ISDA

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
United States of America
Telephone: 1 (212) 901-6000
Facsimile: 1 (212) 901-6001
email: isda@isda.org
website: www.isda.org

February 23, 2004

Ernst N. Csiszar, President
National Association of Insurance Commissioners
Director of Insurance, State of South Carolina
300 Arbor Lake Drive
Suite 1200
Columbia, South Carolina 29223

Robert Esson
Senior Manager, Global Insurance Markets
International Insurers Department
National Association of Insurance Commissioners
2301 McGee Street
Suite 800
Kansas City, MO 64108-2662

Comment on the Draft White Paper entitled "Weather Financial Instruments (Temperature): Insurance or Capital Markets Products?"

Dear Gentlemen,

I am writing on behalf of the International Swaps and Derivatives Association, Inc. ("ISDA"). ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business which includes, among other things, interest rate, currency, commodity, credit, equity and weather derivatives. ISDA was chartered in 1985, and today numbers over 600 member institutions from 46 countries on six continents. These members include most of the world's major institutions that deal in, and leading end-users of, privately negotiated derivatives, as well as associated service providers and consultants. Since its inception, ISDA has pioneered efforts to provide standard documentation for derivatives in order to reduce the sources of risk in derivatives and risk management business. ISDA has also taken an active role in promoting sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

As mentioned in Joshua Cohn's letter of January 6, 2004, ISDA is extremely concerned about the draft "white paper" being circulated by an NAIC working group entitled "Weather Financial Instruments (Temperature): Insurance or Capital Markets Products?" (the "Draft White Paper"). We are grateful for the opportunity to provide our comments on the Draft White Paper and to share our viewpoint on the important issues raised therein.

We will make the following two major points in our discussion below: (1) weather derivatives are not insurance and (2) the weather derivatives market needs no additional regulation. We will also emphasize that the weather derivatives market should be viewed as a welcome adjunct to the substantially federally supported crop and flood insurance businesses.

I. Executive Summary

ISDA urges the NAIC to reject the Draft White Paper.

Weather derivatives are very different from insurance. Weather derivatives do not require a party to have an insurable interest and do not provide loss indemnification. Insurable interest and loss indemnification are key elements in common definitions of insurance found in statutes, judicial discussions and treatises. Weather insurance policies, as distinct from derivatives, exhibit these key elements of insurance.

The weather derivatives market has not exhibited misconduct or any other circumstance that would demonstrate a need for consumer protection regulation. Congress, in providing an array of exclusions and exemptions for many derivatives (including weather derivatives) from commodities and securities regulation, has stated a policy of promoting growth in the derivatives markets free of the risk of unwarranted regulation.

The derivative markets, including the weather derivatives markets, have enormous economic utility. They provide highly flexible risk transfer, risk trading and hedging mechanisms that have an independent place in our economic system. Some of these derivatives markets, including the weather derivatives markets, are also enormously useful to and supportive of the insurance industry.

The Draft White Paper would sweep away customary definitions of insurance, but provide no replacement criteria to distinguish insurance from the many other varieties of risk management contracts. The Draft White Paper's logic could extend to a broad array of derivatives and would create substantial and disruptive regulatory uncertainty.

II. Discussion

1. Weather Derivatives are not Insurance.

A. Weather Derivatives Lack Key Features of Insurance: Insurable Interest and Loss Indemnification

That weather derivatives are not insurance is made plain in a variety of authoritative sources. *Couch on Insurance*[1], a leading insurance treatise, defines insurance as "a contract by which one party (the insurer), for a consideration that usually is paid in money ... promises to make a certain payment ... upon the destruction or injury to something in which the other party (the insured) has an interest."[2] For purposes of this discussion, the pivotal element of this definition is the requirement that insurance cover an insurable interest of the insured. An insurance contract is a type of indemnity, compensating the insured for loss or damage to something in which the insured has an interest.[3]

In contrast, weather derivatives are simply contracts with contingent payment obligations. Weather derivatives contracts (both exchange-traded as well as privately negotiated variants) do not require that either party actually suffer a loss[4] or have an insurable interest in the underlying subject matter of the transaction[5] in order to collect payment. As a result, even parties with no exposure to weather-related risks, and consequently no potential for demonstrating a weather-related loss, may enter into weather derivatives transactions. The absence of the fundamental elements of insurable interest and loss irrevocably distinguish weather derivatives from insurance contracts.

