Request for Information on Climate-Related Financial Risk

Submission of the Centers for Better Insurance

CBI responds to the Commodity Futures Trading Commission's (CFTC) request for information appearing at 87 FR 34856 (June 8, 2022) which seeks to better inform the CFTC's understanding and oversight of climate related financial risk as pertinent to the derivatives markets and underlying commodities markets. These comments focus on the rapidly unfolding incursion into the CFTC's jurisdiction over swap transactions by climate-related event contracts mis-sold as "parametric insurance."

The Centers for Better Insurance, LLC (CBI) is an independent organization committed to enhancing the value the insurance industry delivers to all stakeholders (including policyholders, employees, and society at large). CBI does so by making available unbiased analysis and insights about key regulatory issues facing the industry for use by insurance professionals, regulators, and policymakers. Additional information regarding CBI is available on the web at www.betterins.org or by email request at info@betterins.org.

Executive Summary

Parametric contracts may ultimately mature into an effective tool to assist U.S. businesses, nonprofits, local governments, and even families to manage risks relating to climate change. Before this product set can be trusted to deliver on that promise, parametric contracts must first be securely grounded in an appropriate regulatory framework.

Parametric contracts are undoubtedly swaps within the jurisdiction of the CFTC. The regulatory safe harbor CFTC granted to traditional insurance products only extends to state-regulated insurance policies indemnifying the policyholder to the extent of an actual, proven loss. This exception to the CFTC's jurisdiction cannot reasonably stretch to encompass parametric contracts that promise a formulaic payout based on the parameters of an external event.

There is mounting evidence that Congress, state insurance regulators, consumers, and other stakeholders have embraced state regulation of parametric insurance contracts despite the clear jurisdictional mandate of the CFTC. For example, a bill currently pends before the U.S. House that would compel insurance companies to offer parametric pandemic insurance contracts regulated not by the CFTC but by state insurance regulators. Similarly, a recent federal Civil Innovation Grant awarded $1 million to pilot climate-related parametric insurance contracts provided to underserved communities in New York City.

Nothing prohibits an insurance company from offering parametric products so long as it complies with CFTC rules such as registration, data reporting, anti-money laundering protections, training and oversight of staff, and use registered brokers. In fact, compliant insurance companies and NFA registered insurance agents and brokers are well positioned to compete alongside other financial services sectors in a vibrant parametric contract market overseen by the CFTC.

The CFTC must either aggressively police its jurisdictional perimeter or expressly cede its authority over parametric contracts to insurance regulators. Until the CFTC speaks up, the potential for parametric contracts to contribute to the management of climate-related risk will profoundly underdeliver while consumers are marketed inefficient and legally dubious parametric insurance contracts.

The Nature of Parametric Insurance

The National Association of Insurance Commissioners (NAIC) defines parametric insurance as a form of non-indemnity insurance that pays out based on the parameters of an event rather than on the basis of the losses resulting from that event:[1]

> The term parametric insurance describes a type of insurance contract that insures a policyholder against the occurrence of a specific event by paying a set amount based on the magnitude of the event, as opposed to the magnitude of the losses in a traditional indemnity policy.

Parametric insurance is consistently described as "non-traditional" insurance.[2] Indeed, the Insurance Information Institute characterizes "[t]he parametric model [a]s an alternative to traditional insurance."[3] Insurance broker Marsh & McClennan describes parametric insurance by contrasting it with traditional insurance:[4]

> Parametric covers are alternative risk solutions provided by insurance and reinsurance companies that enable organizations to finance or to transfer risk in a non-traditional way.
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> Parametric covers are not intended to replace traditional insurance – but to complement them and speed up recovery.
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> Parametric covers can be especially useful when there is a lack of capacity or appetite from traditional insurance markets, especially for risks that are typically underinsured or uninsured or where the impact of the event is related to business interruption losses that are greater than the direct costs of the loss or damage of physical assets.

Under a parametric contract the trigger of a payout and the amount of that payout are determined by the **objective characteristics** (i.e., parameters) of a defined external event. In contrast, under an insurance contract the trigger of a payout and the amount of that payout are determined by the **insured's loss or liability** resulting from a defined external event.[5]

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[1] Parametric Disaster Insurance, NAIC, www.content.naic.org/cipr_topics/topic_parametric_disaster_insurance.htm

[2] See Written Testimony of Brian Kuhlmann on behalf of APCIA and NAMIC, Insuring Against a Pandemic: Challenges and Solutions for Policyholders and Insurers (Nov. 19, 2020) ("Unlike the traditional insurance claims adjustment process, the parametric trigger would provide payments automatically upon the occurrence of certain events."); Written Testimony of Joanna Syroka of Fermat Capital, Creating a Climate Resilient America: Strengthening the U.S. Financial System and Expanding Economic Opportunity (October 1, 2020) (referring to "the use of innovative risk transfer mechanisms such as parametric insurance and catastrophe bonds"); The Insurability of Business Interruption Risk in Light of Pandemics, EIOPA Staff Paper (2021) at page 10 (comparing "parametric solutions" with "classical indemnity-based solutions").

