

*Article / March 2008***Perspectives on industry loss warranties**

Against a widely reported background of softening rates, and a marked increase in ultimate net loss capacity in 2008, senior industry figure Tim Carroll, CEO of Swiss Re GB, recently commented in conversation that he still sees “industry loss warranty cover as an optional component in well structured reinsurance and retrocession programmes”.

According to The Insurance Insider Executive Briefing Autumn 2007, the value of industry loss warranties (ILWs) doubled in recent years and significant competition exists between providers with more than 20 markets offering cover.

ILWs are generally simpler structures than some of their competing products such as catastrophe bonds because they are typically not rated or listed instruments. However, they can be used in similar ways and share some features in common, such as the ability to structure the product as reinsurance or a contract for differences (commonly referred to as a “swap”).

There are also some notable differences. A publicly traded catastrophe bond is yet to make payment to a reinsured (or protection buyer if the ILW is executed as a swap). A determination in respect of payment under Kamp Re is notoriously the subject of ongoing monthly postponements. In contrast, ILWs tend to respond quickly once triggered and the majority of ILWs providing cover in respect of hurricane Katrina reportedly have responded.

Although usually not rated, ILWs are frequently collateralised and can be constructed using market loss or parametric triggers. Market loss based trigger thresholds are commonplace in the United States, utilising estimates of insured property losses contained in catastrophe bulletins issued by PCS (the Property Claim Services unit of Insurance Services Office, Inc). There is no equivalent independent industry-wide recognised service provider equivalent to PCS the US. Consequently, for catastrophe perils outside the US, ILW loss threshold triggers tend to be parametric based. Parametric triggers are based on modelled losses calculated by reference to the modelled impact of event data for example, wind speed, earthquake magnitude or river depths at specified locations.

Recently, a number of products such as the Carvill Hurricane Index (Carvill/CME) which traded its first contracts in the last few weeks, Re -Ex (Gallagher Re/NYMEX), SelectCat (Guy Carpenter) and WindX (RMS/Weatherflow Inc) have been developed to provide further risk management tools to the natural catastrophe (predominantly hurricane) risk sector. Some of the products are exchange traded and, to varying degrees, provide a mechanism for use by reinsurance buyers and investors in respect of exposure to certain catastrophe events to trade in and out of positions even as events unfold. It is also worth noting that the Chief Risk Officers Forum in collaboration with an industry working group (which includes Allianz, AXA, Munich Re, Swiss Re and Zurich Financial Services) is promoting and attracting support for the creation of a European equivalent to PCS to provide an industry loss index and post-event industry loss

estimates initially focussed on windstorm for the UK and continental Europe (west of Poland).

Double trigger

A key feature of a typical English law ILW is the presence of a double trigger. The conditions for both triggers must be satisfied for payment to be made to the reinsured/protection buyer. The double trigger comprises a primary trigger of an industry loss or parametric threshold and a secondary indemnity based trigger of the value of losses incurred by the reinsured/protection buyer under assumed reinsurance (and, increasingly, direct insurance) arising from the same risk event(s) that are covered by the ILW. In addition to the importance of the triggers in determining whether payment under an ILW is to be made, the triggers are at the centre of larger legal issues that are important to understand.

Primary trigger and legal basis risk

The primary trigger needs to be carefully constructed and documented to minimise the legal basis risk between the events and losses to which the reinsured is exposed and the protection provided by the ILW. Legal basis risk can be minimised by appropriate drafting. Issues of concern may include:

- carefully defining the protection, risk events and triggers to ensure that cover is in place for the perils and in the locations intended by the reinsured/protection buyer

- where the ILW structure interposes a transformer vehicle to convert the reinsurance risk to capital markets risk (using a swap, enforceable under English law as a contract for differences), the documentation must be aligned across the complete structure to ensure that the ILW performs in the same way as the swap. The alignment includes addressing in the drafting the different legal principles and rules of contract applicable to insurance contracts and swaps

- for ILWs referencing PCS loss estimates, understanding the PCS classifications and definitions for the perils that the ILW is intended to cover, any geographical or temporal limitations and what is and is not included in its published industry loss estimates is critical. Examples of factors that should be considered include loss adjustment expenses, whether the loss estimates include workers compensation, storm surge, flood damage caused by a tsunami or a dam giving way in an earthquake. If the ILW references a parametric model, similar due diligence is required in respect of the model. Other forms of basis risk (for example, economic) must also be considered. Economic basis risk may arise where an insured is

heavily exposed to the circumstances of a particular catastrophe (or series of smaller catastrophes) which does not generate a large enough loss on an industry basis to trigger payment under the ILW.

