Off-setting Credit Risk Via Transformer Companies

By Maria Ross

The much commented upon film-financing litigation has not been good publicity for insurers hoping to diversify into credit enhancement arrangements. In summary, the recent litigation has revolved around insurance policies put in place for a number of special purpose vehicles, each created to finance film-making activities. These SPVs issued notes which were rated "AAA" on the strength of certain insurance policies issued in support of the notes (i.e. the policies were intended to guarantee sufficient funds to repay the notes in full if the film did not itself generate adequate revenue to do so).

The recent litigation concerns the precise nature of the insurer's obligations under these policies. The insurers have argued that the policies did not constitute an unconditional guarantee of note repayment, but rather that the insurer's obligation to pay follows general insurance law principles, including compliance with warranties in the policy, the insurer's right to examine the validity of a claim before payment is made and of course, compliance with the concept of utmost good faith.

The article examines another area of risk which insurance companies have embraced only relatively recently, that of off-setting credit risk via transformer companies; considers whether some of the difficulties that have come to light in the context of film financing could be repeated in the area of transformers; and looks at ways in which it may be possible to reduce these risks.

What is a transformer?

As their name suggests, these are companies which, in effect, "transform" a contract, in this case a derivative contract, into an insurance policy. To understand why these companies are popular, it is worth looking at the underlying issues more carefully.

The similarities and the differences

Similarities

Broadly, a credit derivative is a financial instrument designed to assume or lay off credit risk on loans, debt securities or other assets or in relation to a particular entity or country. In return for the laying off of risk, there is a payment from the originating party to the counterparty. Credit derivatives may take the form of credit default options, credit-linked notes or total return swaps, but the product which is most similar to insurance is the credit default swap. Credit default swaps typically pay out on the occurrence of a specified credit event - such as the insolvency of the referenced entity, or a material deterioration in that entity's credit-worthiness.

Compare this, then, to insurance, or more particularly credit insurance, which is defined in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 as being insurance against "loss to the persons insured arising from the insolvency of debtors of theirs or from the failure (otherwise than through insolvency) of debtors of theirs to pay their debts when due". Thus the same or a similar kind of risk could equally well be offset either by a derivative or an insurance product, both being contracts of indemnity and having a similar economic effect.

Differences

Although insurance and derivative contracts can be extremely similar, a derivative contract is *not* an insurance. One needs to understand the meaning of "insurance" in order to appreciate the difference between the two.

There is no English statutory definition of a contract of insurance but case law has identified certain essential elements as follows:

- there must be a promise to pay;
- the insured must have an insurable interest in the subject matter of the policy;
- what the insured purchases is the right to receive monies on the occurrence of an uncertain event (the key feature being that there *must* be an element of contingency, either as to the happening of the event or as to its timing);
- there must be a premium passing between the parties.

It is also worth considering the commercial effect of an insurance contract, which is to transfer risk from one party (the insured) to another (the insurer). Where there is doubt as to the correct characterisation, then as with any contract, what is likely to carry most weight with an English court is the substance of the contract as a whole, taken in its commercial context. How the parties choose to describe the contract will be of little persuasive force. Furthermore, it has been established that either the contract as a whole is a contract of insurance or it is not. Only where the *principal* object of the contract is to insure will the contract be one of insurance. So a contract which contains an element of insurance which is collateral to its principal purpose will not constitute insurance.

The most important of the above features for the purpose of distinguishing credit insurance from a credit derivative is that the insured must have an insurable interest in the subject matter of the insurance. In other words, the insured must stand to lose financially if the event insured against happens.

The statutory definition of "insurable interest" is as follows:

> "a person is interested in a [marine] adventure where he stands in any legal or equitable relation to the adventure or to any insurable property at risk therein, in consequence of which he may benefit by the safety or due arrival of insurable property, or may be prejudiced by its loss, or damage thereto, or by the detention thereof, or may incur liability in respect thereof."

The key concept is that of loss - is the insured's relationship with the matter insured such that he would incur financial loss should the risk insured against occur? If not, then the requirement that there must be an insurable interest is not satisfied. (Nor indeed is the requirement that there be a transfer of risk, since one cannot have a transfer of risk unless the insured would otherwise be exposed to that risk.)

Note, however, that the test is two-pronged: there must be a legal or equitable relationship, as well as an economic interest. Thus, for example, under English law, an individual cannot insure against being disinherited by his parents; nor can a person take out life assurance on the life of any other person save where he stands to suffer financial loss on that death (the most famous case in this respect involving the courts' refusal to classify as insurance a contract by a subject to insure the life of the King!), in both cases because there is no legal or beneficial interest in the property in question. It is this requirement of a legal or equitable interest that distinguishes insurance from gambling.

