

# Credit Default Swaps and Insurance: Against the Potts Opinion

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## Abstract

Little attention has been given to the possibility that CDS transactions might be construed as insurance contracts in English law. This article challenges the widespread “Potts opinion”, which states that CDSs are not insurance, because they do not require the protection buyer to sustain a loss or to have an insurable interest in the subject matter. CDSs often do provide protection against loss that the buyer is exposed to; loss indemnity is not a necessary characterisation of an insurance contract; insurable interest does not form part of the definition of insurance, but is an additional requirement of valid insurance; and what matters is the substance not the form of the contract. The situation in the US and Australia is also briefly considered.

Credit default swaps; credit derivatives; insurance law; Potts opinion; Dodd-Frank Act.

# Introduction

It is normally thought that credit default swaps (CDSs) are not insurance contracts, but careful analysis reveals major weaknesses in this position. Whether or not CDSs are insurance is an issue of significant implications. If a court would answer that question in the affirmative, many outstanding CDS contracts might be null and void, and possibly illegal.<sup>1</sup> There would also be other implications such as those concerning accounting rules, taxation, reserves regulation and the doctrine of utmost good faith.

This article challenges the well-known “Potts opinion”, which says that CDSs are not insurance in English law. London is a leading centre of CDS contracting activity and a large part of the business is documented under English law.<sup>2</sup> Much of the analysis can be applied to other jurisdictions too, but there are also differences. The article does not discuss the broader question of whether or not CDS contracts should be defined and regulated as insurance by way of specific legislation; nor does it investigate the extent to which the same analysis can be applied to other types of credit derivatives.

## Credit Default Swaps: Stylised Facts

### *Basic Structure*

In its basic form, a CDS is a promise by the “protection seller” to make a lump-sum payment to the “protection buyer” upon the occurrence of a credit event, such as bankruptcy, reorganisation, payment default or credit rating downgrade. In consideration, the CDS buyer makes periodical payments to the seller. The simplest case is the single name CDS, where the reference entity is normally an individual corporation or a government. There are however many various such as basket

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<sup>1</sup> It is a criminal offence for an unauthorised entity to enter into insurance business in the UK. However, since the entry into force of the Financial Services and Markets Act (FSMA) on 1 December 2001, there is a distinction between trading without authorisation and trading without permission. For example, the sale of a CDS by an FSA regulated bank would not be as serious a matter its sale by an unregulated hedge fund. See Financial Services Authority, *Cross-sector risk transfers*, Discussion Paper DP 11, May 2002, Annex B. p. 3.

<sup>2</sup> See letter from Richard Metcalfe, International Swaps and Derivatives Association, to the Law Commission, in response to *Insurance Contract Law: A Joint Scoping Paper (January 2006)*, 18 April 2006, available from [www.isda.org](http://www.isda.org).

and portfolio CDSs; the latter in particular are used in connected with synthetic securitisation transactions.<sup>3</sup>

There two principal ways of handling the credit event payment. One is physical settlement, in which the protection buyer delivers the defaulted asset or assets in exchange for par (in cash) from the protection seller. The other is cash settlement, which is usually calculated as par value minus recovery value or determined in an auction of the default assets.<sup>4</sup>

Economically, "CDS functions like an insurance policy, with the swap buyer paying the swap seller a premium to protect against losses resulting from a defined credit event [...]."<sup>5</sup> Note also that normally, like in indemnity insurance, the credit event payment in a CDS is directly linked to the loss of the value of the reference entity: in physical settlement, the protection seller must accept the reference asset and pay par value; in cash settlement, the loss amount is estimated. Thus most CDSs are structured as essentially "indemnity" deals, although the protection buyer may not in fact own the reference obligation. There are also "specific value" deals, but they seem to be less common.

## *Market and Uses*

The market for credit derivatives started in the early 1990s. The contracts are over-the-counter (OTC) and there are no reporting requirements. It is difficult to know exactly the size of the market; the only certain fact is its stunning growth. The notional amount of all credit derivative contracts has been estimated as 180 billion USD in 1996, but it then skyrocketed and reached 28.5 trillion USD at the end of 2006. According to Bank of International Settlement (BIS) estimates, the notional value of outstanding contracts was 57.3 trillion USD at the end of June 2008. CDS deals account for a lion's share of the credit derivative market as a whole.<sup>6</sup>

Originally, the main market participants were banks, and the dealership continues to be dominated by major investment banks.<sup>7</sup> However, the growth of the market has significantly

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<sup>3</sup> See for example R. Ayadi and P. Behr, "On the necessity to regulate credit derivative markets", (2009) *Journal of Banking Regulation* 179-201, at 181-184.

<sup>4</sup> See R. Ayadi and P. Behr, "On the necessity to regulate credit derivative markets", (2009) *Journal of Banking Regulation* 179-201, at 184-185; Financial Services Authority, *Cross-sector risk transfers*, Discussion Paper DP 11, May 2002, para 3.19.

<sup>5</sup> E. Banks, M. Glantz and P. Siegel, *Credit Derivatives: Techniques to Manage Credit Risk for Financial Professionals* (New York etc.: McGraw-Hill, 2007), p. 33.

