Chapter 7: REGULATORY ISSUES

The goal of this chapter is assist practitioners in determining how legal and regulatory risks can be best addressed and the importance of addressing these issues at the outset of program. Legal and regulatory systems vary across countries, making it impossible to have a one-size-fits-all approach to addressing these issues. There are important differences, particularly between countries with a common-law legal system versus a civil-law legal system. Furthermore, insurance markets in developing countries are at very different stages of development, and there are significant differences in regulatory and supervisory capacity. Given that laws, legal systems, regulatory systems, and frameworks differ, it is not possible to provide specific country advice without further study of each country. So instead, this chapter will consider legal and regulatory risks in general and the possible consequences of these risks.

7.1 LEGAL RISK

Since insurance by definition establishes the rules that govern the relationship between the parties to the contract (the contract between the insurer and insured) and any beneficiaries under the contract (the effect of the contract on third parties), this raises legal risks. Legal risk for an insurance contract has been described as "a failure in the legal framework, documentation or counterparty that results in the increased probability of risk and loss." Risks can be generic in nature or entity (contract) specific.[16]

Practitioners will primarily be concerned with generic legal risk, such as the risk that a contract does not fall within the legal definition of insurance or a contract does not adequately provide for an insurable interest (if needed in the country), resulting in a lack of enforceability. However, entity-specific (or contract-specific) risk may also be important. Entity-specific legal risks are those legal risks that relate, for example, to a party's capacity to contract or problems with the contract documentation. For example, the contract may adequately provide for insurance interest required in the country eliminating generic legal risk, but there remains a specific contract risk that a person who does not have an insurable interest purchases the insurance. Entity-specific risk may also be important if the project selects one or more specific insurance companies to participate in the pilot.

Legal risk can be difficult to mitigate. It is not possible to seek a declaration from the court as to the legal status of an index insurance contract in advance. Therefore, the principal way to reduce legal risk is by thoroughly analyzing local legislation and obtaining local legal advice. If the advice is to be worthwhile, it is imperative that the local legal adviser fully understands the legal issues involved, which may require additional briefing on index insurance generally and the legal issues common to index products. It is also important to carry this review out at the outset of the program so that any potential legal risks can be anticipated and potentially mitigated. While there are a variety of different potential challenges, such as a dispute over tax treatment, the most obvious legal challenge would be one brought by a policyholder who feels that a payout from the contract does not match the losses suffered. Unfortunately, even with a thorough legal review, the prospect of future adverse court decisions resulting in a legal challenge to an index insurance contract cannot be eliminated completely. Like a latent design defect in a building, legal risk can materialize many years after the product was first designed and fully implemented.

7.1.1 Legal Issues

Differences between common law and civil law legal frameworks. There are substantial differences between common-law and civil-law legal systems. Countries with a common-law system have a legal system based on the English system of law, derived in part from statutory law and in part from judicial decisions. In common law, jurisdiction-specific legislation on insurance contracts is still relatively uncommon, although legislation concerning contracts may apply (such as legislation on unfair contract terms). In the absence of specific legislation on insurance contracts in a

16 http://www.GlobalAgRisk.com.

country and without established local legal precedents, common-law principles will usually apply, and the courts will consider, and may apply, cases decided in other established common-law countries. This may result in some uncertainty as to the likely legal position. However, in the absence of specific insurance contracts legislation, there are less likely to be specific detailed requirements concerning the form of an insurance contract and the matters that must be included.

A civil-law system is one that has a codified set of laws, usually based on the European continental system of law. Civil-law countries will invariably have specific legislation on insurance contracts. The requirements on insurance contracts may be contained in the Civil Code, or an equivalent law (for example, Commercial Code), or it may be contained in separate insurance contracts legislation. Unfortunately, civil-law countries with a less developed insurance market may have laws that, although based on the laws of a more developed civil-law country, are much less sophisticated. In particular, the law may contain very specific requirements relating to the matters that must be covered in an insurance contract, without any exemptions. These may be inconsistent, or even incompatible, with index insurance. For example, insurance contracts legislation may prohibit an insured from receiving a payment under an insurance contract that exceeds the loss or damage that the insured has sustained.[17]

Insurable Interest. Insurable interest is a requirement in most countries for all types of insurance contract—both indemnity and nonindemnity contracts. The concept of insurable interest is complex, and the definition varies from country to country, including differences in the rules that apply to insurable interest under indemnity and nonindemnity insurance contracts. While no specific definition can be provided in general, insurable interest is defined as the need for the insured to possess the interest being covered. Defining an insurable interest is not as straightforward in an index insurance contract as it is in a traditional indemnity insurance contract, where the requirement to establish loss will usually also establish an insurable interest.[18]

Where the insurance law requires an insurable interest, a number of matters will need to be considered by practitioners, with the assistance of local legal advice:

- What is required for an insurable interest? Must the interest be financial or is the definition broader, including a wider economic interest?
- Are there special rules relating to insurable interest in the case of property, and if so, is the index insurance properly regarded as form of property insurance?
- When does the law require the insurable interest to be held? Under an indemnity contract, an insurable interest is always required to be held at the time of the loss, but in some countries an insurable interest is also required when the contract is entered into.
- Does the contract design adequately provide for insurable interest?
- Will any effort be taken to ensure that only persons with an insurable interest are able to purchase the contract, and if so, how will this be achieved?

