

# Competitive Convergence in the Financial Services Markets

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## I. Introduction

### A. Convergence in the Marketplace

This paper is a preliminary inquiry into the comparative taxation of financial services firms and the products or services that those firms offer their customers. The paper is premised on the belief that, as nominally different financial services businesses and the products that they offer converge in the marketplace, it will become increasingly important to ensure that different species of financial services firms are taxed comparably in respect of comparable financial services that they offer, and that consumers of the products or services offered by those firms similarly face comparable tax burdens when choosing among economically similar products or services sold under different names.

This paper is inspired in large measure by a pioneering work published in 1975 by Robert Charles Clark, titled *The Federal Income Taxation of Financial Intermediaries*.<sup>1</sup> In that article, Professor Clark demonstrated how savings could be intermediated through different forms of finan-

cial institutions (e.g., banks, insurance companies or mutual funds), and how widely the resulting tax burden oscillated, depending on the form the capital intermediation took. As described below, the present work begins with a narrower definition of the financial institutions within its scope, but takes a broader view of the kinds of financial intermediation that pose challenges to the tax system.

These challenges have grown more urgent as financial markets and financial services firms converge. The reasons for that convergence are fourfold: the surge in the applied mathematics of risk measurement and modeling; the enormous leaps in computer technology, which made much of that applied mathematics feasible to implement in real-time markets; the rapid globalization of the financial services industries (which in turn required massive investments in technological infrastructure); and more flexible regulatory environments in the world's major financial centers. These fundamental reasons for

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convergence in the financial services marketplace are described in a little more detail in the remainder of this paper, but they are neither novel nor controversial.<sup>2</sup>

A comprehensive comparative functional analysis of convergence of services in the financial services markets would be both vast in scope and technically complex. To keep this preliminary effect digestible, this paper employs as one example of the larger theme corporate credit intermediation services in the domestic institutional markets.<sup>3</sup>

In practice, convergence means not only that financial products with radically different labels (put options and insurance, for example) compete against one another, but that financial risks are exported from one, traditional marketplace to a different marketplace. This is the conclusion reached in a recent and thoughtful report on “cross-sector” transfers of risk between the banking and insurance industries by the U.K. Financial Services Authority, the U.K. independent agency charged with regulating the banking, securities and insurance industries.<sup>4</sup> (Indeed, one can argue that the existence of a single regulator in the United Kingdom—probably the largest insurance and credit derivatives marketplace in the world<sup>5</sup>—for all three industries is itself persuasive evidence of the rapid pace at which the financial services industries are converging.)

The “securitization” of insurance risk is one example of cross-sector risk transfer, where the risk of a natural catastrophe is moved from the property and casualty insurance market to the capital markets through “catastrophe (‘cat’) bonds” issued by an insurance company to capital markets investors. Those bonds

pay a higher interest rate than would straight debt instruments of the issuer, but the principal owed at maturity is reduced or forgiven if certain specified catastrophic events occur. In economic substance, capital markets investors in such instruments function from the perspective of the primary issuer like reinsurers of the issuer’s catastrophe insurance coverage.<sup>6</sup>

The “insuratisation” of capital markets risk is another example, where what are predominantly market-related risks—most importantly, the risk of default on corporate debt obligations—are absorbed by insurers. In general, insurers in major jurisdictions like the United States and the United Kingdom are not permitted to deal directly in derivatives contracts, except as hedges of existing risk positions or in the context of very limited (and hedged) income generating transactions, like writing covered call options.<sup>7</sup> As a result, insurers generally cannot engage in the business of selling *non*-insurance credit protection through credit derivatives.

Insurers are, however, generally permitted to *invest* on the asset side of their business in synthetic structured debt obligations that are themselves created by the use of credit derivatives.<sup>8</sup> “Synthetic CDO” vehicles,<sup>9</sup> for example, are investment vehicles that assemble a *synthetic* portfolio of corporate bonds by acquiring a portfolio of high quality debt (such as AAA asset-backed securities or U.S. Treasuries) and then “selling” credit protection through derivative contracts on a portfolio of corporate names. By accepting the risk of default on those corporate issuers, together with the fees paid by the credit protection buyer (most commonly, a bank looking to lay off risk on its bank loan portfolio), the

synthetic CDO structured vehicle emerges in an economic position similar to that of an institutional investor in a portfolio of actual corporate debt, but presumptively at more attractive pricing and with fewer administrative burdens. The CDO vehicle then can “securitize” its synthetic portfolio by selling securities to insurers and other investors that represent participation at different seniority levels in the default risk and economic returns of the total pool.

Moreover, in mid-2000, the U.S. National Association of Insurance Commissioners for the first time permitted U.S. insurers, with the permission of their substantive state regulators, to engage directly in the creation of synthetic assets, by, for example, combining a U.S. Treasury bond owned by the insurer with a credit derivative in which the insurer “sells” to a bank credit protection in respect of the risk of default by a particular corporate issuer to which the bank has extended credit.<sup>10</sup> These synthetic investment securities are called “Replication (Synthetic Asset) Transactions,” or RSATs.<sup>11</sup>

So credit risks can move “cross-sector” from banking (or securities firms) to insurance by insurers *investing* in structured assets that contain embedded credit derivatives, or creating synthetic *investments* through RSATs. Moreover, an insurer can *underwrite* insurance that itself is designed to replicate a credit derivatives contract by using a “transformer company.”<sup>12</sup> For example, a securities dealer might enter into a derivatives contract to protect against the risk of default by an issuer on its debt. As noted above, U.S. and U.K. regulatory rules generally would prevent an insurance company from acting as the direct counterparty to that contract, ab-

sent a specific “insurable risk.” To address this issue, the counterparty to the dealer’s contract could be an offshore “transformer” company—a company that, in contrast to the activities permitted an insurer under the U.S. regulatory framework, is authorized to write both derivatives contracts and insurance to customers.<sup>13</sup> The “transformer” company, which now has a specific contractual risk, in turn might hedge that risk by acquiring credit default reinsurance from an insurance company that specializes in writing financial insurance (and reinsurance); the reinsurance contract in turn would perfectly mirror the economics of the credit derivatives, and might even be documented using standard International Swaps and Derivatives Association, Inc. (ISDA) forms. As a result, the securities dealer’s credit risk would have migrated into an insurance contract. Other forms of “insuratisation” devices include “protected cell companies,” which are effectively special purpose vehicles inside a larger insurance company (typically in Bermuda or the Channel Islands) or certain special purpose vehicles.<sup>14</sup>

One final, concrete example can illustrate the extent of convergence in the financial services marketplace today. The following is a description prepared by a third-party analyst of the principal business of a specialist financial services firm:

Examples of underlying business exposures for which [the Company] had designed customized [credit protection] solutions include: credit enhancement of subordinated tranches of collateralized debt obligations; credit protection of mezzanine debt collateral-

ized by pharmaceutical royalties; residual value [protection] for a portfolio of automobile and motor bike operating leases; credit protection for a privately placed note issuance collateralized by Japanese consumer loan receivables; and debt/equity structure, supported by residual value [protection], to facilitate real estate sale and lease-back arrangements.

The description could describe a commercial bank, or a specialist investment bank, but in fact is a description of an insurance company group (Centre Solutions (Bermuda) Limited), for which I have simply substituted the term “protection” where “insurance” originally stood.<sup>15</sup>

#### *B. Credit Protection Products*

A great many recent articles have described in detail how guarantees, letters of credit, put options, credit default swaps and credit insurance all can be designed to fulfill similar (or even identical) economic agendas, while at the same time having different tax consequences to end users and financial services professionals.<sup>16</sup> In light of both the number and the quality of these detailed technical analyses, this paper does not purport to describe the mechanics of the credit protection marketplace or its products, or the basic tax rules to which those products are subject. Very generally, however, the common theme to credit protection contracts is that, through them, financial services firms offer to enter into transactions that transfer from one party (the “protection buyer”) to an unrelated party (the “protection seller”) the risk of loss in respect of credit default or nonperformance under

designated obligations by one or more specified obligors (each a “reference entity”).<sup>17</sup>

Credit protection contracts have become the financial sector’s darling, because they effectively allow users to isolate the management of credit risk—independent of interest rate, currency and related risks otherwise inherent in financial instrument cash flows. The WALL STREET JOURNAL recently reported that the market value of outstanding credit derivative products has grown more than 10-fold over the last five years, from \$180 billion in 1997 to \$1.95 trillion in 2002<sup>18</sup>; another recent report by the British Bankers’ Association predicts that the market will grow to \$4.8 trillion by 2004.<sup>19</sup> Of the current \$1.95 trillion market, banks are by far the largest buyers of credit protection derivatives; in gross terms, they are also one of the two largest classes of gross sellers of credit protection.<sup>20</sup> While banks are generally believed to be net buyers of protection largely as hedges of existing credit risk, other protection buyers, like hedge funds, are thought to be using credit derivatives to take “naked” short positions in corporate credits.<sup>21</sup> On the other side of the coin, insurers and reinsurers are the largest net sellers of credit derivative contracts, although, as noted earlier, much of this activity is on the investment side of the business.<sup>22</sup>

Financial services firms today offer credit protection contracts in a variety of forms, involving both single-name and basket-credit variations. Some of those forms, such as guarantees, have been marketed for generations; others, such as credit default swaps, for less than a decade. Some credit protection contracts are more or less pure credit risk-shifting devices, as in the case of a guarantee

pursuant to which the guarantor makes the same payments at the same times as the obligor of the reference credit would have done had the obligor not defaulted. Other credit protection contracts can shift significant quanta of market risk along with credit risk.<sup>23</sup>

For example, an end-user might obtain credit protection by acquiring a “put” option in respect of a specified reference credit: that put option in turn could require physical delivery of the reference credit, or alternatively might be cash-settled. A traditional put option, however, transfers market as well as credit risks, because a holder of the option can exercise it if the underlying reference credit remains creditworthy, but prevailing interest rates increase, thereby reducing the market value of *all* fixed-income investments.

It is tempting to conclude from the above that a hypothetical tax regime for credit risk-shifting products should exclude put options, because they are also market risk-shifting devices, but that kind of line-drawing is exactly what runs afoul of modern financial innovation. Thus, a “knock-in” option is one that can be exercised only after a specified contingency has occurred<sup>24</sup>; a “knock-in” put option where the knock-in trigger is a credit event would operate primarily as a credit risk-shifting device, while still being treated for tax purposes, in all probability, as just another option.<sup>25</sup> The functional analysis proposed in this article is intended to address the futility of these sorts of normative line-drawing exercises.

### C. The Tax Policy Agenda

As briefly summarized above, financial services firms that are subject to different regulatory regimes offer financial products to customers

that, while different in label, perform very similar economic functions. These financial services firms are themselves taxed differently (*e.g.*, as banks, securities dealers or insurance companies), or their products are taxed differently in the hands of end-users.<sup>26</sup> These differing costs to financial services providers and their customers in turn impose two related challenges to the tax system: first, whether the tax system accurately taxes these financial services and products when compared to general tax norms, and second, whether the tax system unfairly prefers one form of financial services business organization (or one form of financial product) over another. The comparative functional analysis adopted by this article seeks to illuminate these two tax policy issues.

Tax policymakers rightly brood over the possibility that systematic over- or undertaxation of an industry or product will result in the misallocation of capital, with obvious attendant economic inefficiencies. Thus, if life insurance is systematically undertaxed, tax economists would predict that the country as a whole would be systematically over-insured, and that capital that in a tax-neutral world would have gone for housing, or software start-ups, will be misallocated to insurance products. As Professor Clark demonstrated, a comparative functional analysis helps to identify economically similar functions with different commercial labels, which in turn makes it easier to ensure that we tax correctly different forms of business organization or the products and services they offer customers, according to our collective general tax norms.<sup>27</sup>

A comparative functional analysis also serves a goal that is both less lofty and less abstract, but of

much more immediate urgency: that is to forestall regulatory (in this case, tax) arbitrage by taxpayers. As a nontax example of such arbitrage, it has been suggested that a principal driver behind “insuratisation” is that current regulatory capital adequacy regimes generally require insurers to hold less capital against contingent credit claims than banks are required to hold.<sup>28</sup>

Regulatory arbitrage works clear immediate mischief. It means that regulators are not able to do their own jobs correctly (or that regulated businesses flow to the least costly environment), that regulators in effect are called on to regulate businesses that in a neutral world would be regulated by other (presumably more expert) regulators, that competitive pressures build for “level playing fields” (which in practice means both “level” and “less costly”), and that external costs are visited on regulatory systems that were not designed to deal with the creative solutions developed to arbitrage a more logical primary regulator.<sup>29</sup>

We have an obligation to discourage systematic tax arbitrage through choice of the form of business organization or nomenclature of a product, just as we should discourage regulatory capital arbitrage across different classes of financial services firms. In the field of tax policy, this second theme thus emphasizes *comparability* of tax burdens for directly competitive economic functions, while the first theme of capital allocation emphasizes the complementary theme of the *accuracy* of tax burdens against general norms that cut across all sectors of the economy.

The comparability of tax burdens in turn must be measured at two levels: the relative tax burdens

imposed on financial services firms themselves in respect of economically similar intermediation functions, and the relative tax advantages or disadvantages to customers of acquiring nominally different financial products (for example, a put option, a credit default swap or financial insurance) that can be tailored to suit the identical economic agenda. In light of the globalization of the financial services industries, the comparability of tax burdens on financial services firms and their products properly should be measured, not only across domestic competitors, but also across foreign competitors that participate in the same domestic marketplace.

For reasons of space constraints, this paper focuses largely on domestic U.S. tax rules and emphasizes the comparative taxation of financial services firms more than the better-studied comparative taxation of customer products. This limited scope in turn means that the paper necessarily is incomplete in that it does not fully consider comparative customer taxation, and almost wholly ignores the vitally important issue of the tax regimes relevant to non-U.S. financial services firms that offer their products or services in the United States.

#### D. Methodology

The Code (and every other regulatory scheme) has an explicit or implicit understanding of which economic or commercial functions are unique to which species of financial services firms, and the resulting tax (or other regulatory) system for each class of financial firms assumes the predominance of those quintessential functional characteristics. New “cross-over” products and organizations put stress on these traditional criteria,

but at the same time the traditional approach is so engrained in most relevant regulatory systems as to make a fundamental erosion of the barriers between different classes of financial services firms unlikely.

This article proposes, as an analytical approach to the challenges posed by convergence, first, a more explicit acknowledgement of the different functions traditionally assumed to predominate in each class of financial services firm, and second, the development of tax rules designed to tax “cross-over” products in accordance with the *function* that the products perform, not the label that the product bears or that defines the predominant activity of the financial services firm.<sup>30</sup> The article further proposes that the classic functions of banks, securities firms and property and casualty (P&C) insurers can best be approached as an inquiry into the differing risk management strategies of each.

The approach of this article can be contrasted with the traditional approach to the analysis of financial instruments, which tends to focus on the terms of the instrument itself before assigning the instrument to one “cubbyhole” or another.<sup>31</sup> Thus for example, much of the technical tax analysis to date on credit protection contracts has focused on the detailed terms of specific types of credit protection contracts themselves, in an attempt to assign credit protection contracts to one or another established tax cubbyholes for financial instruments. For reasons developed below, these efforts can lead to both a factual and an intellectual dead-end—where often arcane distinctions in contract terms lead to significantly different tax conclusions.

By contrast, the functional analysis suggests that the “market-

making” model currently used for most interest rate and currency derivatives generally will provide the most appropriate and economically consistent results with respect to credit protection contracts involving “hedgeable” reference debt obligations. The tax regime currently applied to insurance appropriately should be limited in its application to credit protection contracts based on a pooling of non-marketable credit risks of a type historically associated with the insurance function.

## II. Financial Services Firms

### A. Overview

Unlike Professor Clark’s 1975 article, which considered a broad range of financial intermediaries from fire insurance companies to mutual funds,<sup>32</sup> this paper limits its scope to *financial services firms*. These businesses share three fundamental themes that distinguish them from other financial intermediaries: Each firm’s core business is with *customers* (and not, for example, with the market); its business requires at least in part the delivery of specialized *services* together with the application of capital; and its business often (although admittedly not always) is *regulated*. Thus, for example, this paper does not address the tax regimes applicable to mutual funds or hedge funds.

At the same time, the financial services operations that this paper addresses are not pure service operations, such as investment advisory services. These consulting-type services raise no special tax policy issues. Instead, the financial services on which this paper focuses are those that require

*the application of capital to provide customer services*—for example, insurance protection, loans of money, or market-making in securities. As so defined, financial services income necessarily is hybrid income, whose character for tax purposes depends entirely on the context in which it is earned.

Financial services firms almost invariably are highly leveraged, although that leverage is not always obvious; thus, for example, a typical life insurer will show little long-term indebtedness on its balance sheet, but it nonetheless is highly leveraged—the leverage consists of its obligations to policyholders to fund both death benefits and fixed investment returns over time.<sup>33</sup> By the same token, hedge funds also are highly leveraged, and so leverage by itself is not a determining feature of a financial services firm, as opposed to other types of financial intermediaries.

It is important to recognize that the financial services sector of the economy comprises many different industries, each with its own dominant business model, competitive environment, system of regulation and customer base. For convenience, these industries can be divided into four umbrella categories: banks, finance companies, securities firms and insurance companies. Each of these categories in turn includes sub-industries that are as different as they are similar: life insurance is a very different business from P&C insurance, just as consumer lending is very different from financing customer purchases of an affiliate's major equipment sales.

For the sake of brevity, and because credit intermediation is largely a professional's market, this paper restricts its scope to those financial services firms that (1) serve

institutional (as opposed to retail) customers and (2) are active participants in providing credit intermediation services. As a result, the paper concentrates on the comparative taxation of commercial banks, securities dealers and P&C insurers, as exemplified in the credit intermediation markets.<sup>34</sup> Many of the larger themes that this paper attempts to address apply with equal or greater vigor to other financial services firms: for example, the competition for long-term retail savings to which Professor Clark's paper was addressed.

It is sometimes believed that financial services firms employ only a relative handful of capital risk takers (traders, credit officers or senior actuaries, for example) and a "back office" of administrative staff. That model may aptly describe a hedge fund, but not the financial services industries, which, precisely because they operate *customer service* businesses, have significant fixed assets and enormous work forces.<sup>35</sup> Thus, Citigroup in 2000 employed approximately 242,000 people, roughly 40 percent of whom—nearly 100,000 employees—were located outside the United States.<sup>36</sup> In the securities industry, even The Goldman Sachs Group, which generally is thought of as an institutionally-oriented financial services firm (although it in fact has an important private client services group), employed roughly 22,600 people in 2001.<sup>37</sup>

Each financial services industry has its own dominant business model, which typically has significant structural differences from other financial services businesses. To be effective, tax legislation needs to be sensitive to these differences in dominant business models across the financial services industries. For this reason, Part III

develops these themes a little bit further—recognizing, of course, that to develop them fully would require a book-length inquiry.

### B. *The Centrality of Customer Relationships*

As suggested above, a central feature of a financial services firm is that its business is a *customer* business.<sup>38</sup> Unlike hedge funds or mutual funds, financial services firms do not simply lend money to the market, or purchase securities from the market: they lend to, or trade with, their customer base—which can of course include, but only in a small number of cases is composed exclusively of, other financial services firms. The principal exception to this observation, of course, is the investment activity of an insurance company, which functionally is indistinguishable from the investment activity of a pension fund or other institutional investor.

It of course is true that it is impossible to offer a comprehensive and self-executing definition of what constitutes a "customer," but that fact does not mean that the concept is valueless. The Code itself has required an inquiry into customer status for many decades, as part of its fundamental mechanism for distinguishing capital assets from "property held ... primarily for sale to customers in the ordinary course of ... [a] trade or business."<sup>39</sup> Similarly, virtually every substantive regulator of financial businesses applies special oversight or protective rules to "customer" activities.<sup>40</sup>

The leading tax case in the securities dealer arena summarized the concept as follows:

In determining whether a seller of securities sells to "custom-

ers,” the merchant analogy has been employed. Those who sell “to customers” are comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between the purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a middleman bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods.<sup>41</sup>

Thus, in the context of dealing in securities, a dealer is one who makes two-way markets, by regularly and continuously buying from customers those securities that customers wish to sell, and selling to customers those securities that customers wish to buy. The dealer’s mark-up is compensation for the *services* the dealer provides by applying its capital to bring liquidity to the secondary market for securities.

Most major financial services firms seek to differentiate themselves from one another, and to enhance the customer relationship, by providing their services—that is, by applying their capital to customer requirements—through direct customer contact. Thus, if an individual wants to borrow money from BankAmerica, that individual applies to BankAmerica for a loan; if a corporation wishes to trade bonds with Merrill Lynch, that corporation must open a customer account with Merrill Lynch, and so on. While mortgage or Treasury bond brokers have some limited role, the general business model

across different financial services industries is one of vertical integration, so that customers can be “captured” and different financial products and services cross-sold to that customer base.<sup>42</sup>

The principal exception to the centrality of customer relationships seems to be some parts of the insurance industry, where independent agents and brokers play a major role in activities ranging from arranging retail or institutional insurance to intra-industry reinsurance treaties and facultative contracts. The attenuated nature of the customer relationships in these businesses lies at the heart of some of the international tax policy challenges unique to the insurance industry, but unfortunately these issues are largely beyond the scope of this paper.