<sup>6</sup> See R. Ayadi and P. Behr, "On the necessity to regulate credit derivative markets", (2009) *Journal of Banking Regulation* 179-201, at 181.

<sup>7</sup> R. Ayadi and P. Behr, "On the necessity to regulate credit derivative markets", (2009) *Journal of Banking Regulation* 179-201, at 187.

changed the participation structures. According the BBA estimates, banks accounting for more than 80 percent of protection buying in 2000; by 2006 their share had fallen below 60 percent, and hedge funds had bought 28 percent of deal value.<sup>8</sup>

In terms of protection selling, bank share has fallen from 63 percent (2000) to 44 percent (2006), where as hedge fund participation has grown from 5 to 32 percent in the same period. Insurance companies sold only 17 percent of the global deals in 2006.<sup>9</sup>

In terms of motivation, there are many reasons why someone might want to participate in the credit derivatives market. Broadly speaking, the uses can be divided into hedging (managing and reducing risks) and speculating (profiting from risk taking). For a protection buyer, a credit derivative may serve a function similar to more traditional risk management instruments; but the CSD buyer may also take a short position, seeking to profit from the default of the reference entity. The latter use explains the growing participation of hedge funds as protection buyers (although the term “protection buyer” appears rather inappropriate in such cases).

Protection sellers, in contrast, have access to a range of highly specific risks through credit derivatives. In the general case, the protection seller is betting on the creditworthiness of the reference entity, and in return collects premium payments, basically just like an insurance company. The growing role of hedge funds also as protection sellers suggests that they have found a lucrative market not traditionally accessible to those other than insurance companies. However, hedge funds may also be taking simultaneously long and short positions in the markets, seeking to profit from pricing inefficiencies.

To understand the spectacular growth of the market, it is important to grasp its potential for *regulatory arbitrage*. As the Financial Services Authority (FSA) has noted, modern risk transfer transactions can be used for regulatory arbitrage both across industries and within firms.<sup>10</sup> For example, bank capital regulation under the highly simplistic Basel I regime implied that traditional credit insurance could not be used to free up regulatory capital, because insurance companies attracted a 100 percent risk-weight; in contrast, OECD banks had the much more attractive 20 percent risk-weighting under the Basel rules. Transferring the credit risk of a loan portfolio to another bank through a credit derivative enabled banks to take advantage of these regulatory discrepancies.<sup>11</sup>

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<sup>8</sup> See D. Mengle, “Credit Derivatives: An Overview” (2007) *Federal Reserve Bank of Atlanta Economic Review*, Fourth Quarter, 1-24, at 9.

<sup>9</sup> *Id.*

<sup>10</sup> Financial Services Authority, *Cross-sector risk transfers*, Discussion Paper DP 11, May 2002, Annex F, pp. 2-3.

<sup>11</sup> See Financial Services Authority, *Cross-sector risk transfers*, Discussion Paper DP 11, May 2002, Annex D, p. 1-2.

## *Regulation and Documentation*

Until recent legislative initiatives, credit derivatives have not been subject to any specific regulation. The market is entirely OTC in nature, which has made it difficult to know much about what is happening. However, a high degree of standardisation has been developed, because many contractual features are laid down in the Master Agreements of the International Swaps and Derivatives Association (ISDA), a trade association that mainly represents major investment banks.

The transaction in its totality can appear highly complex, and the terminology used in CDS contracts is specific to credit derivatives. The language of insurance is deliberately avoided and replaced by financial derivative terms such as “reference instrument” (the debtor that is the subject of the CDS) or “reference obligation” (an instrument or security that is the subject of the CDS) and “credit support” (collateral, basically).

## Potts Opinion: Credit Derivatives Are Not Insurance

The attitude of finance professionals towards CDS reveals a paradox. On the one hand, most experts are of the opinion that the transactions are economically equivalent to insurance. On the other hand, the size of the CDS market, and the nature of the participants, suggest that no one is worried about the possibility that CDS transactions might be construed as insurance contracts in law.

As such, the fact that something is called insurance in finance has limited relevance in law, but in this case matters turn out to be more complicated. So far, the matter has never been explicitly discussed in case law, nor has it been settled by way of legislation in the UK. In fact, there hardly exists any case law related to CDS contracts. In the absence of legal authority, one must look to expert opinion for guidance.

The most famous argument to the effect that credit derivatives do not legally constitute insurance is known as the “Potts opinion”. Sponsored by ISDA, Mr Robin Potts QC wrote in 1997 an opinion which concluded that credit derivatives should not be characterised as contracts of insurance, because they are structured to pay out on the occurrence of a default or other credit event, irrespective of whether the buyer suffers a loss.<sup>12</sup>

At common law, writes Potts, an insurance policy is defined as “a contract to indemnify the insured in respect of some interest which he has against the perils which he

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<sup>12</sup> Opinion prepared for the ISDA by Robin Potts QC, Erskine Chambers, 24 June 1997. See for example, A. Kimball-Stanley, “Insurance and Credit Default Swaps: Should Like Things Be Treated Alike?”, (2008) 15 *Connecticut Insurance Law Journal* 241, pp. 246-247; P. C. Harding, *A Practical Guide to the 2003 ISDA Credit Derivatives Definitions* (Euromoney Books, 2004), p. 19. Unfortunately, the original full opinion does not seem to be available to the public.