So whilst it can be seen that the commercial and economic effects of credit derivatives can be similar to contracts of insurance, there is a clear conceptual distinction:

- With a credit default product, the event triggering payment is the occurrence of the credit event and not the *loss suffered* by the originating party as a result thereof. The existence or otherwise of such a loss is irrelevant to the contract.

- Under the terms of an insurance contract, however, loss to the insured is critical. If the insured has not suffered a loss, the insurer will not be under an obligation to pay.

In the case of a credit default product, although the originating party *may* suffer a loss if the relevant credit event occurs and, indeed, *may* have entered into the credit derivative specifically to hedge against that risk of loss, the counterparty is obliged to pay the originating party on the occurrence of the credit event *whether or not* the originating party has actually suffered a loss.

Why does the difference matter?

The difference is probably of greatest significance in relation to regulation. In the UK, a contract of insurance can only be issued by an authorised insurance company; an insurance contract issued by a non-authorised party will be unenforceable against the policyholder and monies paid under it may be recovered by the insured, together with compensation for loss. In addition criminal sanctions are available against the issuer.

Conversely, UK-authorised insurers are prohibited from carrying on any commercial business in the UK or elsewhere "other than insurance business and activities directly arising from that business" (paragraph 1.3 of the Interim Prudential Sourcebook for Insurers). (The intention of this provision ("the FSMA restriction") is to ensure that the business of insurance companies is completely ring fenced and isolated from the risks associated with any other commercial activity, whether regulated or not.) Breach of this provision could lead to enforcement proceedings by the FSA.

In addition, a number of consequences flow from a contract being one of insurance rather than non-insurance and these are, generally speaking, undesirable from a commercial perspective. Two of the most relevant in this context are, first, that insurance premium tax at the rate of 5% is payable on insurance premiums. Secondly a contract of insurance is a contract of utmost good faith. Whilst <u>all</u> contracts (including derivatives) are subject to considerations of good faith to the extent that the law cannot support fraud, in ordinary commercial contracts, parties are not required to reveal all that they know about the proposed agreement. Subject to certain statutory protections available to purchasers (and in particular consumers), the common law applicable to most commercial contracts is that of "caveat emptor" (let the buyer beware). Not so for insurance.

The "utmost good faith" doctrine means that a duty of full disclosure is imposed on both parties to the contract. In practice, the duty of the insured to give full disclosure is the only one of importance. The duty is onerous - the insured must disclose all material facts which he knows or which he should have known about. The consequence of failure to disclose all material facts is, in English law, also harsh - the insurer can consider the contract void and avoid payment completely.

Thus any person who wishes to write a credit derivative has plenty of reasons to ensure it is not actually a contract of insurance!

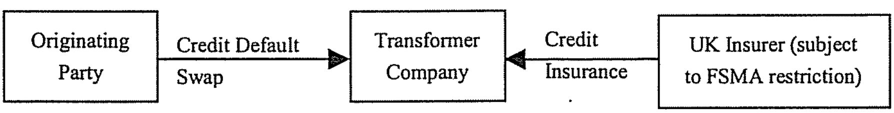
How do transformer companies work?

So, although insurers may wish to write credit derivatives, they may not do so. Bodies (such as banks) which do want to write credit derivatives need to take precautions to ensure the contracts they write cannot be characterised as insurance.

The first of these issues has been addressed by the development of transformer companies.

Although UK insurers cannot write derivative products, they are allowed to enter into insurance policies to insure a counterparty in a derivative agreement. Such a policy would indemnify the counterparty against having to pay losses incurred under the derivative agreement. The transformer effectively places itself in the middle of a structure, enabling the insurer to issue an insurance policy one step removed from the derivative contract.

In a typical transaction, the transformer would write the original swap contract, and the UK authorised insurer would then insure the transformer company, hence avoiding the FSMA restriction. For the insurer there may also be the opportunity to offset its insurance liability by reinsuring the risk.



In addition, depending on the place of registration of the transformer, it is possible to transform an insurance risk into a derivative contract (i.e. the converse of the above structure - a transformer entering into an insurance policy and then offsetting the risk via a derivative contract). This is possible because in certain jurisdictions (for example, Bermuda) insurance companies *are* permitted to carry on non-insurance business.

It is also worth noting that although many transformer companies are set up as shells (i.e. with insufficient capital to honour their commitments under the derivative contract without the benefit of the insurance), and it could therefore be argued that the transformer has only a technical (and artificially constructed) liability to pay rather than an actual one, (i.e. casting doubt on the existence of an insurable interest) the inclination of the English courts is to find in favour of an insurable interest whenever the facts allow. Economic effect is *not* the test applied to the characterisation of a contract.