Loss or Damage. Indemnity insurance is intended to precisely indemnify the insured for a particular insured loss. There is, therefore, a significant risk in both common-law and civil-law countries that, if the indemnity principle is not observed, an index contract would fall outside the definition of insurance. In many civil-law countries, the law contains very clear and inflexible wording that prohibits the insured recovering more than his actual loss. Given the nature of an index insurance contract, where the index can never be more than a proxy for loss, if there is an express provision such as this in the law, the legal risks associated with index insurance are significant.

For this reason, index insurance has often been categorized in the pilots as a special type of indemnity insurance contract, known as a valued policy. A valued policy is an insurance contract in which the parties agree in advance on the value to be placed on the insured property in the event of its total loss. In the event of a partial loss, the insured is entitled to recover that percentage of the total loss value that is equal to the percentage loss of the property insured. Not all civil-law countries in Europe permit valued policies[19] (although most do). There is a risk, therefore, that if a developing country has modeled its laws on a country that does not permit valued policies, this argument will not be permitted. However, even among those countries that permit valued policies, different rules may apply.

17 This is discussed in more detail later in this chapter.

18 The case studies suggest that all the pilot contracts were written as indemnity contracts (valued policies being a special form of indemnity insurance).

19 This summary of the law in different European countries is taken from Principles of European Insurance Contract Law. See http://www.sellier.de/pages/en/buecher_s_elp/europarecht/672.htm.

Other Legal Issues. Many other legal issues may arise in offering an index insurance contract, particularly in civil-law countries, where there may be less flexibility:

- Rights to cancel the contract on notice, for a partial return of the premium, which is clearly inappropriate for an index insurance contract
- A lack of clarity on the purchase of insurance by groups of farmers not organized as a legal entity, such as a cooperative
- A requirement for formal notice of claim to be submitted by the insured, which again is not appropriate for an index insurance contract where the knowledge is vested in the insurer

7.2 REGULATORY RISK

Regulatory issues relate to the regulation and supervision by an insurance regulator of entities that provide services in the insurance market. The insurance regulatory framework of a country will always cover insurers—those companies that offer and write direct insurance business in the market—and will usually cover certain insurance intermediaries such as insurance agents and brokers. In some countries, providers of other insurance-related services, such as loss adjusters, are also regulated and supervised.

Regulatory risk can be described as the risk that the implementation of the regulatory framework by the regulator, or future changes to the regulatory framework, will result in the product being categorized as other than insurance, or will have some other significant impact on the ability of the product to achieve its objectives. The principal regulatory risk is that a regulator, which may be the insurance regulator or another regulator, classifies a product designed as an index insurance contract as a noninsurance product. The alternative classification is most likely to be a derivative or a gaming contract. Some other likely regulatory issues will relate to how the product is sold (for example, additional market conduct requirements or limitations on delivery channels), which would add to the transaction cost.

Beyond these primary regulatory risks, other regulatory risks include the following:

- The index insurance product, although insurance, falling in a class of insurance business for which the insurer is not licensed or authorized
- Limits on the types of clients to whom the insurance can be sold
- Refusal of the regulator to permit certain delivery systems for the product
- Additional requirements on insurers providing index insurance, perhaps as to technical provisions or in respect of market conduct, which impose additional costs on the insurer

In some countries, regulatory approval is required for new insurance products. Although usually regarded as highly inconvenient for traditional products, a requirement for prior regulatory approval substantially mitigates the regulatory risk, as the most likely adverse consequence is simply that the product will not be approved. However, increasingly, regulators are moving toward a more principles-based system for regulating insurance and other financial services products. Rather than approving specific products, the regulatory framework sets out principles and rules. The regulator may provide additional guidance, but there is no product approval process. In this case, there is clearly a risk that the product is determined not to be insurance after it has been developed, marketed, and sold. This is much more serious, not just because significant costs will have been incurred in the product development process, but because it would throw into doubt the status of products sold. Furthermore, if the regulator subsequently determines that the products are derivatives or gaming contracts, there may be serious breaches of and possibly offenses against the investment business or gaming legislation. If the regulator has been fully engaged as the product develops, there is a reasonable likelihood that, even if this were the case, neither criminal nor regulatory enforcement action would be taken against the insurer.

