Risk segregation of a different kind

Martin Eveleigh, managing director of Atlas Insurance Management, discusses a new product for Nevis – the statutory fund company

Life insurers, particularly those operating in the private placement arena, have long enjoyed the benefits of being able to segregate risks through the use of separate accounts or segregated funds.

Non-life insurers, notably captives established in offshore domiciles, have until recently had to rely on non-statutory methods of segregating risk. However, the advent of protected cell company (PCC) or segregated portfolio company (SPC) legislation in many domiciles has given new statutory protection to the users of rent-a-captives and opened up a whole new world of structuring possibilities for alternative risk transfer.

In 'Segregating Risk' *(BVI Financial Services Review 2005)*, I said creative thinkers in the private sector will find ways to use new types of entity that were not imagined at the time legislation was passed.

Shock of the new

Those creative thinkers now have a new opportunity and a new type of entity. Section 17 of the Nevis International Insurance Ordinance 2004 allows non-life insurers to segregate risks through the establishment of "one or more statutory funds". The Ordinance effectively allows for the creation of a new type of entity, the 'statutory fund' company. I do not think there is a great difference in effectiveness between segregation of risk in a cell company and in a statutory fund company. However, the mechanics and regulation are certainly different and captive professionals comparing the two will see advantages to using one or the other depending on the particular project.

Apart from throwing out the aside that I believe the statutory fund company is particularly suited to segregating a large number of relatively small premium accounts written as part of a programme, I do not propose to look at potential uses of such companies, but would rather use this space to look at how statutory funds are established and some practical differences between them and protected cells.

> "The insurer's 'core' capital is not at risk in respect of policies properly allocated to a statutory fund. This contrasts with protected cell legislation, which, in some jurisdictions, does put core capital at risk"

Section 17(1)(a) provides that a "registered insurer may establish and maintain one or more statutory funds, under an appropriate name, in respect of such part or parts of the offshore business carried on by it, as the registered insurer determines".

Section 17(1)(c) states that a policy may not be allocated to a particular statutory fund "unless the owner of the policy or the person who upon the issue of the policy will become the owner has consented in writing to the application of this section to the policy".

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There are a number of differences here from typical PCC legislation. First, there is no requirement to obtain regulatory approval prior to the formation of a new statutory fund. Second, the policy is issued by the insurance company and not by the fund with the policy being allocated by the company to the fund. In the case of protected cell companies, the individual cell contracts with the policyholder when issuing the policy. Perhaps this difference explains the requirement that the policyholder consents.

It is important to note the consent is not to the allocation of the policy to a statutory fund so much as to the "application of this section" (Section 17) of the Ordinance. In these circumstances it would be prudent for a statutory fund insurer to ensure the wording of the consent makes specific reference to the application of Section 17 of the Ordinance as well as clearly identifying the statutory fund to which the policy will be allocated and stating that claims shall lie only against that statutory fund.

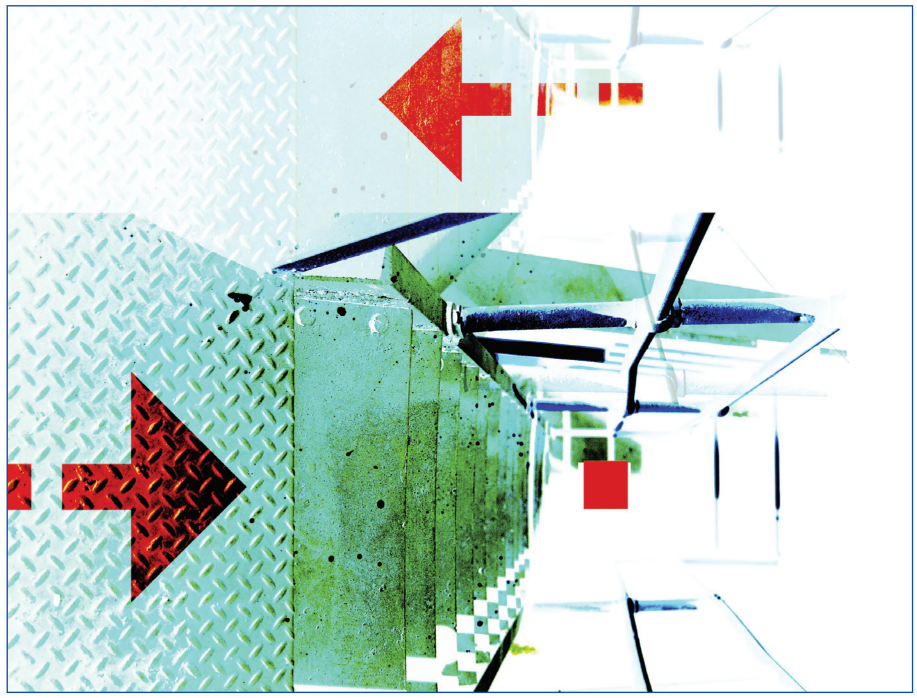
Section 17(1)(d) provides: "All amounts received by a registered insurer in respect of any part of its offshore insurance business in respect of which it has established a statutory fund, shall be carried to and become assets of that fund, including any income arising from investments of the assets of that statutory fund." Section 17(1)(e) allows investment of fund assets "in such manner as the registered insurer thinks fit" while subsection (1)(f) allows disbursement of reinsurance premium from within the statutory fund.