The New York State Department of Insurance has opined consistently with this view. In early 2000, the Office of the General Counsel for the Department ("OGC") was asked to consider the case for classifying weather derivatives as insurance under the New York statutory definition of insurance. In an opinion letter analyzing this question, the OGC looked to the statutory definition[6] and found that weather derivatives lacked the fundamental requirements of loss and payment proportional to loss, and consequently were not insurance.[7] Simply put, weather derivatives are not insurance under New York law because, under a weather derivative contract, a payment to a purchaser is not dependent on that party suffering a loss.

Notably, New York does not stand alone. The statutory definitions of insurance in many other states share New York's inclusion of loss as a requisite element for identifying insurance

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[1] 1 COUCH ON INSURANCE 8 (3rd ed. 2003 (updated)) (hereinafter "Couch on Ins").

[2] Id.

[3] See 12-256 APPLEMAN ON INSURANCE LAW & PRACTICE §7001 (1st Ed. 2002) ("Indemnity has been considered an essential element of a contract of insurance, so that a contract which does not possess this element has been held not one of insurance."); 1-1 HOLMES APPLEMAN ON INSURANCE (2nd ed. 2002) (hereinafter "Holmes on Insurance") ("A contract of insurance is a contract to indemnify the person secured thereby.").

[4] Weather derivatives may be divided into the two categories of exchange-traded contracts and privately negotiated contracts. Exchange-traded weather derivatives are offered on the Chicago Mercantile Exchange in the form of weather futures contracts and options on weather futures contracts. Details of the terms of these contracts may be found at <www.cme.com>. Privately negotiated weather derivatives, on the other hand, are agreements that may be documented under a master agreement such as the ISDA 2002 Master Agreement as published by ISDA and available at <www.isda.org> using a confirmation such as the ISDA Weather Swap Confirmation also available at <www.isda.org>. In both the exchange-traded and privately negotiated cases, payment under the weather derivative contracts are based on the occurrence of weather-related events, no proof of loss is required.

[5] That is to say that neither the exchange-traded contracts nor the privately negotiated weather confirmation require that either party have exposure to weather-related risks. See note 4, *supra*.

[6] The New York Insurance Law Section 1101(a) defines an "insurance contract" as:

> any agreement or other transaction whereby one party, the "insurer", is obligated to confer benefit of pecuniary value upon another party, the "insured" or "beneficiary", dependent upon the happening of a fortuitous event in which the insured or beneficiary 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.

[7] New York State Department of Insurance opinion letter dated February 15, 2000.

contracts. Statutes in California[8], Connecticut[9], Indiana[10], Kentucky[11], Nebraska[12] and North Carolina[13] all describe as a fundamental element of insurance, the requirement that the insurer must indemnify the insured against loss suffered by the insured. In jurisdictions without statutory definitions of insurance, courts have similarly found the elements of insurable interest and loss to be fundamental to a common law conception of insurance.[14]

Despite the foregoing, the Draft White Paper seems to suggest that any contract that treats risk is an insurance contract, regardless of whether an insurable interest or loss is required. In so doing, the Draft White Paper ignores numerous types of risk-oriented contracts (including those dealing with financial and commodity risk) that have existed for centuries without being classified as insurance.