[3] 2021 Insurance Fact Book, Insurance Information Institute, at page 12.

[4] Parametric Insurance: A Tool to Increase Climate Resilience, Marsh Insights (Dec. 2018).

[5] *See, e.g., Mass. Stat. Ch. 175 § 2*. *See also* New York Office of General Counsel Opinion (Feb. 15, 2000) (explaining that because "[n]either the amount of the payment nor the trigger itself in the weather derivative bears a relationship to the purchasers loss ... the instrument is not an insurance contract"); IRS Memorandum 201511021 (3/13/15) (explaining that "insurance policies protect against damage or

CFTC's Jurisdiction over Parametric Contracts

A parametric contract falls squarely the CFTC's jurisdiction as a "swap" under Dodd-Frank.

7 U.S.C. 1a(47)(A)(ii) defines a swap to include any contract that provides for any payment that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event associated with a potential financial, economic, or commercial consequence.

7 U.S.C. 16(h) provides that a swap shall not be considered insurance and may not be regulated as an insurance contract under the law of any State.

The CFTC introduced a non-exclusive safe harbor exception to the statutory definition of "swap" for traditional, state-regulated insurance.[6] As detailed in the appendix, this regulatory exception applies to:

- Traditional insurance products; and
- Other products meeting both a product test and provider test.

The product test is satisfied if the contract requires, *inter alia*, that (a) the beneficiary has an insurable interest continuously throughout the duration of the contract; and (b) a loss must occur and be proved, and any payment is limited to the value of the insurable interest.

The provider test requires that the contract is provided by a person regulated by a state insurance commissioner and the contract is regulated as insurance under state law.

As made clear by the NAIC's definition, parametric insurance products cannot satisfy the insurance exception to the CFTC's jurisdiction. By definition, a parametric contract is:

- A non-traditional form of "insurance"; and
- Pays based on the parameters of an event rather than the amount of the contract holder's proven loss.

Similarly, most state insurance statutes define "insurance" as a contract of indemnity.[7]

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impairment to an asset or income from an asset caused by a casualty event"); FASB Standard 815 (excluding from treat as a "weather derivative" insurance contracts that "entitle the holder to compensation only if, as a result of an insured event, the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk").

[6] 17 CFR § 1.3.

[7] *See Definitions of Insurance and Related Information*, GAO-06-424R; and 15 U.S. Code § 6712(c) (regarding as insurance a product that "insures, guarantees, or indemnifies against liability, loss of life, loss of health, or loss through damage to or destruction of property").

State Legislative Incursion into CFTC Jurisdiction

In 2020, the NAIC formed the Climate and Resiliency (EX) Task Force to serve as the coordinating body for discussion and engagement on climate-related risk and resiliency issues including “evaluation of insurance product innovation directed at reducing, managing and mitigating climate risk, and closing protection gaps.” In addition, the NAIC’s Property and Casualty Insurance (C) Committee 2022 mandate includes:[8]

> Provide a forum for discussing issues related to parametric insurance and consider the development of a white paper or regulatory guidance.

The Committee and the NAIC’s of the Climate & Resilience Task Force have been holding regular hearings regarding parametric insurance including presentations from The Bermuda Monetary Authority, “Role of Parametric Insurance in Climate Resilience: Bermuda’s Supervisory Experience” and the Wharton Risk Management and Decision Processes Center. The NAIC has also been reviewing presentations from providers of parametric insurance products currently on offer to retail consumers in the United States.

The NAIC’s interest in this area has resulted in several of its member jurisdictions enacting insurance-based regulatory frameworks for parametric insurance. At least three jurisdictions have established statutory or regulatory provisions to treat parametric contracts as insurance:

- Vermont;[9]
- Tennessee; [10] and
- Puerto Rico.[11]

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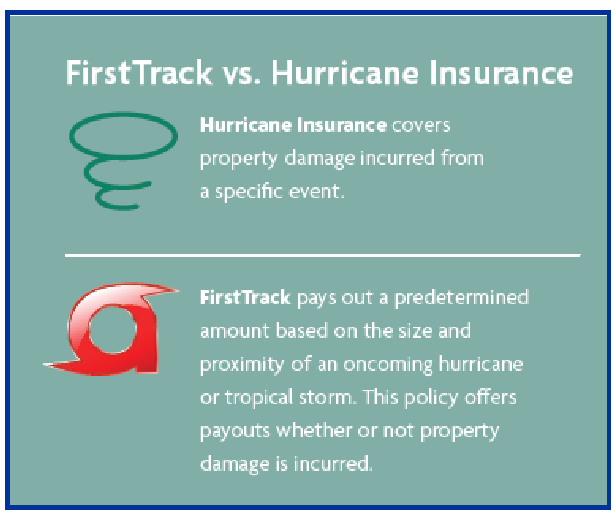
[8] https://content.naic.org/cmte_c.htm
[9] Vermont H.515 (2022).
[10] Tenn. Code Ann., § 56-13-102(19).
[11] Requirements for Submitting and Processing Parametric Catastrophic Microinsurance in Personal Lines. Rule 103, Sec. 4.c. (July 2, 2020).

