

Feature

KEY POINTS

- Credit default swaps ('CDSs'), guarantees and insurance policies are commonly used in the financial markets to provide protection from the failures of obligors.
- Banks in particular need to ensure that CDS and guarantees are not treated as insurance policies.
- Care needs to be taken in structuring transactions to achieve the desired characterisation.

Author Leonard Ng

Credit default swaps, guarantees and insurance policies: same effect, different treatment?

INTRODUCTION

Credit default swaps ('CDS'), guarantees and insurance policies are used regularly by financial institutions seeking to protect themselves from counterparty failures or, in the case of CDS, also to engage in speculative trading or arbitrage activity. However, the proper characterisation of such instruments can be important from a legal, regulatory and accounting perspective.

WHY PROPER CHARACTERISATION MATTERS

The proper characterisation of credit derivatives, guarantees and insurance policies is important for a number of reasons.

From a regulatory perspective, if a bank in the UK purports to provide credit protection under a 'CDS' or a 'guarantee', but in fact the contract is one of insurance, then that bank may be in breach of the UK Financial Services and Markets Act 2000 (the 'FSMA'), because banks are not authorised by the Financial Services Authority (FSA) to carry on insurance business.

Conversely, pursuant to para 1.5.13R of the Prudential Sourcebook for Insurers ('INSPRU') contained in the *Handbook of the Financial Services Authority* insurance companies are prohibited from engaging in business other than insurance business. Thus INSPRU 1.5.13R would prohibit a FSA authorised insurance company from carrying on investment business, including providing credit protection *via* a credit derivative. For the same reason, banks are not authorised to carry on insurance business since such authorisation would in effect prevent banks from engaging in banking business.

New regulations are also currently being promulgated, both in the European Union and other significant jurisdictions such as

This article examines the issue of how credit default swaps, guarantees and insurance policies are used to achieve similar aims in respect of credit protection, but which need to be characterised in particular ways so as to avoid certain outcomes which may be undesirable for the parties involved.

the US, which will apply to specific types of derivative contracts. For example, the proposed EU Regulation on Short Selling and Credit Default Swaps will regulate CDS of sovereign debt and contains a definition of 'credit default swaps'. In addition, new regulations on the clearing of OTC derivatives (of which CDS are a sub-category) and changes to the Basel regulatory capital framework in respect of OTC derivative exposures may mean banks may look for alternatives to OTC derivatives.

Next, one effect of a CDS or guarantee being (re)characterised as a contract of insurance is that insurance contracts impose a duty of utmost good faith and full disclosure; a failure by the insured in respect either duty may result in the insurer being able to avoid the contract.

Formal requirements are also applicable only to certain types of contracts. In the current context, s 4 of the Statute of Frauds 1677 requires that a 'special promise to answer for the debt default or miscarriages of another person' (ie a guarantee) may not be enforced unless the relevant agreement is in writing and signed by or on behalf of the guarantor. Such a requirement does not apply to contracts of insurance (although it would be difficult to envisage insurance contracts used in the financial markets being otherwise than in writing).

From a tax perspective, if a guarantee or a CDS were to be recharacterised as an insurance contract, the protection fees paid by the protection buyer may be subject to insurance premium tax.

Finally, from an accounting perspective, contracts with the characteristics of insurance contracts appear to be treated differently from those which do not, including 'typical' CDS. In particular, certain types of financial contracts are subject to mark-to-market or fair value accounting while other contracts containing insurance-like characteristics are not.

CONTRACTS OF INSURANCE UNDER THE UK REGULATORY REGIME

Article 10 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the 'RAO') provides that the activities of 'effecting a contract of insurance as principal' and 'carrying out a contract of insurance as principal' are regulated activities and thus subject to the requirement for authorisation under the FSMA. The RAO does not, however, define 'contract of insurance' in any meaningful way; it defines 'contract of insurance' simply to mean 'any contract of insurance which is a contract of long-term insurance or a contract of general insurance ...'

In Chapter 6 (*Guidance on the Identification of Contracts of Insurance*) of the FSA Perimeter Guidance ('PERG 6'), the FSA acknowledges that, in order to determine whether any particular contract is a contract of insurance, one must look to the English courts for guidance, and that it is for the courts (and, therefore, the position under common law), rather than the FSA, to determine whether or not there exists a contract of insurance.