### C. Regulation

Financial services firms are largely regulated institutions. Domestically, the regulatory environment for financial services firms was substantially rewritten in 1999, when Congress enacted the Gramm-Leach-Bliley banking legislation.<sup>43</sup> Because the scope of substantive regulation of financial services firms is directly relevant to the themes of convergence to which this paper is addressed, it is useful to summarize briefly what Gramm-Leach-Bliley did (and more important, did not) do.

The major financial markets outside the United States (with the exception of Japan) generally have long permitted commercial banking groups to engage in investment banking and insurance activities (either directly or through affiliates).<sup>44</sup> In the United States, however, a complex framework of federal and state laws that traced its origin to the 1930s until recently severely restricted banks and bank

holding company groups from participating in full-scale securities or insurance businesses.<sup>45</sup> In the most basic terms, Gramm-Leach-Bliley substantially leveled the playing field through its repeal and preemption of selected provisions of the former legal framework that restricted affiliations between U.S. commercial banks on the one hand and investment banks and insurance firms on the other.

As a result of Gramm-Leach-Bliley, bank holding companies that qualify as “financial holding companies” are permitted to engage through subsidiaries in a broad range of activities that are “financial in nature,” “incidental” to such activities or “complementary” to financial activities.<sup>46</sup> For example, non-bank subsidiaries of an eligible financial holding company may now engage in full securities underwriting, dealing and market-making activities (through a securities affiliate), or act as a principal, agent or broker for the purpose of insuring against “loss, harm, damage, illness, disability, or death” (through an insurance affiliate).<sup>47</sup> Gramm-Leach-Bliley also authorizes banks to establish “financial subsidiaries”—operating subsidiaries of banks that are permitted to engage in most (but not all) of the activities in which financial holding companies may engage.<sup>48</sup> Gramm-Leach-Bliley retained, however, most of prior law’s existing restrictions on activities that may be conducted *directly* by a bank.

Citigroup is perhaps the best-known example of the impact of Gramm-Leach-Bliley. Although Citigroup was formed before the enactment of Gramm-Leach-Bliley (in a move some characterized as a bet on the even-

tual passage of financial modernization legislation),<sup>49</sup> Citigroup's combination under one holding company of a major bank (Citibank), securities firm (Salomon Smith Barney) and insurance company (Travelers), was subject to medium and long-term regulatory uncertainties that Gramm-Leach-Bliley intentionally eliminated.

While Gramm-Leach-Bliley revolutionized the formation of cross-industry financial services groups and expanded the scope of permissible banking activities, it did *not* alter the fundamental arrangement in the United States under which different financial services industries—banking, securities and insurance—generally are subject to different regulatory regimes and different substantive regulators. Gramm-Leach-Bliley preserved the role of the Board of Governors of the Federal Reserve System as the “umbrella supervisor” of financial holding companies, but retains (and enhances) a system of “functional regulation” designed to capitalize on the experience of various federal and state financial supervisors.<sup>50</sup> Thus, Gramm-Leach-Bliley permits a financial holding company to own both a bank and an insurance company; it does not expand the types of insurance services that a bank may offer or permit state insurance regulators to review the regulatory capital adequacy of a sister national banking association. Because the regulatory framework for *operating* financial services firms remains fundamentally intact after Gramm-Leach-Bliley, the United States therefore will continue to have separate banks, securities firms and insurance companies for the foreseeable future.

### III. Traditional Business and Risk Management Models

#### A. *Financial Risk Takers and Managers*

This paper earlier defined financial services firms as institutions that provide customer services through the application of capital. In doing so, financial services firms take on a wide variety of financial risks: the identification and effective management of these risks, along with the nurturing of customer relationships, are the two pillars that support every successful financial services firm.

As a result of the surge over the last few decades in applied mathematics, quantitative research and data processing, financial services firms can now measure and manage financial risks with great accuracy and objectivity. The evolution of financial risk management from art to science in turn has encouraged the convergence of financial products in the marketplace, as researchers identify points of commonality in seemingly disparate financial products, and import the formal analyses of one discipline into managing the risks of another.

In a world where traders talk knowingly of “convexity smiles,” and rocket scientists are in danger of running out of Greek letters to call various subunits of risk, it will seem almost childish to observe that financial risk boils down to interest rate risk, market risk (including currency risk) and credit risk, but tax policy does not really look any deeper than that.<sup>51</sup> Moreover, even today, each industry within the financial services sector of the economy tends to

have one dominant risk management model (or handful of such models) around which those businesses are still organized, and on which their substantive regulation and taxation are based. This effectively is the conclusion reached in an exhaustive study of the topic recently completed by a joint task force of the world's banking, securities and insurance regulators.<sup>52</sup>

This Part III therefore attempts to sketch out some of the features of these traditional business and risk management models, in their classic (and oversimplified) implementations, on the theory that by understanding these implicit models better, we can predict more accurately where tax fractures are most likely to occur.

#### B. *Commercial Banks*

**Customer Services.** In their traditional roles, banks are the classic financial intermediaries. Banks:

- act as middlemen between depositors seeking liquid claims and borrowers wishing to borrow at longer terms using less liquid instruments,
- use their expertise to collect and evaluate information relating to market and credit risks and absorb risks arising from intermediation between borrowers and depositors,
- provide risk management and information services to meet customer needs, and
- provide various payment services.<sup>53</sup>

In doing so, banks, through demand deposits and their relationship with central banks, participate directly in a country's monetary policy through the management of its money supply. In their narrowest role, as deposit-takers and money lenders, banks earn their profits through the spread on lending and deposit rates and



through actively managing the asset pool with close monitoring of the risks involved.<sup>54</sup> Banks also secure alternative sources of funding by the issuance of intermediate- and long-term debt and commercial paper.

At the same time, of course, banks also act as dealers in a wide variety of securities, currencies and derivatives. Much of this expansion has occurred outside the United States, principally in London, Tokyo and Singapore.<sup>55</sup> A substantial portion of the assets held by foreign branches and subsidiaries of U.S. insured commercial banks relates to these trading activities rather than traditional commercial lending.

U.S.-based commercial banks compete with other domestic and foreign banks, thrift institutions, credit unions, and mutual funds for deposits and other sources of funds. In addition, banks face growing competition with respect to the diverse financial services and products they offer; this competition, of course, has increased as major money center commercial banks have migrated from classic financial intermediaries into trading powerhouses. Bank competitors now include finance companies, broker-dealers, investment banking companies, merchant banks, insurance companies, credit card companies, mortgage banking companies, leasing companies, e-commerce and other internet-based companies and a variety of other financial services and advisory companies.<sup>56</sup>

**Risk Management.** In their classic (and oversimplified) roles as lenders, banks are exposed primarily to credit and interest rate risks. Traditionally, banks addressed credit risk primarily by rationing credit, rather than through differential pricing. Banks lent to good credits—subject to a ceiling, even for

the best credits—and they refrained from lending to bad credits, rather than lending to both, and charging materially higher rates to the latter. (Of course banks lent to a range of credits, but that range in turn represented only a narrow band of the potential universe of borrowers.) The relatively recent emergence of a credit derivatives market, in which banks are some of the largest participants,<sup>57</sup> also reminds us that before that marketplace developed, once a loan was booked, credit risk was more absorbed than managed, or alternatively transferred along with the loan by selling a participation in the loan itself.<sup>58</sup>

Traditionally, banks managed interest rate risk in their core lending business through matched funding—that is, banks would strive to reduce interest rate risk by managing the liability side of their balance sheet effectively to mirror their assets (or, phrased conversely, they would price their assets—their loans—with a view to the rate at which coterminous liabilities could be incurred).

### C. Securities Dealers

**Customer Services.** Putting to one side pure service functions that are not the subject of this paper, securities firms earn their profits by successfully anticipating and addressing the needs of capital users and capital suppliers. Dealers “make markets” by buying and selling securities with their customers on a continuous basis. Marketmakers effectively are compensated for the liquidity they provide by buying securities that customers wish to sell, selling securities that customers wish to buy, and earning a spread on such customer transactions (the bid/ask spread). Marketmakers maintain inventories of securities out of

which to satisfy customer requirements, and they hedge these inventories to protect their capital from most market fluctuations. Dealers issue equity and debt securities to form their capital base, but incur very substantial leverage by financing their securities and other positions on a secured basis, including through the “repo” markets. Dealers also stand ready to write derivative contracts, on either side of the market (e.g., long or short positions in options, swaps and forward contracts).

**Risk Management.** As described above, the core risk management strategy of a bank in the traditional model is to manage credit risk through rationing and to manage interest rate risk through matched funding. By contrast, in the traditional model a dealer focuses almost exclusively on managing market risks, which it accomplishes through hedging. Traditionally, dealers dealt only in liquid financial instruments, and funded those positions through overnight secured loans. Even today, when dealers carry large books of illiquid over-the-counter derivatives positions, the interest rate risks in those books typically are managed by hedging, rather than by matched funding on the liability side of the balance sheet. (Of course, another reason for this fact is that interest rate derivatives can expose dealers to interest rate risk without requiring immediate funding of a physical asset.)

As a result, in the traditional model, the asset side of a dealer's balance sheet is dominated by liquid financial assets, while the liability side reflects substantial overnight borrowings and contractual liabilities that are themselves market hedges (e.g., the obligation to return securities borrowed to effect a short sale).<sup>59</sup> By definition, a dealer stands ready to buy from or

to sell to customers, and therefore has little control over its customer positions (other than through adjusting its markups, or withdrawing from a market in the most extraordinary of circumstances). In most cases, therefore, securities dealers cannot ration market risks, or assure themselves of natural hedges (by only taking on a “long” position when an offsetting customer “short” position is located). The only effective risk management solution is active market hedging, which has the collateral economic advantage of increasing liquidity in the marketplace. The growth of new financial instrument dealer markets over the last two decades is therefore in every case also the story of the development of effective hedging analytics, and of a deep and liquid hedging marketplace.

#### *D. P&C Insurers*

**Customer Services.** Like commercial banking, the modern P&C insurance industry is the result of the continuous evolution of business practices whose origins date back at least to 14th century Italy.<sup>60</sup> As used in the United States, P&C insurance encompasses all forms of insurance other than life and health insurance. Obviously, this covers a range of widely disparate risks, from marine insurance (the birthplace of the modern industry) through automobile or fire insurance to protection against defaults by corporate borrowers, or even protection against challenge by the IRS to the tax-free status of a purported reorganization.

In many respects, then, even the traditional model of P&C insurance encompasses a range of risks far broader than those contemplated by traditional contracts of banking or securities dealing. Notwithstanding this wide diversity of risks, however, there are some com-

mon elements to every traditional insurance business.

P&C insurance in its purest form begins with an “insurable risk”—a risk to the insured of financial loss as a result of a specifiable but fortuitous event, *e.g.*, a ship sinking while carrying the insured’s cargo. Insurance of that risk in turn is based on two elements: the transfer of the financial consequences of the occurrence of that fortuitous event from the insured to the insurer (risk shifting) and the commingling of that risk with other similar but uncorrelated risks, *e.g.*, the risk of different ships sinking (risk distribution and risk pooling).<sup>61</sup>

The insurance industry entered the business of providing financial insurance—in effect, credit insurance—in a systematic fashion early in the 20th century through mortgage insurance,<sup>62</sup> and then, beginning around 1971, by providing municipal bond insurance, followed in the 1980s by asset-backed securities insurance.<sup>63</sup> These mortgage and other specialized financial guaranty insurers, of which Mortgage Guaranty Insurance Corp., MBIA, Inc., Ambac Assurance Corp. and Financial Security Assurance Corp. are among the best known, are referred to as “monoline” insurers, because state regulators universally require that these forms of financial insurance be conducted in a separate insurance company whose activities are restricted to guaranteeing scheduled interest and principal payments on the debt obligations it insures.<sup>64</sup>

More recently, other, more complex forms of financial insurance and reinsurance products have appeared. These products often are referred to as “alternative risk transfer” products. The alternative risk transfer marketplace is not marked

by pellucid transparency to outsiders, but the term generally is understood to include a range of insurance products under which insureds may either retain significant amounts of pure *insurance* risk (*e.g.*, through captive insurance arrangements or “retrospective” pricing) or shift significant *financial* risk to the insurer.<sup>65</sup>

One important instance of “alternative risk transfer” products in the insurance industry is “finite insurance,” which is generally understood as an insurance product that “represents a combination of risk transfer and risk financing which *emphasizes* the time value of money.”<sup>66</sup> In other words, finite risk insurance tends to be a smallish insurance dog dragging a large investment tail; for that reason, the contracts in question tend to be unique deals that are individually managed, rather than commingled with other similar risks, as in classic insurance company risk distribution methodologies,<sup>67</sup> and the participants themselves often see themselves as insurance-investment firm hybrids.<sup>68</sup>

The finite risk business is often described as a reinsurance, rather than primary insurance, business. As implied earlier in this paper, however, in a world of “transformers” and “protected cell” companies, there is not necessarily much significance to the difference. Finite insurance/reinsurance requires unusual regulatory flexibility and modest taxation to flourish. For that reason, many of the most successful specialists in the field are domiciled in Switzerland (Swiss Re, Zurich Re) or Bermuda (Centre Solutions, XL Capital).

**Risk Management.** Insurers traditionally face two principal financial risks: underwriting risk (the risk that insurance benefits

actually paid exceed actuarially-projected payments) and, somewhat less intuitively, investment risk.<sup>69</sup> This statement is true for both life and P&C insurers, although there are important technical differences in the precise nature of the risks to which each sector is primarily subject.

Just as banks traditionally rely on credit rationing and matched funding, and securities dealers traditionally rely on market hedging, the core underwriting risk management technique that distinguishes the insurance industry is risk pricing, through the underwriting process, and loss predictability, through the pooling and distribution of those risks in reliance on the statistical phenomenon of the law of large numbers.<sup>70</sup>

The IRS has succinctly summarized how risk pooling and distribution accomplish risk management through the application of the law of large numbers:

Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks.<sup>71</sup>

Insurance companies engaged in classic risk pooling and distributing rely on the law of large numbers, not to eliminate or offset loss, but rather to make losses predictable in magnitude and timing. For example, a life insurance

company's principal mortality risk is that its insureds will die young: the insurance company does not generally manage that risk by finding a hedging transaction (*i.e.*, going "short" life expectancies), but rather by developing a suitably diversified and representative base of policyholders such that its death benefit payment obligations are reasonably susceptible to statistical modeling.

The law of large numbers is *not* hedging by another name. In a hedging transaction, a dealer, for example, seeks to offset potential losses from one risk position with *gains* from a hedging position; the two positions thus are bets in the opposite directions, on interest rates, currency movements, asset prices or the like. Similarly, the law of large numbers as applied by insurers is *not* the same as diversified investing. By diversification, an investor brings the market risks of its investment portfolio in line with the volatility of the market as a whole. Insurers, by contrast, use the law of large numbers to distill their liabilities into a predictable outflow of payments to insureds over time.

A traditional insurer thus has a very different attitude towards loss events than does the traditional banker. The commercial banker conceptually recognizes that some credit losses are inevitable, but secretly believes that better credit decision-making should reduce those losses to near zero. The classic insurer, by contrast, is in business for the purpose of suffering individual losses (benefit payments), but expects to profit by reducing individual uncorrelated and unpredictable events into a predictable outflow, through the law of large numbers, which is more than offset by the premiums received and investment returns.

Like any other insurers, the monoline insurance companies accept contingent risks (in their case, credit risks) in exchange for insurance premiums. Some corners of the financial insurance business, such as private mortgage insurance, follow the general risk management patterns of the other P&C insurers.<sup>72</sup> The major municipal bond and structured finance monoline insurers, by contrast, appear to follow a hybrid "zero-expected-loss" risk management philosophy in respect of their core activities:

In contrast to other types of insurance, financial guaranty insurance is written to a "zero-expected-loss" standard. A life insurance company knows that some cars will get stolen and some houses will burn down. Financial guaranty insurers, on the other hand, expect that the assets they insure will not default. There will, of course, be some level of losses experienced. But the track records of this so-called "zero-expected-loss underwriting" supports relatively modest loss reserves (less than 0.1 percent of total insured debt service outstanding) and relatively high leverage as measured by total insured debt service as a function of resources available to pay claims (more than 75:1).<sup>73</sup>

The risk management philosophy of the monoline insurers thus has much in common with the traditional approach of commercial banking.

***Attenuated Customer Relationship.*** Unlike the securities and banking business, many insurance companies rely to a significant extent on "independent agents" and "brokers" to market and dis-

tribute their products to customers.<sup>74</sup> Very generally, in the insurance industry, an “agent” represents the insurer, and a “broker” the insured.<sup>75</sup> In the United States, most retail-oriented insurance policies (life and “personal lines” P&C insurance) are sold through agents.<sup>76</sup> By contrast, “commercial lines” (*i.e.*, institutional) P&C insurance, as well as reinsurance (intra-industry insurance) contracts most commonly are placed by independent brokers representing the insured. (Insurance brokerage firms in turn, of course, are enormous financial institutions in their own right.<sup>77</sup>) One industry expert, for example, has estimated that less than 20 percent of all “commercial lines” property and casualty insurance is placed through exclusive agencies.<sup>78</sup>

Insurance companies devote enormous energies to developing their retail insurance product distribution systems through a Byzantine array of overlapping channels that leave even economists bewildered.<sup>79</sup> From a tax policy perspective, however, it is important simply to note the extent to which the insurance industry relies on nonemployee agents to sell its retail products, to place commercial insurance or reinsurance, to adjudicate claims and to provide other necessary services.<sup>80</sup> The same point, of course, is even more forcefully made in the context of brokerage (which, as noted above, is the dominant means by which institutional insurance and reinsurance is placed), where the broker in fact is the legal representative of the insured, and the insurer has no direct customer relationship with the insured.

Even exclusive nonemployee insurance agents arguably can be “independent” agents, at least for some tax purposes. In the U.S. domestic context, the issue arises

most frequently as a question of whether an “independent” insurance agent should be treated as an employee of an insurer.<sup>81</sup> In the international context, the critical question becomes whether a nonemployee exclusive insurance agent will be treated as in fact an independent agent for purposes of tax treaties (or internal law analogies) that impute the activities of a “dependent agent”—but not an agent of independent status—to a principal not otherwise resident in a host country.<sup>82</sup>

***Reinsurance and “Fronting.”***

Reinsurance is insurance for insurers: it is the device by which insurance firms diversify their risk beyond the geographical area in which they operate, or reduce risk outright.<sup>83</sup> The reinsurance market is international in scope, and distribution channels are dominated by brokers.<sup>84</sup> In 1997, insurance companies ceded \$124 billion in insurance premiums to reinsurers.<sup>85</sup> In contrast to other financial services industries, where “tax haven” jurisdictions appear to account for a *de minimis* level of business, Bermuda in particular has emerged as a major professional reinsurance (*i.e.*, noncaptive) market. Bermuda professional reinsurers took in roughly 4.5 percent of reinsurance premiums in 1997; one major industry participant has described it as “the most important offshore reinsurance market in the world.”<sup>86</sup> Ace Ltd. and XL Capital Ltd. are the two best-known Bermuda-based professional reinsurers (and primary insurers); both are publicly held and traded on the New York Stock Exchange.

“Fronting” is the logical extreme of reinsurance, in which an insurer systematically cedes most of its insurance exposure to a reinsurer (typically in a different jurisdiction).<sup>87</sup> (In securities deal-

ing, the analogous concept is “riskless principal” trading.) Fronting serves a useful commercial role in making sufficient capital available to underwrite local risks.<sup>88</sup> More recently, however, some sectors of the U.S. insurance market have complained to Congress that domestically controlled competitors owned by Bermuda parent companies have in effect relied on fronting to reduce the tax burden on their insurance activities without bringing the foreign parent companies into the U.S. net income tax system; in these cases, the principal source of tax savings is the ability to invest “long-tail” P&C reserves in a tax-free environment.<sup>89</sup>

Both simple reinsurance and fronting obviously raise tax concerns of deemed agency arrangements, but it is a relatively simple matter to conduct reinsurance business in such a manner as to avoid doing business in the primary insurer’s jurisdiction.<sup>90</sup> Moreover, a reinsurer can in fact have a commercial presence in the primary insurer’s jurisdiction through the retention of an agent of independent status, thereby facilitating its reinsurance business in respect of risks in that jurisdiction.<sup>91</sup>

***Regulation and Structure.*** In the United States, the 50 states traditionally have exercised primary regulatory authority over the insurance industry,<sup>92</sup> and Gramm-Leach-Bliley maintained that arrangement. All 50 states have enacted laws and established state insurance departments to supervise insurance activities. The states exercise broad authority in all areas of insurance oversight, such as licensing companies to engage in the insurance business, licensing

agents, defining statutory surplus, regulating premium rates, establishing reserve requirements and solvency standards. In addition, the National Association of Insurance Commissioners (NAIC) (an association of the heads of the state insurance departments) helps in developing standard regulatory requirements (such as risk-based capital standards) that states are encouraged to enact.<sup>93</sup>

## IV. Tax Framework

Part III of this paper summarized the traditional business and risk management models employed by commercial banks, securities dealers and P&C insurers. Those descriptions are, of course, both simplistic and outdated, but that does not mean that they are pointless, because our current tax rules effectively follow these models. This Part IV attempts to make this point, by demonstrating how the tax models for taxing each category of financial services firm correspond, more or less closely, to the traditional business and risk management models described in Part III. Part IV then continues by considering how nontraditional activities are taxed—the dealer income of a bank, for example, or the lending activities of a securities firm.

