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corporate bulletin

February 2011

applying insurance principles to derivatives

Derivatives brought the world economy to its knees. Warren Buffett has called them weapons of mass destruction. Enormous effort around the world is being focused on how best to regulate derivatives in order to avoid a reoccurrence. There are important lessons from the field of insurance carefully developed over the centuries that should be considered in this debate.

A promise to pay a sum of money on the happening of an event can be insurance, a derivative or a gamble. Where a derivative falls in the spectrum between insurance and gambling can make the difference between the derivative being a useful financial instrument or a dangerous one. Over the centuries, our courts have developed criteria for distinguishing between insurance and gambling, which used to be against public policy. Insurance regulations added additional safeguards. These criteria and safeguards are equally applicable to derivatives and would go a long way to avoiding a repeat of the havoc wreaked on the global financial system.

insurable interest

Courts have insisted that for the contract to be valid as insurance, as opposed to being a wager, the person have an insurable interest in the subject of the insurance – the property being protected. George Soros recently suggested requiring insurable interests in the case of credit default swaps ("CDS"), and without this requirement, he called these derivatives "licenses to kill."

duty of outmost good faith

Since the days of Edward Lloyd's coffee house on the banks of the Thames River (where from 1688 on, those interested in receiving the most up to date news on shipping met, be they ship owners, merchants or "underwriters"), those who signed a sheet of paper under the bare particulars of the voyage (ship, captain, cargo, ports of call), and thereby assumed a percentage of the risk of the voyage, the courts insisted on the duty of outmost good faith on the part of those seeking to obtain the protection of insurance from these underwriters. The courts required truthful and full disclosure of the facts so that the persons taking on the risk could assess it fairly.

The implication of breaching this duty and misrepresenting a material fact in the application for insurance is severe. The underwriter can rescind the whole contract. The sophistication of the underwriter is immaterial, for the withholding of the information by the applicant for insurance is all that matters. Had these principles applied to the subprime transactions that Goldman Sachs was caught up in (if the allegations against it are true) and to the conduct that, according to Michael Lewis's The Big Short, underpinned most of the collaterized debt obligation ("CDO") market, the losses would have fallen on completely different per sons and perhaps the derivative "bets" would never have been made!

indemnity

Another principle of insurance law enunciated by our courts over the years is the concept of indemnity. A person cannot recover more under an insurance contract than his or her loss – the value of the thing lost or the cost to repair or rebuild it. The only exception is life insurance where, understandably, courts could not put a monetary value on a person's life. This is an extension of the requirement of insurable interest and, like that principle, limits the universe of wagers. Derivatives, like synthetic CDOs, have no such controls and, therefore, as long as you can find a mark to take the other side of the bet, there is no upper limit to the amount that can be "in play" – billions, trillions! And with out the governors of the duty of outmost good faith or the consequences of misrepresentation, it is easy or at least easier to find those marks, be they German banks or pension funds or corporate treasuries.

contract interpretation

As insurance contracts became ever more complex and insurers more sophisticated than those Lloyd's coffee house under writers, courts introduced rules of con tract interpretation and duties to rebalance the equities, this time in favour of the insureds. They ruled that insuring clauses, those promises to pay, be interpreted broadly and exclusions, clauses seeking to avoid the promise, be interpreted narrowly. Courts recognized that the policies were skewed in favour of the drafters, the insurance companies. Courts introduced the concept of the duty of out most good faith in the adjusting (settling) of insurance claims. The consequence of breaching this duty is an award of exemplary and punitive damages against the insurance company. How would these principles have impacted the billions that AIG Financial paid?

reserves

Insurers are required to set aside capital in the form of reserves to ensure that in the future and in some cases the far future, when it comes time to make good on that promise to pay, the money is there. Over the years with experience and trial and error, a whole science and profession (actuaries) developed to assist in the setting of these reserves and in testing their adequacy under various scenarios and stresses. This requirement for capital is the very reason why the activities that brought AIG to its knees were those of its unregulated AIG Financial arm and not those of its insurance operations.

While the principles of insurance cannot avoid all problems, and a number of monocline companies providing financial guarantee insurance failed or faltered, the insurance industry by and large weathered the recent financial meltdown quite well. Where they ran into difficulties was the very areas where they ventured into the derivative territory.

principles

Finally, having principles as opposed to rules is another important lesson from the common law. As the evolution of derivatives over the years shows clearly, if there is financial incentive, loopholes around rules will be found. As the ever-increasing complexity of the income tax codes shows, a rules-based system is almost guaranteed to be an endless cycle of finding loopholes, stopping them up and finding new ones. While this topic is much broader than just the regulation of insurance, it is an important adjunct to ensuring that whatever is put in place is flexible enough to evolve in order to address the unanticipated problems and challenges that are sure to arise. This is one of the strengths of the system of common law, which develops over time by applying the principles of the past to new situations that arise.

The current debate is properly focused on how to avoid in the future a similar economic disaster to the one that derivatives caused in the last three years. There is 300 years of insurance experience built case-by-case. We ignore these principles and lessons at our peril.

by Frank Palmay

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a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.