



Introduction to Weather Risk Management Insurance vs Derivatives

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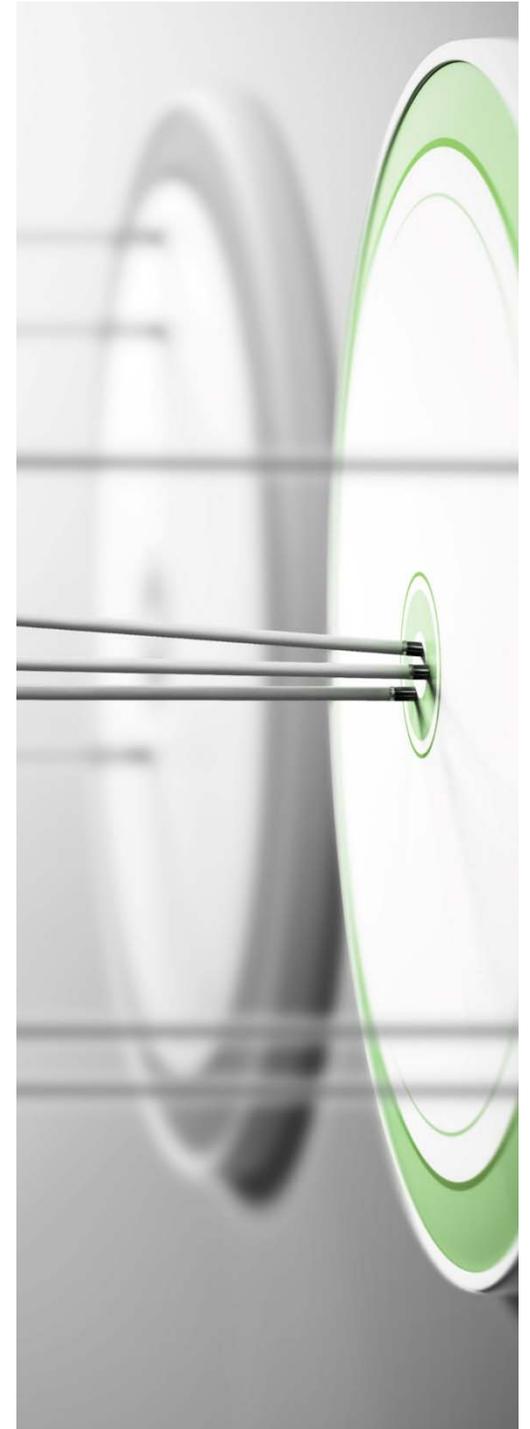
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Overview

- Classification of weather risk products
- Consequences
- Why does it matter?
- Other considerations
- Relevant factors in decision making



Insurance vs Derivatives

The spectrum of commercial contingent contracts

- Gambling
- Gaming and wagering compared
- Derivatives
- Other instruments
 - E.g. participations, syndication, index linked pay-out products
 - Sureties
 - Guarantees
 - Indemnities
 - Performance bonds
 - Insurance

Historic precedence

Insurance Characterisation

Legal classification

- Civil law vs common law
- Civil law
 - Public good
 - Mutualisation of risk
 - Syndication
 - Documentation and terminology

Common law characterisation

- Statutory definitions have historically been rare
- Case law is predominantly around gaming characterisation
- Nevertheless the courts have identified several indicia of an insurance contract

Features Of An Insurance Contract

Legal classification

- Payment of consideration
- To secure a benefit
- The benefit is contingent on the occurrence of a future event
- The future event is uncertain as to its occurrence
- The benefitting party has an interest in the subject matter of the future event
- The occurrence of the event would be adverse to the interest of the benefitting party

Regulation of Insurance Contracts

- Insurance Contracts Act 1984

“A reference in this Act to a contract of insurance includes a reference to a contract that would ordinarily be regarded as a contract of insurance although some of its provisions are not by way of insurance”

- Does not require an insurable interest at the time the contract was entered into
- Legal or equitable interest not required at time of loss
- Reinsurance is generally unregulated

Derivatives Characterisation

Legal classification

- Hedging vs speculation
- Commercial purposes
- Public good
- Cross over products
 - Options and warrants
 - Forwards and futures
 - Contracts for differences
 - Participations
 - Structured financial instruments (e.g. weather lined notes)

Features Of a Derivative Contract

- Regulatory classification
- Section 761D Corporations Act 2001
 - Part must provide particular kind of consideration to someone
- Future date at least the time prescribed by regulation
- Consideration or the value of the arrangement is determined, derives from, or varies by, reference to the value of something else (any nature, deliverable or non-deliverable), including for example, assets, rates, indices, commodities
- Anything designated as a derivative by regulation

Derivatives vs Insurance

- Common characteristics
- Distinguishing features
 - Insurable interest
 - Legal or equitable?
 - Legal or economic?
- Anomalies
 - Travel insurance
 - Parametric insurance
 - Rain checks
 - Spread betting

Consequences of Derivatives vs Insurance

Recharacterisation and its consequences

- Insurance vs reinsurance

Licensing & regulation

- Mutually exclusive or dual capacity

Enforceability

- Void
- Unenforceable
- Asymmetric enforceability

Insurance Characterisation

Special body of law

- Governing law
- Duty of utmost good faith
- Restricted application of the 'buyer beware' rule (due diligence)
- Misrepresentation
- Legal presumptions
- Subrogation
- Tax

Derivative Characterisation

Recharacterisation and its consequences

- Subsequent recharacterisation as gambling or wagering
- Commercial purpose test

Licensing & regulation

- Mutually exclusive or dual capacity
- Permissions within a financial services license

Enforceability

- Void and ultra vires
- Unenforceable
- Asymmetric enforceability

Derivative Characterisation (2)

No special body of law

- No duty of utmost good faith
- Enhanced buyer protections are regulatory
- Banker vs dealer and customer relationship
- Public good turns on purpose

Other Factors

- Tax
- Accounting
- Marking to market
- Collateral and margining
- Transaction reporting and LEIs

Factors Affecting The Choice

- Familiarity with the product
- Purpose of acquiring risk protection
- Constitutional and regulatory constraints
- Governance considerations
- Accounting treatment
- Operational constraints
- Enterprise bandwidth
- Quantifying and isolating risk
- Value for money and self-revalidation

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