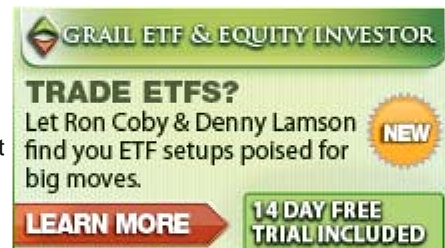
$2.5 billion. That ruling was overturned in 2008 by the United States Supreme Court, which ruled 5-to-3 to limit Exxon Mobil's liability to $507.5 million, the amount of actual economic losses suffered by fishermen, landowners, and others affected by the spill.

Years earlier, in 1994, to protect the company in case the $5 billion award was affirmed, Exxon Mobil obtained a $4.8 billion credit line from **JPMorgan** (JPM).

JPMorgan, knowing that the Basel rules required banks to hold 8% of their capital in reserve against outstanding loans, wasn't thrilled about tying up $384 million in the event the loan went bad. All sorts of swaps already existed at that time -- currency swaps, interest rate swaps -- but according to Gillian Tett's 2008 book *Fool's Gold*, Blythe Masters, a member of JPMorgan's swaps team, hit upon the idea of the credit default swap as a way to allow the bank to sell the credit risk associated with the Exxon loan to the European Bank of Reconstruction and Development. The EBRD stood to gain a substantial return for taking on the risk of Exxon defaulting, while JPMorgan was able to keep more cash available for other things and greatly reduce its own risk by laying it off on someone else -- in essence, insurance to cover its loan to Exxon.

"Interesting -- I didn't know that," was the first thing Cato Institute senior fellow Jerry Taylor said when told of the Exxon Valdez/CDS connection in an interview with Minyanville.

Taylor, who has testified frequently on Capitol Hill regarding assorted energy and environmental policy matters and is an adjunct scholar at the Institute for Energy Research, asserts, as do most financial professionals, that there's nothing inherently "evil" about credit default swaps, a claim that has lately become rather fashionable to bounce around at dinner parties when discussing the economic meltdown.



"Credit default swaps are simply a creative means of managing risk," he explained. "That's all they are. There are lots of ways to do it; a CDS is just one method."

The problems begin when banks stray from the tight risk models JPMorgan had in place at the time of the Exxon Valdez deal.

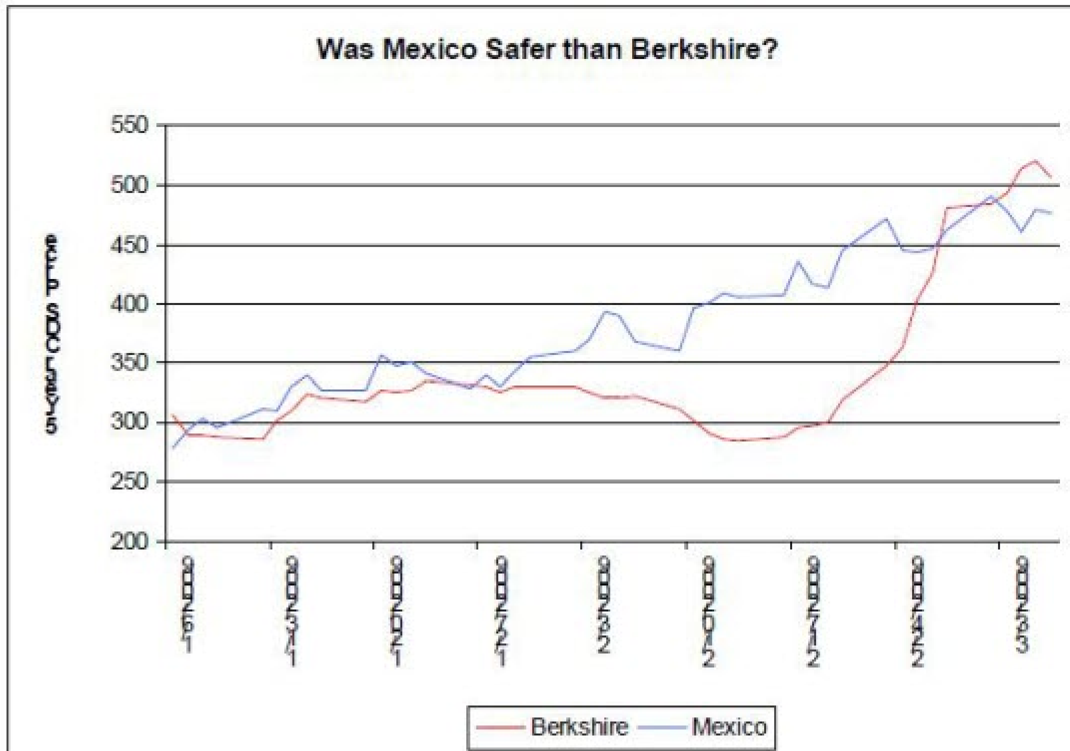
"I don't mean to steal a line from the NRA, but it's not the gun that kills someone else, it's the person pulling the trigger," Taylor said. "Wow, I never knew that," was also money manager Ryan Krueger's first response when told of the Exxon Valdez/CDS connection.

