INSURABLE INTEREST AND PARAMETRIC POLICIES

INTRODUCTION

1.1 Parametric policies and industry loss warranties (ILW) are becoming increasingly common in the insurance industry. We understand that, taking a simplistic view, these products provide for a fixed sum to be paid on the occurrence of the event without the policyholder having to demonstrate the extent of its own loss.

1.2 Under these contracts, the fact that the event insured against has occurred may be sufficient to trigger a payout (although the policyholder may be required to demonstrate at least a nominal loss). Such products can be structured either as insurance or as derivative contracts, and we have been told that in some cases the decision as to which type of product to use may be left very late and is not of central concern.

1.3 The purpose of this paper is to discuss our understanding of parametric products and to set out how we think our proposed recommendations on insurable interest would apply to them. Although our proposed recommendations are not directed at these products and it would not be appropriate to make any special provision for them in any draft legislation we produce, it is important that we know how any changes which we recommend could affect the legal analysis of a parametric product.

1.4 We have not seen any detailed legal analysis of these products specifically. In the next section, we discuss our understanding of them and our provisional views about how they would fit into our proposed reforms.

1.5 We are very keen to receive more information about these products and, in particular:

(1) an idea of what drives the decision to structure a product as an insurance product or a derivative, where the choice exists;

(2) any information about how parametric insurance products are viewed from a legal perspective ie as indemnity/contingency insurance;

(3) the basis for the policy value and in particular any relationship with the anticipated loss;

(4) confirmation that under parametric insurance products the policyholder will always have an insurable interest in the subject matter of the insurance (ie the property, or the reinsured liabilities) both at the time of the contract and at the the time of any loss; and

(5) confirmation that the policyholder will only recover when it has suffered some loss of its own (even though the value of the payout may be based on an industry loss scale).

EXAMPLES OF PARAMETRIC PRODUCTS

1.6 The following simplified examples illustrate our understanding of when such products may be used.

Example 1

1.7 An insurer seeks to cover its exposure to hurricane losses in Florida. It buys an ILW which, in order to prompt a payout, requires a “triple trigger”:

(1) Florida must be exposed to a hurricane classified as at least Category 4 on the Saffir-Simpson scale;

(2) the total industry insured loss from the hurricane must be above $10 billion; and

(3) the relevant insurer does receive some hurricane-related claims.

Example 2

1.8 A consortium of Caribbean governments seeks to limit the financial impact of devastating hurricanes and earthquakes by providing financial liquidity quickly. They purchase a parametric insurance policy which allows the provider to estimate the loss on the ground by using data from the National Hurricane Centre in the case of hurricanes and the United States Geological Survey in the case of earthquakes, and a pre-fixed and calibrated catastrophe risk model. This method means that loss adjusters are not required to survey affected governments to determine actual loss, a process which can take several months or years.[1]

INSURANCE OR DERIVATIVE?

1.9 Very broadly, derivatives are contracts which provide for payment of money on the occurrence of a certain event. ISDA explained credit derivatives, currently the most common form of derivative contract, as follows:

> credit derivatives enable one market participant to transfer credit risks to another by a contract which provides for a payment or other benefit should a defined credit event (payment default or other relevant event) occur with respect to the underlying reference entity.

[1] http://www.ccrif.org/sites/default/files/publications/CCRIFBrochure20101129.pdf.

1.10 Other derivative products such as longevity/mortality derivatives, natural catastrophe derivatives and weather derivatives allow parties to hedge risks. ISDA said of longevity or mortality derivatives:

> These products permit parties such as pension funds, life insurers and long-term health care providers to hedge the risks in their businesses associated with mortality rates in particular sections of a population. So, to take a simplified example, increasing longevity would tend to increase the liabilities of a pension fund and would alter the liability profile of a life insurer. Derivatives dealers can provide innovative solutions through derivatives to permit parties to hedge against such risks. The risks can then be laid off with other market participants, to whom these risks are attractive as they have low correlation with other financial risks in their portfolio.
>
> In order for the derivatives dealers to offer such solutions, they must be entirely satisfied that the derivative products that they offer would not be classified as insurance. As the derivatives contracts do not require participants to hold an insurable interest in the underlying risks, the contracts can be clearly distinguished from insurance contracts under the Potts analysis.