### A. Definitions

The Code defines the terms “bank” and “securities dealer.” Treasury regulations define the term “insurance company,” but only by reference to the issuance of “insurance,” which itself is not defined.<sup>94</sup> Many of the interpretational difficulties that arise in respect of financial insurance stem from uncertainty as to the scope of what constitutes an “insurance company.”

**Banks.** Code Sec. 581 defines a “bank” as a domestically-incorporated bank,<sup>95</sup> a substantial part of the business of which consists of receiving deposits and making loans, or of exercising fiduciary powers of the sort permitted to national banking associations, and which is subject to supervision and examination by a domestic (state or federal) banking authority. Consequently, there is no such entity in our tax lexicon as an unregulated domestic bank—regulation and supervision *as a bank* constitute part of the definition.<sup>96</sup>

There are a great many lending institutions that borrow funds and make loans, but only regulated banks can accept demand deposits and offer certain fiduciary services. In effect, then, the Code looks primarily to deposit-taking and substantive regulation to distinguish these banks from other forms of lending institutions. The result is an unambiguous definition of what constitutes a bank.

**Securities Dealers.** Code Sec. 475(c)(1) defines a “dealer in securities” as any taxpayer that *either* regularly purchases securities from customers, or regularly sells securities to customers, in each case in the ordinary course of business, *or* regularly offers to enter into derivative contracts (and other “positions in securities”) with customers, or regularly offers to terminate such positions with customers, in each case again in the ordinary course of a trade or business. Unlike the case of a domestic bank, there is no requirement that a domestic securities dealer be taxed as a corporation, or that it be subject to substantive regulation. Both distinctions accord with commercial practice; until comparatively recently, some of the country’s best-known securities dealers were

organized as partnerships (and many smaller ones still are), and some important dealer activities (e.g., dealing in interest rate derivatives) can be conducted in an entity that is not regulated as a broker-dealer.

Many articles have extensively criticized the overbreadth of Code Sec. 475(c)(1),<sup>97</sup> which arises from the fact that the definition looks to a taxpayer that *either* sells securities to customers *or* buys securities from customers. The traditional definition, by contrast, describes a securities dealer as a “merchant” in securities, profiting by earning a middleman’s spread by being willing to buy what customers wish to sell, and to sell what customers wish to buy.<sup>98</sup> In response, the Treasury has been forced to promulgate regulations that adopt a series of commonsense carve-outs, such as the “negligible sales” and the “customer paper” exceptions.<sup>99</sup>

For purposes of this article, however, the key points are that the statute, like prior case law, emphasizes the centrality of the customer relationship,<sup>100</sup> and that any taxpayer can be classified as a securities dealer in respect of a fraction of its activities. This second observation follows from the fact that, unlike the definition of a “bank,” for example, dealing in securities need not constitute a “substantial part” of a securities dealer’s activities.

While it might at first appear that there is a conflict in philosophy between the functional approach reflected in the definition of a securities dealer, and the formal approach followed by the definition of a bank (through its referral to regulated institutions), in practice there is little distinction, because the function that makes banks unique among lending institutions (taking demand

deposits) is strictly regulated throughout the world. As a practical matter, therefore, both definitions operate by reference to the unique functions of banks and dealers, respectively.

**P&C Insurers.** The Code famously lacks a definition of what constitutes a nonlife insurance company.<sup>101</sup> The relevant Treasury regulations help only a little, by providing that an “insurance company” is a company “whose primary and predominant business activity during the taxable year” is the issuance of insurance (or reinsurance) contracts. The regulations go on to explain that, while state law regulation is a significant factor in predicting the business that a company intends to carry on, “it is the character of the business actually done ... which determines whether a company is taxed as an insurance company ... .”<sup>102</sup> Like domestic banks, insurers (whether domestic or foreign) must be taxed as corporations, rather than as partnerships.<sup>103</sup>

The definition of an insurance company is marvelously circular, because an insurance company is one that sells insurance, and insurance contracts in turn are (presumably) obtainable only from insurers—that is, I am aware of no case that treats affirmatively as insurance in the hands of a customer a contract to which the counterparty was affirmatively not an insurance company.<sup>104</sup> How does one get this tax dog of a definition to stop chasing its tail?

One answer that is clear, both from the Treasury regulation summarized above, and from the caselaw, is that substantive regulation is not dispositive. Thus, cases and rulings have held that some entities that are regulated as insurance companies nonetheless may not constitute insurance

companies for tax purposes, either because of the sporadic nature of their noninvestment activities<sup>105</sup> or because the contracts they wrote were not *insurance* contracts.<sup>106</sup> Similarly, rulings have treated an entity that affirmatively was not subject to substantive insurance regulation as an insurance company for tax purposes, where the IRS concluded that it performed the functions of an insurer.<sup>107</sup>

Because insurance companies are defined as companies predominantly engaged in writing insurance, all of the relevant caselaw and rulings approach the definition of an “insurance company” by looking at the economic nature of the contracts that the company writes. The leading case on the definition of an insurance contract for tax purposes is *E. Le Gierse*,<sup>108</sup> which inquired as to whether (1) the contract looked like insurance in the common commercial sense, (2) the putative insured had an “insurance” risk, the economic consequences of which were shifted by the contract to the putative insurer, and (3) the putative insurer managed that risk through risk pooling and distribution.

Very recently, the IRS issued three related revenue rulings on the meaning of the term “insurance” for tax purposes.<sup>109</sup> Using identical language, those rulings distilled the learning of *Le Gierse* as simply, “in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present.”<sup>110</sup> The rulings go on to amplify what the IRS understands by risk shifting and risk distribution:

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial conse-

quences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks.<sup>111</sup>

As implied by the reference in the above quotation to the distribution of the risk of “random” events, risk pooling and distribution—and therefore the tax definition of insurance itself—contemplates fortuity: the prospect of loss-causing events that individually cannot be predicted with any chance of accuracy. Fortuity is the reason for risk pooling and distribution, and a definition of insurance that focuses on risk pooling and distribution thereby also contemplates fortuity as the core trigger of those insurance contracts.

Another corollary to the above quotation is that, from the perspective of the insured, “risk shifting” implies a true bet: that is, the insured has not shifted risk if the insured is certain to get back its premiums, in the form of insurance benefits or retrospective credits. This point is relevant to

the analysis of “captive” insurance companies,<sup>112</sup> and also to the more aggressive forms of “finite” insurance, in which pure investment returns dominate the risk shifting functions of the contract.<sup>113</sup>

As David Miller demonstrated in a useful analysis of *Le Gierse*, risk shifting looks at risk from the perspective of the insured, and risk pooling from the perspective of the insurer.<sup>114</sup> The passage quoted above from the recent set of revenue rulings makes the same point. This distinction offers a useful way of disentangling the circularity of the regulatory definition: *an insurance company is one that offers to customers contracts by which the customers shift the financial risk of fortuitous loss to the insurer, which risks the insurer in turn aggregates and manages through risk distribution and pooling.*<sup>115</sup>

The recent spate of revenue rulings—and indeed *Le Gierse* itself—emphasize the distribution and pooling of fortuitous risk as a core requisite of insurance in the tax sense, but they do not appear to care very much whether an insured has an “insurable interest” in the underlying fortuity: that is, the rulings do not rest their analysis on whether the insured made naked or covered bets. The original purpose of an insurable interest was to distinguish insurance, on the one hand, from illegal wagering, on the other, as well as to minimize opportunities for fraud.<sup>116</sup> Neither purpose is particularly relevant to tax policy; in particular, it has long been observed that many financial contracts can be described as wagers, but doing so accomplishes very little, in light of the poorly developed tax law of wagering.<sup>117</sup>

In sum, while it is certainly true that insurance regulators typically require prospective insureds to have an “insurable interest” in the

underlying risk, that concept is not inherent either in risk shifting or in risk shifting and pooling, which are the primary criteria on which the courts and the IRS rely in their tax analysis.<sup>118</sup> The *Le Gierse* court’s reference to insurance in its common commercial sense most logically can be seen as embodying the themes of fortuity, commercially-based (*i.e.*, actuarially determined) premiums, claims processing and the like, rather than the enormous nontax jurisprudence of the law of insurable interests.<sup>119</sup> Otherwise the tax law would become hostage to a large body of nontax jurisprudence designed to address other concerns, to no apparent tax policy purpose.<sup>120</sup>

#### B. Overview of Bank Taxation

In contrast to the tax landscape that Professor Clark confronted in 1975, the taxation of domestic commercial banks today in respect of their traditional deposit taking and lending activities can be quickly summarized. All but the smallest banks are accrual method taxpayers,<sup>121</sup> and no bank (again other than the smallest banks) may deduct any reserves for future bad debts.<sup>122</sup> A bank may, however, deduct partially worthless debts as and when that partial worthlessness occurs, regardless of whether the debt is evidenced by a security.<sup>123</sup> A bank’s gain or loss from essentially any debt instrument, regardless of whether that instrument constitutes a security, is treated as ordinary income or loss, rather than capital gain or loss.<sup>124</sup> Finally, a bank generally is not required to adopt a mark-to-market method of tax accounting for its core lending activities, and I know of no bank that has attempted to do so.<sup>125</sup>

The last point might at first seem surprising, since mark-to-market

accounting appears inherently more accurate than simple accrual methods.<sup>126</sup> The difficulty with mark-to-market accounting, however, is that at least as a tax matter it has always been construed as applying only to a taxpayer’s assets, rather than its liabilities. By good fortune, mark-to-market accounting introduces few significant distortions for traditional securities dealers, because of their extensive reliance on overnight funding. If mark-to-market accounting as currently understood were to be applied, however, to the core lending activities of a commercial bank, the result would be a massive distortion of income, because the bank’s assets would be marked to market, while its natural interest rate hedge—its matched funding—would not.<sup>127</sup> Simple accrual method accounting thus is an appropriate response to the fundamental risk management techniques employed by commercial banks in respect of their core lending business.<sup>128</sup>

#### C. Overview of Dealer Taxation

The taxation of domestic securities dealers is now governed almost entirely by Code Sec. 475, which for this purpose adopted two fundamental principles. First, gain or loss from any security held “in connection with” a taxpayer’s dealer activities gives rise to ordinary income or loss.<sup>129</sup> Second, securities dealers now report their dealer income on a mark-to-market basis.<sup>130</sup> The fact that there are ongoing disputes as to how precisely to apply mark-to-market accounting to a dealer’s book of derivatives positions<sup>131</sup> should not obscure the basic tax policy point, which is that mark-to-market accounting is the only accounting method that fairly measures a taxpayer’s income from hedging

activities, because mark-to-market accounting is the only way to capture net changes in wealth both from positions being hedged and from hedging positions, where those positions in turn are not coterminous.<sup>132</sup> For that reason, sophisticated dealers in the era preceding the adoption of Code Sec. 475 lobbied for more comprehensive mark-to-market regimes, to address the timing whipsaws to which they would otherwise have been subject between their positions being hedged and their hedging contracts.<sup>133</sup> Hedging is the paradigmatic dealer market risk management strategy, and therefore Code Sec. 475 appropriately requires all dealers to use mark-to-market accounting.

### D. Overview of P&C Insurer Taxation

The taxation of domestic P&C insurance firms is a strange hodgepodge of rules explainable principally as a result of a long history of skepticism on the part of Congress as to how accurately statutory and financial accounting rules measure insurance income. As noted earlier, insurance companies (whether domestic or foreign) all are taxed as corporations. P&C and life insurers are subject to two different regimes; this article of course summarizes only the taxation of P&C insurers.<sup>134</sup>

A P&C insurance firm is subject to tax at regular corporate rates on the sum of its underwriting income and its investment income (plus various miscellaneous income items).<sup>135</sup> The insurer's gross underwriting income in turn is defined (in the typically opaque style of the Code) as, in effect, the insurer's *earned* premiums for a tax year, plus 20 percent of its *unearned* premiums—except that, in the case of credit default in-

surance on securities described in Code Sec. 165(g)(2) with maturities of at least five years, the insurer must include only 10 percent of its unearned premiums.<sup>136</sup>

Although Code Sec. 832(b)(1) and (8) provide that an insurer's gross income and expenses are computed on the basis of its statutory accounting reports to its insurance regulator, the Code—or at least the IRS—does not really mean it, and a great deal of litigation and regulation-writing has been devoted over the years to scaling back the extent to which deference is given to a taxpayer's statutory accounts.<sup>137</sup> Nowhere is this point more obvious than in the calculation of earned and unearned premiums. Although statutory accounting contemplates various premium reserves, tax accounting does *not*. As recent Treasury regulations make clear, the concept of earned and unearned premiums is basically one of the ratable inclusion of gross premiums over the period of the insurance contract (or 12 months, in the case of multi-year contracts)—without reduction, for example, for any reserves for potential retroactive refunds that might be due customers with better than expected loss experience (“retro credits”),<sup>138</sup> while including in unearned premiums estimates of future premium receivables arising from retroactive adjustments for customers with worse than expected loss experience (“retro debits”).

The inclusion of 20 (or 10) percent of *unearned* premiums in gross income might fairly strike the reader as odd: its purpose, it turns out, is to do rough timing justice.<sup>139</sup> P&C insurers are permitted to deduct on a current basis their costs of originating new insurance contracts (that is, there is

no “Deferred Acquisition Cost” construct for P&C insurance, as there is for life insurance)<sup>140</sup>; the 20- (or 10-) percent acceleration of gross income is designed to create a rough matching of future income against the acquisition expenses incurred to generate that income. Obviously, this percentage will veer more or less widely from reality, depending on the precise nature of the insurance being written.

Net underwriting income equals the insurer's earned and includible unearned income (as described above), less Code Sec. 162-type expenses, and less *incurred* insurance payouts.<sup>141</sup> Just as the current tax construct of earned and unearned premiums includes no reserves of any kind, so too an insurer cannot deduct any reserve for *future* loss events: that is, an “incurred” loss is one for which the insurance trigger has taken place.<sup>142</sup> Insurers are, however, permitted to deduct estimates of “incurred but not reported” (IBNR) losses, which effectively constitute anticipated future claims for loss events that have taken place. IBNR reserves in turn must be discounted to reflect the time value of money until their ultimate anticipated payout.<sup>143</sup>

Losses can be treated as “incurred” for IBNR purposes even when the insurer has no actual knowledge of the loss event. In such cases (e.g., medical malpractice insurance), where the loss event itself may go unnoticed for a time, the development of IBNR estimates is a high art, requiring educated actuarial guesswork as to how many loss events have occurred, as well as the magnitude of the claims to be made in respect of those loss events.<sup>144</sup> One might think of such loss event as “silent.” Other insurance lines might be called “noisy”: an in-



surer that writes earthquake insurance will know when a loss event has occurred, and the development of its IBNR deduction will therefore focus on the estimation of the expected magnitude of claims to be made with respect to that event.

In sum, and in contrast to popular perception, domestic P&C issuers are not permitted tax deductions for reserves for future contingencies or other loss events, although they may establish discounted reserves for their best estimates of loss events that have occurred but have not yet been brought to the insurer's attention. Code Sec. 832(e) creates an apparent exception to this rule for writers of mortgage guaranty insurance, tax-exempt bond insurance and "lease guaranty" insurance, but this exception in turn has little practical utility.<sup>145</sup> The deduction for IBNR is a quasi-reserve, but applies only after a loss event has occurred, and then is subject to discounting rules intended to keep those reserves tax-neutral. The resulting regime is one that might work tolerably well for steady-state insurers of many relatively small potential payouts, but obviously introduces distortions in lines that are subject to lumpier distributions (e.g., earthquake insurance).

For better or worse, the current system seems predicated more on existential tax despair than on any clear tax policy. Congress, having felt itself abused by prior allowances of various statutory reserves (many of which in turn were motivated by regulators' solvency concerns, not their desire to measure periodic income precisely), has responded with what is intended to operate as the economic equivalent of a pure accrual regime, coupled with an arbitrary stab at income and expense match-

ing through the unearned premium inclusion concept.

The other part of a P&C insurer's taxable income is its net investment income. A P&C insurer in general is taxed as is any other investor, notwithstanding the fact that investment returns are an integral part of the fundamental business model (particularly in respect of long-tailed lines). This means that P&C insurers in general are subject to all the special rules on investment income that apply to other corporate taxpayers, including the netting of capital losses only against capital gains, and the tax straddle rules—which in turn leads to feverish debates as to whether "gap hedging" is a hedge of an insurer's (investment) assets (and hereby subject to the straddle rates) or (ordinary) liabilities (and thereby eligible for hedging treatment).<sup>146</sup>

There are two principal exceptions to the general parity between domestic P&C insurers and other corporate investors in respect of investment income. First, P&C insurers must "prorate" the tax benefits of certain tax-favored income, such as income from tax-exempt bonds and dividends eligible for the dividends-received deduction.<sup>147</sup> The apparent premise of this rule is a recognition that insurers, like other financial institutions, are highly leveraged, but that the particular form of an insurer's leverage (its obligations to policyholders) is not addressed by the standard anti-leverage rules applicable to other corporate investors.

The second exceptional investment rule for P&C insurers provides a sort of Code Sec. 1231 style recharacterization of what otherwise would be capital losses into ordinary loss, in circumstances where a P&C insurer sells capital assets "to meet abnormal

insurance losses" or to provide funds for policyholder dividends.<sup>148</sup> This rule of course cannot be explained away on any purported policy grounds; rather, it seems to operate as an elective tax contingency plan for undoing any adverse consequences of the fundamental tax policy error, which is to treat "investment" income of an insurance company as giving rise to capital gain or loss in the first place.

Foreign insurers that are directly engaged in a U.S. insurance business through a U.S. branch are taxed under the special rules of Code Sec. 842. As noted earlier, however, offshore insurance and reinsurance companies often have been able to leverage the more attenuated customer relationships that prevail in the institutional insurance and reinsurance industries than in commercial banking or corporate finance relationships to provide insurance or reinsurance of U.S. risks without directly doing business in the United States. Premiums paid to an offshore P&C insurer *not* engaged in a U.S. insurance business in respect of the primary insurance of U.S. risks are subject to a four percent excise tax under Code Sec. 4371; reinsurance premiums by contrast, are subject to an excise tax of only one percent. Those rates in turn are often reduced to zero by tax treaties (as, for example, in the case of the United Kingdom or Switzerland). The insurance excise tax has no counterpart in the U.S. taxation of any other class of foreign business with a U.S. nexus.

### *E. Overlapping Tax Regimes*

To this point, the discussion in this Part IV has summarized the tax rules applicable to "pure" banking, dealing or insurance operations.

The reality of commercial convergence, however, implies precisely the opposite: banks, for example, conduct dealer businesses “inside” a bank, just as many securities dealers today lend money to corporate customers pursuant to bank-like standby loan facilities. This Part IV.E therefore considers how the different tax regimes summarized above apply to a modern “mixed” financial services firm.

The bank and securities dealer regimes coexist remarkably well. As pointed out above, the definition of a “bank” does not require a specified level of lending activity, and a taxpayer can fall within the definition of a “securities dealer” in respect of only a fraction of its activities. As a result, a bank, for example, typically applies the general accrual principles summarized earlier to its classic bank lending business, while employing mark-to-market accounting for its derivatives and foreign currency dealer businesses.<sup>149</sup> A bank thereby can achieve the matching of interest income and interest expense on its classic lending business, while simultaneously matching the timing of income or loss on its market trading positions and their related hedges through mark-to-market accounting. The converse also is true: a securities dealer can “elect out” of Code Sec. 475’s mark-to-market rules if it so chooses with respect to loans made to corporate customers that the dealer does not intend to resell.<sup>150</sup>

The P&C insurance tax rules, by contrast, do not coexist well with the bank or dealer regimes. First, as described above, an entity must be engaged predominantly in the business of writing insurance to be taxed as an insurance company. This rule means, in effect, that if a bank or dealer were to engage in

activities that arguably met the tax definition of insurance (because those activities involved the shifting of risk to the financial services firm, and the managing of that risk through risk pooling), the bank or dealer nonetheless could not construct an insurance “division” within the same corporate entity as its predominant banking or dealing activity.