contemplates it will be liable to.”<sup>13</sup> In consequence, “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.”<sup>14</sup>

Potts admitted that the economic effect of some credit derivative transactions might be similar to the economic effect of an insurance contract, but went on to argue that the mere economic consequences of a contract are not likely to be determinative. He further recommended that the ISDA documentation include a clause stating that the parties do not intend to enter into an insurance contract.<sup>15</sup>

Other arguments to same effect essentially repeat the Potts opinion or explicitly rely on it.<sup>16</sup> The view that CDSs are not insurance is also implied by the Law Commission in a 2008 paper on the doctrine of insurable interest.<sup>17</sup> However, the Law Commission merely assumes the distinction and cites the Potts opinion at length although not without criticism, which will be discussed shortly.<sup>18</sup>

The importance of the Potts opinion cannot be underestimated. In the words of an anonymous ISDA representative, without the Potts opinion “there would have been no market at all [because] a bank cannot sell insurance”.<sup>19</sup> In a 2006 letter to the Law Commission, ISDA Senior Policy

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<sup>13</sup> Opinion prepared for the ISDA by Robin Potts QC, Erskine Chambers, 24 June 1997, para 5, citing *Wilson v. Jones*, (1867) 2 Exch. Div. 150; cited in A. Kimball-Stanley, “Insurance and Credit Default Swaps: Should Like Things Be Treated Alike?” (above), p. 247.

<sup>14</sup> Opinion prepared for the ISDA by Robin Potts QC, Erskine Chambers, 24 June 1997, para 5; cited in English and Scottish Law Commissions, *Insurance Contract Law: Issues Paper 4: Insurable Interest*, 14 January 2008, para 7.12.

<sup>15</sup> See P. C. Harding, *A Practical Guide to the 2003 ISDA Credit Derivatives Definitions* (Euromoney Books, 2004), p. 19

<sup>16</sup> See D. Benton, P. Devine and P. Jarvis, “Credit derivatives are not insurance products”, (1997) 16 *International Financial Law Review* 29; M. Ross and C. Davies, “Credit Derivatives and Insurance – a World Apart?”, *International Securities Monthly*, March 2001; P. C. Harding, *A Practical Guide to the 2003 ISDA Credit Derivatives Definitions* (Euromoney Books, 2004), p. 18-19.

<sup>17</sup> English and Scottish Law Commissions, *Insurance Contract Law: Issues Paper 4: Insurable Interest* (14 January 2008), summary paras 1.20, 1.40; main text paras 7.3, 7.5.

<sup>18</sup> *Ibid.*, paras 7.10-7.15.

<sup>19</sup> I. Huault and H. Rainelli-Le Montagner, “Market Shaping as an Answer to Ambiguities: The Case of Credit Derivatives”, (2009) 30 *Organization Studies* 549-575, at 560.

Director Richard Metcalfe highlighted the “widespread acceptance of the so-called ‘Potts opinion’” which has come to represent “current market consensus”.<sup>20</sup>

## Critique

This section will challenge the universal validity of the Potts opinion. Three general points are worth noting. First, the Potts opinion may be famous, but in law, it is only a private opinion. Second, its widespread acceptance by CDS market participants is of no legal consequence. Third, the impartiality of the Potts opinion is suspect given that it was sponsored by ISDA, the leading advocate of the derivatives market and a representative of major investment banks. It turns out that the argument put forward by Mr Potts is, at best, inconclusive.

### *CDSs Often Provide Loss Protection*

A glance at the broader insurance law literature supports the sceptical view of the FSA and casts doubts on the universal validity of the Potts opinion. There is no strict definition of insurance in English law, because it is feared that a definition might inadvertently exclude contracts which should be within the scope of insurance law.<sup>21</sup> The courts have therefore followed a range of different concepts, and scholars have offered their own definitions that seek to summarise the case law. This definitions clearly seem to apply to some CDS transactions.

The three broad requirements of insurance are payment, uncertainty and interest.<sup>22</sup> The notion of “interest” raises some difficulties, which are discussed later, but what seems to be required is some form of *adverseness*. According to MacGillivray: “A contract of insurance is one whereby one party promises in return for a money consideration to pay to the other party a sum of money or provide him with some corresponding benefit, upon the occurrence of one or more

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<sup>20</sup> Letter from Richard Metcalfe, International Swaps and Derivatives Association, to the Law Commission, in response to *Insurance Contract Law: A Joint Scoping Paper (January 2006)*, 18 April 2006, available from [www.isda.org](http://www.isda.org).

<sup>21</sup> M. A. Clarke, *The Law of Insurance Contracts*, 4th edn (London: LLP Professional Publishing, 2002), p. 1.