Although the Draft White Paper purports to rely on the NAIC White Paper on the Definition of Insurance (the "NAIC Definition Paper") for the proposition that "risk alone is enough"[15], the NAIC Definition Paper does not support this proposition. In fact, the very same paragraph of the NAIC Definition Paper that the Draft White Paper cites for the proposition that "risk alone is enough" makes it quite clear that the promise by one party to pay premium to the other for indemnification from loss is "the bargain that is the basis of the insurance contract."[16] Overall, the NAIC Definition Paper recognizes the need for an insurable interest and indemnification from loss as consistent elements in state statutory and case law definitions of insurance.[17] Furthermore, the NAIC Definition Paper offers "common factors" to help begin an analysis of whether a contract is insurance. Those factors include (a) "the transfer [from the insured to the

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[8] Cal Ins. Code Section 22 ("Insurance is a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event.").

[9] Conn. Gen. Stat. Section 38a-1(10) ("'Insurance' means any agreement to pay a sum of money, provide services or any other thing of value on the happening of a particular event or contingency or to provide indemnity for loss in respect to a specified subject by specified perils in return for a consideration. In any contract of insurance, an insured shall have an interest which is subject to a risk of loss through destruction or impairment of that interest, which risk is assumed by the insurer and such assumption shall be part of a general scheme to distribute losses among a large group of persons bearing similar risks in return for a ratable contribution or other consideration.").

[10] Ind. Code Section 27-1-2-3(a) ("'Insurance' means a contract of insurance or an agreement by which one (1) party, for a consideration, promises to pay money or its equivalent or to do an act valuable to the insured upon the destruction, loss or injury of something in which the other party has a pecuniary interest, or in consideration of a price paid, adequate to the risk, becomes a security to the other against loss by certain specified risks; to grant indemnity or security against loss for a consideration.").

[11] Ky. Rev. Stat. Ann. Section 304.1-030 ("'Insurance' is a contract whereby one undertakes to pay or indemnify another as to loss from certain specified contingencies or perils called 'risks,' or to pay or grant a specified amount or determinable benefit or annuity in connection with ascertainable risk contingencies, or to act as surety.").

[12] Neb. Rev. Stat. Ann. Section 304.1-030 (Insurance "shall mean a contract whereby one party, called the insurer, for a consideration, undertakes to pay money or its equivalent or to do an act valuable to another party, called the insured, or to his or her beneficiary, upon the happening of the hazard or peril insured against whereby the party insured or his or her beneficiary suffers loss or injury.").

[13] N.C. Gen Stat. Section 58-1-10 ("A contract of insurance is an agreement by which the insurer is bound to pay money or its equivalent or to do some act of value to the insured upon, and as an indemnity or reimbursement for the destruction, loss, or injury of something in which the other party has an interest.").

[14] See *e.g.*, Griffin Systems Inc. v. Washburn, 505 N.E.2d 1121 (Ill. App. Ct. 1987). (In the absence of a statutory definition of insurance, the court turned to common law and found "that insurance can be characterized as involving: (1) a contract or agreement between an insurer and an insured ... (2) *an insurable interest (usually property) possessed by the insured*; (3) consideration in the form of a premium paid by the insured to the insurer; and (4) the assumption of risk by the insurer whereby *the insurer agrees to indemnify the insured* for potential pecuniary loss to the insured's property resulting from certain specified perils."(emphasis added). 505 N.E. 2d at 1123-24).

[15] White Paper at 3-4.

[16] NAIC Definition Paper at 4.

[17] Id.

insurer] of the burden of loss from exposure to one or more identified risks" and "an acceptance of the risk by the insurer, accompanied by the obligation to indemnify, defend or provide some other form of benefit to offset that risk."[18] In other words, there must be an insurable interest and indemnification from loss.

B. Insurance Products Continue to Rely on the Features of Insurable Interest and Loss Indemnification

The Draft White Paper attempts the further argument that the insurance industry has developed products that have abandoned the traditional requirement that the insured demonstrate actual loss. As a result, the Draft White Paper contends these so-called "valued at" policies are virtually indistinguishable from weather derivatives. As one example of these policies, the Draft White Paper highlights group risk crop insurance under the Federal Crop Insurance Act[19] (the "FCIA"). Group risk crop insurance, however, is vastly different from weather derivatives.