Given that index insurance is still a new type of insurance product, dialogue with the regulator should be carried out from the beginning of the project. Even though the regulator may not be required to approve new insurance products, every effort should be made to ensure that the regulator understands the product and has considered all the relevant regulatory issues. Furthermore, the regulator might be able to provide an indication of any potential future changes to the regulatory framework. There is a tendency for regulators not to consider proposals for pilots with rigor since it is only a pilot. But proceeding with a pilot without a full regulatory review, even with the support of the regulator, does not reduce regulatory risk.

Of course, regulatory risk cannot be completely eliminated. International standards change, regulators may change their thinking regarding how to apply regulations, and the legislature, which has the ultimate control of the regulatory framework through primary legislation, may introduce or amend legislation that the regulator did not expect. In many countries, legislation at the level of regulations is under the control of the government, which may also make changes that are not expected by the regulator. Regardless, it is important to attempt to mitigate this risk as effectively as possible at the outset.

Regulatory areas to be considered by practitioners when starting a program include these:

- Contacting the appropriate person or persons at the regulatory authority
- Engaging any other necessary regulatory authorities (such as the securities regulator)
- Providing the regulator with a good understanding of the regulatory issues raised by the product
- Fairly and adequately discussing the project and possible problems with regulators
- Identifying any plans for future changes in the regulatory regime

7.2.1 Regulatory Issues

Given that index insurance is not specifically provided for in the regulatory framework of most countries, there are specific issues that practitioners will need to consider with the regulator. It may be appropriate for the regulator to impose special conditions on insurers to ensure that policyholders are adequately protected and that there is no contagion between index insurance and other lines written by the insurer in order to ensure that insurers continue to offer the insurance after a heavy loss.

Provisioning and reserving. The normal rules for technical liabilities, as they relate to general insurers, will almost certainly not be wholly appropriate for index insurance. In particular, the requirements for technical provisions that apply to traditional products will need to be adjusted. For all insurance, insurers are required to provision for unearned premiums. In the case of traditional insurance products, premium is released from unearned premium to earned premium in tranches over time as the risk expires. With a weather risk policy, the risk does not expire on a proportionate basis over time but rather remains until after the end of the insured period, so it is important that all premiums received are regarded as unearned until it is known whether payment is due under any policies. If payments are due, the appropriate amount of premium should be treated as a known claims provision, pending payment, the balance being treated as earned premium. In addition to provisioning, WII exposes insurers to catastrophic risk and adequate reinsurance coverage should be obtained (where the premium income is sufficient to justify it).

Practitioners should also consider whether it is appropriate for insurers participating in the program to be required to establish an equalization reserve to smooth gains and losses over time. Due to the covariate nature of the risk, the insurer is likely to experience a number of good years and less frequent bad years. If the underwriting gains in the good years are treated as profit, there is a possibility that insurers will be tempted to refuse to offer insurance the following year or, at worst, if the claims are sufficiently large, they will have an adverse effect on the insurer's solvency. It should be noted that international accounting standards do not permit an equalization reserve to be treated as a provision, but it may be established as a true reserve.

Delivery channels. Given that one of the principal objectives of index insurance is to reduce transactions cost, it is important that efficient delivery channels be used to sell the insurance. In many countries, this requires the use of alternative channels to individual agents, such as banks and MFIs acting as agents. The regulatory frameworks of some countries do not allow corporate agents; in others, banks may be restricted from acting as agent under the banking legislation. It may be necessary to press for the amendment or introduction of regulations to permit the use of alternative delivery channels.

7.3 CONCLUSION

The possible consequences of proceeding with an index insurance program in circumstances in which a full investigation of legal and regulatory risk, but in particular legal risk, has not been carried out could be significant. If an index contract is determined by a court to be illegal or unenforceable, not only could significant development costs be wasted, but the reputation of index insurance, and possibly traditional insurance, could be damaged. Clients who have entered into contracts and paid premiums could find themselves without enforceable rights. This could cause very serious consequences at an individual level, particularly if the client has taken action on the basis of the insurance, such as taking out a loan or planting additional crops. Introducing a product operating outside a country's regulatory framework could have similar consequences. Supporting an index insurance project that is determined to be legally flawed or not properly regulated could result in significant reputational damage to any group supporting these activities.

To date, limited attempts in pilot countries have been made to complete comprehensive legal and regulatory reviews when implementing pilots, despite the possible consequences. Donors and practitioners need to practice some caution regarding how pilots are advanced and perform careful legal and regulatory reviews with international and local expertise as a first step in a project design.