

Banking and insurance contracts

Ian Fagelson makes a lawyer's comparison of banking and (re)insurance contracts.

Who are you?

I am a partner in the London office of international law firm Reed Smith Richards Butler. I handle a range of financial transactions including reinsurance/insurance as well as banking transactions.

Would you agree there are fundamental differences between insurance/reinsurance contracts and banking contracts?

Although there has been some convergence in recent years, significant differences remain.

Why is this the case and can you please highlight some of the key differences?

I'm glad you asked me that. Please read on...

Once upon a time there was a (fairly) clear dividing line between the kinds of transactions undertaken by banks and the kinds of transactions undertaken by insurers (and reinsurers). Bankers accepted deposits and made loans. Insurers (and reinsurers) charged premiums for assuming risks.

In recent times the dividing line has become blurred, and banks and insurers (reinsurers) are increasingly offering functionally similar solutions. For example, a bank may offer a derivative product that simulates the response of an insurance policy or a reinsurance contract. Banks and insurers may offer similar credit enhancement products.

However, banks and insurers/reinsurers are to some extent still playing different sports under different rules. There are a number of special rules that apply to insurance and reinsurance contracts but do not apply to banking contracts.

Insurable interest

Insurers are legally obliged not to carry on any commercial business other than insurance business and activities directly arising from that business, and pure reinsurers are legally obliged not to carry on any business other than the business of reinsurance and related operations.

Lawyers may argue about what that really means. However, as a practical matter, most insurers and reinsurers interpret this to mean that they can write only transactions that are properly characterised as insurance or reinsurance, which normally requires that the counterparty must have an insurable interest

in the underlying subject matter. Banks are not so constrained.

Utmost good faith

A banking contract is generally enforceable in accordance with its express terms. The bank will be bound to honour the written terms of its contract unless it can show that it was induced to enter into the contract by fraud or misrepresentation on the part of the counterparty.

Insurance (and reinsurance) contracts are different. They are regarded by the law as contracts of utmost good faith with the consequence that an insurer (or reinsurer) is entitled to avoid the contract if the (re)insured failed to disclose a material fact before the contract was entered into, even if the (re)insurer failed to ask about it.

This difference has a profound impact on the dynamics of contract negotiation. A prudent bank will want to ensure that the contract includes a full slate of representations. Traditionally, insurers (reinsurers) have taken a more relaxed approach, safe in the knowledge that they can rely on the insured/reinsured's duty of full disclosure to fill in the blanks.

Many a slip

This may be one reason why insurance and reinsurance transactions have often been concluded on very slim documentation (cover notes and slip contracts) compared to the complex, lengthy and detailed agreements favoured by banks.

However, sophisticated policyholders and ceding companies are increasingly uncomfortable with a rule that enables an underwriter to avoid liabilities on the ground of material non-disclosure in the absence of actual fraud or misrepresentation. Quite often, a contract is negotiated in which the (re)insurer's remedies for non-disclosure are specifically excluded.

In addition, the new regulatory environment in which contracts are required to express accurately the economic substance of the transaction, is encouraging insurers and reinsurers to transact business on the basis of detailed documents that increasingly resemble banking agreements.

Warranties

Banking contracts are written under 'ordinary' contract law. In ordinary contract law, a warranty is a contractual provision of relatively minor importance. Unless the contract expressly provides to the contrary, breach of a warranty by a bank's customer will entitle the bank to claim damages for losses caused by the breach but will not enable the bank to walk away from its contractual obligations.

In insurance law, a warranty is a provision of such fundamental importance that its breach by the policy-

holder/cedant automatically discharges the insurer/reinsurer from any further obligations to perform the contract with effect from the date of the breach (not *ab initio*). This is an automatic consequence, regardless of how small the breach or how insignificant its consequences.

As soon as the insured commits a breach of warranty, the insurer's obligations under the contract come to an end. The insurer continues to be liable for indemnity obligations that arose before the date of the breach and can retain the whole of the premium. However, where the warranty was broken at the very outset of the contract, for example a warranty as to existing facts contained in a proposal form that is subject to a 'basis of the contract clause', the effect is similar to avoidance *ab initio* – but the insurer can keep the premium. Indeed, it seems that even future instalments of premium can remain payable.

Quite often, and especially where insurance or reinsurance solutions are offered as capital markets products, a lot of time and effort is expended in negotiating contract language designed to ensure that the rights and obligations of the parties are spelled out in the contract so that the special insurance law rules about warranties do not apply.

Law reform

The English and Scottish Law Commissions are engaged in a project to examine and suggest possible reforms to insurance contract law. This may well result in legislation designed to remove some of the differences between insurance contract law and ordinary contract law. In the meantime, the market has to operate on the basis of the special rules of insurance contract law – modified as appropriate, by specific agreement between the parties on a case-by-case basis.

How can I find out more?

This article is one of a series promoted by the actuarial profession's Action Group for Banking (AGB) and explores situations where the actuarial and banking worlds overlap to the benefit of both sectors. The articles serve the following broad purposes:

- **Push:** to demonstrate where actuarial skills and thinking have been applied in a banking or financial context to add real commercial value.
- **Pull:** to highlight tools and skills available in banking and finance that may be of use to traditional life and pensions actuaries.

Please contact either the author or Mark Symons (mark.symons@actuaries.org.uk) for more information on the article and the AGB's activities.

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