Legal and Regulatory Framework to Facilitate Agricultural Insurance
Part 1 — Application to Dong Thap Project

Richard Carpenter

GlobalAgRisk INC.

FORD FOUNDATION

Introduction

- Dong Thap Pilot — Proposed insurance contract written as index-based business interruption policy
- Index insurance relatively new
- Not specifically covered by international standards
- Number of legal and regulatory challenges
- Considered fully by DoI (insurance regulator) and proposed contract approved

Dong Thap Contract — Outline

- Pays indemnity to policyholder if level of Mekong River exceeds agreed level (threshold) at Tan Chau Water Level Gauging Station during policy period
  - Index = River level
  - Insured event = River level (calculated on 3-day moving average) exceeding agreed threshold
- Amount of indemnity depends upon the amount that river level exceeds agreed threshold, up to agreed maximum
- Agreed that level of water in the Mekong River during the policy period, as measured at the Tan Chau Water Level Gauging Station, is a reasonable and appropriate indicator of early flooding
- Early flooding causes policyholder business interruption costs — parties pre-agree on the value of these costs (policyholder's loss)
- Policyholder is not required to prove their actual loss

Essential Legal Characteristics of an Insurance Contract*

a) Payment of premium by policyholder to insurer
b) In return, insurer agrees to accept risk of an uncertain event occurring at future time (whether or when)
c) Insured must have insurable interest in property insured
d) Insurer agrees to indemnify or compensate insured for loss or damage that the insured sustains upon occurrence of event
e) Specified contractual term

*Insurance Contract — a special type of contract, which, in all countries, must have certain characteristics to be regarded by law as "insurance" contract

GlobalAgRisk INC.

Position in Vietnam

Vietnam has two laws governing insurance

1. Civil Code (Section 11): governs contractual relationship between insured and insurer
2. Law on Insurance Business (IBL): governs the regulation and supervision of insurance business

These two laws, together, cover essential characteristics of an insurance contract

Index Contracts as Insurance

- All index insurance contracts satisfy requirements for
  - Premium (a)
  - Risk of uncertain event (b)
  - Term (e)
- An index insurance can, if needed, specify that the insured has an insurable interest (c)
- Potential challenge — Compensation for loss (d)

GlobalAgRisk INC.

Indemnity/Compensation for Loss

Proposed policy — Business interruption insurance under Vietnam law

Traditional business interruption insurance

- Pays based on the actual loss sustained by the insured
- The insured proves the amount of the loss and is compensated for it

Immediate problem with index insurance — Basis Risk

- Basis risk — mismatch between insured losses and compensation for losses
  1. Likely that compensation received will not exactly compensate insured for loss
  2. Possible that insured sustains no loss at all, even though insured event has occurred (never the case with traditional business interruption insurance)

Can Index Contracts Be Insurance?

- Given differences between traditional business interruption insurance and index-based business interruption insurance, there is a risk that a court (or a regulator) may determine that index insurance is not actually insurance at all
- This is a legal risk associated with index insurance
- However, index-based business interruption insurance may be considered as similar to a "valued policy"
  - Commonly used for marine insurance policies
  - Used for property that is difficult to value (e.g., a work of art)

Valued Policies

Under a Valued Policy

Parties agree in advance on the value of the insured property

a) When a total loss occurs → the insurer must pay the total value of the policy, even though the value may be greater than the total loss

b) When a partial loss occurs → the insurer is responsible for paying a proportion of the agreed value equal to the proportion of the total loss

Rationale for valued policies (same as for index insurance): to reduce the transaction costs

Difference between Valued Policy and Index Insurance

Valued Policy

1. Insured must prove he has suffered loss
2. Insured must prove the size/proportion of the loss

Index Policy

1. No requirement for insured to prove he has suffered loss
2. Size/proportion of payment based on an index

GlobalAgRisk INC.

Legal Risk

- Courts usually look to substance of contract, regardless of what the parties choose to call the contract
  - Two parties may reach agreement and describe it as "insurance"
  - Court may not uphold the contract as insurance if it deems the essential characteristics (e.g., compensation for loss) are not met
- Legal risk → that we agree to an index insurance contract and later, the court decides that it is not insurance

Contracts should be designed to minimize legal risk

How Can We Design Index Contract as Insurance Contract?

- No precedent — An index contract has never been tested in court
- Must accept that there is some legal risk
- However, there is *always* legal risk with all legal contracts
- Key is to mitigate the legal risk
- Every step must be taken to mitigate legal risk of this contract

How Does Dong Thap Index Contract Minimize Legal Risk?

1. Insurer and policyholder agree that the level of water in the Mekong River during the policy period, measured at the Tan Chau Water Level Gauging Station, is a reasonable and appropriate indicator of early flooding

2. If early flooding occurs, policyholder will suffer business interruption costs and expenses

3. If threshold is reached, business interruption payment will be triggered to indemnify policyholder for the business interruption loss

4. This index chosen, as historical data show, that, if the river level rises above a certain point, it is highly probable that early flooding will occur; Therefore, provided that threshold is appropriate, early flooding is virtually certain and the index passes an objective test that it is a suitable proxy for loss

Minimizing Legal Risk

5. Insurer and policyholder pre-agree on value of the business interruption costs and expenses (policyholder's loss)
6. As actual loss does not need to be proved, there is a level of basis risk – but basis risk does not have to be eliminated
   - Traditional property insurance contract — always some basis risk
   - Valued policy — basis risk is accepted because of the savings in transaction cost
7. But, it is important that the policyholder cannot recover more than the loss he would sustain under a total loss
   - Total loss must always be equal to or more than the maximum payment under the index insurance contract

Minimizing Legal Risk

8. Policyholder must therefore warrant that the maximum sum insured does not exceed its maximum potential loss as a result of the occurrence of an Excess River Level Event
9. In order to be able to provide this warranty, the policyholder must be able to calculate its maximum loss due to early flooding

Does the Index Contract Work under Vietnamese Law?

Our view

1. Excess water at the Tan Chau Water Level Gauging Station can be regarded as "the insurable event"

2. Policy holders can insure a sum up to their maximum loss, but cannot "over insure" (see Articles 41 and 42 of the Insurance Business Law)

3. As the basis for the insurance payment can be "agreed by the parties in the insurance contract" (see Article 46.1 of the Insurance Business Law), the water level index may be used as the basis for the insurance payment

GlobalAgRisk INC.

Approval Process — Vietnam

- Process team worked closely with DoI throughout development of contract
- Issues, challenges, and legal risks discussed fully with DoI at all stages
- Considerable discussion with, and review by, Bao Minh lawyers
- Modifications made, as appropriate, to take full account of Vietnamese law
- DoI has approved the contract and Bao Minh lawyers agreed with the insurance policy document
- Despite legal and regulatory challenges, it has been possible to facilitate a contract under current Vietnamese law