The Federal Crop Insurance Corporation ("FCIC") (the entity established under the FCIA to administer the federal crop insurance program) has developed group risk insurance in an effort to reduce costs associated with demonstrating actual loss. The FCIC's approach to affordable weather-related crop protection employs a proxy for crop damage rather than requiring each policyholder to certify losses. Nevertheless, examination of the policy requirements for insurance under the FCIA makes plain that these contracts have not abandoned the requirements of insurable interest and loss.[20]

In June of 1999, the FCIC promulgated final regulations establishing the Group Risk Plan of Insurance ("GRP").[21] Under GRP, farmers (or others with "crop ownership interests"[22]) have the option of purchasing coverage for their crops under a policy where the indemnity is based on countywide production shortfall averages and not individual farm performance. GRP insurance, however, is restricted to only those crops planted in the reference county. Policyholders in the GRP program are required to certify that their crops have been planted on the acreage under coverage before a specified cut-off date, guaranteeing that the requirement of insurable interest is maintained. Policyholders are also required to maintain "good farming practices" as required by Section 508(a)(3)(c) of the FCIA.

In this light, it is clear that GRP coverage is not simply a federally subsidized analog to a weather derivative. GRP policies retain strict requirements for insurable interest that in turn establish the suitability of countywide average loss as a highly effective proxy for individual damages. The requirements of insurable interest and loss are preserved.

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[18] Id. at 5.

[19] 7 U.S.C. 1506

[20] Were the White Paper correct that these requirements had been abandoned, the better analysis would be that GRP contracts are actually not insurance.

[21] See "Group Risk Plan of Insurance", 64 Federal Register 108 (June 7, 1999)

[22] 7 C.F.R. Section 407.8 (1999).

We are not aware of any weather insurance policy outside of the GRP example that does not require the insured to demonstrate an insurable interest and suffer a loss before coverage is triggered.[23] Insurable interest and loss remain touchstones of insurance. These touchstones of insurance are not elements of weather derivatives. Weather derivatives are not insurance.

2. The Weather Derivatives Markets Need No Additional Regulation.

The weather derivatives markets, to the best of our knowledge, have been operating free from scandal. We know of no facts, nor are any stated in the Draft White Paper, that would justify insinuations in the Draft White Paper that the weather derivatives markets require regulation by insurance regulators. In fact, weather derivatives are offered in two settings, one that is regulated and the other that has been encouraged by Congress to grow without a regulatory burden.

The Market for Weather Derivatives Products

Some weather derivative contracts are available on futures exchanges. These contracts are standardized and are freely available to buyers and sellers without regard to insurable interest or proof of loss. Based on a market survey conducted by the Weather Risk Management Association[24] ("WRMA"), over half of all weather derivatives transactions in 2002-2003 were weather future contracts or options on weather future contracts traded on the Chicago Mercantile Exchange.[25]

Privately negotiated weather derivatives contracts are also available to buyers and sellers without regard to insurable interest and loss. Unlike weather insurance products, privately negotiated weather derivative contracts are typically bilateral and reciprocal. Both parties to a weather derivatives transaction generally have the same basic rights and obligations, including the rights to terminate the agreement or to assign the transaction to a third party.

Privately negotiated weather derivatives are often documented under standard ISDA documentation. This documentation allows for complete customization of transactional and credit terms. In other words, privately negotiated weather derivatives, unlike standardized insurance contracts, allow complete contractual freedom to the executing parties. Using such contracts, parties are able to utilize weather derivatives as investments or hedging tools.

Regulation of Weather Derivatives

Exchange-traded weather derivatives are, of course, subject to the jurisdiction of the Commodity Futures Trading Commission ("CFTC") under the Commodity Exchange Act (the "CEA"). In fact, under section 1a(4) of the CEA, the definition of commodity includes "all...interests in

[23] Insurable interest is generally established during the underwriting of an insurance contract. The process of underwriting involves an investigation that seeks, among other objectives, to verify the applicant's insurable interest and to assess the risk of loss. This is distinct from a weather derivatives contract where the parties will focus on each other's creditworthiness and ability to perform obligations under the contract, and not their insurable interests.