In theory, the converse is not the case: in particular, Treasury regulations contemplate that an insurance company can be taxed as a securities dealer in respect of any dealer activities that it conducts.<sup>151</sup> In practice, however, it is possible for insurers to offer financial “insurance” products whose economics largely emulate those of capital markets instruments, but on which the writer is taxed as an insurer, rather than a securities dealer. The entire “finite” insurance (and reinsurance) markets are predicated on this phenomenon.<sup>152</sup>

As noted earlier, insurance regulators generally do not permit insurers to enter into pure market-risk contracts, except as hedges of their insurance portfolio or the new class of synthetic assets termed RSATs.<sup>153</sup> On the other hand, regulators generally do not demand that every contract denominated as insurance contain predominantly pure insurance risks (*i.e.*, risks managed through risk pooling). To the contrary, the rule of thumb in the United States is that a contract with a 10-percent probability of a 10-percent loss attributable to fortuitous events has sufficient insurance risk for an insurance company to be permitted to issue it.<sup>154</sup>

The result is that a credit-risk specialized insurer can, if it chooses, offer contracts, each of which is overwhelmingly a market-risk prod-

uct, but still maintain that it is predominantly engaged in writing “insurance” contracts, and therefore be taxed under insurance rules. Of course, there is little reason for a domestic insurer to do so (because the P&C insurance company rules are not particularly conducive to operating a hedged market-risk business inside a domestic P&C insurance company). There are good reasons, however, for an offshore insurance company to do so, because such an insurer can manage the asset side of its balance sheet through traders physically located in the United States, without being subject to U.S. net income tax (in contrast to an offshore securities dealer). It is true of course that offshore insurance of U.S. P&C risk is subject to a four-percent excise tax; if the contract is one of reinsurance (where the insurance is routed, for example, through a fronting company, as described earlier), the excise tax drops to one percent.<sup>155</sup> Whether the four- (or one-) percent excise tax is in turn a fair substitute for net income tax, however, will depend on the profitability of the asset side of the insurance equation, which will vary from case to case.

The different tax rules for banking and insurance produce little practical differences in result, with respect to *domestic* “zero-expected-loss” institutional monoline insurance. The insurance of corporate or governmental default risk is at the “noisy” end of the incidence spectrum. As a result, even under the view summarized earlier that institutional monoline insurance (as opposed to retail mortgage insurance) is a hybrid activity, with many similarities to banking, the IBNR deduction does not drive a material wedge between an institution regulated as a bank and one regulated as a monoline. In either

case, the institution will not create any reserve for potential future credit defaults, and following a credit event (which will be known generally), the institution will be able to reflect the impairment of its credit extension on a current basis (either as a partially worthless debt or as an IBNR deduction).<sup>156</sup>

In sum, the P&C insurance tax rules tend to create all-or-nothing regimes. Putting aside substantive regulatory issues, a bank or dealer cannot treat a minority activity conducted in the same corporate entity as an insurance business. From the other direction, P&C insurers theoretically might be taxed as dealers in respect of some of their market hedgeable activities, but in practice insurers in a favorable substantive regulatory environment can write “insurance” contracts that themselves are largely market-risk products, while remaining outside the rules applicable to securities dealers. As noted, this last point has particular relevance to offshore insurers (or reinsurers) with U.S. investment managers.

#### F. Summary

The tax rules applicable to domestic banks and dealers appear to be well-suited both to those entities’ respective classic business models and to the demands of commercial convergence. The simple accrual method in fact fits well with traditional lending activities that rely on matched funding; mark-to-market accounting, by contrast, would only introduce distortions in such cases, by marking to market a lender’s assets, but not its matched liabilities. Conversely, mark-to-market accounting fits perfectly with market-risk positions that are hedged with other market contracts, because only mark-to-market accounting ad-

dresses the timing of gains and losses from open market-risk positions that hedge one another. Moreover, taxpayers under either regime generate exclusively ordinary income or loss in respect of core business activities. Finally, banking and dealer activities can coexist within one corporate entity, with each being taxed under its appropriate regime.

The tax rules applicable to traditional P&C insurers, by contrast, appear suboptimal in two fundamental respects. First, the rules themselves are arbitrary and not particularly logical. In particular, the inclusion of a fixed percentage of unearned premiums into current income as a surrogate for expense deferral is useful only if those percentages accurately reflect the business that is undertaken: as insurance moves into more exotic financial settings, there is no empirical evidence of which I am aware to justify those percentages. In addition, the absence of any true loss “reserves” may systematically overstate insurance income, in the case of some “noisier” lines (like catastrophe risk). By contrast, the development of an insurer’s IBNR deduction for other lines may well reflect considerable uncertainties. Finally, the characterization of the asset side of an insurer’s business as “investment” activity is illogical, in the sense that managing investment returns is a core part of the ordinary business activity of insurance, and enables offshore financial insurers to compete in a tax-favored way against domestic banks, securities firms and onshore insurers.

The second respect in which the P&C insurance tax regime appears deficient is that it does not adequately address the fundamental theme of business convergence. Insurance-like activities of banks or dealers are

not taxed as insurance. More importantly, while a P&C insurer is taxed as an insurance company only if it is predominantly engaged in writing insurance, each “insurance” contract in turn—at least in practice—can represent a bundle of market and pure insurance risks in which the market risks predominate. The result is a world in which “insurance” products can compete effectively with market-risk instruments offered by banks or dealers, but where the writers of these products can opt into the P&C insurance tax regimes—a result of particular benefit to offshore insurers.

## V. Credit Default Swaps As a Case Study

### A. Background

The credit default swap is the most common form of credit derivatives contract today.<sup>157</sup> As noted in Part I, the credit derivatives market in total has some \$1.95 trillion (by market value) in outstanding positions, which conservatively means that there are, at a minimum, many hundreds of billions of dollars (by value) in credit default swaps outstanding in the marketplace today. As often has been the case with rapidly evolving financial markets, the IRS has to date not issued any guidance on the tax characterization of credit default swaps.

The terms of standard credit default swaps have been extensively developed elsewhere.<sup>158</sup> Very briefly, a typical credit default swap is documented using standard ISDA documentation and definitions.<sup>159</sup> The contract runs for a fixed number of years.<sup>160</sup> Pursuant to that agreement, the credit protection

buyer makes fixed periodic payments to the credit protection seller measured by reference to a specified notional amount; in exchange, the credit protection seller agrees to make a payment to the credit protection buyer if a specified credit event occurs with respect to a designated issuer ("the Reference Entity"). The most commonly specified credit events for this purpose are (to use the ISDA-defined terms):

- Failure to pay or Default under a specified "Reference Obligation" of the Reference Entity
- Bankruptcy
- Restructuring<sup>161</sup>

The credit default swap contract will specify whether physical settlement or cash settlement is expected if a credit event occurs.<sup>162</sup> If physical settlement is specified, the credit protection buyer must deliver "Deliverable Obligations" that have an aggregate principal amount equal to the contract notional amount; in exchange, the credit protection seller must pay a cash amount equal to the contract notional amount. The credit protection buyer thus is assured receipt of the full principal amount of the relevant obligations (subject, of course, to the credit-worthiness of the credit protection seller), and the credit protection seller assumes the risk of a credit work-out situation as to the Reference Entity.<sup>163</sup> If the contract specifies cash settlement, the credit protection seller pays in cash the difference between the contract notional amount and the post-credit event trading value of an equal principal amount of the designated Reference Obligation.<sup>164</sup>

The Reference Obligation ordinarily serves as the benchmark, with respect to its seniority ranking, legal characteristics, and default triggers, of the types of Deliverable Obligations covered by a credit default swap.<sup>165</sup> For example, a contract

might specify that the term "Deliverable Obligations" includes bonds or loans that are *pari passu* as to the Reference Obligation, that are not amortizing, that mature no later than a specified date, and that are denominated in a specified currency. The occurrence of a credit event triggers the early termination of a credit default swap (that is, the contract typically does not pay twice if two different credit events occur with respect to the Reference Entity over the original contract term). If no credit event occurs prior to the contract's stated maturity, the contract simply expires.

A credit default swap contract written in respect of an underlying corporate Reference Entity almost invariably will use as a Reference Obligation a "senior" (*i.e.*, not expressly subordinated) unsecured debt claim of the Reference Entity, and will define the class of "Deliverable Obligations" broadly to encompass much of the issuer's other senior unsecured debt. The contract can do so and still be fair to both parties because of the near-universal and standardized cross-default provisions in corporate senior debt, under which a default on any one class of senior unsecured debt generally triggers the acceleration of all other classes of the issuer's senior unsecured obligations. Accordingly, following a credit event, the trading value of *all* similarly situated obligations of that issuer generally will converge to reflect an assumed recovery value based on principal amounts—that is, if the recovery value disregards prior valuations based on interest rates or other factors. This legal and value convergence means that, after a credit event, credit protection buyers and sellers essentially will treat all outstanding senior debt of the Reference Entity as equivalent to one another.

The combination of relatively "flat" capital structures among corporate issuers and near-universal and standardized cross-default provisions in corporate senior unsecured debt means that an issuer's class of post-credit event equivalent securities is very large. This fact means that a credit default swap can specify many different Deliverable Obligations, which in turn dramatically increases the utility of credit default swaps to both buyers and sellers of credit protection.

For example, a bank could use a single credit default swap contract as an effective credit hedge for a series of outstanding loans to an issuer under a revolving credit facility (which facility may not even be drawn down at the time the credit protection is acquired). Moreover, a hedge fund or other short seller can profit under a credit default swap without holding any securities of the Reference Entity; following a credit event, the short seller can purchase any of the Reference Entity's debt that qualifies as Deliverable Obligations at a discount from other market participants and deliver it for full face value payment to the credit default swap seller.

As described earlier in this paper, many credit protection sellers are in fact synthetic *investors*, not financial services firms dealing with customer-driven business. Synthetic CDO vehicles and insurance companies investing in RSATs are two examples. Following a corporate credit event, these synthetic investors are simply sad, because they will end up holding one Deliverable Obligation or another in the inevitable bankruptcy.

Other credit protection sellers, however, are financial institutions acting in the capacity of financial services firms dealing with custom-

ers. Their agenda is to *manage* the risk of a Reference Entity default, not simply to accept it. Like credit protection buyers, these firms also rely on a broad definition of “Deliverable Obligations” to make their risk management strategies feasible. If every credit default swap related to a single obligation with a unique place in the reference entity’s credit hierarchy, then a financial services firm could manage the credit risks that it accepts when it sells credit protection only through application of the law of large numbers (or credit rationing), which would limit the scope of the credit derivatives markets to only the highest-grade Reference Entities. In most real-life cases, however, the broad range of post-credit event equivalent obligations (in turn reflected in the definition of Deliverable Obligations) means that a professional credit protection seller can *hedge* the risks it thereby accepts by shorting any of those post-credit event equivalent obligations.<sup>166</sup>

In effect, the existence of cross-defaults in corporate indebtedness, and the market practice of using a broad definition of Deliverable Obligations, creates a *fungible universe* of Reference Entity indebtedness that can be used as hedging instruments. Market hedging can exist only in a world of fungible instruments that can be borrowed and sold short<sup>167</sup>: The credit default swap market is designed to accomplish that purpose, by enabling a credit protection seller to use fungible securities of the underlying Reference Entity to hedge credit default risk, even where the credit protection buyer may be holding a unique loan asset of the Reference Entity.<sup>168</sup>

Market hedging tends to be the low-cost risk management technique, when it is available.<sup>169</sup> For that

reason, my understanding of the credit default swap marketplace is that the preponderance of the default risks accepted by financial services firms in the ordinary course of their customer-driven business are risk-managed through market hedging, rather than simple reliance on the law of large numbers.<sup>170</sup>

### B. Comparative End-User Taxation

It is intuitively obvious that the raw cash flows of a credit default swap fit within the tax definition of a notional principal contract,<sup>171</sup> but could also describe a financial insurance contract, or perhaps a “knock-in” put option with installment premium payments, or some form of guarantee arrangement (with a single lump sum payout, rather than the customary “step into the reference entity’s shoes” cash flows). This fact in turn leads to an important question: How should we distinguish among (at least) three or four different types of contracts, with different tax consequences, when the cash flows under those contracts are likely to be very similar, or even identical?

Happily for this article, most participants in the credit default swap marketplace are institutions. Many domestic institutional participants are tax-exempt, or on mark-to-market accounting; in the latter case, the mark-to-market accounting method addresses not only the *timing* of the costs of credit protection, but also the *character* (as ordinary rather than capital). Thus, when viewed entirely in the domestic context, neither tax exempt nor mark-to-market institutional taxpayers have any strong tax bias in favor of placing credit default swaps in one tax cubbyhole or another.

Banks that buy credit protection in respect of loans that they have made reach a similar result

through a different analysis. Banks are not tax exempt, and, as previously described, ordinarily do not rely on mark-to-market accounting for their core lending activity. If a bank, as an accrual method taxpayer, were simply to acquire a multi-year put option that contemplated annual premium payments, the bank might well worry that those payments would be capitalized and not deducted (or offset against proceeds) until the maturity of the contract. By contrast, annual net payments on a notional principal contract are currently deductible. On the other side, an accrual method taxpayer ordinarily would not accrue any income in respect of an increase in likelihood that it might in the future exercise its put option; by contrast, the tax law is unclear today as to the timing of “contingent” swap payments, but conceivably might one day require current accrual in respect of the right to a future contingent payout<sup>172</sup>—which of course would accelerate income, when the offsetting asset (a bank loan) is not marked to market.

Banks can cut this Gordian Knot by making a hedging election.<sup>173</sup> A credit default swap unquestionably reduces the price risk to a bank of holding a loan covered by that swap, and the loan itself, as previously described, gives rise exclusively to ordinary income or loss, by virtue of Code Sec. 582(c). As a result, a bank that acquires a credit default swap to hedge (in the colloquial sense) the credit risk in a bank loan that it has made (or is committed to make in the future) can make a hedging election. A hedging transaction in turn gives rise exclusively to ordinary income or loss,<sup>174</sup> and the timing of any hedging gain or loss must itself be determined by

reference to the item being hedged.<sup>175</sup> The net effect is a matching of both timing and character, in this case under accrual rather than mark-to-market principles.

To this point, a reader might blithely assume that perhaps this time the IRS got it right when it chose not to make the publication of credit default swap guidance a priority. In fact, however, domestic institutional credit protection buyers care vitally about the issue. In summer 2002, for example, Capitol Tax Partners submitted a long and thoughtful paper to the U.S. Treasury and the IRS urging the publication of a ruling to the effect that credit default swaps should be analyzed as notional principal contracts, and *not*, in particular, as financial insurance arrangements.<sup>176</sup> ISDA responded with its own submission, amplifying the Capitol Tax Partners paper in a few respects and repeating the call for a ruling.<sup>177</sup> More recently, two knowledgeable practitioners in the area have submitted their own paper on the topic, reaching precisely the same conclusion, but strenuously arguing that the characterization of a credit default swap as a notional principal contract is so clear under current law as to obviate the need for any administrative guidance.<sup>178</sup>

What explains this urgent interest in concluding that credit protection buyers in credit default swaps are acquiring notional principal contracts rather than insurance? The answer has nothing to do with the income taxation of the product itself, or the taxation of domestic credit protection sellers. Rather, the fundamental practical issue, consistent with the theme of global convergence in the financial services markets, is that a great

many professional sellers of credit protection to U.S. banks and other domestic credit protection buyers are offshore entities (including insurance companies and synthetic CDO structured vehicles) not doing business in the United States.

As described earlier, the United States imposes a four-percent excise tax on insurance written by offshore insurers in respect of domestic risks (one percent, in the case of reinsurance).<sup>179</sup> The United States also may (or may not—one knows for certain)<sup>180</sup> impose a 30-percent withholding tax on guarantee fees paid to an offshore guarantor. Both are reduced to zero by many treaties (*e.g.*, our treaty with the United Kingdom),<sup>181</sup> but our tax treaty with Bermuda, in particular, offers no reduction in excise or withholding tax burdens. By contrast, the derivatives market generally operates globally without the imposition of cross-border withholding or other taxes. In the United States, that result technically is accomplished by sourcing derivatives income to the residence of the income recipient.<sup>182</sup>

In the capital markets, cross-border withholding taxes (other than withholding taxes on dividends) function as on-off switches, not revenue collection devices, particularly in respect of financial professionals, which operate on thin margins, and which often can locate withholding tax-free substitute instruments. Similarly, there is no data of which I am aware to support the four-percent premium excise tax on foreign insurers, when applied to credit insurance, as in any way commensurate with the income tax that would have been borne by a domestic competitor, which was the original theory behind the excise tax.<sup>183</sup> Indeed, since

the four-percent rate applies to every form of P&C insurance (and the one-percent rate to all reinsurance), and the insurance rate dates back to 1919, it could be expected to be a fair substitute for domestic net income tax only by coincidence.

The institutional credit protection market is global in scope, as are other institutional financial markets. In such an environment, it obviously is unsettling for foreign financial services firms to contemplate an important range of financial products that they offer U.S. customers (for example, options, guarantees and financial insurance) that are closely similar in commercial consequences, but that impose radically different tax costs on those foreign firms. At the same time, the tax costs attendant on some of those characterizations—*e.g.*, as insurance—are themselves completely arbitrary amounts. Since these foreign professionals in turn are often the marginal providers of the products in question, the net effect is that these costs directly affect end user product pricing. The result is market instability, or at a minimum generalized tax anxiety.

This understandable anxiety, then, is the spawning bed of the submissions described above. All the submissions follow a closely similar analysis, which is to identify the legal characteristics that distinguish an insurance contract, on the one hand, from a derivatives instrument, on the other. In this case, the submissions identify as the critical distinctions the facts that insurance provides *indemnification* for actual loss (which in turn implies an insurable interest and proof of actual loss), while credit derivatives, including credit default swaps, look to objective measures of loss (*e.g.*, in the case of cash settlement, a poll of securities dealers as

to the market value of the Reference Obligation or cheapest Deliverable Obligation following a credit event), and do not require that the credit protection buyer in fact have suffered that loss. (Indeed, as previously described, a significant minority of credit protection buyers today use those contracts to establish “naked” short positions.) This analysis follows closely the reasoning adopted in a widely distributed legal opinion obtained by ISDA that concluded that writing credit derivatives contracts did not constitute the illegal conduct of an insurance business in the United Kingdom.<sup>184</sup>

The analysis also follows our collective traditional tax approach to deciding into which cubbyhole to put a new financial product. The fact is that the tax law has always had to address different financial instruments with similar (or even identical) cash flows, and the usual way of distinguishing among them has been to focus, not on pure economics, but rather on differences as to legal rights and obligations. To take an obvious example, we do not distinguish between preferred stock and debt for tax purposes by looking to the absolute likelihood of repayment—if we did, preferred stock issued by a AAA issuer invariably would be classified for tax purposes as debt, and debt issued by a BB issuer as equity. Instead, we look primarily to the different legal remedies available following a failure to pay periodic cash flows: preferred shareholders have one cluster of standard remedies, and debtholders another, quite different set. One of the desirable aspects of the tax law standards for distinguishing debt from equity, for example, is that most of them—whether the instrument has a term, whether it participates in

corporate governance, whether the instrument offers classic creditor or shareholder remedies on a default, and so on—can be determined simply by inspecting the organic documents that create the instrument.<sup>185</sup> The drafters of the recent submissions to the Treasury appear to have been inspired by that example, and have worked diligently to propose legal standards (the objective measure of loss and absence of a requirement to suffer that loss) that also can be determined by direct inspection of the instrument’s terms.

The motive is completely understandable, and, when applied to “naked” credit protection buyers, the analysis in the recent Treasury submissions is persuasive. That analysis, however, is not completely congruent with the tax definition of insurance and may not be sustainable indefinitely into the future, as a matter of substantive regulatory guidance.<sup>186</sup> In particular, when applied to “covered credit protection buyers,” the analysis leaves several important issues unresolved.

First, as a factual matter, the vast bulk of credit protection buyers in credit default swaps *do* acquire effective indemnification for loss. A bank that owns a loan to the underlying Reference Entity (which remains as we have seen the largest segment of the market) essentially is agnostic between acquiring pure insurance-style indemnification and an “objectively determined” payoff—particularly where, as typically is the case, a credit default swap permits the bank as credit protection buyer to deliver its bank loan following a credit event. (By contrast, a bank would *always* care whether it made a loan or acquired preferred stock of the same issuer.)

The proposed analysis thus effectively gives taxpayers a free

option to choose between insurance and derivatives characterization, by referencing (or not) the loan assets that they in fact hold. In this respect, the proposed standards seem to identify a distinction that makes little practical difference.

Moreover, there is considerable pressure in today’s credit default swap market to move closer to pure indemnification-style payouts (to the extent insurance regulators do not object), to eliminate exotic gamesmanship in the choice of Deliverable Obligations.<sup>187</sup> The proposed standards thus are in danger of being made increasingly irrelevant (or worse, producing the wrong answer) as market participants refine the measure of loss in a credit default swap.

The second major unresolved issue in the approach recommended in the recent submissions to the Treasury is that those submissions adopt a reading of the tax definition of insurance that emphasizes a minor theme (whether the insured faced specifically identifiable hazards that were mitigated through insurance) at the expense of the major ones (risk shifting and distributing). As the IRS has stressed repeatedly in recent months, the tax definition of insurance at its core contemplates risk shifting, on the one hand, and risk distribution and pooling, on the other.<sup>188</sup> The recent submissions to the Treasury effectively conclude that risk is not shifted (and a contract therefore fails one of the legs of the definition of insurance) by a contract that does not *require* the credit protection buyer to suffer a loss. This argument is not factually satisfying when applied to the normal case of a protection buyer that in fact is obtaining practical indemnification through that contract, and

it also distorts the purpose of the risk shifting test, which appears to be aimed primarily at distinguishing insurance from synthetic investment contracts, on the one hand<sup>189</sup> (as in *Le Gierse* itself), or from “self insurance” reserves, on the other.<sup>190</sup> The recent submissions effectively appear to argue that a contract that contemplates the possibility that the credit protection buyer might make a “naked” bet is not a risk shifting contract, because in that case the credit buyer is *creating* risk for itself, rather than *shifting* a pre-existing risk; this construction, however, puts too much emphasis on a narrow reading of “risk” and too little on “shifting.”