<sup>22</sup> English and Scottish Law Commissions, *Insurance Contract Law: Issues Paper 4: Insurable Interest*, 14 January 2008, para 7.19. See for example the frequently cited case *Prudential Insurance v. Inland Revenue Commissioners* [1904] 2 KB 658.

specified events.”<sup>23</sup> Furthermore, a specified event “must be of a character more or less adverse to the interest of the person effecting the insurance.”<sup>24</sup>

In practice, the vagueness of the concept of insurance means that the courts have substantial discretion in determining whether a particular contract is one of insurance. Their findings may sometimes be surprising, as insurance law has been applied to numerous cases which an ordinary person would not necessarily have thought involved insurance. As an example, in the *St Christopher Motorists’* case, a motorists’ association “undertook to provide its members with chauffeur services should they be disqualified from driving due to being convicted of having more than the permitted level of alcohol in the blood”.<sup>25</sup> It was held that this constituted insurance.

The difficulty of clearly delineating the boundaries of insurance law has prompted the FSA to provide some guidance.<sup>26</sup> That guidance is not conclusive and it does not explicitly discuss the issue of credit derivatives, but it includes many points that challenge the Potts opinion. On the one hand, the FSA gives negative guidance in terms of contracts that are unlikely to be insurance contracts; none of those examples are applicable to CDS transactions.<sup>27</sup>

On the other hand, in terms of positive guidance, the FSA highlights the importance of the “assumption of risk” as a descriptive feature of all contracts of insurance, and notes that a contract is most likely to be regarded as insurance if it requires the provide to assume a pure risk (a

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<sup>23</sup> N. Leigh-Jones, J. Birds and D. Owen, *MacGillivray on Insurance Law*, 10<sup>th</sup> edn (London: Sweet & Maxwell, 2003), para 1-1.

<sup>24</sup> *Ibid.*, para 1-5. Malcolm Clarke writes: “An insurance contract is commonly described as a contract whereby a person usually but not always in business as such, agrees to pay money (or provide a corresponding benefit) on the occurrence of an uncertain and adverse event, in return for a money consideration.” He notes that *an adverse event* is a more extended notion than the requirement of insurable interest: “If the insured has an insurable interest in the subject matter of the insurance, the event will indeed be adverse to him, but the reverse is not true.” M. A. Clarke with J. M. Burling and R. L. Purves, *The Law of Insurance Contracts*, 4th edn (London: LLP Professional Publishing, 2002), paras 1-1 and 1-1E. See similarly E. R. H. Ivamy, *General Principles of Insurance Law* (London, Dublin and Edinburgh: Butterworths, 1993), pp. 3-4.

<sup>25</sup> J. Birds, *Modern Insurance Law* (London: Sweet & Maxwell, 1982), p. 9, referring to *Department of Trade and Industry v. St. Christopher Motorists’ Association Ltd.* [1974] 1 All E.R. 395.

<sup>26</sup> See Financial Services Authority, *The identification of contracts of insurance*, Policy Statement 04/19, July 2004.

<sup>27</sup> “In summary, these are (1) contracts under which the provider has an absolute discretion as to whether any benefit is provided on the occurrence of the uncertain event; (2) contracts which appear to be pre-payment for services to be rendered in response to a future contingency, (3) periodic maintenance contracts where the service is carried out regardless of the occurrence of an uncertain or adverse event; and (4) contracts under which in consideration for an initial payment the provider stands ready to provide services on the occurrence of a future contingency provided that those services are charged for at a commercial rate.” Summarised by English and Scottish Law Commissions, *Insurance Contract Law: Issues Paper 4: Insurable Interest*, 14 January 2008, para 7.16, footnote 10.

risk of loss) rather than a specific risk (a risk carrying the possibility of either profit or loss).<sup>28</sup> Now, CDS transactions precisely transfer the credit risk to the protection seller, and the credit events as defined in CDSs are always downside risks in terms of reference entity value.

It is difficult to avoid the conclusion that at least some CDS transactions fall squarely within the ordinary definitions of insurance. The term “protection buyer” implies protection *against some adverse event*, so that, *prima facie*, the general purpose of a CDS transaction is to provide against loss in the value of the reference entity.

The conclusion is especially clear in the case securitisation transactions in which a bank buys CDSs to lay off loans it has originated.<sup>29</sup> Especially if the original loans are non-transferable, it is conceptually impossible for the credit event to happen without the protection buyer suffering a loss.<sup>30</sup> But the conclusion may hold for all covered CDSs, i.e. where the CDS buyer is in fact exposed to the reference asset. Further, the credit event payment calculation (whether based on physical or cash settlement) may be seen as implying indemnification for a loss, if the payment amount is directly linked to the loss of value of the reference asset.

### *Loss Indemnification Is Not a Necessary Feature of Insurance*

It may be argued against the foregoing that the conclusion does not follow when there is no reference to loss indemnification in the CDS contract. It may also be said that insurance law surely cannot apply to so-called “naked” CDSs, i.e. ones in which the buyer is merely seeking to profit from the default of the reference entity.

These are important considerations, but their relevance is limited. For one thing, explicit reference to loss may be unnecessary, because the adverseness of the credit event is a factual question; and it may be in the interest of one party so supply relevant proofs of the purpose of the transaction.

