

New US Wind Event Confirmation Template Published

When a tornado or hurricane whips through a community such as Mena, the small Arkansas town affected by a tornado last month, in addition to the human toll, property losses can mount quickly. When a catastrophic event hits a larger, more developed area, these losses are multiplied. An event is designated a “catastrophe” by the insurance industry when claims are expected to reach a certain dollar threshold, currently set at \$25 million.

According to Property Claim Services® (PCS) of the Insurance Services Office, catastrophes occurring in 2008 caused \$26 billion in direct insured losses to property (before reinsurance recoveries). This figure is almost four times the figure for 2007 and almost twice the average over the last 20 years. Further, models have predicted that the occurrence of a single catastrophe causing \$100 billion or more in insured losses is only a matter of time.

Catastrophe risk is typically spread through direct insurance coverage provided by primary insurers and then through reinsurance provided by global reinsurers and insurance-linked securities (cat bonds) to investors. Questions have been repeatedly raised, and are now front and center in the current financial distress, about the ability of insurers to meet their obligations to pay claims resulting from catastrophic events. One method for transferring catastrophe risk and mitigating insurers’ and reinsurers’ exposures to low-frequency, high-severity occurrences is through catastrophe-based derivative contracts.

On May 19, 2009, the International Swaps and Derivatives Association, Inc. (ISDA) published a US Wind Event Confirmation template that is aimed at supporting, through standard legal documentation, an over-the-counter (OTC) market alternative to traditional catastrophe risk diversification. This client

update will outline key terms of the OTC product and some of its exchange-traded counterparts and compare the tax, accounting and regulatory treatment of such derivatives versus traditional insurance and reinsurance.

Catastrophe Futures

A few versions of catastrophe futures have been launched over the years. In 1992, the Chicago Board of Trade (CBOT) introduced catastrophe futures contracts, but the gap between the potential property losses covered by the available futures contract versus the potential losses covered by primary insurers limited their usefulness. (The risk that a hedge transaction like a derivative may not fully cover the losses for which protection is sought is generally referred to as “basis risk”). In 1994, CBOT replaced these contracts with catastrophe options based on an index determined by PCS damage estimates. CBOT also attempted to lower basis risk by introducing products covering more narrowly defined geographical regions. Investors showed little interest in these products, at least partly because of remaining basis risk, and this resulted in limited liquidity, large spreads and increased inefficiency in the event of unwinds by existing market participants.

In December of 2008, the Insurance Futures Exchange (IFEX) established specifications for futures contracts linked to US Tropical Wind Events. This type of contract, like the ISDA OTC confirmation discussed below, is based on the issuance of final or interim loss reports by PCS. In order for a purchaser to receive payment under the contract, there must be a relevant catastrophic event “occurring in or affecting the 50 states of the United States, Washington D.C., Puerto Rico or the U.S. Virgin Islands,” with a date of loss falling within the specified contract risk period.

The contract risk period is set as the calendar year from the first second of January 1 through the last second of December 31 of the contract year. The IFEX contract is focused on the perils of hurricane or tropical storm, as described in a PCS report. In order to qualify for coverage, the relevant loss report must report an amount of estimated insured property damage or loss that exceeds a threshold level chosen from among a selection offered by the contract. The main difference between the IFEX wind events contract and the ISDA OTC confirmation is the commoditization of risk periods and covered perils of the former versus the flexibility of those and other terms in the latter.

ISDA US Wind Event Confirmation Template

The ISDA confirmation template for catastrophe derivatives seeks to fill the standard documentation gap for off-exchange transactions covering catastrophes within a category of “Covered Events” elected by the parties. Similar in many ways to the IFEX transaction, a Covered Event is a wind related event occurring in or affecting any of the United States of America (including the District of Columbia, Puerto Rico and the US Virgin Islands), for which either a final loss report or an interim loss report has been issued by PCS. One key difference between Covered Events in the OTC form and those in catastrophe futures contracts is the ability of parties to choose the types of perils that are covered. For example, the parties might choose to cover only named storms.

In order to qualify as a Covered Event, the relevant loss report must report an amount of estimated insured property damage or loss that exceeds thresholds specified by the parties. In order to trigger payment, the purchaser of the swap must provide a notice relating to a Covered Event that occurred within a risk period agreed to between the parties. Like other OTC products, the coverage of OTC catastrophe derivatives can be tailored to the needs of particular pairs of buyers and sellers and thus presents an advantage over catastrophe futures in terms of basis risk relative to insurance.

Derivatives versus Reinsurance

One of the advantages of catastrophe derivatives over reinsurance is the fact that the derivatives’ payouts are based on cumulative reported industry losses rather than the self-reported losses of a particular insurer. This difference lessens the susceptibility of catastrophe derivatives to the moral hazard problem created by self-reporting in reinsurance arrangements and the resultant monitoring and other costs. Another advantage of catastrophe derivatives is the protection against credit risk, which is often absent in the reinsurance context (since reinsurance agreements are generally uncollateralized). In the on-exchange derivative the exchange absorbs credit risk, and in the off-exchange product the ISDA documentation structure provides mechanisms for collateralization.

Catastrophe derivatives also present potential tax advantages to the counterparty that may affect pricing. Reinsurance activities performed in the United States may subject a non-US reinsurer to US income tax and, potentially, a 30% branch profits tax. Even if the non-US reinsurer is not subject to US income tax, premiums may be subject to a 30% withholding tax or a 1% federal excise tax, depending on the application of a US tax treaty. So long as a catastrophe derivative is not treated as a reinsurance contract for US tax purposes, generally none of these consequences arise. However, the US tax characterization of a catastrophe derivative is subject to uncertainty and will depend in large part on the specific terms of the contract.

There are some differences that favor the use of reinsurance over catastrophe derivatives by insurers. For example, the financial accounting treatment of insurance versus derivatives can create a disadvantage to the latter for managing catastrophe risk in that an insurance premium is treated as an expense, while derivatives are subject to the mark-to-market accounting rules of FAS 133 (Accounting for Derivative Instruments and Hedging Activities).

There is also an important difference in the treatment of reinsurance versus a derivative under insurance statutory accounting. After a catastrophic event, an insurer can take financial statement credit as an offset

against reserves for future claims if it bought reinsurance, but not if its recovery is through a derivative. It is also important to note, however, that if the derivative triggered a cash payment upon the same event, then this difference in statutory accounting treatment would be irrelevant, since the cash proceeds from the derivative transaction would come onto the insurer's balance sheet as an offset against those same loss reserves.

While important obstacles to the use of catastrophe derivatives continue to exist, they are mainly barriers to insurers and reinsurers that might otherwise participate in these products. Potential market participants beyond the insurance industry, however, may see these products as investment opportunities or tools to manage a broader trading portfolio. In addition, these products may be seen as alternative sources of yield to newer entrants in the financial marketplace. From this perspective, catastrophe derivatives, whether on-exchange or OTC, may see the growth that has historically eluded them.

For more information about the new US Wind Event Confirmation Template, or any other matter raised in this client update, please contact any of the following lawyers.

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