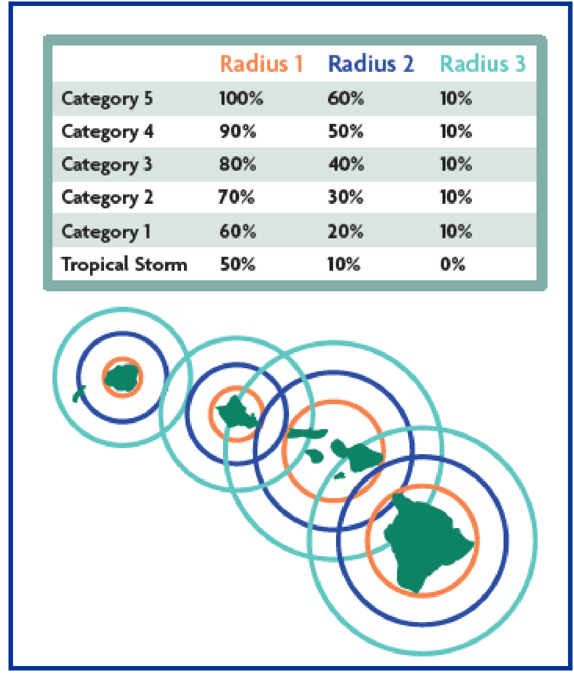
Examples of Parametric Insurance Contracts on Offer in the U.S.

More than three dozen parametric insurance products are currently available in the U.S., many of which target retail consumers and are associated with climate risks.

For example, FirstTrack is sold by a subsidiary of Tokio Marine Group. Marketing materials promise that this product "offers payouts whether or not property damage is incurred". In other words, this "insurance product" is a swap.



FirstTrack purchasers can elect to receive pre-set payments of up to $1000 to $25,000 based on the parameters of (a) the hurricane category; and (b) the distance the hurricane passes from a designated island. For example, if a customer had purchased a contract with a notional value of $10,000 and a Category 1 makes landfall within a designated geographical area, the contract would pay $6000.



	Radius 1	Radius 2	Radius 3
Category 5	100%	60%	10%
Category 4	90%	50%	10%
Category 3	80%	40%	10%
Category 2	70%	30%	10%
Category 1	60%	20%	10%
Tropical Storm	50%	10%	0%

The National Chiropractic Mutual Insurance Company offers a similar product through its subsidiary Professional Solutions Insurance Company. This product (marketed as Recoop Disaster Insurance) allows consumers to select a payout amount of up to $25,000:[12]

Recoop Overview

What is Recoop?

Recoop is the first and only multi-peril disaster insurance product that pays a lump-sum cash benefit (up to $25,000) after a natural disaster. Most homeowners insurance policies leave gaps in coverage, which is why we created Recoop — to pick up where insurance stops, so you can bounce back faster after a disaster.

What types of disasters are covered under Recoop?

Recoop covers these major natural disasters: hurricanes (with storm surge), wildfires, tornadoes, earthquakes, gas explosions, winter storms[1] and dust storms. Recoop does not cover landslides, tsunamis, fresh-water flooding, or hail regardless of cause.

[1] Winter storms and hazardous winter weather are covered when at least 5 inches or more of snow or sleet accumulate within a 12-hour period, or 7 inches or more of snow or sleet accumulate within a 24-hour period.

Once the parameters of the event trigger the payout, the consumer must provide evidence of only $1000 of loss to get the full contract amount. For example, if a customer purchased a contract with a $25,000 notional value and a disaster is declared because of a wildfire in the area of the customer's home, the contract holder would receive the full $25,000 upon providing proof of only $1000 of loss.

Recovery made easy.

You'll get the cash you need, when you need it, as long as you meet 3 basic requirements:

You must carry an **existing homeowners or renters insurance policy.**

Your home or apartment must be in a state or federally declared disaster area[1] and have **sustained damages of $1,000 or more.**

Damage must be a result of one of the following natural disasters: hurricane (with storm surge), earthquake, wildfire, tornado, gas explosion, winter storm[2], or dust storm.

National Chiropractic Mutual Insurance Company calculates that 38¢ of every premium dollar is eaten up in transaction costs including 25¢ of which is earmarked for insurance agents as sales commission.[13] By way of comparison, the transaction cost for a consumer to trade on the CFTC regulated event contract exchange Kalshi averages less than a tenth that amount at 3.5%.

[12] Recoop Disaster Insurance contract is even available for sale as an employee benefit.
[13] SERFF filing PERR-132316307.

Policymakers have become Confused about CFTC's Jurisdiction

There is strong evidence that policymakers become confused as to the remit of the CFTC over parametric contracts. For example, the Rep. Maloney introduced the Pandemic Risk Insurance Act of 2021 (H.R. 5823) which would require that "an insurer under this Act shall in addition make available, in all its commercial property insurance policies, parametric non-damage business interruption insurance coverage." Such a contract would be "triggered irrespective of physical status or condition of the insured physical location and without need for specific proof of loss." In other words, this Bill would require property and casualty insurers to sell swaps, state regulated insurance agents to intermediate those swaps, and state insurance regulators to regulate those swaps.

