In parametric, it's essential to define whether a contract is insurance or a swap

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These days parametric insurance is, excuse the expression, a hot topic among those considering the impact of climate change. From homeowners to businesses to state and local government units to nation states, the notion of risk transfer contracts that settle and pay losses far more quickly than losses covered under customary property insurance contracts is alluring. And the positive impact on resiliency is undeniable as loss payments in parametric transactions are devised to be made soon after events have occurred, which is precisely when everyone impacted by an event needs cash to fund repairs, pay for losses not covered by standard property insurance and speed up recovery efforts.

For some U.S. purchasers of parametric insurance, however, the promise that usual loss adjustment activity can be substantially reduced or avoided altogether should be considered in conjunction with federal securities law and tax issues. The challenge starts with calling all such risk transfer products "parametric insurance." When such products are indeed insurance, the good news is that federal securities and commodities laws should not apply, sparing issuers from regulation as swap dealers.

For commercial purchasers, the cost of such insurance protection would typically be deductible as an ordinary and necessary business expense and casualty loss payments generally would not be included in taxable income. For individuals, of course, insurance premiums are not generally deductible but whether parametric insurance loss payments must be included in taxable income — either as short- or long-term capital gains — definitely does matter.

Insurance or swap?

Following passage of the landmark Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the U.S. Securities and Exchange Commission and the Commodity Futures Trading Commission conducted a joint rule-making exercise concerning swaps that concluded in late 2012 with publication of 600 pages of updated rules comprehensively regulating a corner of the financial markets that up until 2010 had been largely unregulated.

What is a swap? The Commodity Exchange Act defines swap to include, in part, any agreement, contract or transaction "that provides for any purchase, sale, payment or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence." Sounds a little like an insurance contract, doesn't it?

The commissions recognized the possibility of confusion and uncertainty and at the very beginning of the joint rule noted that they did "not interpret this clause to mean that products historically treated as insurance products should be included within the swap or security-based swap definitions. The commissions are aware of nothing in Title VII [in Dodd-Frank] to suggest that Congress intended for traditional insurance products to be regulated as swaps or security-based swaps."

> Is the parametric insurance product being offered in fact insurance, in which case insurance-related tax rules apply; or is it a swap, which is a regulated investment product?

How do state insurance laws define insurance contracts? New York defines an insurance contract as "any agreement or other transaction whereby one party … is obligated to confer a benefit of pecuniary value upon another party … dependent upon the happening of a fortuitous event in which the insured … has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event." Not surprisingly, state insurance law definitions of insurance do vary. California's definition, for example, is arguably narrower, being a "contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event."

In the joint rules, the commissions explained at length how they distinguished between state-regulated insurance products underwritten by traditional insurers and swap transactions to be regulated by the commissions. The commissions' four-part analysis tests the products themselves and the providers of the products, considers "traditional insurance products" and includes a grandfather provision.

In short, the insurance product test under the joint rules excludes from the definition of swap any contracts that do not:

"Require … the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction; and require … that loss to occur and be proved, and that any payment or indemnification therefore be limited to the value of the insurable interest."

The provider test has four prongs, requiring the obligor/insurer essentially to be either a regulated insurer underwriting a regulated product, a government entity, a reinsurer — subject to certain limitations — or a nonadmitted insurer listed by the NAIC's International Insurers Department.

The enumerated products test lists out many traditional insurance products, including property/casualty insurance and reinsurance. The commissions warned that in relation to reinsurance that an "agreement, contract, or transaction that is labeled as 'reinsurance' or 'retrocession', but is executed as a swap or security-based swap or otherwise is structured to evade Title VII of (Dodd-Frank), would not satisfy the Insurance Safe Harbor, and would be a swap or security-based swap."

So, what factors should both providers and purchasers consider in determining whether a particular product is a swap or insurance? First, that the contract is in fact an insurance product — among other things, that the purchaser has an insurable interest in a property to be protected and that the purchaser must "prove" the loss and the amount of the loss, the payment of which may not exceed the value of the insurable interest. Second, that an insurer be the counterparty bearing the risk in the transaction. Third, that the product fits into one of the enumerated types of insurance contracts in the joint rules — including property/casualty insurance.

Tax considerations

Obviously for those that do not pay federal income tax, such as state or local government entities or tax-exempt organizations, neither the deductibility of the cost of parametric insurance nor including parametric insurance loss payments in taxable income should matter. But taxpaying businesses and some individuals, for example, owners of wind/flood-exposed coastal homes looking for an alternative or a supplement to increasingly expensive excess insurance, should carefully consider the facts and circumstances of a proposed transaction. Is the parametric insurance product being offered in fact insurance, in which case traditional insurance-related tax rules apply; or is it a swap — which is a regulated investment product — in which case the "premium" would not be deductible as an ordinary and necessary business expense and loss payments might not be excludable from income as casualty insurance loss payments would be.