However (and notwithstanding a bank's understandable desire to make the insurance policy and the credit derivative contract completely "back to back"), it helps from an insurance regulatory perspective to observe the legal niceties of the distinction between insurance and derivative contracts. For example, it is beneficial (although not conclusive) if the insurance policy side of the equation exhibits all or some of the following features:

(a) the policy has its own self-contained terms (rather than incorporating and annexing the derivative agreement). In particular, the parties should define and include all the key financial provisions of the insurance within the policy, rather than relying on the derivative contract;

(b) the liability under the policy does not *exactly* match the insured's liability under the derivative agreement (i.e. there is a retention of some kind under the policy or some other financial liability for the insured);

(c) where, under a standard ISDA agreement, payment is by instalments with such instalments diminishing if an obligation ceases to be part of the portfolio, be wary of matching this exactly by an identical proportionate premium rebate under the policy;

(d) the benefits of the policy should not be freely assignable, particularly to the originating party.

The Conflict

The difficulty is, of course, that the more effort one makes to ensure that a contract wholly satisfies the requirements of the insurance regulator, the less likely it is that the financial obligations of the insurer will match precisely the obligations which the counterparty intended to hedge. For example, if feature (b) above is incorporated into the insurance policy, it is immediately less economically effective as a hedge.

There has not to date been an equivalent dispute in the world of transformers to that in the world of film financing, and long may that state of affairs continue. However, it does not take too much imagination to predict the kinds of arguments that an insurer reluctant to pay up on a credit insurance policy, could employ to try to avoid payment and it is here where the similarity with film-financing bonds lies. Indeed, wherever insurance companies have ventured into areas which are traditionally the territory of banks there is always a dichotomy between a banker's expectation of such products in terms of certainty of payment and the insurer's expectation, steeped as it is in the concept of utmost good faith and the practice of claims adjustment.

How can banks and insurers minimise any potential exposure?

So, is it all doom and gloom and should insurers and banks who have engaged in transformer structures be bracing themselves for "Film Financing Mark II"?

Thankfully there are a number of features prevalent in most transformer arrangements which distinguish them from film-financing.

The first point to note is that the process involved in placing insurance in transformer structures is quite different to that involved in the film-financing cases, and this difference in itself should be of comfort. Unlike in film-financing, there are typically no brokers involved in transformer structures - banks and transformer companies usually negotiate directly within the insurer. This means there is less risk of misunderstanding, both in terms of the actual risk being covered and of each party's obligations. Moreover, the insured party (the transformer) is often, as already noted, a "shell" company whose sole existence is to enter into these kinds of structure. Often the transformer is also a protected cell company (very broadly a company which can "ring fence" a risk within certain classes of share, so that the bankruptcy of one "cell" does not affect the other "cells" nor the company as a whole). The process of making full disclosure to the insurer (i.e. to ensure that the principle of utmost good faith is complied with) should therefore be relatively easy for a transformer company.

Secondly, the issue of whether or not a contract is one of insurance is unlikely to come to light unless there is a problem. This is a grey area of the law and it is difficult to state with any certainty where the precise dividing line between insurance and derivatives is drawn. That line will not, frankly, be drawn unless and until there is litigation on the point. Thirdly, neither insurance companies nor banks have any vested interest in seeking to set aside commercial arrangements.

This is most definitely the case where monoline, rather than multi-line, insurers have underwritten the credit arrangements - as their name suggests monoline companies have only one line of business. Their business is that of providing insurance policies that operate, effectively, as guarantees. Since this is their only business they are compelled to maintain their reputation and pay out. Dealing with a monoline insurer should therefore reduce the risk that insurers will not respond to claims. Further, banks may take additional comfort from the Standard & Poors "Financial Enhancement Ratings" (FER) on insurance companies. Introduced in July last year, this rating is designed to assist investors in evaluating an insurer's willingness and ability to make timely payments. To qualify for an FER, insurers must indicate their willingness to pay first, according to their strict contractual obligations, and seek to resolve any difficulties later.

So, in summary, the advice (for both parties) is that properly thought-through transformer structures should work for both banks and insurers. Insurers should ensure that the policy documentation observes the requirements of insurance law and can demonstrably be shown to be an insurance contract. Banks should carry out proper due diligence on the insurance company to ensure it falls within the class of insurers whose timely payment of claims can be assured; and also to ensure that the relative payment obligations are matched as closely as possible (within the confines of ensuring the insurance policy is one of insurance).

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