Secondary trigger and insurable interest in the UK and US

The secondary trigger exists to ensure that there is an indemnity element present which must be sufficient for the reinsured to evidence its insurable interest for the purposes of the applicable law. The governing law selected for the ILW is significant in determining the necessary relationship with the principles of indemnity, insurable interest and the enforceability of the policy.

English law

It is a requirement of English law that the insured has an insurable interest in the subject matter of the insurance acquired. Essentially, this requirement arose from public policy to deter gambling in the guise of insurance and curtail the moral hazard arising from the temptation to mischievous activity to bring about an insured loss or event. In the context of property and liability insurance, with which this article is concerned, the insured must have an insurable interest at the time that the loss occurs. The position in respect of life assurance is different in that the insurable interest must exist at the inception of the policy. English law requires the insured, in respect of property and liability insurance, to have an economic interest arising from its relationship to the subject matter of the insurance and that a legal or equitable relationship exists between the insured and such subject matter. For these purposes, an economic interest exists where the insured may be reasonably expected to derive benefit from the continued existence or safety of the insured property or would be prejudiced by its loss or damage.

US law

The requirement for insurable interest also exists in the US, although the degree to which this is driven by public policy concerns varies between states. In contrast to English law and as a general proposition in the US, the law in most states provides that an economic interest alone is sufficient to support the existence of insurable interest. A legal or equitable relationship is not a requirement although it may assist in substantiating the existence of an economic interest in the subject matter of the insurance. The application of the indemnity principle and the requirement for insurable interest in respect of indemnity insurance under New York law are in essence the same test. If the insured has no loss to be indemnified it is unlikely that it could satisfy the insurable interest requirement. However, whereas under English law the insured need

not establish its insurable interest to bring a claim (because it is a matter for the defendant insurer to raise in defence or for the court to call into question if it doubts the existence of such an interest), under New York law a claimant under an insurance policy must plead and establish its insurable interest in the subject matter of a disputed insurance policy.

Legal developments

Two developments in the UK are noteworthy. The Gambling Act 2005, unintentionally, casts doubt on the requirement for insurable interest in general indemnity policies. Under the prior Gaming Act 1845, gambling contracts were unenforceable. That position was reinforced in respect of insurance by the Marine Insurance Act 1906 (MIA), which is said to state the law in respect of general insurance. The MIA provides that every contract of marine insurance by way of gaming or wagering is void. The Gambling Act 2005 repeals the 1845 Act and provides that gambling contracts are enforceable except where a separate rule of law renders the contract unenforceable on the grounds of unlawfulness (unless that rule relates specifically to gambling). It is not yet clear what the effect of the Gambling Act 2005 is on the MIA. To promote discussion ahead of a forthcoming formal consultation the English and Scottish Law Commissions, in their January 2008 'Issues Paper', proposed the abolition of the insurable interest requirement in respect of all forms of indemnity insurance. Over the longer term therefore, the legal necessity under English law for insurable interest may disappear. However, it is likely that the secondary 'indemnity' based trigger will survive in some form because it also serves ILW issuers who want to ensure that a reinsured has 'skin in the game' to create a degree of alignment of economic interest irrespective of whether insurable interest is required as a matter of law.

Conclusion

Those involved in structuring and drafting ILWs should bear in mind the following key issues:

- whether the ILW is to be structured as reinsurance or a swap
- if the ILW is to be transformed between the capital markets and insurance, the drafting needs to take account of the differing legal principles applicable
- whether the industry loss is to be referenced to PCS (including any similar service provider) or a parametric model
- defining and aligning the ILW covered perils, the primary trigger, trigger threshold and industry loss estimates with the parameters of the PCS/parametric model and the protection required by the reinsured/protection buyer to minimise basis risk
- the governing law of the ILW documentation and whether that law requires the reinsured to have an insurable interest in the subject matter of the insurance.

This article first appeared in *The In-Insurance and Reinsurance Review* (March 2008). It is for guidance only and is not intended to be a substitute for specific legal advice. If you would like any further information please contact:

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