More fundamentally, contrary to the Potts opinion, loss indemnification is not a necessary feature of insurance. Law Commission explicitly notes that, *pace* Mr Potts, *non-indemnity* insurance contracts “do not require the policyholder to have suffered a loss”.<sup>31</sup> The typical example

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<sup>28</sup> As summarised in English and Scottish Law Commissions, *Insurance Contract Law: Issues Paper 4: Insurable Interest*, 14 January 2008, para 7.16.

<sup>29</sup> On CDSs and securitisation, see R. Ayadi and P. Behr, “On the necessity to regulate credit derivative markets”, (2009) *Journal of Banking Regulation* 179-201, at 181-183.

<sup>30</sup> See similarly Financial Services Authority, *Cross-sector risk transfers*, Discussion Paper DP 11, May 2002, Annex B, p. 2.

<sup>31</sup> English and Scottish Law Commissions, *Insurance Contract Law: Issues Paper 4: Insurable Interest*, 14 January 2008, para 7.14. See also J. Jakeways, “The Legal Nature of Credit Derivatives”, in A. Hudson (ed.), *Credit*

of non-indemnity insurance is life insurance, but non-indemnity insurance is also possible for property. These are “valued policies that pay out a set amount on the destruction of the property or other specified event without regard to the amount lost”.<sup>32</sup>

The Law Commission thinks that credit derivatives most resemble non-indemnity insurance.<sup>33</sup> That may not always be so, because many CDSs are structured more like indemnity insurance, as has been explained earlier. In any case, the possibility of non-indemnity insurance on property challenges one of the starting points in the Potts opinion.

Omission of this fact by Potts and others is understandable, because non-indemnity insurance is relatively uncommon in other areas than life, personal accident and critical illness insurance. One possible reason for this is that other types of non-indemnity insurance contracts would, prior to the Gambling Act 2005, have had to show insurable interest to be distinguished from gambling; but there continue to be significant uncertainties regarding the application of the insurable interest requirement to non-life, non-indemnity insurance.<sup>34</sup>

### *Insurable Interest Is an Additional Requirement*

Another major assumption of the Potts opinion is that insurance is characterised by insurable interest (i.e. a sufficient economic and legal connection between the insured and the subject matter of the insurance). And credit derivatives are not insurance, because insurable interest is not required. This is a misunderstanding.

The general opinion is that insurable interest is a necessary requirement of a valid insurance contract. Ivamy writes: “Every contract of insurance requires an insurable interest to support it; otherwise, it is invalid.”<sup>35</sup> Clarke expresses some criticism of the traditional doctrine, but is nevertheless forced to say that “an insurance contract made in the absence of insurable interest is void.”<sup>36</sup> The FSA has also noted that insurable interest “is a requirement for a *valid* contract of insurance and not itself a defining feature of the contract”.<sup>37</sup>

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*Derivatives: Law, Regulation and Accounting Issues* (London: Sweet & Maxwell, 2000), pp. 47-63, at 54-55; Financial Services Authority, *Cross-sector risk transfers*, Discussion Paper DP 11, May 2002, Annex B, p. 2.

<sup>32</sup> *Ibid.*, para 3.64. In other words, non-indemnity insurance “pays a lump sum on the occurrence of a defined event, regardless of the amount of loss suffered by the policyholder”: para 5.1, footnote 1.

<sup>33</sup> *Ibid.*, paras 7.9 and 7.14.

<sup>34</sup> See *ibid.*, paras 3.64-3.68.

<sup>35</sup> E. R. H. Ivamy, *General Principles of Insurance Law* (London, Dublin and Edinburgh: Butterworths, 1993), p. 23.

<sup>36</sup> M. Clarke, *Policies and Perceptions of Insurance: An Introduction to Insurance Law* (Oxford: Clarendon Press, 1997), p. 20.

A standard explanation for the doctrine of insurable interest is that it reduces the risk of contracts that tempt the insured to bring about the loss insured against.<sup>38</sup> It is hard to say how significant the problem is, especially in the context of financial markets, but as recent criticism of the CDS market shows, this concern is not entirely irrelevant.<sup>39</sup>

The requirement of insurable interest is imposed by law, not by the parties themselves. When the protection buyer has no insurable interest, the contract does not thereby become a non-insurance contract, but an invalid insurance contract. The immediate consequence would seem to be that all “naked” CDS contracts are invalid insurance contracts. However, it turns out that the matter is more complicated, and this is probably the cause of greatest uncertainty if insurance law principles are applied to CDS transactions.

If a CDS transaction is classified as non-indemnity insurance, then the requirements of insurable interest are especially unclear, as was said earlier. Alternatively, some CDSs may be seen as indemnity insurance, because most CDSs are structured to compensate for the loss of value of the reference asset. The transaction is often drafted so as to avoid any reference to loss, but both physical and cash settlement procedures in fact rely on loss of value. Moreover, sometimes the purpose of the transaction clearly has been to indemnify against loss, for example when a bank enters into a CDS deal to lay off risks related to loans it has originated.