Similarly, the California Department of Insurance, Climate Insurance Working Group issued a report recommending the development of state regulated parametric contracts that would pay a predetermined amount in the event of a wildfire:[14]

> The Insurance Commissioner should consult with independent experts and the NAIC to develop concepts for parametric and community insurance pilot projects in multiple parts of the state. Such products should be used as models of insurance solutions for other risks, such as parametric drought protection or a risk transfer to protect against economic disruptions caused by strong snowstorms or high rainfall events. Specific examples of innovative insurance product concepts are detailed in the individual peril sections.

The National Science Foundation (together with the Department of Energy and Department of Homeland Security) recently awarded a $1 million Civil Innovation Grant to finance a joint effort of the Wharton Risk Center at the University of Pennsylvania, the New York City Mayor's Office of Resiliency, and the Center for New York City Neighborhoods (CNYCN) to sell parametric contracts as insurance to vulnerable communities in New York City:

> The key pilot will be the purchase, by CNYCN, of a parametric flood insurance policy designed to rapidly provide emergency cash grants to LMI [low and moderate income] households post-flood. In addition, R&D will be undertaken on parametric flood policies that community development finance institutions can provide to protect LMI borrowers.

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[14] Protecting Communities, Preserving Nature and Building Resiliency: How First-of-its-Kind Climate Insurance Will Help Combat the Costs of Wildfires, Extreme Heat, and Floods.

Implications of Mis-Selling Swaps as Insurance

The small businesses, nonprofits, local governments, and regular individuals that buy parametric "insurance" may think they are purchasing a "safe" insurance product - but they are actually speculating on a swap. These faux insurance transactions can and do end badly. For example, in 2016 the North Dakota Department of Insurance ordered State National's managing general agent to refund nearly $750,000 to farmers. The Department found:

> Specifically, the product was marketed and sold using materials which discussed yields, bushels and profits while the TWI product and its insurance contract were based on the occurrence of various weather metrics such as the temperature and rainfall at predetermined gathering stations. Yields, bushels and profits are not determining factors in considering whether an insured incurred loss under the terms of the TWI policy.
>
> At least 100 North Dakota farmers who purchased the TWI product had historically low yields and profits during the 2012 growing season and did not receive any payment from the TWI product.

Consumers are purchasing sophisticated swaps from retail insurance agents – when they should be dealing with properly licensed and trained Commodity Trading Advisors, Futures Commission Merchants, and Introducing Brokers. Moreover, swaps are being designed and financed by insurance companies – which is the proper role of licensed swap dealers.

The implications of this mislabeling and mis-selling include:

1. **Unregistered Distributors** - Parametric "insurance" contracts are distributed by insurance agents with no licensing, training, or experience in the distribution of swaps or oversight of the distribution of swaps.

2. **Ineffective Anti-Money Laundering Programs** - Property and casualty insurance is generally exempt from federal anti-money laundering and know your customer requirements such that parametric insurance contracts are sold without even basic KYC / AML controls.

3. **Inappropriate Tax Advantages** - Businesses are misled into believing the cost of parametric insurance contracts can be treated as a business expense, while individuals are misled into believing payouts are not reportable.

4. **Inadequate Consumer Recourse** - Purchasers are unable to apply to the CFTC or NFA for intervention and reparations for violations of the Commodities Exchange Act while any protection from state insurance guaranty funds is surely dubious.

5. **Unfair Competition** – CFTC event contract exchanges and insurers that structure parametric insurance contracts properly limiting payouts to actual, proven losses are at a competitive disadvantage to those insurance companies that mislabel and mis-sell swaps as insurance.

6. **Unchecked Sales to Retail Customers** - Retail customers of uncleared parametric insurance contracts purchase contracts that should be reserved only for eligible contract participants.

APPENDIX

The CFTC and Insurance: A Regulatory History

Prior to the 2008 financial crisis, the CFTC commenced a "comprehensive review" of the Commodity Exchange Act's applicability to "event, prediction, or information markets", collectively known as "event contracts."[15] The CFTC considered contracts "that generate trading prices that predictably correlate with market prices or broad-based measures of economic or commercial activity, or contracts which substantially replicate other commodity derivatives contracts, such as binary options on exchange rates or the price of crude oil" as "unambiguously subject to CFTC regulation."[16] In contrast, event contracts "are neither dependent on, nor do they necessarily relate to, market prices or broad-based measures of economic or commercial activity."[17]

The CFTC further explained that "event contracts may be based on eventualities and measures as varied as the world's population in the year 2050, the results of political elections, or the outcome of particular entertainment events."[18] The CFTC provided the following additional examples: the results of presidential elections, the accomplishment of certain scientific advances, world population levels, the adoption of particular pieces of legislation, the outcome of corporate product sales, the declaration of war and the length of celebrity marriages."[19]

At that time, the Commodity Exchange Act granted jurisdiction to the Commission to commodity options and commodity futures contracts.[20] The term "commodity" was (and still is) defined in two ways. First, the term commodity encompasses certain specified goods (e.g., wheat, cotton, rice). Second, the term commodity broadly includes "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."[21] The Commodity Exchange Act also included (and still includes) the concept of an "excluded commodity" which is defined in part as:[22]

- Any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or
- An occurrence, extent of an occurrence, or contingency that is beyond the control of the parties to the relevant contract, agreement, or transaction; and associated with a financial, commercial, or economic consequence.