1.11 Derivatives and insurance may achieve the same economic effects and there may also be very little to distinguish them from each other. However, the regulatory regime is separate. Insurers are only permitted to write insurance contracts, while banks are prohibited from doing so, and institutions providing these products must know that they are appropriately regulated to conduct their business. [2]

1.12 The law firm BLM said of parametric products:

> Payment is made regardless of any actual loss suffered provided the trigger is activated. These operate as disaster funds where money is paid promptly without the need to calculate loss and provide an indemnity. In practice most policyholders will have an exposure (and therefore an insurable interest) and an event at trigger level is likely to cause loss. In theory such contracts however are very close to gambling.

1.13 BLM's comment suggests that under some contracts there may be no requirement for the insured to show any loss – which might suggest that the contract is a derivative or, if structured as insurance, is a form of contingency insurance.

[2] Insurers and different financial institutions are permitted to undertake certain regulated activities under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544). This is overseen by the Financial Conduct Authority.

1.14 Contingency insurance pays a fixed sum on the occurrence of an insured event without the insured having to show loss in order to make a claim. The payout may or may not correlate to the insured's actual or estimated loss. This type of arrangement is associated with life and protection insurance but rarely arises in a non-life context. We think that writing, or analysing, a parametric insurance product as a contingency policy could have the effect of making the insurance in practice almost indistinguishable from a derivative contract, except for the requirement for an insurable interest at the outset. We have been told that preserving a dividing line – insofar as one exists at the moment – is very important.

1.15 We have been given two examples of insurance policies, and one derivative contract, all relating to weather risk. These examples appear to show a clear intention to distinguish between these different products.

1.16 The insurance policies we were given referred to the insurer reimbursing the insured for losses caused by the insured peril or loss occurrence, subject to the policy limit. In one, the policy limit is the "most the insurer will pay" and is said to be "a reasonable estimate, or smaller amount, of the actual economic loss that will be suffered" by the insured as a result of an insured peril. The insurer is entitled to require, at its sole discretion, the insured to provide a sworn proof of actual loss. All of these elements suggest that there has been an intention to structure the contract as one of indemnity insurance, rather than as a contingency policy. One of the reasons for this may be to avoid too many similarities with derivatives, although parties may elect to enter into derivative contracts for similar purposes. In the other, the policyholder must have sustained its own loss over a certain amount, and the actual amount the policyholder will receive is based on a scale according to the overall industry losses.

1.17 In the derivative contract, there was no mention of "loss" and no explanation of how the value of the contract was arrived at. Although this could also be the case with a contingency insurance policy, it is clear that the contract we saw was not intended to be regarded as insurance and contained no reference to insurance. Curiously, there was a template certificate of loss attached as a schedule, but this was not referred to in the body of the agreement so it is unclear when it would be used.

The demand for a dividing line

1.18 Despite the existing uncertainties in this area, consultees were anxious to stress that there must be a distinction between contracts of insurance and derivative contracts – an issue which is already highly problematic. Both the insurance and derivatives industries rely heavily on Counsel's opinion given in 1997 by Robin Potts QC, which opined that derivatives were not contracts of insurance in part because there was no requirement of insurable interest.

1.19 Linklaters said in their response to our latest paper:

> In framing the proposals, care will need to be taken to ensure that the boundary between insurance contracts and derivatives contracts is not blurred and that such proposals do not result in certain classes of derivative being recharacterised as contracts of insurance (which may have regulatory and tax implications as noted in paragraph 2.3 (1) and footnote 4 of the Issues Paper). In particular, the proposals should only apply to contracts which can properly be characterised as insurance contracts according to the elements identified in *Prudential* and *Gould*.[3] The proposals should not apply to contracts where the terms of the contract and the rights and obligations thereby created are such that the payee's entitlement to receive a payment is <u>not</u> conditional on the payee suffering a loss or detriment or otherwise having an insurable interest in the subject matter of the contract at any time. The fact that the payee <u>as a matter of fact</u> has or acquires an insurable interest … during the life of the contract should not cause a contract to be characterised as a contract of insurance if the terms of the contract are such that the payee's right to receive the payment or other benefit are not conditional on the payee suffering a loss or detriment or otherwise having an insurable interest in the subject matter of the contract.

1.20 There are therefore twin pressures at play. First, stakeholders are extremely keen that where a parametric policy is written as insurance, it should continue to be seen as insurance. They are also keen that a similar contract written as a derivative should *not* be seen as insurance. In the absence of any clear differences, this may be a tall order.