In common law, indemnity insurance is governed by the *indemnity principle*, which means that the insured can only recover what they have lost. This principle is either an implied or an actual term of the contract.<sup>40</sup> The indemnity principle guarantees that the insured has some interest in the subject matter, but “this interest is not the same as the strict insurable interest required by statute.”<sup>41</sup> At least until 1 September 2007, when the Gambling Act 2005 became effective,

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<sup>37</sup> Financial Services Authority, *The identification of contracts of insurance*, Policy Statement 04/19, July 2004, para 2.10. See also Financial Services Authority, *Cross-sector risk transfers*, Discussion Paper DP 11, May 2002, Annex B, p. 1: “For a contract of insurance to be valid, there must be an insurable interest, i.e. the insured must be able to show both an economic and a legal connection with the subject matter of the risk. In some credit default swaps it will be possible to show that the protection buyer has such an interest. However in, for example, a speculative swap, where the protection buyer has no connection with the reference entity the protection buyer is unlikely to have an insurable interest.”

<sup>38</sup> M. Clarke, *Policies and Perceptions of Insurance: An Introduction to Insurance Law* (Oxford: Clarendon Press, 1997), p. 21.

<sup>39</sup> On thinks, for example, of the widespread accusations during the 2010 Greek debt crisis that hedge funds and the “financial mafia” were seeking to destroy the euro by attacking vulnerable member states. I take here no position on the accuracy of those accusations.

<sup>40</sup> *Ibid.*, paras 5.4-5.10.

<sup>41</sup> *Ibid.*, para 1.16.

indemnity insurance contracts also had to satisfy the requirement of insurable interest, for otherwise they would probably have been construed as illegal wagers and therefore null and void.<sup>42</sup>

What those requirements of insurable interest were is not entirely clear; the only certain thing is that the courts have lately tended to apply broader definitions. According to the Law Commission, insurable interest in indemnity insurance would have existed if the insured had legal or equitable title to the subject matter, or was in possession of the subject matter, or “may be either responsible for, or suffer loss in the event of, any damage to the subject matter”.<sup>43</sup> Note, further, that it was only necessary to have an insurable interest *at the time of the loss*, not at the time of making the contract.<sup>44</sup>

There are many uncertainties in applying these principles to CDS transactions, especially for contracts entered into before 1 September 2007. After that date, the indemnity principle alone is relevant. The argument can be made that naked shorting with CDS is still invalid, because the indemnity principle requires the insured to have sustained a loss.

In conclusion, there are many uncertainties and open questions regarding the application of the requirement of insurable interest to those CDS transactions which in substance fall within ordinary definitions of insurance. What is clear is that insurable interest is not part of the definition of insurance, but an additional requirement of valid insurance. The Law Commission has proposed that the doctrine of insurable interest be abolished, as has been done in Australia. It remains to be seen what comes of those proposals, but they will not affect contracts entered into earlier.

### *What Matters is Substance, Not Form*

It may be argued that CDSs nevertheless cannot be construed as insurance, because the language of insurance is not used, the parties may have explicitly stated that they do not intend to enter into an insurance transaction, and mere economic consequences are not determinative. These are once more relevant points, but insufficient.

It should be emphasised that what matters is the substance, not the form, of the agreement. English courts are famous for looking at the substance of the contract as a whole; how the parties have chosen to describe the contract will be of little persuasive force. Therefore, *pace* Mr

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<sup>42</sup> *Ibid.*, para 5.22. There were, however, some exceptions to the prohibition of wagers also before the Gambling Act 2005.

<sup>43</sup> *Ibid.*, para 5.18.

<sup>44</sup> *Ibid.*, para 5.20.

Potts, “no intention to insure” clauses are not conclusive: what matters is evidence of real intention.<sup>45</sup>

The famous case of *Fuji v. Aetna* is especially interesting in this respect.<sup>46</sup> That case concerned the legal nature of a single premium capital investment bond, which was used as a form of life insurance. At first instance the court ruled that the contract was not insurance, because the connection was not close enough: there was uncertainty about when the money would become payable and it did not chiefly depend on the length of the insured life.<sup>47</sup> However, the Court of Appeals decided that the single premium capital investment bond was a form of life insurance.<sup>48</sup> The decision was based on a broad definition of life insurance, the essence of which is that “the right to benefits is related to life or death”.<sup>49</sup> The case illustrates the fact that the courts have the power to interpret the nature of the contract differently from what the parties expressed.

The essentially insurance substance of many CDS deals becomes clear when one considers so-called transformer structures, which are sometimes used to transform a credit derivative into an insurance contract.<sup>50</sup> In a typical transaction, a transformer company would first write the original CDS and an authorised insurer would then insure the transformer company by way of traditional credit insurance. What is more, the latter insurance contract might incorporate the terms of the derivative agreement “back to back”, thus reducing basis risk.<sup>51</sup>

The use of transformers reveals the paradox of claiming that CDSs can never be treated as insurance contracts. The consequence of such a claim is that two contracts, which in substance are exactly equal, are allegedly governed by entirely different legal rules. The result is offensive to common law legal principles.

Note that the argument is not that the two transactions have similar economic consequences; it is that they are similar in legal substance. A farmer may enter into a commodity futures agreement for hedging purposes, but there is no suggestion that the futures contract is an insurance contract. With a CDS, the case is different. A CDS is a promise to pay a sum of money on the happening of a specified event in return for the agreed consideration, which takes the form of periodic payments. In other words, a CDS is an assumption of a credit risk by the protection seller in

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<sup>45</sup> See Financial Services Authority, *Cross-sector risk transfers*, Discussion Paper DP 11, May 2002, Annex B, p. 2.