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[15] 73 FR 25669.
[16] 73 FR 25669, footnote 2.
[17] 73 FR 25670.
[18] 73 FR 25669.
[19] 73 FR 25670.
[20] 7 USC §2(a)(1)(A) (2008).
[21] 7 USC §1a (4), recodified to 7 USC §1a (9). This prong of the definition would later exclude motion picture box office receipts.
[22] 7 USC §1a (13), recodified to 7 USC §1a (19).

Commissioner Quintenz described the breadth of the term “commodity” as:[23]

> The statutory definition of a commodity includes “…an occurrence, extent of an occurrence, or contingency…that is 1) beyond the control of the relevant parties to the contract…and 2) associated with a financial, commercial, or economic consequence.”[4] Since practically any event has at least a minimal financial, commercial, or economic consequence, all events are commodities. Because of this definition, any contract on the outcome of a future event would be considered a commodity futures contract, and, pursuant to the Commodity Exchange Act (CEA), is required to be traded on a registered Designated Contract Market (DCM).

In response to the 2008 financial crisis, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act “[t]o promote financial stability of the United States by improving accountability and transparency in the financial system.”[24]

Title VII of Dodd-Frank, also known as the Wall Street Transparency and Accountability Act of 2010, created a framework for the regulation of swap markets.[25] Dodd-Frank placed the CFTC at its center.[26]

7 U.S.C. 1a(47)(A)(ii) defines a “swap” broadly to include:

> Any agreement, contract, or transaction … that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence.

7 U.S.C. 16(h) provides that a swap:

> (1) shall not be considered to be insurance; and
>
> (2) may not be regulated as an insurance contract under the law of any State.

On August 20, 2010, the CFTC published an advance notice of proposed rulemaking seeking comments on further defining the term “swap.”

In response, the National Association of Insurance Commissioners (NAIC) raised concerns that the statutory definition of “swap” might swallow the state-regulated insurance industry:[27]

> Given the breadth of these definitions, we are concerned that they could theoretically encompass a multitude of insurance products that are regulated under state law. For example, insurance policies such as auto insurance, homeowner’s insurance, and life insurance all involve contracts that provide for payment of money that is "dependent on

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[23] Statement of Commissioner Brian D. Quintenz on ErisX RSBIX NFL Contracts and Certain Event Contracts (March 25, 2021).
[24] H.R. 4173 (111th Congress).
[25] 15 USC 8301, et seq.
[26] 7 USC §2(a)(1)(A).
[27] NAIC Comment Letter (Sept. 20, 2010) at page 2.

> the occurrence, non-occurrence or the extent of an event or contingency associated with a financial, economic or commercial consequence."

The NAIC requested the CFTC to "expressly exclude insurance products regulated by the states from the definitions of swap and security-based swap."

Similarly, the Property Casualty Insurers Association of America (PCI) sought an exclusion of state regulated insurance contracts from the definition of "swaps": [28]

> There is no logical reason for property casualty insurance contracts to be regulated as swaps and no evidence of any Congressional intent that state regulatory authority over insurance products be supplanted by federal regulation of swaps. We therefore propose that the CFTC clarify the definition of swaps to exclude agreements, contracts, and transactions of insurers that are a part of the business of insurance regulated by a state insurance regulator as of the enactment date of the DFA. For new financial products that are regulated by state insurance regulators as part of the business of insurance that were not regulated as insurance or swaps before the DFA, a rebuttable presumption of an exclusion that could be overcome by a formal CFTC finding would provide further clarity regarding regulatory jurisdiction.

The American Insurance Association (AIA) sought a wider declaration that swaps do not include insurance:[29]

> Accordingly, when further defining the term "swap" through regulation, we request that the SEC and the CFTC clearly state that a property-casualty insurance contract is not a swap and is not subject to Title VII.

The Reinsurance Association of America (RAA) sought a similar blanket exemption for insurance, pointing to the insurance principle of indemnification as the key differentiator: [30]

> Reinsurance transactions, unlike swaps, are contracts of indemnity, in which an assuming insurer (or reinsurer) in consideration of premium paid, agrees to indemnify the ceding company against all or part of the loss which the latter may sustain under the policy or policies which it has issued.

[28] PCI Comment Letter (Sept. 17, 2010) at page 1 (suggesting that for new forms of insurance "a rebuttable presumption of an exclusion that could be overcome by a formal CFTC finding would provide further clarity regarding regulatory jurisdiction").
[29] AIA Comment Letter (Sept. 20, 2010) at page 2.
[30] RAA Comment Letter (Sept. 20, 2010).