1.21 One difference between the two products is function. It appears that derivatives are often used to protect against low-value, high probability events such as variations in temperature or rainfall whilst insurance tends to be used to protect against high-value, low probability events such as natural disasters. A distinction based on function is unworkable though as it cannot be right for the same instrument to be characterised differently depending on what use it is put to.

1.22 As far as we can tell, the main difference appears to be that parametric insurance contracts require some at least nominal element of loss before the policy will pay out. This adds some element of indemnity, and creates a distinction between these policies and either contingency insurance policies or derivatives, which are not dependent on actual loss being suffered as long as the defined event occurs.

[3] *Prudential Insurance Company v Commissioners of Inland Revenue* [1904] 2 KB 658 and *Gould v Curtis* [1913] 3 KB 84, both of which mentioned the requirement for insurable interest as an essential element or condition of insurance.

1.23 However, the extent of the loss required to be evidenced may bear little relationship to the amount of the payout. We seek views on the extent to which the loss evidenced and the payout may vary. For example, might a Government claiming under a parametric insurance policy be required to certify that it has suffered at least $1 of loss in order to receive a payout of $15 billion?

1.24 We think that insurable interest plays a role in distinguishing between insurance contracts and derivatives through:

(1) the requirement for an insurable interest at the outset (or a reasonable prospect of acquiring such); and

(2) the requirement of an insurable interest at the time of the loss.

1.25 This suggests that a parametric policy should be written as a (non-life) indemnity insurance. If there was no requirement for an insurable interest at the time of the loss – as in contingency insurance - we think this could blur further the division between insurance and derivatives. This requirement could be a matter of the terms of the instrument. The policies we have seen suggest the current practice of the insurance industry is to require proof of some loss under an insurance contract. We seek views on whether this is always – or could always be – the case.

1.26 The fact that the loss demonstrated may not be equal to the payout does not necessarily prevent a contract from being an indemnity insurance contract, although it may not be a "pure" indemnity contract.

VALUED POLICIES AND OTHER MODIFIED INDEMNITY POLICIES

1.27 A valued policy involves the parties agreeing a value to be placed on the insured property at the outset of the policy. The agreed value is then conclusive and binding between both parties,[4] so the policyholder need not prove the actual value of the subject matter for the purposes of calculating the claims payment due from the insurer. In the case of damage or partial loss which diminishes the value of the property, the assured receives a proportion of the agreed value corresponding to the depreciation in its actual value. Such policies might be used, for example, to protect works of art, so that a set value is determined at the outset. The mere fact that a policy contains financial limits or a reference to the "sum insured" does not convert it into a valued policy.

1.28 Our view is that, although they do not fall within the strict linguistic definition of indemnity, from a legal perspective, such contracts are indemnity insurance.[5]

[4] Marine Insurance Act 1906, s 27(3); *Feasey v Sun Life Assurance Co of Canada* [2003] EWCA 885, [67], [102].

[5] For example, MacKinnon J in *Goole Steam Towing Co v Ocean Marine* [1928] 1 KB 589 at 594: "it is not a contract of indemnity ideally, but of an indemnity according to the conventional terms of the bargain".

1.29 It does not matter that the true value of the insured subject matter is lower than the agreed value or that the true value changes during the currency of the policy. However, other incidents of indemnity insurance still apply to a valued policy, in particular:

(1) the insured cannot recover in the absence of a loss (although he need not prove the value of the insured subject matter);[6]

(2) an interest at the time of loss is still required;[7] and

(3) the risk must have attached.[8]

1.30 There are also other policies which are not "pure" indemnity contracts, such as "new for old" household policies and perhaps some reinstatement conditions for property insurance. However, this does not prevent them from being indemnity insurance.

1.31 Even an insurance on property substantially in excess of the property's market value is not prima facie illegal or unenforceable.[9]

1.32 However, the case authorities, the Marine Insurance Act 1906 and general contract law suggest that there are five circumstances in which the agreed value may not be conclusive and binding:

(1) fraud by the policyholder;

(2) non-disclosure or misrepresentation;

(3) mistake on the part of both parties;

(4) wagering/sham transactions (where both parties are fully aware that the agreed value is in excess of the actual value);[10] and

(5) where the agreed value is effectively an unlawful penalty clause because the value is grossly in excess of any genuine pre-estimate of loss.

[6] *The Capricorn* [1995] 1 Lloyd's Rep 622, 636-642.

