Introduction to Weather Risk Management
Insurance vs Derivatives

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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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