[24] See "WRMA's 2003 Annual Survey Finds Use of Weather Contracts Triples" (Press release dated June 5, 2003) (available at www.wrma.org).

[25] The Chicago Mercantile Exchange is the largest futures exchange in the United States and the second largest exchange in the world for the trading of futures and options on futures. The exchange moves approximately $1.8 billion in settlement payments daily and manages approximately $27 billion in collateral deposits. In 2002, weather derivatives contracts traded on the CME totaled 7,239 while privately negotiated contracts totaled 4,517. See WMRA 2003 Annual Survey, supra note 20.

which contracts for future delivery are ... dealt in." Accordingly, on the basis of the existence of the CME contracts alone, "weather" is a commodity.

Less than four years ago, Congress, in the Commodity Futures Modernization Act[26] ("CFMA"), created a series of exclusions and exemptions from potential jurisdiction under the Act for privately negotiated derivatives contracts that meet certain requirements. One requirement for several of those exclusions and exemptions is that a contract be based on an "excluded commodity." Under the CFMA, weather would qualify as an excluded commodity.[27]

The Draft White Paper's recommendation of regulation of weather derivatives as insurance is apparently based on a misguided concern over the alleged potential for abuse in the "unregulated" privately negotiated market.[28] This recommendation, however, ignores the Congressional view embodied in the CFMA that, for the most part, privately negotiated derivatives do not require regulation.

A central purpose of the CFMA was to provide "legal certainty" to qualifying privately negotiated derivatives.[29] That "certainty" was from lingering concern that jurisdiction under the Act might jeopardize the stability of contractual relationships and chill the development of the privately negotiated derivatives markets. The exclusionary and exemptive provisions of the CFMA make it clear that Congress believed that appropriate privately negotiated derivatives, including weather derivatives, should not be subject to potential regulation under the CEA.[30] Congress also provided that certain types of privately negotiated derivatives would be excluded from regulation as securities.[31] Given this Congressional effort on behalf of the privately negotiated derivatives markets, it would be most incongruous if state insurance regulators were to take a contrary course.

Weather Derivatives Contracts Complement and Support Weather Insurance.

For reasons we discuss both above and below, weather derivatives are not simply "disguised insurance" as the Draft White Paper would contend. In addition to the distinctions drawn thus far, we believe a further difference between derivatives and insurance should be highlighted. Simply stated, the insurance and derivatives industries have different models for mitigating risk. On the one hand, insurance generally functions by dispersing catastrophic risk across a broad array of policyholders. In contrast, derivatives reduce risk through trading -- matching counterparties with complementary and offsetting risk profiles.

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[26] P.L. 106-554 106th Cong. (December 21, 2000)

[27] CEA Section 1a(13)(iv).

[28] We assume that the White Paper is not suggesting that state insurance regulators usurp the authority of the CFTC and impose insurance regulation on exchange-traded weather derivatives.

[29] 146 Cong. Record S. 11896 ("This bill will bring much-needed .. legal certainty, clarification and reform to the regulation of futures, options and over-the-counter financial derivatives.")

[30] Under the current amended version of the CEA, for example, derivative transactions executed outside a trading facility, in an excluded commodity such as weather, that are privately negotiated between "eligible contract participants" are excluded from regulation. Contacts that do not qualify, of course, remain subject to potential CFTC jurisdiction.

[31] See CFMA Sections 301, 302 and 303 and note the specific reference to weather in new section 206A(a)(3) of GLBA.