More fundamentally, the proposed standards give too little weight to risk distribution and pooling, which are the core activities that distinguish insurance contracts from other forms of risk shifting contracts (like a put option). The practical difficulty, of course, is that risk distribution and pooling are attributes of the credit protection seller’s risk management strategy, which might well be opaque to a credit protection buyer. This is a serious practical concern (and one that is addressed below), but the fact that the inquiry is awkward does not mean that it can be ignored.

In other words, the very definition of insurance requires an inquiry, not simply into what the credit protection buyer has acquired, but also into the credit protection sellers’ risk management strategy. Insurance is not like preferred stock: inspecting the terms of the instrument is insufficient to determine the cubbyhole into which it fits. The core determinant of insurance is that it ultimately is *not* a market risk product—if it were, it would be risk managed through

hedging—and the proof of that conclusion lies in inspecting, not the terms of the instrument, but rather the protection seller’s risk management strategy.

The third major unresolved issue in the approach recommended in the recent submissions to the Treasury is that those submissions focus exclusively on the taxation of the *product*, without indicating what that conclusion should tell us about the taxation of the financial services firm that sells that product. In fact, there are powerful tax policy reasons to care about the tax characterization of the activities of the credit protection seller, even when those activities are putatively offshore. These reasons are described in the next section; what is important here is that this issue, like the fundamental tax definition of insurance, points towards activities of the credit protection seller as a relevant part of the calculus when analyzing the tax cubbyhole into which the product belongs.

### *C. An Alternate Approach*

Rather than a normative approach to analyzing credit default swaps as an abstract product, as reflected in the recent submissions to the Treasury, this paper advocates a functional approach that considers the credit protection seller’s risk management strategy as well as the formal terms of the contract in question. By focusing on the financial services firm that is the credit protection seller, we can develop rules that are truer to the existing tax jurisprudence, less easily gamed, less susceptible to the evolution of market terms, and ultimately fairer to the fisc. This Part V.C briefly summarizes these themes.

The functional analysis proposed here, as well as tax law’s definition of insurance, requires a

credit protection buyer to inspect the credit protection seller’s risk management strategy, but the seller’s internal operations generally are opaque to a buyer. How can this practical conundrum be resolved? The recent submissions to the Treasury did so by de-emphasizing risk distribution and pooling as relevant to the tax analysis, in an effort to sidestep the problem. A more satisfying solution, however—and one that happily reaches the same conclusion when applied in the current marketplace—is to construct a presumption that, in the world of financial services firms, what can be hedged at reasonable cost, is hedged, because market hedging generally is more efficient than relying on the law of large numbers. As described earlier, most credit default swaps or credit insurance contracts that effectively are synthetic credit default swaps (by virtue of a transformer company) in fact are designed to be hedgeable by credit protection sellers, by shorting fungible debt instruments of the same underlying Reference Entity. As applied to the current market, then, the proposed presumption would lead to the conclusion that credit default swaps ordinarily fall outside the tax definition of insurance.

A presumption that financial services firms that are credit protection sellers in fact rely on hedging to manage their risks—and therefore that the products they sell are *not* insurance—is consistent with my understanding of the market, and provides a practical solution for how to apply the legal definition of insurance (including its emphasis on risk distribution) in the absence of complete information. As noted above, this approach reaches the same conclusion as that proposed in the recent submissions



to the Treasury, but is less susceptible to gaming (as when an owner of debt instruments seeking practical indemnification opts in or out of insurance treatment by referencing, or not, the assets that it in fact owns), and is less susceptible to an inadvertent tripwire as market definitions of credit events and measures of loss evolve.

The functional approach proposed here also is a more robust tool than is the normative approach recommended in the recent submissions to the Treasury to address other categorization issues. For example, why under the normative approach is the purchaser of a “cat” bond not a reinsurance company? The insurer that issues the cat bond certainly has an insurable interest, and shifts the risk of that specific catastrophe to the cat bond purchasers, to the extent of their investment. The answer, of course, lies not in the risk shifting side of the arrangement, which might well be indistinguishable from facultative reinsurance, but in the risk assignee’s perspective: The cat bond purchaser is not engaged in risk distribution and pooling by virtue of that investment, and in any event is not acting as a financial services firm, but rather as a customer of one.

It might be objected that the functional approach proposed here, like the normative approach recommended in the recent submissions to the Treasury, is an elaborate justification for offshore financial services firms paying lower federal taxes—in this case, by avoiding the four (or one) percent excise tax on insurance (or reinsurance). This is one consequence of the proposal, but that fact does not mean that the fisc necessarily would be the poorer for it.

The fundamental analysis proposed in this paper first constructs a presumption that an offshore financial services firm that sells standard credit protection contracts to U.S. institutional customers is not selling insurance, because those contracts can be hedged in the marketplace. Market hedging is a key indicator of a *securities dealer*, not an insurance company. As a result, the functional analysis proposed herein would as a corollary create a presumption, not only that the product sold was a derivatives contract (rather than insurance), but that the seller was a securities dealer in respect of that activity.

It unfortunately is not possible to set out the details of the analysis within the constraints of the space allotted this paper, but, in brief, the U.S. tax system should characterize as a securities dealer any offshore financial services firm that sells credit protection contracts to U.S. customers and hedges its risks in the market, regardless of the label attached to those contracts, or to the financial services firm itself. By doing so, the United States will appropriately sweep into the U.S. tax net the financial services firm’s net income from that line of business, whenever the financial services firm or its agents engage in the United States in significant activities in connection with that business, including hedging activities. By contrast, an offshore *insurance company* that is not affirmatively characterized as a dealer can hedge market risks continuously and use employees physically located in the United States to do so, without attracting U.S. net income tax, by virtue of the securities “trading” safe harbor of Code Sec. 864(b)(2).

The presumption contemplated herein that contracts that can be hedged in the securities markets in

fact are risk managed through hedging thus is a two-edged sword. First, the presumption forms a robust basis for concluding that most credit default swaps and similar products in the marketplace today are not insurance contracts. Second, the presumption forms a basis for a much more careful inquiry than currently seems to be the practice into whether contracts offered by offshore reinsurance companies to “transformer” vehicles and the like are in fact part of a securities dealer business that properly should lose its Code Sec. 864(b)(2) immunity from U.S. net income tax.

The above proposal would not adversely affect credit default swaps sold by offshore CDO structured vehicles. Entering into credit default swaps would not constitute the conduct of an *insurance* business by a CDO structured vehicle, because the risks remain market-based risks, and thus outside the scope of the definition of what insurers do. Factually, such vehicles in turn are not securities dealers, because they do not have customers, they *are* customers. The result again is a logical one: a synthetic mutual fund is no more an insurer engaged in risk distribution than is an actual mutual fund, because synthetic or actual diversified investing is not the same as the management through the application of the law of large numbers of a financial services firm’s risks incurred through its dealings with customers.

## VI. Conclusion and Recommendations

The products and services offered by different classes of financial services firms are converging in the marketplace. At the same time, however, the core activities of different

sectors of the financial services industry are divided by real and important differences in substantive regulation and risk-management philosophy; that is, market convergence in some products does not mean that there no longer are any meaningful distinctions among banks, securities firms and insurers.

Tax policy makers must confront the implications of product convergence for a tax model that today tends rigorously to segregate the taxation of both different products and different financial services firms in reliance on largely normative standards. A comparative analysis of the taxation of different financial products with similar commercial or economic roles no doubt can help to conform the taxation of different normative cubbyholes to one another as the products in question converge more closely to one another. (Thus, for example, one can argue that the taxation of options is so fundamentally different from the taxation of the other risk-shifting products described in this paper as to invite closer inspection.) This paper argues, however, that in the end there are limits to the utility of further refinements to the tax law's normative financial product cubbyholes.

Insurance, in particular, is a slippery concept, ill-suited to a normative product-level definition. Colloquially, the term can be used for any risk reduction strategy.<sup>191</sup> Commercially, the term can apply to any contract offered by an insurance company—which, as described earlier, can include contracts that are overwhelmingly market risk contracts.

Notwithstanding the breadth of some colloquial or commercial references, the tax law should construe the term “insurance” narrowly in the context of finan-

cial risks. Problems arise when financial services firms offer nontraditional “finite” and other predominantly market-risk products, and tax commentators attempt to analyze these products through a normative inquiry into the terms of the product, viewed solely from the perspective of the protection purchaser. That approach makes tax differences turn on formal distinctions with little commercial relevance, and does violence to the fundamental tax definition of insurance, which looks not only at what the contract means to the insured, but also how the contract is risk managed by the insurer.

Insurance as a tax construct thus should be limited to those cases where the professional financial services firm that offers the product to customers manages its attendant risks through risk distribution and pooling. There are many examples of genuine financial insurance in this narrow sense: mortgage insurance is an obvious example. The firms that offer these products engage in the same actuarial efforts, and rely to the same extent on the law of large numbers, as do fire or life insurers.

This paper proposes, as an alternative to the normative mode of analysis, that in some cases—in the particular example considered here, the case of insurance—a financial product can more usefully be categorized for tax purposes by considering, in addition to the formal terms of the instrument, which of the three paradigmatic risk management strategies the professional provider of the product adopts. Because these strategies often are opaque to the customer, the paper proposes the construction of a presumption that risks that *can* be managed through market hedging *are* so managed, and therefore fall

outside the relatively narrow category of financial insurance.

As applied to the current debate surrounding the characteristics of credit default swaps, the proposed presumption would operate in two steps. As a preliminary matter, the presumption would ask whether the credit protection seller was a financial services firm, and the credit protection buyer a customer of that firm. If the answer is in the negative (as is the case when investment vehicles like “synthetic CDO” structured vehicles sell credit default protection), the contract lacks the requisite commercial context to be insurance.

As a second, more substantive level, the presumption would ask whether the risks assumed by the credit protection seller are of a type that can be hedged. This concept in turn can be refined by asking whether the contract is based on Reference Obligations that are (or that have cross-default provisions with other classes of securities that are) actively traded in an established securities market. If the answer is affirmative, then the credit protection buyer should be entitled to assume that it is dealing with a professional financial services firm that is acting in the capacity of a securities dealer.

This approach also channels the construct of financial insurance into those applications where the insurance model is the only means of explaining how risk is managed. In light of the limited utility of the P&C insurance company tax model when dealing with risks that in fact are hedged in the markets, this result is appropriate.

In the domestic context, mark-to-market accounting plainly is a more accurate measure of that portion of a financial services firm's net income derived from acting as a *de facto* dealer in market risk posi-

tions and their related hedges than is the simple accrual regime (with the arbitrary inclusion of 10 or 20 percent of unearned premiums) to which “zero-expected-loss” monoline financial insurers effectively are subject.<sup>192</sup> In the international context, the United States makes a bad trade when it attempts to collect a four-percent (more often, one-percent) excise tax on gross “premiums” in transactions that more properly might be viewed as securities dealer activity. That excise tax (if collected) either will operate to forestall marginal trades that would be feasible if a net income tax were imposed in-

stead, or (more probably) will operate to subsidize offshore “insurers” at the expense of the domestic securities industry.

This approach reaches a result in almost all credit default swaps that is consistent with the result recommended in the recent submissions to the U.S. Treasury.

The other side of the presumption proposed herein is that financial services firms that in fact manage customer risks through market hedging are engaged in the securities dealer business, and should be taxed as such. Current practice, if not current law, appears to countenance a small insurance company tail wag-

ging a large securities dealer dog, when the reverse should be the case.

Accordingly, this paper also recommends that a financial services firm that offers to customers contracts, the preponderance of whose risks are hedgeable in the capital markets, should be taxed as a securities dealer in respect thereof. As a result, many specialized offshore financial insurers and reinsurers, in particular, would find that a significant portion of their business would be characterized as the conduct of a securities dealer division, which, if the requisite factual nexus were present, in turn would be subject to U.S. net income tax.

# ENDNOTES

\* The author wishes to acknowledge the substantial assistance of his colleagues Maxim S. Kulikov and Raphaël Béra in preparing this paper for publication.

<sup>1</sup> Robert Charles Clark, *The Federal Income Taxation of Financial Intermediaries*, 84 YALE L.J. 1603 (1975).

<sup>2</sup> See, e.g., GROUP OF TEN, REPORT ON CONSOLIDATION IN THE FINANCIAL SECTOR, 70-76 (Jan. 2001) (available online at [www.bis.org](http://www.bis.org)); SWISS RE, WORLD FINANCIAL CENTRES: NEW HORIZONS IN INSURANCE AND BANKING, SIGMA No. 7/2001, at 33-39 (available online at [www.swissre.com](http://www.swissre.com) in the Sigma Archive) (discussing forces shaping today's financial system); ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, THE NEW FINANCIAL LANDSCAPE—FORCES SHAPING THE REVOLUTION IN BANKING, RISK MANAGEMENT AND CAPITAL MARKETS (1995) (same). For examples of convergence between banking and insurance, see ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, CONVERGENCE IN THE FINANCIAL SERVICES INDUSTRY, at 18-19 (Sept. 1999). For examples of convergence between financial instruments and insurance, see Miller, *Distinguishing Risk*, *infra* note 16, at 80-131.

<sup>3</sup> For a comprehensive summary of the current credit derivatives marketplace, see ANTHONY C. GOOCH and LINDA B. KLEIN, DOCUMENTATION FOR DERIVATIVES (2002) (discussing legal regimes applicable to various over-the-counter products). See also JANET M. TAVAKOLI, CREDIT DERIVATIVES & SYNTHETIC STRUCTURES (2001) (discussing the economics of different credit-linked structured products).

<sup>4</sup> See FINANCIAL SERVICES AUTHORITY (“FSA”) DISCUSSION PAPER No. 11, CROSS-SECTOR RISK

TRANSFERS, 21 (May 2002) (available online at [www.fsa.gov.uk/pubs/discussion/dp11.pdf](http://www.fsa.gov.uk/pubs/discussion/dp11.pdf)) (hereinafter, “FSA DISCUSSION PAPER”); “So a broad generalization would be that credit risk has been transferred from banks to internationally active insurers and reinsurers and monolines [i.e., specialist financial insurers]”; FINANCIAL SERVICES AUTHORITY, FEEDBACK ON RESPONSES TO DISCUSSION PAPER NO. 11 ON CROSS-SECTOR RISK TRANSFERS (Dec. 2002) (available online at [www.fsa.gov.uk/pubs/discussion/fs11.pdf](http://www.fsa.gov.uk/pubs/discussion/fs11.pdf)) (hereinafter, “FSA FEEDBACK STATEMENT”).

<sup>5</sup> The Lloyd's insurance markets are the largest reinsurance markets in the world. Similarly, the U.K. markets account for roughly half of the worldwide volume in credit derivatives. See BRITISH BANKERS ASSOCIATION CREDIT DERIVATIVES REPORT—EXECUTIVE SUMMARY (2002) (available online at [www.bba.org.uk/public/services/publications/58309](http://www.bba.org.uk/public/services/publications/58309)) (hereinafter, “BBA CREDIT DERIVATIVES REPORT”).

<sup>6</sup> For an overview of “cat bonds,” see ERIC BRIYS and FRANCOIS DE VARENNE, INSURANCE: FROM UNDERWRITING TO DERIVATIVES, at 33-37 (2001); SWISS RE, CAPITAL MARKET INNOVATION IN THE INSURANCE INDUSTRY, SIGMA No. 3/2001 (available online at [www.swissre.com](http://www.swissre.com) in the Sigma Archive); FSA DISCUSSION PAPER, *supra* note 4, at 39-57; Gregory L. Stephenson et al., 2001: A Risk Odyssey, J. TAX'N FIN. PRODUCTS, Win. 2001, at 22-23; Viva Hammer and Ann Singer, *Insurance Derivatives: A Tax Angle*, 554 PLI/Tax 421 (2002).

<sup>7</sup> For a summary of the U.S. regulatory environment, see NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, SECURITIES VALUATION OFFICE, *Replication (Synthetic*

*Asset) Transactions*, in 1 SVO RESEARCH, Issue 8, at 4 (Dec. 2001) (available online at [www.naic.org/1svo\\_research/documents/December\\_2001\\_cc.pdf](http://www.naic.org/1svo_research/documents/December_2001_cc.pdf)) (hereinafter, “NAIC RSATs REPORT”).

In the United Kingdom, “Section 16 of the Insurance Companies Act 1982 restricts the permitted activities of an insurance company to those which are ‘in connection with or for the purposes of’ its insurance business. This will exclude writing a risk transfer contract in the form of a swap, for example, although swaps and options as part of the company's day-to-day treasury function are permitted, subject to guidelines issued by the insurance regulatory.” Alexandra Booth and Elborne Mitchell, *The Fine Line Between Investment and Insurance—the Authorization of an Intermediary*, at 11 (on file with Cleary, Gottlieb, Steen & Hamilton). See also FSA DISCUSSION PAPER, *supra* note 4, at ¶13.108 and Annexes B and C.

<sup>8</sup> See NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, SECURITIES VALUATION OFFICE, *Introduction to Credit Linked Notes*, in 1 SVO RESEARCH, Issue 4, at 4 (May 2001) (available online at [www.naic.org/1svo\\_research/documents/SVO\\_May01cc.pdf](http://www.naic.org/1svo_research/documents/SVO_May01cc.pdf)).

<sup>9</sup> For a description of CDOs, see GOOCH & KLEIN, *supra* note 3, at 645-46; Linda Beale, David S. Miller and Paul Wysocki, *An Overview of the U.S. Federal Income Tax Treatment of Collateral Debt Obligation Transactions*, J. TAX'N FIN. INST., (Jul.-Aug. 2001); FSA DISCUSSION PAPER, *supra* note 4, at 8-10; Humphreys, *The Way (Securitization) Things Ought To Be*, *infra* note 16, at 17-20.

## ENDNOTES

- <sup>10</sup> See NAIC RSATs REPORT, *supra* note 7, at 4.
- <sup>11</sup> See *id.* The recent development of RSATs might explain some of the recent surge in direct credit derivatives contract writing by insurers described below.
- <sup>12</sup> For an overview of transformer companies, see FSA DISCUSSION PAPER, *supra* note 4, at 13 and Appendix A; Maria Ross and Charlotte Davies, *Credit Derivatives and Insurance—a World Apart*, INT'L SECURITIES MONTHLY (Mar. 2001).