The law firm Cleary Gottlieb Steen & Hamilton LLP saw this same blurring between the respective jurisdictions of the CFTC and state insurance commissioners.[31] Rather than a blanket exemption, the firm proposed a test for the exemption of insurance products from the "swap" definition including criteria such as:

> [T]hat insured parties have an insurable interest in the insured property and are generally unable to obtain payment under a policy of insurance in the absence of, or in excess of, an actual loss to such property.

The American Council of Life Insurers (ACLI)[32] and Committee of Annuity Insurers[33] pushed back against these criteria proposing instead that the "swap" definition should exclude contracts that are:

- Issued by an insurance company regulated by state insurance regulators;
- An insurance contract as defined by state law; and
- Not of the kind the CFTC has affirmatively decided to regulate.

On May 23, 2011, the CFTC published a proposed rule including an expanded definition of the term "swap". The CFTC stated upfront that it "[does] not interpret [Dodd-Frank] to mean that products historically treated as insurance products should be included within the swap or security-based swap definition."[34] However, the CFTC expressed concern "that agreements, contracts, or transactions that are swaps or security-based swaps might be characterized as insurance products to evade the regulatory regime under Title VII of the Dodd-Frank Act."[35]

The CFTC proposed to exclude from the "swap" definition a contract that meets both a "product test" and a "provider test".

The Product Test

The CFTC's proposed product test included that:

- The beneficiary of the contract maintains an insurable interest throughout the duration of the contract; and
- A loss must occur and be proved and any payment under the contract must not exceed the beneficiary's insurable interest.

[31] Cleary Gottlieb Steen & Hamilton LLP Comment Letter (Sept. 21, 2010) at pages 2-4. The firm appeared to be interested in preventing credit default swaps from being treated as insurance.
[32] ACLI Comment Letter (Nov. 12, 2010).
[33] CAI Comment Letter (Dec. 3, 2010).
[34] 76 FR 29821.
[35] 76 FR 29822.

The CFTC saw the insurable interest requirement as a key differentiator from credit default swaps in which no underlying interest is required:[36]

> The requirement that the beneficiary be at risk of loss (which could be an adverse financial, economic, or commercial consequence) with respect to the interest that is the subject of the agreement, contract, or transaction at all times throughout the term of the agreement, contract, or transaction would ensure that an insurance contract beneficiary has a stake in the interest on which the agreement, contract, or transaction is written.

More broadly, the CFTC viewed the requirement to indemnify an actual loss as the key distinguishing characteristic between insurance and swaps:[37]

> [T]he requirement that an actual loss occur and be proved under the proposed rules similarly would ensure that the beneficiary has a stake in the insurable interest that is the subject of the agreement, contract, or transaction. If the beneficiary can demonstrate actual loss, that loss would ''trigger'' performance by the insurer on the agreement, contract, or transaction such that, by making payment, the insurer is indemnifying the beneficiary for such loss. In addition, limiting any payment or indemnification to the value of the insurable interest aids in distinguishing swaps and security-based swaps (where there is no such limit) from insurance.

The CFTC further proposed interpretive guidance that "traditional insurance products" provided by state regulated insurance companies and regulated as insurance would not be regarded as "swaps."[38] Specifically, the CFTC identified traditional insurance products as "surety bonds, life insurance, health insurance, long-term care insurance, title insurance, property and casualty insurance, and annuity products."

The Provider Test

The CFTC's proposed provider test included that the contract is provided by a company organized as an insurance company and subject to the supervision of a state insurance commissioner. Further, the contract itself must be regulated as insurance under state or federal law.

The CFTC explained the rationale behind the provider test:[39]

> The purpose of this proposed requirement is that an agreement, contract, or transaction that satisfies the other conditions of the proposed rules must be subject to regulatory

[36] 76 FR 29823.

[37] 76 FR 29823. This reasoning aligns with FASB 720-20-25-1 which provides "[t]o the extent that an insurance contract … does not, despite its form, provide for indemnification of the insured … by the insurer … against loss or liability, the premium paid … shall be accounted for as a deposit by the insured." See CFTC Letter 14-67 in which no-action relief is granted to reinsurance on the basis that the "coverage provided under the Reinsurance Agreement is either 100%, or some lesser percentage, of the actual … risk assumed [by the cedant]."

[38] 76 FR 29824.

[39] 76 FR 29824. The provider test includes the lawful reinsurance of a contract meeting the provider test even if the reinsurer does not itself meet the provider test because it is regulated outside of the United States.

oversight as an insurance product. As a result of the requirement that an insurance regulator must have determined that the agreement, contract, or transaction being sold is insurance (i.e., because state insurance regulators are banned from regulating swaps as insurance), the Commissions believe that this condition would help prevent products that are swaps or security-based swaps from being characterized as insurance products in order to evade the regulatory regime under Title VII of the Dodd-Frank Act.