There is no single definition of 'contract of insurance' under common law, but the case of

Prudential v Commissioners of Inland Revenue [1904] 2 KB 658 is often cited as a starting point in providing a definition. In *Prudential*, Channell J identified three elements as being necessary for a contract to be considered to be one of insurance:

- (a) '[i]t must be a contract whereby for some consideration, usually but not necessarily for periodical payments called premiums, you secure to yourself some benefit, usually but not necessarily the payment of a sum of money, upon the happening of some event';
- (b) '... the event should be one which involves some amount of uncertainty. There must be either uncertainty whether the event will ever happen or not, or if the event is one which must happen at some time there must be uncertainty as to the time at which it will happen', and
- (c) '... the insurance must be against something ... The insurance is to provide for the payment of a sum of money to meet a loss or detriment which will or may be suffered upon the happening of the event'.

The first two elements of the *Prudential* case are quite likely to be present in most credit protection contracts including CDS and guarantees, but as discussed below, it is usually the third element that is used to support an argument that a particular contract either is or is not a contract of insurance.

Before proceeding further, it is worth noting that, while the English courts will give due regard to the form of contract chosen by the parties to the arrangement, the form of the contract is not decisive in determining whether a particular contract is a contract of insurance (eg *Fuji Finance Inc. v Aetna Life Insurance Co. Ltd* [1997] Ch. 173).

CDS COMPARED WITH INSURANCE CONTRACTS

Broadly speaking, under a CDS the parties agree that, in relation to a reference asset issued by a reference entity (eg a corporate bond issued by BP plc), the protection seller will make a 'credit protection payment' to the protection buyer upon a 'credit event' in

respect of the reference entity. The credit event will usually include the failure to pay, bankruptcy or restructuring of the reference entity. The protection buyer pays a regular (typically quarterly) payment (effectively, a fee or premium) to the protection seller throughout the life of the CDS. A CDS is documented under the standard form agreements published by the International Swaps and Derivatives Association ('ISDA').

In 1997, ISDA asked the late Robin Potts QC to opine on whether credit derivatives were insurance contracts. ISDA asked Potts QC to consider, specifically, CDS, credit-linked notes and total return swaps/credit spread swaps. The resulting opinion has come to be known in the financial services industry simply as the 'Potts opinion'.

In his opinion, Potts QC cited, amongst others, the *Prudential* case for the proposition that the insurance must be against an uncertain event which is *prima facie* adverse to the interest of the payee, and concluded that:

'A contract is only a contract of insurance if it provides for payment to meet a loss or detriment to which the payee is exposed. In the case of credit default options the payment falls to be made quite irrespective of whether the payee has suffered loss or ever been exposed to the actual risk of loss.'

Potts QC then went on to opine that:

'credit default options plainly differ from contracts of insurance in the following critical respects:

- (1) the payment obligation is not conditional on the payee's sustaining a loss or having a risk of loss;
- (2) the contract is thus not one which seeks to protect an insurable interest on the part of the payee. His rights do not depend on the existence of any insurable interest.'

That is, Potts QC was of the view that a CDS should not be characterised as a contract

of insurance if the protection seller would be required under the terms of the CDS to make a payment to the protection buyer even where the relevant credit event (eg a failure to pay on the part of the reference entity) resulted in no loss or detriment being suffered by the protection buyer.

On that basis, the approach generally taken in CDS transactions since the issuance of the Potts opinion has been to structure the CDS to include a specific clause providing that there is no requirement for the protection buyer to hold the reference asset or to suffer a loss in order to make a claim under the CDS. The aim of such a structural feature and provision is to show that, at the time the credit event occurs, the protection buyer might not be the holder of the reference asset, so that the loss or detriment arising from the credit event might be suffered not by the protection buyer but rather by the person holding the reference asset at the relevant time. This is particularly true of CDS which have been entered into for hedging purposes (as opposed to speculative trading or capital arbitrage), since the protection buyer is seeking credit protection under the CDS precisely because it holds the reference asset and has an exposure to the reference entity.

It should not be assumed, however, that the mere insertion of such a clause means that the CDS would not be characterised as a contract of insurance. Amongst other things, the right of the protection buyer to transfer the reference asset to a third party might be considered to be illusory if in fact it is impossible for the protection buyer to do so. In this regard the FSA noted in its Discussion Paper on Cross-sector Risk Transfers (May 2002) that: 'Where the reference event is defined in such a way that it is conceptually impossible, at the time the contract was entered into, for the event to occur without the protection buyer suffering a loss, the contract may well be insurance. (This might be the case where, for example, the protection buyer was buying protection on a loan that he had originated, which was not transferable or liquid).'