One criticism of the FSA DISCUSSION PAPER is that it is not always apparent how the FSA categorized different technical means of accomplishing cross-sector credit risk transfers. The text gives as an example of this problem an insurer's use of credit derivatives on the investment asset side of its business and the use of "synthetic credit derivatives" on the insurance underwriting side of the business. Other examples might include credit derivatives used as hedges of insurance underwriting risks and credit derivatives written by noninsurance subsidiaries of insurance company groups. It is unclear to this reader, at least, how all of these different functions are reflected in the FSA's analysis.
- <sup>13</sup> See sources cited *supra* note 12.
- <sup>14</sup> Protected cell companies consist of core capital and multiple "cells." Creditors of a cell have access only to the assets of that particular cell or, to the extent they are insufficient to discharge the cell's liabilities, to the core capital, but do not have access to the assets of other cells. See FSA DISCUSSION PAPER, *supra* note 4, Annex A; WILLIS GROUP, PROTECTED CELL COMPANIES: THE PRESENT AND FUTURE (Oct. 2000); Stephenson et al., *supra* note 6, at 21.
- <sup>15</sup> See A.M. BEST REPORT ON CENTRE SOLUTIONS (2002) (available online at [www3.ambest.com/frames/frameserver.asp?Site=ratings&tab=1&RefNum=85566&AltSrc=1&AltNum=](http://www3.ambest.com/frames/frameserver.asp?Site=ratings&tab=1&RefNum=85566&AltSrc=1&AltNum=)).
- <sup>16</sup> See, e.g., Thomas A. Humphreys, *The Way (Securitization) Things Ought to Be*, THE TAX CLUB, Nov. 25, 2002, at 15–18; Thomas A. Humphreys, *Gambling on Uncertainty—The Federal Income Tax Treatment of Weather Swaps, Cat Options, and Some Other New Derivatives*, TAX FORUM NO. 528 (Nov. 2, 1998); Bruce Kayle, *Will the Real Lender Please Stand Up: The Federal Income Tax Treatment of Credit Derivative Transactions*, 50 TAX LAW. 568 (1997); Bruce Kayle, *The Federal Income Tax Treatment of Credit Derivative Transactions*, 554 PLI/TAX 381 (2002); David S. Miller, *Credit Derivatives: Financial Instruments or Insurance? And Why It Matters*, J. TAX'N FIN. PRODUCTS, Win. 2002, at 31; David S. Miller, *Distinguishing Risk: The Disparate Tax Treatment of Insurance and Financial Contracts in a Converging Marketplace*, TAX FORUM NO. 552 (Oct. 1, 2001); David Z. Nirenberg and Steven L. Kopp, *Credit Derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, J. TAX'N 82 (Aug. 1997).
- <sup>17</sup> For a good overview of credit derivative products, see, e.g., J.P. MORGAN GUIDE TO CREDIT DERIVATIVES (2001).
- <sup>18</sup> See Henry Sender, *Market Backfires and Investors Pay*, WALL ST. J., Dec. 5, 2002, at C1.
- <sup>19</sup> See BBA CREDIT DERIVATIVES REPORT, *supra* note 5. For a discussion of some of the difficulties associated with comparing credit derivatives data from different sources, see BIS QUARTERLY REVIEW—DERIVATIVES MARKETS, 10–11 (June 2002) (available online at [www.bis.org](http://www.bis.org)).
- <sup>20</sup> *Id.* (banks represented approximately 52 percent of protection buyers' market, followed by securities firms at 21 percent; banks also represented 39 percent of protection sellers' market, followed by insurance companies at 33 percent).
- <sup>21</sup> See Sender, *supra* note 18; Navroz Patel, *Serving the Credit Funds*, RISK, at 22 (Aug. 2002).
- <sup>22</sup> See BBA CREDIT DERIVATIVES REPORT, *supra* note 5. While banks today are somewhat larger sellers of credit protection than are insurance companies, banks are also the largest buyers of protection; on a net basis, banks appear to be the largest net buyers of credit protection, and insurance companies the largest net sellers. See FSA DISCUSSION PAPER, *supra* note 4, at 17–18.
- <sup>23</sup> For an overview of various products, see, e.g., DEUTSCHE BANK, CREDIT DERIVATIVES AND STRUCTURED CREDIT (Aug. 30, 2000); Kayle, *The Federal Income Tax Treatment of Credit Derivative Transactions*, *supra* note 16, at 385–89. See also FSA DISCUSSION PAPER, *supra* note 4, at 10–11.
- <sup>24</sup> GARY L. GASTINEAU and MARK P. KRITZMAN, DICTIONARY OF FINANCIAL RISK MANAGEMENT 182 (1999). For an overview of the economics of knock-in options with credit-related triggers, see TAVAKOLI, *supra* note 3, at 145–49.
- <sup>25</sup> See Kayle, *The Federal Tax Treatment of Credit Derivative Transactions*, *supra* note 16, at 401–03. The hallmark of an option is that "it limits the promisor's power to revoke his or her offer . . ." *Old Harbor Native Corp.*, 104 TC 191, 201, Dec. 50,452 (1995). Thus, an "option" whose exercise is controlled by its writer or is dependent on the occurrence of wholly speculative events may not be a true option for tax purposes. The purpose of a knock-in feature in an option, by contrast, is to define the nature of the risk being transferred. These circumstances are neither wholly speculative nor within the control of the writer of the option. The knock-in option, therefore, is analogous to a conventional cash-settled put option in that its exercise is possible (but not inevitable) and may not be limited by the writer of the option after it has been granted. Cf. Nirenberg and Kopp, *Credit Derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, *supra* note 16, at 91 (arguing that the trigger event in credit default swaps is different from typical knock-in triggers because "[i]t is not a condition the occurrence of which starts the option period . . . it is the element of the option that causes the option to be exercised").
- <sup>26</sup> See, e.g., Miller, *Credit Derivatives: Financial Instruments or Insurance? And Why It Matters*, *supra* note 16, at 32.
- <sup>27</sup> See Clark, *supra* note 1, at 1609–23.
- <sup>28</sup> See Simon Johnson, *Financial Guarantee Insurance at Lloyd's* (unpublished paper, on file with Cleary, Gottlieb, Steen & Hamilton). Compare FSA DISCUSSION PAPER, *supra* note 4, at 23 ("Some think that regulatory arbitrage is the main driver [of cross-sector credit risk transfer]—the banks want to free up regulatory capital. Evidence of such deals abound, and originators themselves grudgingly admit to it") with FSA FEEDBACK STATEMENT, *supra* note 4, at 7, ¶3.11 ("Respondents were generally sceptical that regulatory capital requirements were currently the main driver in the credit risk market") and ¶3.13 ("There were clearly significant inconsistencies between current regulatory charges and risk, even if regulatory capital was not currently a significant driver").
- <sup>29</sup> These issues and the difficulties of developing cross-sector measures of comparability of regulatory burdens have recently been explored by the Joint Forum, which comprises the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors. See THE JOINT FORUM, RISK MANAGEMENT PRACTICES AND REGULATORY CAPITAL: CROSS-SECTORAL COMPARISON, at 46–67 (Nov. 2001) (available online at [www.bis.org](http://www.bis.org)) (hereinafter, the "JOINT FORUM REPORT").
- <sup>30</sup> Cf. BRIYS & DE VARENNE, *supra* note 6, at Ch. 6 (entitling the chapter *A Functional Approach to the Insurance Industry*); SWISS RE, *supra* note 2, at 33:

"The roles of FIs [i.e., financial intermediaries] are evolving. Some FIs are

## ENDNOTES

constantly reinventing their core value propositions, blurring the distinctions between intermediaries. This happens when, for example, banks manufacture and distribute insurance products or securities firms package and redistribute insurance risks. As a result, it is sometimes argued that classifying intermediaries by the functions they perform (e.g., risk transformers) is more meaningful than using traditional industry classifications (e.g., insurers). Despite this blurring of boundaries, each type of FI retains distinctive characteristics that differentiate it from the others."

<sup>31</sup> For a discussion of the traditional "cubbyhole" approach in the context of equity derivatives, see Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1348-61 (1991).

<sup>32</sup> See Clark, *supra* note 1.

<sup>33</sup> For example, long- and short-term debt accounts for less than two percent of the total liabilities of The Hartford insurance company. THE HARTFORD, 2001 ANNUAL REPORT, at 33 (2002).

<sup>34</sup> The list can be fairly criticized for excluding some institutionally-oriented finance companies, but I do not believe that they present significant tax issues in this context different from those that apply to commercial banks.

<sup>35</sup> Admittedly, some reinsurers are an exception to this rule, depending on the nature of their business specialties. Thus, for example, ACE Ltd. and XL Capital Ltd., two large publicly held Bermuda reinsurance companies, were said to have had fewer than 800 employees between them working in their Bermuda reinsurance businesses. See Lee A. Sheppard, *Would Imputed Income Prevent Escape to Bermuda?* 86 TAX NOTES 1663 (Mar. 20, 2000).

<sup>36</sup> See CITIGROUP, INC. 2000 ANNUAL REPORT, at 170 (2001).

<sup>37</sup> See GOLDMAN SACHS, 2001 ANNUAL REPORT, at 3 (2002).

<sup>38</sup> Institutional insurance arguably represents a partial exception, or at least a very attenuated example. See Section II.D, below.

<sup>39</sup> Code Sec. 1221(a)(1).

<sup>40</sup> For example, the Securities and Exchange Commission has developed expansive anti-fraud provisions to regulate conduct by broker-dealers in their dealings with their customers. See NORMAN S. POSER, *BROKER-DEALER LAW AND REGULATION*, (3rd ed. 3-3 2000); EDWARD GREENE, ALAN BELLER, EDWARD ROSEN, LESLIE SILVERMAN, DANIEL BRAVERMAN and SEBASTIAN SPERBER, *U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS*, at

§9.07(1), (2)(a) (2000) (hereinafter, "GREENE & BELLER"). The self-regulatory organizations also impose suitability rules that, by way of one example, require brokers, when making investment recommendations or exercising discretion on behalf of a customer, to take action consistent with the customer's financial situation and needs. See, e.g., NASD Rule 2310; NYSE Rule 405. Title V of the Gramm-Leach-Bliley Act of 1999 (PL. 106-102) (hereinafter, "Gramm-Leach-Bliley") imposes certain requirements on firms engaged in financial activities regarding the use and disclosure of nonpublic personal information of "consumers" with whom the firms have established a "customer relationship." See Gramm-Leach-Bliley, Title V, 113 Stat. 1338, 1436-1445 (1999); see also 12 CFR Part 216 (Federal Reserve Board regulations implementing Gramm-Leach-Bliley Title V and defining "customer relationship" and "customer").

<sup>41</sup> G.R. Kemon, 16 TC 1026, 1032-33, Dec. 18,271 (1951) (citing *Schafer v. Helvering*, SCt, 36-2 USTC ¶9537, 299 US 171, 57 SCt 148 (1936)).

<sup>42</sup> The ability to cross-sell various products has been described as the "holy grail" of the financial services industry. See, e.g., John Authers, *Cross-Selling's Elusive Charm*, FIN. TIMES (Nov. 16, 1998).

<sup>43</sup> PL. 106-102, 113 Stat. 1338 (Nov. 12, 1999).

<sup>44</sup> See generally Charles W. Calomiris, *Universal Banking and the Financing of Industrial Development*, WORLD BANK (1995) (working paper); E. Paulet, *Universal Banks and the European Banking System: Prospects and Problems*, EUROPEAN INSTITUTE (1996); S.H. Talley, *Bank Holding Companies: A Better Structure for Conducting Universal Banks*, WORLD BANK (1991).

<sup>45</sup> The principal legal restrictions that prevented most banks from engaging in, or affiliating with firms engaged in, securities activities were contained in the Glass-Steagall Act, 12 USC §§24 (7th) 335, 377, 378, some (but not all) of which was repealed by Gramm-Leach-Bliley. Restrictions on bank holding companies' ability to engage in broad securities activities, particularly securities underwriting and dealing, stem from the Federal Reserve Board's historical interpretation of Act Sec. 4(c)(8) of the Bank Holding Company Act of 1956, 12 USC §1843(c)(8) (hereinafter, "the BHCA"). Limitations on the ability of banks to engage in, and affiliate with firms engaged in, broad insurance activities, particularly insurance underwriting, stem from an interplay of federal law (principally the McCarran Ferguson

Act, 15 USC §§1011-15; the National Bank Act, 12 USC §92; and the BHCA, 12 USC §1843(c)(8) (as amended by the Garn-St. Germain Act)) and state insurance laws. See generally ROBERT L. TORTORIELLO, *GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES*, Part I (6th ed. 2001) (hereinafter, "SECURITIES ACTIVITIES GUIDE").

Notwithstanding the legal restrictions on banking organizations' ability to conduct securities and insurance activities that existed before Gramm-Leach-Bliley, banks and bank holding companies engaged to a significant extent in such activities before 1999. For example, bank holding companies were authorized to engage in full securities brokerage and to control so-called "Section 20 Affiliates" that engaged in securities underwriting and dealing activities, subject to important restrictions. Banks themselves were authorized to engage in securities brokerage and in underwriting and dealing in certain government securities. Similarly, national banks were authorized to engage in insurance agency subject to geographical limitations and were authorized to underwrite certain forms of credit-related insurance. See generally *id.*

<sup>46</sup> See BHCA §4(k), 12 USC §1843(k).

<sup>47</sup> See BHCA §4(k)(4)(B), (E), 12 USC §1843(k)(4)(B), (E).

<sup>48</sup> See, e.g., 12 USC §24a. Financial subsidiaries are subject to certain operational safeguards and other restrictions that distinguish them from other operating subsidiaries of banks.

<sup>49</sup> See, e.g., Kenneth H. Thomas, *Don't Underestimate the Power of Sandy Weil*, BUS. WEEK, at 18 (Sept. 30, 2002) ("Citigroup was not only successful in getting Alan Greenspan's Federal Reserve to grant an unprecedented two-year grace period in the hopes that Congress would change the law but also was the primary force behind the passage of the 1999 GLB that legalized this merger").

<sup>50</sup> See, e.g., Laura S. Unger, *Testimony Concerning Functional Regulation Provisions of the Gramm-Leach-Bliley Act*, 1273 PLI/CORP 119 (2001). The Board of Governors of the Federal Reserve System is permitted to examine each financial holding company and its subsidiaries, but may examine a functionally regulated subsidiary only in limited circumstances (e.g., the Board has reasonable cause to believe that such subsidiary is engaged in activities that pose a material risk to an affiliated depository institution). For an overview of the Federal Reserve System's role under the new regulatory regime, see William J. Sweet, Jr. and Stacie E.

- McGinn, *Financial Holding Company Regulation*, 1206 PLI/CORP 465, 495-500 (2000).
- <sup>51</sup> Cf. Code Sec. 1221(b)(2) (defining a hedging transaction as a transaction designed to manage the risk of market movements, currency risk or interest rate risk, but giving the IRS the power to list other types of appropriate risks in regulations).
- <sup>52</sup> THE JOINT FORUM REPORT, *supra* note 29, at 1 ("It has been found that while there is convergence between the [banking, securities and insurance] sectors in various respects, there still remains significant differences in the core business activities and the risk-management tools that are applied in these activities. There are also significant differences in the regulatory capital frameworks, in many cases reflecting differences in the underlying businesses and in supervisory approaches").
- <sup>53</sup> See ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *THE NEW FINANCIAL LANDSCAPE—FORCES SHAPING THE REVOLUTION IN BANKING, RISK MANAGEMENT AND CAPITAL MARKETS*, at 190, 235 (1995).
- <sup>54</sup> See *id.*, at 191, 236.
- <sup>55</sup> See *id.* For some products, market centers outside of the United States play a significantly more important role than those in the United States. For example, the foreign currency turnover in London is almost twice the turnover in the United States. BANK FOR INTERNATIONAL SETTLEMENTS, *TRIENNIAL CENTRAL BANK SURVEY OF FOREIGN EXCHANGE AND DERIVATIVES MARKET ACTIVITY IN 2001*, at 10 (2002) (hereinafter, "BIS SURVEY").
- <sup>56</sup> Due to these competitive pressures and other forces, the traditional role of banks has evolved significantly in recent years in a trend known as "disintermediation." See SECURITIES ACTIVITIES GUIDE, *supra* note 45, at 1-15-17.
- <sup>57</sup> See Sender, *supra* note 18. Banks participating in the BIS SURVEY of derivatives market activity (i.e., large banks) accounted for 31 percent of total positions outstanding, compared to 55 percent for other financial institutions (nonreporting banks, hedge funds, insurance companies, etc.) and 14 percent for nonfinancial users. See BIS SURVEY, *supra* note 55, at 21. See also Letter from Gregory May and Robert Scarborough to the Department of the Treasury (Oct. 1, 2002), 97 TAX NOTES 1483 (Dec. 16, 2002) (noting that banks are the "longest-standing major participants in the credit derivatives market"), text accompanying *supra* note 19-22.
- <sup>58</sup> See THE JOINT FORUM REPORT, *supra* note 29, at 55 ("Before the advent of credit risk transfer products, banks were largely unable to actively manage the credit risks embedded in their loan portfolios. Using these products, banks can now manage exposures per counterparty, per sector and per geographic area on a worldwide basis ...").
- <sup>59</sup> For example, in its 2001 annual report, the Goldman Sachs Group described its balance sheet as "highly liquid," and long-term borrowings accounted for less than 10 percent of total liabilities. See GOLDMAN SACHS, 2001 ANNUAL REPORT, at 36 and 48 (2002). See also THE JOINT FORUM REPORT, *supra* note 29, at 1-2 ("Securities firm balance sheets primarily reflect securities portfolios and securities financing ... . As a result, the primary risks faced by securities firms are the market and liquidity risks associated with the price movements of their proprietary securities positions and of the collateral they have obtained or provided ... . Hedging techniques and capital play dominant roles in their strategies for the management of these risks ...").
- <sup>60</sup> For a brief summary of the early development of insurance and banking, see PETER SPUFFORD, *POWER AND PROFIT: THE MERCHANT IN MEDIEVAL EUROPE*, at 30-43 (2002).
- <sup>61</sup> For an overview of risk pooling and distribution as hallmarks of insurance, see e.g., EMMETT J. VAUGHAN and THERESE VAUGHAN, *FUNDAMENTALS OF RISK AND INSURANCE*, at Ch. 2 (1999); CHRISTOPHER L. CULP, *THE ART OF RISK MANAGEMENT*, at 312-13 (2002); Miller, *Distinguishing Risk*, *supra* note 16, at 73-80. See also Rev. Rul. 2002-91, IRB 2002-52, 991 (holding that an arrangement whereby a number of companies in a highly concentrated industry with significant liability hazards formed a captive insurance company to insure them against certain risks has sufficient indicia of risk shifting and risk pooling to qualify as insurance).
- <sup>62</sup> For a brief history of private mortgage insurance, see MORTGAGE INSURANCE COMPANIES OF AMERICA, 2002-2003 FACT BOOK, at 5-7 (available online at [www.micanews.com](http://www.micanews.com)).
- <sup>63</sup> For a timeline, see the Web site of the Association of Financial Guaranty Insurers at [www.afgi.org/facts-tline.htm](http://www.afgi.org/facts-tline.htm). For examples of recent activities, see Paul Beckett and Henry Sender, *Bad Guesses: Rocky Markets Foil Firms' Bets Based on Risk Models*, WALL ST. J., Sept. 30, 2002, at A1. Monoline insurers have so far insured \$155 billion of CDOs, *id.*, and their ability to handle the risk in these deals is being questioned by some market participants. In an ironic development, a large hedge fund used another credit risk transfer product—credit default swaps—to bet against MBIA's ability to continue providing protection against bond defaults.
- See Henry Sender, *Backing Corporate Bonds Can Be Risky Business*, WALL ST. J., Nov. 5, 2002, at C1.
- <sup>64</sup> See, e.g., N.Y. INSURANCE LAW, at §6902(a)(1) (2000) (restrictions on the activities of financial guaranty insurance companies).
- <sup>65</sup> See, e.g., Gregory K. Myers, *The Alternative Insurance Market: A Primer*, 7-10 (available online at [www.captive.com/service/munch-american/munch\\_article1.html](http://www.captive.com/service/munch-american/munch_article1.html)); SWISS RE, *ALTERNATIVE RISK TRANSFER FOR CORPORATIONS: A PASSING FASHION OR RISK MANAGEMENT FOR THE 21ST CENTURY?* SIGMA No. 2/1999 (available online at [www.swissre.com](http://www.swissre.com) in the Sigma Archive).
- <sup>66</sup> SWISS RE, *ALTERNATIVE RISK TRANSFER VIA FINITE RISK REINSURANCE: AN EFFECTIVE CONTRIBUTOR TO THE STABILITY OF THE INSURANCE INDUSTRY*, SIGMA No. 5/1997 (available online at [www.swissre.com](http://www.swissre.com) in the Sigma Archive) (emphasis added); David L. Wasserman, *Financial (Finite Risk) Reinsurance*, in ROBERT W. STRAIN, ED., *REINSURANCE*, at 280-92 (1987).
- <sup>67</sup> See, e.g., Kim Moore, *Providing the Unconventional*, REACTIONS (June 2002) ("Centre [ostensibly an insurance company] has a lot of contact with capital markets. Many of its deals bear more resemblance to capital market instruments than insurance policies").
- <sup>68</sup> See, e.g., Chris Gibbons, *Centre's Exceptional Solutions*, BERMUDIAN BUS. (Sum. 2002) ("We're as much a finance company as we are an insurance company ... . In fact, we've coined the term 'insurance-based merchant finance'").
- <sup>69</sup> See THE JOINT FORUM REPORT, *supra* note 29, at 12-13, 21-22.
- <sup>70</sup> *Id.*, at 21.
- <sup>71</sup> Rev. Rul. 2002-91, *supra* note 61.
- <sup>72</sup> The (not inconsiderable) underwriting loss experience of the private mortgage industry is summarized in Mortgage Insurance Companies of America, 2002-03 FACT BOOK, at Exhibit 9 (available online at [www.micanews.com](http://www.micanews.com)).
- <sup>73</sup> SALOMON SMITH BARNEY, *EQUITY RESEARCH REPORT, THE FINANCIAL GUARANTORS: INDUSTRY AT A CROSSROADS*, at 30 (Apr. 5, 1999). The Report goes on to conclude that:  
"In many ways, monoline insurers are a hybrid between banks and insurance companies. The insurance comparisons are easy enough to draw, but like a bank, their primary function of the insurers is to take calculated risks. As a result, they have developed a credit research culture and competence over time and have been able to exploit a niche market between the broader banking and insurance industries. Traditional insurance companies tend to take different types of actuarial risk and,

## ENDNOTES

thus, have not developed a credit-risk culture. Banks, while clearly skilled at credit research, have historically been prohibited from participating in this market by relevant regulatory bodies. In addition, banks have historically funded short and lent long. Therefore, a book of contingent liabilities often stretching out more than a decade has been generally unappealing to banks." *Id.*, at 30-31.

<sup>74</sup> See Allen N. Berger, J. David Cummins and Mary A. Weiss, *The Coexistence of Multiple Distribution Systems for Financial Services: The Case of Property-Liability Insurance*, 70 J. Bus. 515 (1977) (addressing why alternative distribution systems with significantly different costs are able to coexist in the property-liability insurance industry). See also Laureen Regan and Sharon Tennyson, *Agent Discretion and the Choice of Insurance Marketing System*, 39 J. LAW & ECON. 637 (1996).

<sup>75</sup> See HAROLD D. SKIPPER, ED., *INTERNATIONAL RISK AND INSURANCE: AN ENVIRONMENT-MANAGERIAL APPROACH*, at 86 (1998). In the retail life insurance market in the United States, the legal classification of a "broker" is more complex. See KENNETH BLACK, JR. and HAROLD D. SKIPPER, JR., *LIFE AND HEALTH INSURANCE*, at 608 (13th ed. 1999).