<sup>46</sup> See English and Scottish Law Commissions, *Insurance Contract Law: Issues Paper 4: Insurable Interest*, 14 January 2008, para 7.25, footnote 21.

<sup>47</sup> *Fuji Finance Inc. v. Aetna Life Insurance Co. Ltd* [1994] 4 All ER 1025.

<sup>48</sup> *Fuji Finance Inc. v. Aetna Life Insurance Co. Ltd* [1996] 4 All ER 608.

<sup>49</sup> *Ibid.*, at 618.

<sup>50</sup> See Financial Services Authority, *Cross-sector risk transfers*, Discussion Paper DP 11, May 2002, paras 3.107, 3.116; Annex A; and Annex B, p. 3-4. Also M. Ross and C. Davies, “Credit Derivatives and Insurance – a World Apart?”, *International Securities Monthly*, March 2001.

<sup>51</sup> Financial Services Authority, *Cross-sector risk transfers*, Discussion Paper DP 11, May 2002, Annex B, p. 3.

return for periodic consideration by the protection buyer, and that, in substance, is an insurance transaction.

## Other Jurisdictions

The foregoing analysis may apply to other jurisdictions too, but there are also likely to be differences. Certainly in the US and Australia, there are important differences which are considered briefly.

### *United States*

New York is the main jurisdictional competitor to London for the global CDS market. The present position of US law on CDSs is now somewhat clearer due to specific legislation, but there are also ambiguities, and the legislative history itself raises questions.

Insurance law in the US has largely inherited the English common law tradition, but in terms of legislation, all states have their own laws, although in practice there is significant coordination among the legislatures. In New York, insurance statutes and regulations do not specifically state whether or not CDSs are included within the definition of insurance. The New York State Insurance Department (NYSID) has, to be sure, stated in 2000, that CDS transactions are not insurance contracts.<sup>52</sup> However, that opinion has now been reversed by NYSID Superintendent Eric Dinallo, in whose view “covered” CDSs are insurance and the 2000 opinion was incomplete, because it only discussed naked CDSs and had been given in response to “a very carefully crafted question” that did not cover the CDS market as a whole.<sup>53</sup>

Since the market turmoil that started in 2007, the CDS question has received widespread attention. On 22 September 2008, the NYSID issued a Circular Letter in which New York Governor David Paterson stated that “the making of the CDS itself may constitute ‘the doing of an insurance business’ within the meaning of Insurance Law § 1101”, and expressed the intention of the state to start regulating “covered swaps” as insurance as of January 2009.<sup>54</sup> However, on 20

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<sup>52</sup> See Opinion of the Office of General Counsel of the NYSID (OGC), June 16, 2000 (unnumbered); discussed in L. Campbell and R. Choi, “State Initiatives To Regulate Credit Default Swaps Deferred Pending Federal Action”, *Metropolitan Corporate Counsel*, September 2009, 20-21, at 20.

<sup>53</sup> Testimony by Eric Dinallo to the United States Senate Committee on Agriculture, Nutrition, and Forestry, October 14, 2008, p. 5.

<sup>54</sup> D. A. Paterson, “Best practices” for financial guaranty insurers, Circular Letter No. 19 (2008), September 22, 2008, p. 7.

November 2008, the NYSID announced that it would “delay indefinitely its application of New York Insurance Law” to CSDs pending federal action.<sup>55</sup> The Circular Letter also promised that the Office of General Counsel would rectify the incomplete 2000 opinion, but a new opinion has not been published.<sup>56</sup>

A more significant step was taken by the National Conference of Insurance Legislators (NCOIL), which in May 2009 published its draft Credit Default Insurance Model Legislation.<sup>57</sup> Among other things, the Model Legislation stipulated that (1) covered CDSs (those whose buyers have a material interest in the reference entity) would be regulated as “credit default insurance”, and its providers would be subject to regulation by state insurance regulators as “credit default insurance corporations”; and (2) naked CDSs would be banned entirely. In April 2009, New York State introduced a similar bill, seeking to regulate credit default swaps as financial guaranty products under New York Insurance Law and ban naked CDSs.<sup>58</sup>

At the same time, there were different federal initiatives.<sup>59</sup> One proposal was to grant the CFTC regulatory authority of OTC derivatives, including CDSs; alternatively, SEC Chairman Christopher Cox asked for the power to regulate CDSs. Most of the federal proposals, however, focused on forcing all credit derivatives to be traded on an exchange or cleared through regulated central counterparties. The original proposals did not address the question of CDS and insurance. Nevertheless, effective lobbying during the legislative process succeeded in adding a provision to the final version of the Wall Street Reform and Consumer Protection Act 2010 (Dodd-Frank Act), which expressly states that CDSs shall not be considered insurance and may not be regulated as insurance under state insurance laws.<sup>60</sup>

It seems that the Dodd-Frank Act therefore settles the matter in the US, creating a specific set of regulations for the CDS market and pre-empting CDS regulation as insurance. However, the effect of the federal pre-emption may be ambiguous, as insurance law is still in principle a state matter.<sup>61</sup>

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<sup>55</sup> L. Campbell and R. Choi, “State Initiatives To Regulate Credit Default Swaps Deferred Pending Federal Action”, *Metropolitan Corporate Counsel*, September 2009, 20-21, at 20.