In addition, given that Potts QC's view hinged on the 'insurable interest' issue, it

Feature

Biog box

Leonard Ng is a partner in the Financial Service Regulatory Group at Sidley Austin LLP in London. Email: lng@sidley.com

is worth noting that the Law Commission and the Scottish Law Commission (the 'Commissions') published, in January 2008, an 'issues paper' on the subject of insurable interest, and raised the question as to whether the concept of 'insurable interest' should be reformed in some way. The Commissions noted the FSA's view in its Policy Statement 04/19 (July 2004) that insurable interest was a requirement for a valid contract of insurance, but was 'not itself a defining feature' of a contract of insurance. The FSA's guidance in PERG 6 does not refer to the concept of insurable interest.

GUARANTEES COMPARED WITH INSURANCE CONTRACTS

A guarantee serves to perform a similar function to an insurance contract in that

First, under a guarantee, the guarantor agrees to perform the obligations of the debtor (also called the principal) should the debtor fail to perform its obligations to the creditor. In contrast, in an insurance contract the insurer reimburses or indemnifies the creditor for loss shown to be suffered by the creditor upon the occurrence of one or more events specified in the insurance contract. In this regard, the guarantor's obligation under the guarantee is secondary to the primary obligation that the debtor has to the creditor under the underlying contract. The guarantor's liability is co-extensive with that of the debtor; if the underlying contract is void, illegal or discharged, the guarantor does not have any obligation under the guarantee and the creditor cannot make a claim under the guarantee. An insurer's obligation, on

In recent years there has been an increasing use of 'financial guarantees'. Amongst other things, financial guarantees are exempt from fair value (mark to market) accounting under Statements of Financial Accounting Standards ('FAS') No. 133 (*Accounting for Derivative Instruments and Hedging Activities*) or International Accounting Standard ('IAS') No. 39 (*Financial Instruments: Recognition and Measurement*).

However, it would generally be difficult, for example, simply to take the contractual terms of a CDS from an ISDA standard form agreement and reorganise them under a document referred to as a 'guarantee' with a view to classification as a 'financial guarantee' under FAS 133 or IAS 39. Amongst other things, in order for an instrument to be a 'financial guarantee' under FAS 133 or IAS 39, the relevant protection provider must under the relevant contract reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due. It is this requirement for a reimbursement of loss that generally makes it difficult for a financial guarantee to be characterised as a 'guarantee' rather than an insurance policy; indeed, 'financial guarantees' are sometimes referred to as 'financial guarantee insurance policies'.

CONCLUSION

This article has focussed on comparing CDS and guarantees with insurance policies, but there are other contracts which raise equally interesting questions. For example, this article has not considered longevity derivatives, which reference mortality risk and for which issues of contingency (as opposed to indemnity) insurance may need to be considered. What seems clear is that, given the heightened scrutiny of CDS and other credit protection arrangements since the advent of the global financial crisis, not only from regulatory but also from accounting bodies, financial institutions are likely to be considering the issues discussed in this article more closely than before in order to avoid unintended and potentially undesirable legal, regulatory or accounting consequences. ■

"Financial guarantees' are sometimes referred to as 'financial guarantee insurance policies'."

both contracts purport to protect the relevant creditor from the failure of a debtor to perform its obligation under a contract. To that end it is not always easy to distinguish between the two types of contract. In a case often cited in relation to the distinction between guarantees and insurance, *Seaton v Heath* [1899] 1 QB 782, Romer LJ noted that:

'... the difference between these two classes of contract does not depend upon any essential difference between the word 'insurance' and the word 'guarantee'. There is no magic in the use of those words. The words, to a great extent, have the same meaning and effect; and many contracts, like the one in the case now before us, may with equal propriety be called contracts of insurance or contracts of guarantee.'

However, there are certain characteristics of each type of contract (apart from the forms of contract used) that may be helpful in distinguishing between them.

the other hand, is primary; that is, it exists regardless of the status of the underlying contract between the debtor and the creditor.

Secondly, guarantees tend to be tripartite arrangements, involving a debtor, the guarantor and the creditor; the debtor usually applies to the guarantor for the guarantee. Insurance contracts are bipartite in nature; the debtor is usually not even aware that the creditor has sought protection from the insurer. It should be noted, however, that on at least one occasion the English courts have recognised the possibility of bipartite guarantees (eg *Owen v Tait* [1976] 1 QB 402).

Thirdly, in traditional guarantees the guarantor is not paid a fee for providing the guarantee or, if a fee is paid, it is paid by the debtor to the guarantor. In contrast, under an insurance policy a premium is usually payable, and this is paid by the creditor to the insurer (as noted above, the debtor may not even know of the existence of the insurance taken out by the creditor). However, the courts have recognised fee-based guarantees as contracts of guarantee (eg *International Commercial Bank v Insurance Corporate of Ireland* [1991] ILRM 726 at 736).