Agents in turn fall into two categories: "exclusive" agents, who represent one insurer, and "independent" (or "American system") agents who represent multiple insurance companies. See, e.g., J. FRANCOIS OUTREVILLE, *THEORY AND PRACTICE OF INSURANCE*, at 208-11 (1998); GEORGE E. REJDA, *PRINCIPLES OF RISK MANAGEMENT AND INSURANCE*, at 588 (4th ed. 1992). The Independent Insurance Agents of America, for example, claims that a typical independent retail agent in the U.S. domestic market represents an average of eight insurance companies. Available online at [www.independentagent.com](http://www.independentagent.com).

<sup>76</sup> Exclusive agents are most common in distributing "personal lines" insurance, while independent agents dominate the retail life insurance field. See SKIPPER, *supra* note 75, at 87, 473, 518.

<sup>77</sup> Thus, Aon Corporation and Marsh & McLennan Companies, which probably are the world's two largest independent insurance brokerage firms, each employ over 50,000 individuals in well over 100 countries. See AON CORPORATION 1999 ANNUAL REPORT, at 12 (2000). See also MARSH & MCLENNAN COMPANIES, INC., 10-K (2000). (The brokerage service provider employs a 57,000 employee workforce, of which 35,500 are devoted to providing broker, agent or consulting

services for insurers.) In 1999, Aon recorded approximately \$4.2 billion in insurance brokerage commissions and fee revenues. In 2000, Marsh & McLennan earned approximately \$4.7 billion in brokerage revenue.

<sup>78</sup> Regan and Tennyson, *supra* note 74, at 625. (Insurers that use the exclusive agency system capture 19.84 percent of the commercial multiperil insurance market share, and 18.74 percent of the general liability market share; the residual is captured by insurers employing the American agency system of distribution model.) See also *Online is Your Customer's Parlor* 24/7, *The Internet v. The Independent Agent—Interview with George Nordhaus, Chairman of Insurance Marketing & Management Systems (IMMS), INSURANCE ADVOCATE* (Sept. 16, 2000).

<sup>79</sup> See generally, BLACK & SKIPPER, *supra* note 75, at ch. 24 (life insurance); Berger et al., *supra* note 75 (addressing why alternative distribution systems with significantly different costs are able to coexist in the property-liability insurance industry). See also Regan and Tennyson, *supra* note 74.

<sup>80</sup> Cf. OFFICE OF TAX POLICY, DEPARTMENT OF TREASURY, *THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS*, at 72 (2000) ("[T]he insurance industry relies upon, independent third parties to perform many key tasks for it"). Thus, for example, independent agents "own" their customer lists: the insurer is not permitted to contact the customer directly in respect of renewals, and the agent is free to place renewal contracts with other insurers.

<sup>81</sup> See A. Ware, DC Mich., 94-1 USTC ¶150,126, 850 F.Supp 602. See also Joseph B. Treatster, *Allstate Agents File Suit Seeking Pay for Overtime*, N.Y. TIMES, Dec. 20, 2000, at C2 (reporting on lawsuits brought for overtime pay stemming from Allstate's decision to transform its 14,500 employee salespeople into independent contractors).

<sup>82</sup> See *Taisei Fire & Marine Ins. Co.*, 104 TC 535, Dec. 50,620 (1995) (analyzing the legal and economic independence of a re-insurer claimed to be an agent of foreign insurers).

See also *Inverworld*, 71 TCM 3231, Dec. 51,428(M), TC Memo. 1996-301 (wholly owned U.S. subsidiary of a Cayman corporation was not an independent agent based on a facts-and-circumstances analysis in which the court considered the exclusive nature of the agent/principal relationship); Robert S. Schwartz, *Taisei: U.S. Agent Did Not Create Permanent Establishment*, 6 J. INT'L TAX'N 292 (1995); Joel Nitikman, *The Meaning of "Permanent Establish-*

*ment" in the 1981 U.S. Model Income Tax Treaty: Part 1*, 15 INT'L TAX J. 159 (1989); Joel Nitikman, *The Meaning of "Permanent Establishment" in the 1981 U.S. Model Income Tax Treaty: Part 2*, 15 INT'L TAX J. 257 (1989) (containing a thorough discussion of the agency concept in the U.S. Model Income Tax Treaty); Ewing W. Madole, *Agents as Permanents Establishments under U.S. Income Tax Treaties*, 23 TAX MGMT. INT'L J. 281 (1994).

<sup>83</sup> For a very good summary of the reinsurance industry, see Larry D. Gaunt, *The Role, Importance and Functioning of Reinsurance*, in HAROLD D. SKIPPER, ED., *INTERNATIONAL RISK AND INSURANCE: AN ENVIRONMENT-MANAGERIAL APPROACH*, at 580-605 (1998).

<sup>84</sup> *Id.*, at 587.

<sup>85</sup> SWISS RE, *THE GLOBAL REINSURANCE MARKET IN THE MIDST OF CONSOLIDATION*, SIGMA RESEARCH REPORT NO. 9/1998, at 3 (available online at [www.swissre.com](http://www.swissre.com)).

<sup>86</sup> *Id.*, at 16, 19 (\$5.6 billion in 1997 reinsurance out of \$124 billion worldwide volume).

<sup>87</sup> See Gaunt, *supra* note 83, at 599.

<sup>88</sup> See *id.*; SWISS RE, *supra* note 85, at 6.

<sup>89</sup> For excellent discussions of the so-called "Bermuda loophole" debate, see John Almeras and Ryan J. Donmoyer, *Insurers Approach Congress to Fix "Bermuda Loophole"*, 86 TAX NOTES 1660 (Mar. 20, 2000); Lee A. Sheppard, *Would Imputed Income Prevent Escape to Bermuda?*, 86 TAX NOTES 1663 (Mar. 20, 2000); George Guttman, *Is the United States Picking on Bermuda?*, 86 TAX NOTES 1669 (Mar. 20, 2000); Robert A. Marzocchi and H. David Rosenbloom, *Insurance Taxation—The Problem With an Elective System*, 2000 TNT 189-34 (June 23, 2000) (making the case for aggrieved U.S. P&C insurers); Robert A. Marzocchi and H. David Rosenbloom, *Insurance Taxation—Can Regulations Solve the Problem?*, 2000 TNT 189-35 (June 28, 2000).

The current legislative proposal to address the issue is the Reinsurance Tax Equity Bill of 2001, H.R. 1755 (introduced May 8, 2001). For a description, see 2001 TNT 106-31 (May 8, 2001) (remarks of Hon. Richard E. Neal of Massachusetts); for the text of the bill, see 2001 TNT 106-46 (May 8, 2001).

<sup>90</sup> See Sheppard, *supra* note 89 ("Reinsurance in Bermuda, which involves few contracts that cover huge risks ... , is usually written on a facultative basis. That means the contracts are individually negotiated. All negotiations are carried on in Bermuda, and the con-



tracts are signed in Bermuda"); Marzocchi and Rosenbloom, *supra* note 89 ("We do not contend that reinsurance, per se, constitutes an agency arrangement ... Even if in a particular case agency could be established, it would be relatively simple for a [reinsurer] ... to adjust its arrangement with its ... [primary insurer] affiliate to avoid the characterization").

<sup>91</sup> See *Taisei Fire & Marine Ins. Co.*, *supra* note 82 (activities of an independent reinsurer that accepted reinsurance premiums on behalf of foreign insurance companies did not constitute a permanent establishment).

<sup>92</sup> For a brief history, see MARK S. DORFMAN, INTRODUCTION TO RISK MANAGEMENT AND INSURANCE, at 137-41 (7th ed. 2002).

<sup>93</sup> See ECONOMICS AND STATISTICS OFFICE OF POLICY DEVELOPMENT, U.S. DEPARTMENT OF COMMERCE, THE U.S. INSURANCE INDUSTRY: STRUCTURE, PERFORMANCE, AND PROSPECTS (Feb. 1996).

<sup>94</sup> See, e.g., Rev. Rul. 2002-91, *supra* note 61 ("Neither the Code nor the regulations define the terms 'insurance' or 'insurance contract'").

<sup>95</sup> Domestic banks generally must be taxed as C corporations. Reg. §1.581-1(a). A bank may, however, elect to be taxed under subchapter S if it satisfies the relevant stock ownership requirements and (assuming that it is a small bank) if it foregoes the benefits of bad debt reserve accounting otherwise available to small banks. Code Sec. 1361(b)(2). Less than two percent of the country's banking assets are held by S corporations. STANLEY I. LANGBEIN, FEDERAL INCOME TAXATION OF BANKS AND FINANCIAL INSTITUTIONS, ¶15.01, at 15-3 (7th ed.).

<sup>96</sup> Rev. Rul. 58-605, 1958-2 CB 358, held that a corporation engaged in the insurance business with fiduciary powers similar to those permitted to national banks did not qualify as a bank for purposes of Code Sec. 581 if it was not subject to the supervision of state banking authorities. Conversely, LTR 8814053 (Jan. 13, 1988) treated a trust company subject by law to supervision and examination by state banking authorities as a bank under Code Sec. 581.

<sup>97</sup> See, e.g., Edward D. Kleinbard and Thomas L. Evans, *The Role of Mark-to-Market Accounting in a Realization-Based Tax System*, 75 TAXES 788, 809-10 (1997); Lee A. Sheppard, *Who's Marking What to Market?* 76 TAX NOTES 12 (1997).

<sup>98</sup> See Reg. §1.471-5; Kemon, *supra* note 41. See generally Kleinbard and Evans, *supra* note 97. David Miller argues that a company entering only into the "short" side of a credit derivative would

not be treated as a dealer under Reg. §1.475(c)-1(a)(2), which treats as a dealer in securities any taxpayer that in the ordinary course of the taxpayer's trade or business "regularly holds itself out as being willing to enter into either side of a transaction enumerated in Section 475(c)(1)(B)." See Miller, *Distinguishing Risk*, *supra* note 16, at 552, note 270. Miller thus interprets the term "either side" in the conjunctive—to be treated as a dealer, a taxpayer must be willing to accommodate customers' needs regardless of whether these customers want to take a long or short position in an instrument. See, e.g., Reg. §1.475(c)-1(a)(2)(ii), Example 1 ("B is willing to enter into interest rate swaps under which it either pays a fixed interest rate and receives a floating rate or pays a floating rate and receives a fixed rate"). The statutory definition, however, is very broad, encompassing taxpayers that "regularly purchase securities from or sell securities to customers." Code Sec. 475(c)(1) (emphasis added). Moreover, Reg. §1.475(c)-1(a)(2) describes its rule as a nonexclusive illustration, not a comprehensive definition. As a result, and consistent with the admittedly inappropriate overbreadth of the statute generally, the rule in Reg. §1.475(c)-1(a)(2) probably should be interpreted in the disjunctive—a taxpayer is a dealer if it regularly holds itself out to customer as willing to enter into at least one, but not necessarily both, sides of a derivatives contract.

<sup>99</sup> See, e.g., Reg. §1.475(c)-1(c) (negligible sales); Reg. §1.475(c)-1(b) (customer paper).

<sup>100</sup> See Code Sec. 475(c)(1).

<sup>101</sup> Rev. Rul. 2002-91, *supra* note 61, states that "neither the Code nor the regulations define the terms 'insurance' or 'insurance contract.'" Notice 2002-70, 2002-44 IRB 765, which sets forth the intention of the IRS to challenge certain reinsurance arrangements on the ground that they do not involve genuine insurance companies, does not provide any definition of nonlife insurance companies either. See generally Humphreys, *Gambling on Uncertainty*, *supra* note 16, at 40-43 (discussing what constitutes an insurance company).

<sup>102</sup> Reg. §1.801-3(a)(1).

<sup>103</sup> Reg. §301.7701-2(b)(4).

<sup>104</sup> Cases cited in note 105, *infra*, did not specifically address the question of how insurance-like products underwritten by noninsurance companies were treated in the hands of their customers. A recent case has, however, suggested in passing that the same instrument may be insurance from the perspective of the

customer and not insurance from the perspective of the company selling it. See *R.A. Johnson*, 108 TC 448, 472, at note 7, Dec. 52,090 (1997), *aff'd in part and rev'd in part*, CA-8, 99-2 USTC ¶150,699, 184 F3d 786. See also Miller, *Distinguishing Risk*, *supra* note 16, at 78-79.

<sup>105</sup> See, e.g., *Bowers v. Lawyers Mortgage Co.*, SCT, 3 USTC ¶905, 285 US 182, 189, 52 SCT 350 (1932) (a company was not an insurance company because less than one-third of its income was derived from insurance-related activities); *Indus. Life Ins. Co.*, DC S.C., 72-1 USTC ¶9381, 344 FSupp 870, 877, *aff'd per curiam*, CA-4, 73-2 USTC ¶9533, 481 F2d 609 (same holding where less than 20 percent of income was derived from insurance-related activities); *Inter-American Life Ins. Co.*, 56 TC 497, 506-08, Dec. 30,823, *aff'd per curiam*, CA-9, 73-1 USTC ¶9127, 469 F2d 697 (same holding where the taxpayer's "investment income far exceeded its earned premiums and the amounts of earned premiums were de minimis"). See also Notice 2002-70, *supra* note 101 ("an insurance company is a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies"). See generally Humphreys, *Gambling on Uncertainty*, *supra* note 16, at 40-43.

<sup>106</sup> In *Allied Fidelity Corp.*, CA-7, 78-1 USTC ¶9325, 572 F2d 1190, 1193, surety bail contracts written by the taxpayer company (subject to state insurance laws) were held to resemble "more a contract to perform services than a contract of insurance"; thus the taxpayer was not entitled to be taxed as an insurance company. Notice 2002-70, *supra* note 101, also allows the IRS to disregard insurance and reinsurance arrangements if they are "shams in fact" or "shams in substance."

<sup>107</sup> See Rev. Rul. 83-172, 1983-2 CB 107 (a group providing self-insured workmen's compensation was held taxable as an insurance company even though it was not recognized as an insurance company under state law); LTR 200138010 (June 20, 2001) (a company providing coverage for motor vehicles against mechanical breakdown beyond the coverage afforded by the manufacturer's warranties was held taxable as an insurance company even though it was not recognized as an insurance company under state law).

<sup>108</sup> *E. Le Gierse*, SCT, 41-1 USTC ¶10,029, 312 US 531. See also *Sears, Roebuck*



## ENDNOTES

- & Co., 96 TC 61, Dec. 47,132 (1991), *aff'd*, CA-7, 92-2 USTC ¶150,426, 972 F2d 858 (applying a three-prong test to define insurance: (1) presence of insurance risk, (2) risk shifting and risk-distributing and (3) characterization as insurance for essentially all nontax purposes). For a thoughtful overview of Le Gierse, see, e.g., Miller, *Distinguishing Risk*, *supra* note 16, at 57-61.
- <sup>109</sup> Rev. Rul. 2002-89, IRB 2002-52, 984; Rev. Rul. 2002-90, 2002-52 IRB 985; Rev. Rul. 2002-91, *supra* note 61.
- <sup>110</sup> *Id.*
- <sup>111</sup> *Id.*
- <sup>112</sup> See Rev. Rul. 2002-91, *supra* note 61.
- <sup>113</sup> See text accompanying notes 66-68, *supra*. An early example of a failed finite insurance product was examined in Rev. Rul. 89-96, 1989-2 CB 114. The ruling held that a retroactive agreement entered into by a casualty insurance company (whereby it purchased additional "liability insurance" coverage after the occurrence of a catastrophe) was not an insurance contract for federal income tax purposes, because "the present arrangement does not involve the requisite risk shifting necessary for insurance. The catastrophe has already occurred, and the economic terms of the contract demonstrate the absence of any transfer of risk apart from an investment risk." But see Miller, *Distinguishing Risk*, *supra* note 16, at 55-56 (arguing that the arrangement described in Rev. Rul. 89-96 involved insurance risk).
- <sup>114</sup> See Miller, *Distinguishing Risk*, *supra* note 16, at 73 ("As previously discussed, Cecile Le Gierse was properly denied an estate tax exemption because she failed to transfer or diminish the economic risk of her early demise. However, in the course of its opinion, the Le Gierse court also observed that insurance companies typically manage the insurance risk transferred to them by pooling and distributing it. The court then suggested that, in addition to the failure by Cecile to transfer any 'insurance risk' to the insurance company, the policy also did not qualify as insurance because the company hedged the risk of Cecile's early death through the annuity and did not 'pool and distribute' the risk").
- <sup>115</sup> The text picks up this theme below, in the context of whether an "insurable interest" and other formal indicia of insurance are properly part of the tax definition.
- <sup>116</sup> "The specific concerns [addressed by the doctrine of insurable interest] include avoiding inducements to wagering, preventing inducements to the destruction of life or property and avoiding economic waste." ROBERT E. KEETON

and ALAN I. WIDISS, *INSURANCE LAW*, at 136, note 1 (1988).

- <sup>117</sup> See Humphreys, *Gambling on Uncertainty*, *supra* note 16, at 34. It is true that Rev. Rul. 2002-91, *supra* note 61 (one of the recent triumvirate of revenue rulings discussing the meaning of "insurance"), for example, inquired whether the insureds in that case "truly face hazards," but the context of the inquiry seems to simply have been on demonstrating the fortuitous nature of the risks and the related fact that each insured might receive more insurance benefits than its premium payments (or conversely might pay more premiums than it received in benefits). Thus, the ruling contains no reference to any formal "insurable risk" analysis under substantive insurance regulation, and poses the question of whether the putative insureds "face hazards" in a paragraph describing other indicia of normal insurance company behavior, such as whether the premiums are based on commercial rates as determined using recognized actuarial principles, and whether the insurance company investigates claims before paying on them.
- <sup>118</sup> Cf. FSA FEEDBACK STATEMENT, *supra* note 4, at ¶1.3.4, summarizing the core description of insurance as "[A]ny enforceable contract under which a 'provider' undertakes:
- (1) in consideration of one or more payments;
  - (2) to pay money or provide a corresponding benefit ... to a 'recipient';
  - (3) in response to a defined event;
  - (4) the occurrence of which is uncertain (either as to when it will occur or as to whether it will occur at all); and
  - (5) adverse to the interests of the recipient."
- This description emphasizes fortuity; "insurable interest" concepts arise only indirectly through the last clause, in distinguishing (presumptively) speculative fortuities from those the occurrence of which is "adverse" to the interests of the recipient.
- <sup>119</sup> Cf. Rev. Rul. 2002-91, *supra* note 61 (stating that "courts have held that an arrangement between a parent and its subsidiary can constitute insurance because the parent's premiums are pooled with those of unrelated parties if (i) insurance risk is present, (ii) risk is shifted and distributed, and (iii) the transaction is of the type that is insurance in the commonly accepted sense.")
- <sup>120</sup> If, of course, the tax law had chosen to follow the nontax definition of insurance more closely in deciding which entities would be taxed as insurers, the importation of these nontax objectives would be-

come more defensible, but once the decision was made that insurance in the tax sense did not necessarily follow precisely the footsteps of substantive insurance law, it seems odd to elevate some relatively narrow substantive insurance law requisites to talismanic tax significance.

- <sup>121</sup> Code Sec. 448(c) precludes a bank from using a cash method of accounting if it is a C corporation and has average annual gross receipts of at least \$5 million.
- <sup>122</sup> Code Sec. 585(c).
- <sup>123</sup> Code Sec. 582(a), Code Sec. 166.
- <sup>124</sup> Code Sec. 582(c).
- <sup>125</sup> As discussed above, the mandatory mark-to-market rules of Code Sec. 475 are tremendously overbroad, and in theory apply to any bank that makes loans and regularly resells more than a negligible number of those loans. Banks that do not wish to adopt a mark-to-market method of accounting in respect of their core lending activities therefore typically identify their loans as held for investment or not held for sale, as contemplated by Reg. §1.475(b)-1(a).
- <sup>126</sup> This issue has been hotly debated in the financial accounting arena, where it has been argued that many banks have entered into below-market loan commitments that eventually will drag down recorded profits and which (it is argued) properly should be reflected on current income statements through a mark-to-market mechanism, which would have the effect of recording a loss each time a below-market commitment was entered into.
- <sup>127</sup> Kleinbard & Evans, *supra* note 97, at 811 ("Mark-to-market accounting cannot successfully be applied to the lending activities of a commercial bank, because of the significant long-term liabilities which are used to fund its loans. Phrased differently, those matching liabilities function as natural hedges for the interest rate risk inherent in the bank's loan portfolio. To mark one leg of a hedged transaction to market, while leaving the other leg valued at cost, is a fundamental error that is inherently distortive").
- <sup>128</sup> One could, of course, come to a different conclusion in respect of unfunded commitments, on the theory that they are properly viewed as in the nature of derivatives, but this controversy is not relevant to the themes of this article.
- <sup>129</sup> Code Sec. 475(d)(3).
- <sup>130</sup> Code Sec. 475(a).
- <sup>131</sup> See, e.g., *Bank One Corp.*, Tax Ct. Dkt. Nos. 5759-95 and 5969-97. For an overview of the case, see, e.g., Lee A. Sheppard, *Bank One: The Battle of the Expert Witnesses*, 91 TAX NOTES 720 (Apr. 30, 2001).

<sup>132</sup> Kleinbard & Evans, *supra* note 97, at 810 ("a compelling rationale for the use of mark-to-market is that taxpayers running a business that by necessity consists of hedged positions need a mark-to-market system to avoid distortions and whipsaws created by timing differences between their long and short positions or between their long-dated and short-dated positions").