Historically, weather insurance has offered protection against catastrophic weather events.[32] Insurers are able to provide protection against these events through collections of premia across a geographically and temporally disperse base of policyholders. In fact, because extreme weather events may affect a large geographical area (triggering widespread losses), a viable weather insurance model must rely on infrequent occurrences or substantial premia.[33]

In contrast, weather derivative contracts do not disperse risk across the base of participants but rather tend to match parties with offsetting risks. The risks dispersed, furthermore, are not necessarily catastrophic. Weather derivatives allow judicious business decision-making through risk transfer. Thus, for example, a beer manufacturer whose profits suffer when summers are cool may wish to purchase protection against unseasonably cold weather. On the other side of the market, a cold storage company may wish to hedge against high cooling bills resulting from an unusually hot summer. In the derivatives market, either through an exchange or private negotiation, these parties may directly or indirectly agree to cover each other's risks to a greater or lesser extent. Under any particular circumstance, a party profiting from the conditions (as the case may be for the hypothetical beer manufacturer during a hot summer) is willing to forgo some of its profit (in the form of payments to the other party) in exchange for protection were circumstances to change.

Seen in this light, weather derivatives serve as a helpful adjunct to weather insurance offerings. In cases where weather insurance might be prohibitive either due to the high likelihood or concentration of loss, weather derivatives offer a market-based means for participants to hedge their exposures. The very fact that government subsidization has been needed in the crop and flood insurance markets indicates the need for a complementary market offering additional, affordable and adjustable risk capacity. Equally importantly, weather derivatives can serve the insurance industry itself as an important outlet for dispersing weather risk beyond the typical insurer/reinsurer model.

3. The Draft White Paper Broadly Jeopardizes Regulatory Stability.

The "risk alone is enough" premise for insurance regulation offered in the Draft White Paper would not, on its face, apply to weather derivatives alone. In fact, acceptance of the premise would create regulatory uncertainty with respect to a variety of derivatives products, unsettling markets to no discernable positive effect.

The derivatives markets are important to the well-being of our economic system. They have been the subject of much study and legislative consideration. In the absence of some manifest public interest, their stability should not be threatened.[34]

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[32] See Anthony C. Gooch and Linda B. Klein, DOCUMENTATION FOR DERIVATIVES 756 (4th Ed. 2002) ("Insurers typically write protection for events over two or three standard deviations from the mean -- with a less than 1% chance of the risk of loss occurring.")

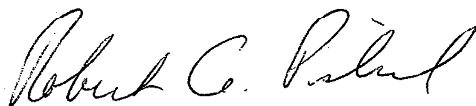
[33] In fact, government subsidy of weather insurance can be viewed as a response to this problem. The introduction of the Federal Crop Insurance Program and the Federal Flood Insurance Program guarantees that farmers and other individuals subject to weather-related risks may purchase insurance policies to protect them from damage to crops or property. These programs offer the public access to insurance where the free market might otherwise charge exorbitant rates or simply fail to provide coverage at all.

[34] Chairman Alan Greenspan, in a 2002 address, stated that derivatives "have especially contributed, particularly over the past couple of stressful years, to the development of a far more flexible, efficient, and resilient financial system than existed just a quarter-century ago." Remarks by Chairman Alan Greenspan before the Council on Foreign Relations, Washington D.C. November 19, 2002.

4. Conclusion

In sum, we disagree with the Draft White Paper's recommendation that weather derivatives be regulated as insurance. First, as we have shown in part 1 above, weather derivative contracts fail to satisfy commonly accepted definitions of insurance (including the NAIC's own definition of insurance) because they lack the requisite elements of insurable interest and loss. Second, the Draft White Paper's call for the extension of insurance regulation to the weather derivatives market ignores the orderly nature of the market and the careful limitation of regulatory jurisdiction imposed by Congress with passage of the CFMA. Finally, we believe that weather derivatives both benefit the economy by providing users an opportunity to protect themselves against risks for which insurance may be absent and benefit the weather insurance markets by providing additional complementary capacity available to insurers themselves. The weather derivatives market has demonstrated its potential to provide safe and efficient risk protection. We urge the NAIC not to stifle the development of this market (and chill other derivatives markets) and to reject the Draft White Paper's unwarranted proposal for new and burdensome regulation.

Sincerely,



Robert G. Pickel
Executive Directive and Chief Executive Officer