<sup>56</sup> D. A. Paterson, “Best practices” for financial guaranty insurers, Circular Letter No. 19 (2008), September 22, 2008, p. 7.

<sup>57</sup> Available at <http://www.ncoil.org/docs/cdsmodelact.pdf>. For a commentary, see *The National Conference of Insurance Legislators’ Model CDS Bill*, Davis Polk & Wardwell, June 3, 2009.

<sup>58</sup> See N.Y. Assem. A10783, 233<sup>rd</sup> Sess. (N.Y. 2010).

<sup>59</sup> See L. Campbell and R. Choi, “State Initiatives To Regulate Credit Default Swaps Deferred Pending Federal Action”, *Metropolitan Corporate Counsel*, September 2009, 20-21, at 21, footnote 22.

<sup>60</sup> Dodd-Frank Act, Title VII, Subtitle A, Part II, § 722(b) and Subtitle B, § 767.

<sup>61</sup> Leah Campbell writes: “With the enactment of the Dodd-Frank Act, states have the opportunity to closely review the adequacy and sufficiency of Federal regulation of CSDs and determine whether state laws should be amended to exclude Covered Swaps from insurance regulation or take other actions to protect and regulate

## Australia

Australia is an interesting case to consider briefly, not only because of its importance in the Asia-Pacific region, but especially because of its differing approach to insurance law. Australia follows the common law tradition, but it now has a single insurance law statute, which in important respects differs from English law.

The Insurance Contracts Act 1984 does not provide a general definition of insurance, but refers to what “would ordinarily be regarded as a contract of insurance”.<sup>62</sup> Importantly, Australia abolished the doctrine of insurable interest for general (non-life) insurance in 1984 and for life insurance in 1995.<sup>63</sup> Thus section 16 of the Act states: “A contract of general insurance is not void by reason only that the insured did not have, at the time when the contract was entered into, an interest in the subject-matter of the contract.” Section 17 further adds that legal or equitable interest is not required at the time of loss.<sup>64</sup>

The precise implications of these provisions would require more detailed study, but the *prima facie* consequence is that CDS transactions are more likely to be construed as insurance in Australian law than elsewhere: as the requirement of interest is dropped, only the other two basic requirements – payment in return for the assumption of risk by another, and uncertainty – need to be satisfied.

That means that, on the one hand, CDSs are more likely to be characterised as insurance, but on the other hand, they are less likely to be found invalid for lack of insurable interest. Note, however, that the protection seller would still have to be an authorised insurer. Moreover, as far as naked CDSs are concerned, there remains the question of how the indemnity principle should be applied if the contract is construed as one of indemnity insurance.

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the CDS market.” L. Campbell, *Insurance Industry Implications of the Dodd-Frank Act*, Client Memorandum, Willkie Farr & Gallagher LLP, August 26, 2010, p. 16.

<sup>62</sup> Section 10(1) of the Insurance Contracts Act 1984.

<sup>63</sup> See sections 16 and 18 of the Insurance Contracts Act 1984, and the Life Insurance (Consequential Amendments and Repeals) Act 1995; discussed in English and Scottish Law Commissions, *Insurance Contract Law: Issues Paper 4: Insurable Interest*, 14 January 2008, paras A.2-A.12 and A.28.

<sup>64</sup> “Where the insured under a contract of general insurance has suffered a pecuniary or economic loss by reason that property the subject-matter of the contract has been damaged or destroyed, the insurer is not relieved of liability under the contract by reason only that, at the time of the loss, the insured did not have an interest at law or in equity in the property.”

## Conclusion

Credit default swaps are important products that have lately attracted significant attention due to their alleged role in the global financial crisis. Surprisingly little attention, however, has been given to the possibility that CDS transactions might, at least in some cases, be interpreted as (potentially invalid) insurance contracts. The majority of commentators have followed the Potts opinion, which states that CDSs are not insurance, because they do not require the buyer to sustain a loss or to have an insurable interest in the subject matter.

Closer investigation shows that the Potts opinion is inconclusive. First, CDSs often do provide protection against loss that the buyer is exposed to, and in those cases it is practically impossible to distinguish the substance of the transaction from insurance. Second, loss indemnity is not a necessary characterisation of an insurance contract, because there is also non-indemnity insurance on property. Third, insurable interest does not form part of the definition of insurance, but is an additional requirement of valid insurance. Finally, the avoidance of the language of insurance is not determinative; what matters is the substance of the agreement.

The finding that CDSs might, at least in some cases, be construed as insurance contracts has problematic consequences and reveals significant uncertainty in the current law. It does not mean that insurance law is necessarily the best way to regulate credit derivatives, although some features such as reserves regulation may be necessary for the stable and reliable functioning of the CDS market. It is therefore hoped that this issue would attract more careful discussion and legal clarification.