<sup>133</sup> *Id.*, at 797 ("Mark-to-market accounting ... was born, not as an anti-abuse measure introduced by Treasury or Congress, but rather in response to a taxpayer initiative. The themes advanced by the cotton dealers—in particular, their emphasis on mark-to-market accounting for open contractual positions as a cure for the timing mismatches that otherwise would result from reporting the income of a hedged trading business on a nonrealization basis for inventory and a realization basis for everything else—remains one essential touchstone in identifying the proper scope of mark-to-market accounting today").

<sup>134</sup> The text ignores all rules applicable to small insurance firms, or to mutuals, as well as all transition rules from prior regimes.

<sup>135</sup> Code Sec. 831(a); Code Sec. 832(b)(1).

<sup>136</sup> Code Sec. 832(b)(4), Code Sec. 832(b)(7)(B) (special credit insurance rule).

<sup>137</sup> Reg. §1.832-4(a)(2) provides that "the underwriting and investment exhibit is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a base for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined by the Code." See, e.g., TAM 200132006 (May 1, 2001) ("Section 832(b)(3) indicates that, in part, the income of a property and casualty insurance company is computed on the basis of the NAIC Annual Statement. The Section does not, however, indicate that the income is taken from the NAIC annual statement nor does it state that income is computed as on the same methods approved by NAIC Annual Statement. The statute also does not mandate the use of the Annual Statement").

By contrast, the Court of Appeals for the Seventh Circuit has held that the tax treatment of loss reserves should follow the NAIC's statement computation. *Sears, Roebuck and Co.*, *supra* note 108, 972 F.2d 858: "Although it is not impossible—almost nothing is impossible in tax law—divorcing Section 832(b)(5) losses from the annual statement computations would make no

sense in terms of the structure of the statute or its genesis."

<sup>138</sup> See Reg. §1.832-4(a)(8)(i) ("retro credits").

<sup>139</sup> See STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 595 (1985): "Prior law permitted a deferral of unearned premium income while the expenses of earning the deferred income (e.g., premium acquisition expenses) were deducted currently. Permitting a deferral of an undiscounted portion of unearned premium income while allowing a current deduction for associated costs of earning the deferred income produced a mismatching of income and expenses and a resulting mismeasurement of income."

<sup>140</sup> The "Deferred Acquisition Cost" rules prescribe how insurance companies must capitalize and amortize certain specified policy acquisition expenses, but these rules apply only to "specified insurance contracts," i.e., life insurance, annuity or noncancellable accident and health insurance contracts. Code Sec. 848(e)(1)(a).

<sup>141</sup> Code Sec. 832(b)(3) and (c).

<sup>142</sup> Code Sec. 832(b)(5).

<sup>143</sup> Code Sec. 846.

<sup>144</sup> SEAN MOONEY ET. AL., BASIC CONCEPTS OF ACCOUNTING AND TAXATION OF PROPERTY/CASUALTY INSURANCE COMPANIES, at 33-37 (1995).

<sup>145</sup> Code Sec. 832(e)(1) and (e)(6) allow the deduction of amounts set aside in a reserve to cover losses resulting from adverse economic cycles in respect of mortgage guaranty insurance, tax-exempt bond insurance and "lease guaranty insurance." This deduction, however, is only allowed to the extent that the company claiming it purchases "Tax and Loss Bonds" (U.S. Treasury obligations issued specifically to companies writing mortgage guaranty insurance) in an amount equal to the tax benefit attributable to the deduction. Because of the requirement that an amount equal to the tax benefits be invested in low-yielding and illiquid obligations, insurance companies have limited incentive to use the deductions allowed by Code Sec. 832(e). For an overview of the "Tax and Loss Bond" rules, see, e.g., LTR 834008 (May 17, 1983).

<sup>146</sup> The purpose of gap hedging for an insurance company is to balance the composition of its investment assets with its insurance liabilities. Currently, the tax hedging transaction rules of Reg. §§1.1221-2 and 1.446-4 do not permit tax hedging for gap hedging, if such hedging is characterized as hedges of capital assets. Preamble to the new Code Sec. 1221 regulations (as

amended by T.D. 8985, IRB 2002-14, 707) merely states that "whether a gap hedge qualifies as a liability hedge is a question of fact and depends on whether it is more closely associated with the liabilities than with the assets."

<sup>147</sup> Code Sec. 832(b)(5)(B). Technically, the proration works, not directly on the investment income, but rather by disallowing as a deduction insurance losses equal to 15 percent of the tax-favored income. See, e.g., FSA 200234013 (discussing the mechanics and rationale of Code Sec. 832(b)(5)(B)).

<sup>148</sup> Code Sec. 832(c)(5).

<sup>149</sup> A taxpayer may use different accounting methods for different lines of business. See Reg. §1.446-1(d)(1). The Code Sec. 475 regulations also contemplate this result. See Reg. §1.475(b)(1)(a) summarized in the text distinguishing between securities held for sale and securities held for investment. Technically, the result is reached by "electing out" of Code Sec. 475 for all classic bank-lending business. See note 125, *supra*.

<sup>150</sup> Code Sec. 475(b)(1)(B); Reg. §1.475(b)(2).

<sup>151</sup> See Reg. §1.475(c)-(4)(iii) and (c)(5); Rev. Rul. 97-39, 1997-2 CB 62. The example proffered by the regulations (the origination and sale by a life insurance company of policyholder loans) is, however, commercially unrealistic, as policyholder loans in reality are a form of tax-favored distributions of cash surrender value, not financial assets that conveniently can be severed from the life insurance contract and sold to third parties.

<sup>152</sup> See *SWISS RE*, *supra* note 85, at 4.

<sup>153</sup> See text accompanying notes 7-11, *supra*.

<sup>154</sup> Jonathan Miles and Diana Owen, *Accounting Developments in Respect of Finite Risk Insurance in Europe*, at 13 (on file with Cleary, Gottlieb, Steen & Hamilton).

<sup>155</sup> Code Sec. 4371(1); Code Sec. 4371(3).

<sup>156</sup> That is not to suggest that the two tax regimes are identical. The banking sector has no rule directly analogous to the premium income acceleration rule applicable to insurers (other than general expense capitalization principles), and banks may well be slower to write down loans than are insurers to establish IBNR reserves.

<sup>157</sup> BBA CREDIT DERIVATIVES REPORT, *supra* note 5, at 3 (single-name credit default swaps represented 45 percent of the credit derivatives market in 2001).

<sup>158</sup> See GOOCH & KLEIN, *supra* note 3, at 642-49; Antulio N. Bomfim, *Understanding Credit Derivatives and Their Potential to Synthesize Riskless Assets*, 5-

## ENDNOTES

- 8 (2001) (on file with Cleary, Gottlieb, Steen & Hamilton); JONATHAN DAVIES, ET AL., PRICEWATERHOUSECOOPERS, *THE FINANCIAL JUNGLE—A GUIDE TO CREDIT DERIVATIVES*, at 36 (2001); Donald Bendernagel, James Hill and Brian Rance, *Credit Derivatives: Usage, Practice and Issues*, 1280 PLI/CORP 755 (2001); *Letter from Jonathan Talisman and Joseph Mikrut of Capitol Tax Partners to the Department of the Treasury*, 2002 TNT 148-34 (July 2, 2002); *Letter from Thomas Prevost (ISDA) to the IRS*, 2002 TNT 232-21 (Oct. 24, 2002).
- <sup>159</sup> See ISDA 1999 CREDIT DERIVATIVES DEFINITIONS (1999).
- <sup>160</sup> The most common term for a credit default swap is five years, which corresponds to the exposure period under five-year revolving credit facilities typically offered by banks. See Ian W. Marsh, *What Central Banks Can Learn About Default Risk From Credit Markets*, BIS PAPER NO. 12, at 336 (2002) (available online at [www.bis.org](http://www.bis.org)).
- <sup>161</sup> For precise definitions of these credit events, see ISDA 1999 CREDIT DERIVATIVES DEFINITIONS, *supra* note 159, at 16–18. For an excellent discussion of various payment triggers, see GOOCH & KLEIN, *supra* note 3, at 662–68. Recently, the use of restructuring as a credit event under credit default swap contracts and its appropriate definitional scope has been called into question because of the practical difficulty of identifying objectively when preliminary discussions by a troubled company with its creditors have progressed to become a formal credit restructuring event. The potential for a dispute among market participants as to whether a triggering credit event has occurred can disrupt the intended risk management mechanics for both buyers and sellers of credit protection. See, e.g., Henry Sender, *Banking “Firewalls” May Have Some Cracks*, WALL ST. J., Dec. 26, 2002, at C1; *Protection Sellers Win Credit Documentation Dog Fight*, DERIVATIVES WEEK, Dec. 23, 2002, at 1.
- <sup>162</sup> Reflecting the market’s costs as a means for credit hedging of loans held by banks, physical settlement of client default swaps currently is the market norm, and credit protection buyers may have to pay an additional cost if cash settlement is desired.
- <sup>163</sup> In that sense, “[a] credit default swap, despite its name, is more analogous to a guarantee or letter of credit than to a swap.” Kayle, *Will the Real Lender Please Stand Up*, *supra* note 16, at 573.
- <sup>164</sup> The contract typically will provide for an agreed valuation process for the Reference Obligation in such cases, through dealer quotations or otherwise.
- See GOOCH & KLEIN, *supra* note 3, at 642–43.
- <sup>165</sup> Often, the credit event triggers may be set more broadly to apply in case of Default or Failure to Pay Under any Obligation of the Reference Entity—not just the Reference Obligation itself. This distinction can be important for credit default swaps relating to Sovereign debt or cross-border situations, for example—where significant differences can arise between the terms of distinct debt issues. For contracts relating to U.S. corporate debt, however, the near-universal system of standardized cross-default provisions in most senior bonds and loans reduces the sensitivity to identifying a particular Reference Obligation as the benchmark for triggering credit default events.
- <sup>166</sup> The convergence in trading value of a company’s different debt obligations following a credit event effectively eliminates basis risk for the credit protection seller in its hedging transactions. “‘Basis risk’ is defined as the risk that the value of a hedge will not move exactly inversely to the value of the asset or liability being hedged. It arises from the imperfect match between the characteristics of the hedge vehicle and the item being hedged.” *Federal National Mortgage Association*, 100 TC 541, Dec. 49,102 (1993). Because the market value of different debt classes will be approximately the same, the protection seller bears little risk that the instrument delivered will differ materially in its liquidation value from another security of that issuer sold short as a hedge.
- <sup>167</sup> “The fungible nature of publicly traded securities forms the economic basis for all securities hedging and arbitrage, for stock loans and sellers. One can only sell short what one can cover (acquire) through later purchases, which by definition is possible only with fungible securities.” Edward D. Kleinbard, *Risky and Riskless Positions in Securities*, 71 TAXES 783, 787 (1993).
- <sup>168</sup> Note that a protection buyer may have “basis risk” if it uses a standard credit default swap to hedge a credit contract that does not have market standard default and payment terms. In fact, this type of “basis risk” is one important factor that constrains the use of credit default swaps by nonfinancial corporations seeking to manage existing credit exposure to suppliers and other counterparties.
- <sup>169</sup> For example, the law of large numbers by definition requires many small and uncorrelated risks: the credit default market presumably could not have absorbed the concentrated and correlated credit risks associated with, say, the telecommunications industry by relying solely on the law of large numbers.
- <sup>170</sup> For a good discussion of a framework for pricing credit derivatives, see Steven Allen, *Credit Risk*, 11–16 (2002) (unpublished manuscript, on file with Cleary, Gottlieb, Steen & Hamilton). A more accessible introduction is DAVIES, ET AL., *supra* note 158, at 157–68. There are currently two approaches in the marketplace to pricing and hedging credit derivatives. In the first class of models, a credit derivative is viewed as a deep out-of-the-money put option on the assets of the firm and valued/hedged based on the option pricing theory. The second approach (so-called “intensity” models) looks at historical transition matrices (showing the probability that a credit rated in one category at the start of a period will default or will transition to another rating category by the end of the period) to estimate the likelihood of default. See *id.* Although the credit derivatives market is still young and approaches to managing credit risk continue to evolve, the ultimate objective of investment banks is to develop risk management techniques for credit derivatives that are similar to techniques for other instruments. As one prominent practitioner put it, “[t]heir approach could be telescoped into the motto ‘What credit risk? All I see is market risk.’” In other words, once you obtain liquid daily prices for credit exposure, you can just view this as another asset class, like foreign exchange, interest rates, equities, and commodities, to be managed using market risk techniques.” Allen, *supra*, at 1.
- <sup>171</sup> See, e.g., Nirenberg and Kopp, *Credit Derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, *supra* note 16, at 90: “A default swap neatly fits the definition of notional principal contract in that it is a financial instrument in which payments by one party (the protection buyer) are paid at specified intervals based on a specified index applied to a notional amount.” Cf. Kayle, *Will the Real Lender Please Stand Up?* *supra* note 16, at 591–92 (arguing that “the credit default swap should qualify as a notional principal contract” but that “this conclusion is not as clear as in the case of a total return swap”).
- <sup>172</sup> See NYSBA, REPORT RESPONDING TO NOTICE 2001-44 ON THE TIMING OF INCOME AND LOSS FROM SWAPS PROVIDING FOR CONTINGENT PAYMENTS, NYSBA TAX SECTION REPORT NO. 1001: “[T]he appropriate method of accounting for Contingent Nonperiodic Swaps generally should result in the inclusion and deduction of that portion of gain or loss that has, in fact, been realized through the

## ENDNOTES

exchange of periodic payments, as opposed to more or less of such gain or loss (i.e., as opposed to all of the gain or loss, whether realized or not; or none of the gain or loss until the swap is disposed of; or the entire amount of a periodic payment, whatever that amount may be." See also Charles Morgan, Rev. Rul. 2002-30/Notice 2002-35—*Contingent Payment Swaps Revisited*, THE TAX CLUB (Sept. 23, 2002) (discussing recent IRS guidance in this area and different possible tax treatments of contingent payment swaps considered by the IRS ("noncontingent swap method," "full allocation method," "modified full allocation method" and mark-to-market method). Viva Hammer, attorney-adviser in Treasury's Office of Tax Legislative Counsel, has suggested that "the most promising method for accounting for contingent swaps would be the importation of the noncontingent bond method of the contingent payment debt rules." See 97 TAX NOTES 1267, 2002 TNT 238-6 (Dec. 9, 2002).

<sup>173</sup> Reg. §1.1221-2.

<sup>174</sup> Reg. §1.1221-1(a)(2).

<sup>175</sup> Reg. §1.446-4.

<sup>176</sup> Letter from Jonathan Talisman and Joseph Mikrut of Capitol Tax Partners to the Department of the Treasury, 2002 TNT 148-34 (July 2, 2002).

<sup>177</sup> Letter from Thomas Prevost (ISDA) to the IRS, 2002 TNT 232-21 (Oct. 24, 2002).

<sup>178</sup> Letter from Gregory May and Robert Scarborough to the Department of the Treasury (Oct. 1, 2002). Reproduced as "Credit Derivatives—A Letter to the Treasury," J. TAX'N GLOBAL TRANSACTIONS, Win. 2003, at 72.

<sup>179</sup> Code Sec. 4371.

<sup>180</sup> Miller, *Distinguishing Risk*, *supra* note 16, at 18. See also David S. Miller, *Federal Income Tax Consequences of Guarantees: A Comprehensive Framework for Analysis*, 48 TAX LAW. 103 (1994). For a comparison of credit default swaps and guarantees, see, e.g., Kayle, *Will the Real Lender Please Stand Up?* *supra* note 16, at 598.

<sup>181</sup> Article 6A of the U.K.-U.S. treaty provides that "the United States tax on insurance premiums paid to foreign insurers shall not be imposed on insurance on reinsurance premiums which are the receipts of a business of insurance carried on by an enterprise of the United Kingdom whether or not that business is carried on through a permanent establishment in the United States," while article 11 reduces to zero the withholding tax rate on interest.

<sup>182</sup> Reg. §1.863-7(b).

<sup>183</sup> For an overview and history of the excise tax, see Michael A. Heimos, *Recent Developments Regarding the Federal Excise Tax on Foreign Insurance*,

31 TAX MNG'T INT'L J. 339, 340-41 (2002).

<sup>184</sup> See FSA DISCUSSION PAPER, *supra* note 4, Annex B.

See also NEW YORK STATE INS. DEPARTMENT LEGAL OPINION RE: WEATHER FINANCIAL INSTRUMENTS (DERIVATIVES, HEDGES, ETC.), available online at [www.ins.state.ny.us/rg000205.htm](http://www.ins.state.ny.us/rg000205.htm):

"Weather derivatives do not constitute insurance contracts under Section 1101(a) of the New York Insurance Law because the terms of the instrument do not provide that, in addition to or as part of the triggering event, payment to the purchaser is dependent upon that party suffering a loss. Under such instruments, the issuer is obligated to pay the purchaser whether or not that purchaser suffers a loss. Neither the amount of the payment nor the trigger itself in the weather derivative bears a relationship to the purchaser's loss. Absent such obligations, the instrument is not an insurance contract."

<sup>185</sup> That is not true, of course, for some other indicia, such as whether the instrument is held in the same proportions as the issuer's equity interests. For a modern overview of equity versus debt criteria, see, e.g., David Hariton, *Essay: Distinguishing Between Equity and Debt in the New Financial Environment*, 49 TAX. L. REV. 499 (1994).

<sup>186</sup> See FSA DISCUSSION PAPER, *supra* note 4, at ¶13.107 and at Annex B, p. 4: "Characterization of a contract as a derivative ... or as an insurance contract, is seemingly becoming a tenuous distinction in practice."

<sup>187</sup> FSA DISCUSSION PAPER, *supra* note 4, at Annex B, p. 4: "Recent market developments, in particular the fact that some credit derivatives contracts are apparently being linked to loss, is also shedding doubt about legal opinions relying on this difference to set the boundary between a credit derivative and an insurance contract." From the other direction, insurance regulators have countenanced insurance contracts where the indemnity for loss is determined by reference to an objective market-derived figure. See, e.g., NEW YORK STATE INS. DEPARTMENT LEGAL OPINION RE: MOTOR VEHICLE REPOSSESSION INSURANCE (available online at [www.ins.state.ny.us/rg008101.htm](http://www.ins.state.ny.us/rg008101.htm)) (automobile "repossession insurance" remains insurance even though loss indemnification is set in some circumstances at National Auto Dealer Association "Blue Book" value, less \$1,500).

<sup>188</sup> See Notice 2002-70, *supra* note 101; Rev. Rul. 2002-89, *supra* note 109; Rev. Rul. 2002-90, *supra* note 109; Rev. Rul. 2002-91, *supra* note 61.

<sup>189</sup> In *Le Gierse*, "any risk that the prepayment would earn less than the amount

paid ... as an annuity was an investment risk similar to the risk assumed by a bank; it was not an insurance risk." *Le Gierse*, *supra* note 108, 312 US, at 539, 542. See also Rev. Rul. 89-96, *supra* note 113; Rev. Rul. 2002-91, *supra* note 61 (addressing the case of a "group captive" formed by a relatively small group of unrelated businesses and stating that "notwithstanding the fact that the group of members is small, there is a real possibility that a Member will sustain a loss in excess of the premiums it paid. No individual Member will be reimbursed for premiums paid in excess of losses sustained by that Member").

<sup>190</sup> This point has been developed in the area of captive insurance cases: see *Kidde Industries, Inc.*, FedCI, 98-1 USTC ¶150,162, 40 FedCI 42 (dealing with a captive insurer arrangement in which the insured corporation made payments to the insurer which were ceded to a subsidiary of the insured. Such payments were treated as nondeductible reserve funds to pay future claims rather than deductible insurance premiums). See also *Humana Inc.*, CA-6, 89-2 USTC ¶9453, 881 F2d 247 (sums paid by parent to its wholly owned captive insurance subsidiary did not constitute insurance premiums but were nondeductible reserves for losses); *Clougherty Packing Co.*, CA-9, 87-1 USTC ¶9204, 811 F2d 1297 (worker's compensation insurance purchased from an unrelated insurer which then reinsured with wholly owned subsidiary of the corporation purchasing the "insurance" did not constitute insurance). See also Rev. Rul. 2002-89, *supra* note 109 (amounts paid by a domestic parent corporation to its wholly owned insurance subsidiary may be deductible as "insurance premiums" depending on the importance of the premiums paid by the parent in the total premiums received by the subsidiary); and Notice 2002-70, *supra* note 101 (dealing with subsidiaries reinsuring insurance policies sold by a taxpayer ("producer owned reinsurance companies" or PORCs)).

<sup>191</sup> In *Corn Products Refining Co.*, SCt, 55-2 USTC ¶9746, 350 US 46, 50, 76 SCt 20, the Supreme Court held that purchases and sales of corn futures by a manufacturer of products made from grain corn were "vitally important to the company's business as a form of insurance against increases in the price of raw corn."

<sup>192</sup> To be clear, the paper does not advocate that domestic monoline insurers generally should be required to adopt mark-to-market accounting. The point in the text is simply that mark-to-market accounting is superior for those lines of business that involve active market hedging of financial risks.