Subsection (2) deals with the establishment of a "long-term business fund" by insurers carrying on long-term business.

Effective restriction

Having dealt with the establishment of statutory funds and long-term business funds in subsections (1) and (2), subsection (3) of Section 17 is then used to impose the restrictions upon both types of fund that give proper effect to the segregation of risk and ensure that statutory fund assets are only available to meet liabilities in respect of the business allocated to the fund. Thus there is a requirement for separate accounting of statutory funds so that the assets and liabilities of each statutory fund "can be readily identifiable at any time".

It is subsection (3)(b) that provides protection to statutory fund assets. It states: "The assets of statutory or long-term business funds shall not be available to meet any liabilities or expenses of the registered insurer other than the liabilities or expenses referable to that part or parts of the insurance business to which the



statutory of long-term business fund relates." Further protection is provided by 17(3)(d) which prevents the insurer from charging or mortgaging the assets of a statutory fund without the consent of all the relevant policy owners.

The provision of identical protection to statutory funds established for non-life business and to long-term business funds is unusual, perhaps unique. However, the statutory fund concept being applied to non-life business is unusual in itself. This parity of treatment will make it easy for those familiar with the use of segregated funds in the context of long-term business to understand the workings of the Nevis Ordinance and to appreciate the merits of the structure.

While the statutory fund is protected by the provisions of subsections (3)(b) and (3)(d), the registered insurer itself is protected in subsection (3)(f), which provides: "No assets of the registered insurer other than those comprising and constituting the statutory or long-term business fund shall be available to meet any liabilities or expenses (each of whatsoever nature) in any way referable to the insurance business to which the statutory of long-term business fund relates." So it is that both the assets and the liabilities of the statutory fund are ring-fenced from other assets and liabilities of the insurance company that has established the fund. The insurer's 'core' capital is not at risk in respect of policies properly allocated to a statutory fund. This contrasts with protected cell legislation, which, in some jurisdictions, does put core capital at risk to some extent.

The International Insurance Ordinance specifically includes "reinsurance business" in its definition of "insurance business". This would clearly allow an insurer that wishes to allow its insureds or some of them to participate in their risks to do so by reinsuring their policy to a Nevis reinsurer for allocation to a statutory fund, the profits of which could be made available for the benefit of the original insured or at his direction. In this case, the consent to the application of Section 17 would come from the reinsured. It should be noted a statutory fund can only be established for "offshore insurance business", whose definition would prevent a Nevis reinsurer assuming business from a Nevis insurer and establishing statutory funds in respect of that business.

Producing opportunities

The use of a statutory fund as a reinsurer is compatible with programme business – a number of similar, probably relatively small, accounts. Before the introduction of the International Insurance Ordinance, Nevis was already home to a large number of producer-owned reinsurance companies and it is now easy enough to envisage the producer–owned statutory fund.

The Nevis statutory fund company would appear to offer effective segregation of risks and, for some programmes, to have advantages over protected cell companies, particularly in terms of regulatory burden. The creative thinkers in the alternative risk financing and asset protection industries will want to look closely at statutory funds. We are sure to see them put to some interesting uses and very likely to see the legislation develop further at the prompting of the industry.