Proposed Text of the Product and Provider Test

The CFTC proposed the following wording to reflect the relevant parts of the product and provider tests:

> (4) Insurance. The term swap … does not include an agreement, contract, or transaction that:
>
> (i) By its terms or by law, as a condition of performance on the agreement, contract, or transaction:
>
> (A) Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction; [and]
>
> (B) Requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest; [and]
>
> ***
>
> (ii) Is provided:
>
> (A) By a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the insurance commissioner (or similar official or agency) of any State or by the United States or an agency or instrumentality thereof, and such agreement, contract, or transaction is regulated as insurance under the laws of such State or of the United States;

The NAIC generally supported the CFTC's product and provider tests with certain reservations.[40]

First, the NAIC suggested elevating the list of traditional insurance products from interpretive guidance to the text of the rule itself. The NAIC also suggested adding to the list of traditional insurance products "mortgage guaranty, accident, and disability insurance."

Second, the NAIC expressed concern about the insurable interest requirement:

> With regard to the first prong, most insurance products do not require a person or entity to have an insurable interest continuously throughout the duration of the insurance policy or contract. For example, if a person wishes to procure insurance on the life of another person, then he or she only needs to have an insurable interest at the time that he or she procures the life insurance policy. With regard to insurance covering property damage, in many jurisdictions, a person only needs to have an insurable interest at the time of the loss. Indeed, an insurable interest is not even required for a liability, surety or accident and health insurance policy or contract.

The associations representing insurance companies took a range of positions.

The PCI applauded the two-prong (product and provider) test as "an effective means of helping to distinguish between those contracts that qualify for exclusion from the definition of swap and swap-related securities from those contracts that will not."[41]

In contrast, the AIA rejected the two prong-test in favor of near complete deference to state insurance regulators:[42]

> [W]e urge the Commissions to state unequivocally in the rule and the interpretive guidance that, where an agreement, contract or transaction is reportable as insurance in the provider's regulatory and financial reports under a state's (or a foreign jurisdiction's) insurance laws, then that agreement, contract or transaction constitutes an insurance product rather than a swap or a security-based swap.

The ACLI sought a middle solution through which products subject to state insurance regulation are presumed to be excluded from the definition of swaps.[43]

On August 13, 2012, the CFTC released its final rule defining "swap" for the purposes of Title VII.[44]

The Product Test

In adopting the final rule, the CFTC left the product test (including its requirements of an insurable interest and proof of loss) unchanged. However, the final rule included an alternative to the provider test for a

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[40] NAIC Comment Letter (July 22, 2011).
[41] PCI Comment Letter (July 22, 2011).
[42] AIA Comment Letter (July 22, 2011).
[43] ACLI Comment Letter (July 22, 2011). See also MetLife Comment Letter (July 22, 2011).
[44] 77 FR 48208.

product that is one of the "enumerated types of traditional insurance."[45] The enumerated list of traditional insurance includes "property and casualty insurance."

The CFTC equates the enumerated product list with traditional insurance products:[46]

> The Commissions believe that the Enumerated Products, as traditional insurance products, are not the types of agreements, contracts, or transactions that Congress intended to subject to the regulatory regime for swaps and security-based swaps under the Dodd-Frank Act. Codifying the Enumerated Products in the final rules appropriately places traditional insurance products outside the scope of the swap and security-based swap definition so long as such Enumerated Products are provided in accordance with the Provider Test, including a requirement that an Enumerated Product that is provided in accordance with the first prong of the Provider Test must be regulated as insurance under applicable state law or the laws of the United States.

The CFTC refers to the original product test for the evaluation of non-traditional products:[47]

> [The CFTC does] not believe it is appropriate to determine whether particular complex, novel or still evolving products are swaps or security-based swaps in the context of a general definitional rulemaking. Rather these products should be considered in a facts and circumstances analysis.

The Provider Test

The provider test remains a second hurdle to the insurance exclusion whether the original product test or the traditional insurance test is applied.[48] The CFTC expanded the provider test to include non-U.S. insurance companies that are eligible to provide insurance in the United States under state law.

The CFTC emphasized that the provider test retains the requirement that a product is "regulated as insurance" under applicable state law:[49]

> The Commissions have retained the requirement in the first prong of the Provider Test that an insurance product must be regulated as insurance, but have revised the provision to clarify that an insurance product must be regulated as insurance under applicable state law or the laws of the United States. As discussed above, the Commissions believe that this condition will help prevent products that are not regulated as insurance and are swaps or security-based swaps from being characterized as insurance products in order to evade the regulatory regime under the Dodd-Frank Act.

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[45] 77 FR 48213.
[46] 77 FR 48216.
[47] 77 FR 48218.
[48] 77 FR 48213.
[49] 77 FR 4822. The CFTC also noted that "[a]n agreement, contract, or transaction that is labeled as 'reinsurance' or 'retrocession' but is structured to evade Title VII of the Dodd-Frank Act, would not satisfy the Insurance Safe Harbor, and would be a swap or security-based swap." 77 FR 48213. See footnote 41 referencing potential mislabeling of a "weather derivative or catastrophe swap" as reinsurance.