[7] Marine Insurance Act 1906, s 75(2).

[8] Marine Insurance Act 1906, s 75(2).

[9] *Rickards v Forrestal Land, Timber and Railways Co Ltd* [1942] AC 50, 90.

[10] *Lewis v Rucker* (1761) 2 Burr 1167 at 1171. We have not yet found any more recent cases in which both parties have been fully aware that the agreed value is grossly in excess of the anticipated loss, but we think this point could be relevant to the products discussed in the next section which may in some circumstances be more like derivatives than insurance.

Applying this analysis to parametric products

1.33 As part of the insurable interest project, we are not necessarily required to offer a view of the current law – and think that it would be difficult to do so. However, we think it is important that we can explain how our proposed changes would impact on these products.

1.34 ILWs are (almost certainly) non-life insurance products because they are triggered by a natural or man-made catastrophe rather than by a life-related event such as death or injury of a particular life or lives.

1.35 Our current view is that other parametric policies are better categorised as non-life, indemnity insurance products as opposed to contingency insurance. We think that valued policies provide a useful comparison.

1.36 <u>However, we are very keen to know whether stakeholders consider that insurance products exist (either as parametric products or elsewhere in the insurance market) which are "non-life contingency" products. The key question is whether there might be a situation in which the policyholder had no interest at all in the subject matter of the parametric insurance at the time of the loss, and/or suffered no loss at all.</u>

Timing of insurable interest in non-life insurance

1.37 Under our proposed recommendations for non-life insurance, the insured must have an insurable interest (or a reasonable prospect of acquiring one) at the outset of the contract. The insured must also have an actual insurable interest at the time of the loss or insured event.[11] The indemnity principle operates to require some relationship between the loss and the insurance payout.

1.38 We are not proposing to define insurable interest, but we propose a non-exhaustive list to confirm that a policyholder has an insurable interest at the time of the insured event if the insured:

(1) has a right in the property which is the subject matter of the insurance or a right arising out of a contract in respect of it;

(2) has possession or custody of the insured subject matter; or

(3) suffers an economic loss on the occurrence of an insured event, arising in the ordinary course of things.

1.39 It may be useful to set out how these requirements would apply to an ILW or similar parametric product. We take the example in which the policy provides a payout of $1 billion in the event of a hurricane of a certain velocity hitting Jamaica.

[11] This differs from life-related insurance, which requires an insurable interest at the time of the contract but not at the time of the insured event. This means that, for example, if a policyholder insures the life of their spouse and later divorces them during the policy term, the policyholder may still receive a payout on the ex-spouse's death despite no longer having an insurable interest in their life.

1.40 At the outset of the policy, there must be a reasonable prospect (or similar) that the insured will suffer an economic loss on the insured event.

> Where the policyholder is the Jamaican government or a business with interests in Jamaica, this criterion would be met. Similarly, where ILWs are used as a form of reinsurance, it would be sufficient for the insurer to have a reasonable prospect of writing hurricane insurance in Jamaica.

1.41 At the time of the hurricane, the insured must either have a right in insured property which has been damaged, or have possession of property which has been damaged, or must have suffered some economic loss.

1.42 Parametric products are unlikely to have particular property as their subject matter. From our non-exhaustive lists of interests, the policyholder would normally be expected to demonstrate that it has suffered an economic loss on the occurrence of the insured event. However, we are keeping open the possibility that the court could develop a new type of insurable interest if it were minded to do so.

1.43 <u>We think that the requirement to demonstrate an economic loss is almost always a part of ILW products which are structured as insurance and should not present an obstacle to such contracts. We think that this would also assist in distinguishing these contracts from derivatives.</u>

Value of the loss

1.44 In non-life insurance there is no statutory requirement that the value of the policy is limited to the value of the policyholder's insurable interest, although for indemnity contracts the extent of any payout will generally be limited to the value of the policyholder's loss (with an exception for non-pure indemnity contracts such as valued policies as discussed above). We think that products which have the parametric trigger but also require the insured to suffer a (minimum) loss take ILWs closer to, or into, valued policy territory.

1.45 We think it is unlikely that a court would seek to look behind the financial limit of a parametric policy if it was said in the contract to be a genuine pre-estimate of the insured's interest or the loss which might be suffered by the insured as a result of an insured peril, unless the court was looking to expose the contract as a "sham" insurance scheme which should have been written as a pure derivative.