Krueger agrees that credit default swaps are a healthy way to manage risk when used properly.

"Trouble is, credit default swaps became an unregulated backroom at the salon," he said. "Classifying them as something else when they should not have been helped get credit default swaps around the insurance laws. But, in some cases, it got to the point where you could make something worth more dead than alive by betting enough. In the past, a buyer of stressed debt who might use a CDS in case the loan did go belly-up was still motivated to keep the company alive so it could make its interest payments. However, it is hard to argue that we did not witness just the

opposite in a few cases, where the goal became default -- when genuine fear caused some corporate bonds to become so cheap that the price of the bond plus the cost of a CDS to insure it was less than the value of the bond at maturity, it is not inconceivable to think some companies might have been worth more to some people if they went under."

In a client letter from June 2009, Krueger displayed the chart below:



"You are looking at the posted odds at Wall Street casinos on Credit Default Swaps (CDS), which show the price paid for a ticket to bet on who will go belly-up," he wrote. "As it turns out, many of the Wall Street bookmakers for CDS tickets assumed incorrectly they could never lose. You may have already heard that part of the story as legendary franchises were buried as a result. But look again at what was also happening that directly impacted even the highest quality assets, which in many cases should have had nothing to do with other credit disasters. Many of our own positions were affected greatly by price being dislocated from reality like this. You are looking at CDS prices implying that Berkshire Hathaway carried more risk than Mexico. So something else was going on here besides crooked bookmakers. What were the speculators doing?"

Krueger, a believer in free markets through and through, continued:

> New York State Insurance Superintendent Eric Dinallo testified in Congress recently that, "One likely reason they aren't termed credit default 'insurance' is that using that term would trigger state regulation and higher capital requirements for the underwriters, making the swaps expensive hedging instruments" -- otherwise known as what should be happening (my words, not his). I share because I think it might

> help explain something else -- that fears about more regulation in '09 and beyond might actually be off-target for a change. It is hard to argue more regulation does not make sense here. I cannot even believe I just typed that. But yes, that's how bad things got.

"Really? I had no idea," was independent trader Sean Udall's first response when told of the Exxon Valdez/CDS connection, too.

Udall believes that, just as people who own stocks should be able to benefit from the insurance afforded by buying puts, credit default swaps are "very viable" for the same reason. With that in mind, insurable interest is a necessity to stave off the difficulties that invariably occur without it, such as the runs on banks in 2008-2009.

He elucidates the point:

> You can't buy fire insurance on a theater you don't own, then burn it down and collect your money. Same with life insurance -- let's say 5,000 people you didn't know each had a million dollars in life insurance on you. How long do you think you would live?

Um… as long as the actuaries predict?

"Yeah, right," Udall responded. "You'd have days, if you were lucky. Someone would make sure you had an 'accident' some way, somehow, so they could collect. This is how we almost lost some very healthy banks like **Morgan Stanley** (MS)."

The simplicity of the credit default swap used by JPMorgan to hedge its exposure on the Exxon Valdez loan seems almost quaint in comparison to the types of deals that began to occur over time--particularly in the packaging and repackaging (and repackaging and repackaging and repackaging) of subprime mortgages which were then sold as securities.

As trader Jeff Macke said, "During the whole mortgage meltdown they had *zillions* of different variants on that crap, but it all came down to the idea that you could somehow mess with the model so that by aggregating a bunch of garbage loans, they would magically turn into good loans."

Now, if someone could just magically make the oil spewing from the Deepwater Horizon into a "good" thing.

Unfortunately, not even the most inventive, innovative, not-yet created swap is capable of that.