In administering the definition of a "swap," the CFTC will look beyond self-serving characterizations of a product "to prevent evasion through clever draftsmanship of a form, label, or other written documentation."[50] The CFTC further warned:[51]

> [T]he structuring of instruments, transactions, or entities to evade the requirements of the Dodd-Frank Act may be ''limited only by the ingenuity of man.'' Therefore, the CFTC will look beyond manner in which an instrument, transaction, or entity is documented to examine its actual substance and purpose to prevent any evasion through clever draftsmanship— an approach consistent with the CFTC's case law in the context of determining whether a contract is a futures contract and the CFTC's interpretations in this release regarding swaps.

Text of the Final Rule

As compared to the proposed rule, the relevant text of the final rule is as follows:[52]

> (4) Insurance. (i) This paragraph is a non-exclusive safe harbor. The terms swap … and security-based swap … do~~es~~ not include an agreement, contract, or transaction that:
>
> (A~~i~~) By its terms or by law, as a condition of performance on the agreement, contract, or transaction:
>
> (1~~A~~) Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction; [and]
>
> (2~~B~~) Requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest; [and]
>
> ***
>
> (B~~ii~~) Is provided:
>
> (1~~A~~)(i) By a person ~~company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and~~ that is subject to supervision by the insurance commissioner (or similar official or agency) of any State or by the United States or an agency or instrumentality thereof~~,~~; and

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[50] 77 FR 48298.
[51] 77 FR 48300.
[52] 77 FR 48350.

(ii) such agreement, contract, or transaction is regulated as insurance under applicable State ~~the~~ laws ~~of such State~~ or the laws of the United States;

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(4) In the case of non-admitted insurance, by a person who:

(i) Is located outside of the United States and listed on the Quarterly Listing of Alien Insurers as maintained by the International Insurers Department of the National Association of Insurance Commissioners; or

(ii) Meets the eligibility criteria for non-admitted insurers under applicable State law; [or]

(C) Is provided in accordance with the conditions set forth in paragraph (xxx)(4)(i)(B) of this section and is one of the following types of products:

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(7) Property and casualty insurance;

Note on Exemption of Consumer and Commercial Agreements

The CFTC was concerned that the broad scope of the term “swap” could sweep in “various types of agreements, contracts, and transactions [consumers enter into] as part of their household and personal lives [and businesses enter into] as part of their operations relating to, among other things, acquisitions or sales of property (tangible and intangible), provisions of services, employment of individuals, and other matters.”[53] Accordingly, the CFTC developed guidance to exclude these contracts.

This guidance exempts the following consumer contracts entered into by individuals primarily for personal, family, or household purposes:[54]

- Transactions to acquire or lease real or personal property, to obtain a mortgage, to provide personal services, or to sell or assign rights owned by such consumer (such as intellectual property rights);
- Agreements, contracts, or transactions to purchase products or services at a fixed price or a capped or collared price, at a future date or over a certain time period (such as agreements to purchase home heating fuel);
- Agreements, contracts, or transactions that provide for an interest rate cap or lock on a consumer loan or mortgage, where the benefit of the rate cap or lock is realized only if the loan or mortgage is made to the consumer; and

[53] 76 FR 29832.
[54] 76 FR 29832-3.

- Consumer loans or mortgages with variable rates of interest or embedded interest rate options, including such loans with provisions for the rates to change upon certain events related to the consumer, such as a higher rate of interest following a default.
- This guidance exempts the following consumer contracts entered into by individuals primarily for personal, family, or household purposes:

The guidance also exempts customary business arrangements such as:[55]

- Employment contracts and retirement benefit arrangements;
- Sales, servicing, or distribution arrangements;
- Agreements, contracts, or transactions for the purpose of effecting a business combination transaction;
- The purchase, sale, lease, or transfer of real property, intellectual property, equipment, or inventory;
- Warehouse lending arrangements in connection with building an inventory of assets in anticipation of a securitization of such assets (such as in a securitization of mortgages, student loans, or receivables);
- Mortgage or mortgage purchase commitments, or sales of installment loan agreements or contracts or receivables;
- Fixed or variable interest rate commercial loans entered into by nonbanks; and
- Commercial agreements, contracts, and transactions (including, but not limited to, leases, service contracts, and employment agreements) containing escalation clauses linked to an underlying commodity such as an interest rate or consumer price index.

In developing these lists, the CFTC extracted the following common characteristics:[56]

- They do not contain payment obligations, whether or not contingent, that are severable from the agreement, contract, or transaction;
- They are not traded on an organized market or over-the-counter; and
- In the case of consumer arrangements, they involve an asset of which the consumer is the owner or beneficiary, or that the consumer is purchasing, or they involve a service provided, or to be provided, by or to the consumer, or
- In the case of commercial arrangements, they are entered into to serve an independent commercial, business, or non-profit purpose and other than for speculative, hedging, or investment purposes.

Two of the key components reflected in these characteristics that distinguish these agreements, contracts, and transactions from swaps and security based swaps are that: (i) The payment provisions of the arrangements are not severable; and (ii) the agreement, contract, or transaction is not traded on an organized market or over-the-counter— so that such arrangements would not involve risk-shifting arrangements with financial entities, as would be the case for swaps and security-based swaps.

[55] 76 FR 29833.
[56] 76 FR 29833.