

FOCUS ON

# CONVERGENCE

The convergence of the reinsurance and capital markets can be attractive to fund managers for several reasons. Insurance linked securities (ILS) are a key subset of the convergence market; *HFMWeek* spoke to Brian Desmond and Andre Perez of ILS Fund Services Ltd about the popularity of these products in Bermuda



## Brian Desmond

is a director and founding member of ILS Fund Services Ltd, a fund administration company dedicated to providing ILS funds with traditional fund administration, independent valuation and transformer services. Brian is a chartered accountant and also serves as COO of ISIS Fund Services Ltd.



## Andre Perez

is a director and founding member of ILS Fund Services Ltd. He is also the CEO of The Horseshoe Group, an independent insurance manager and advisor. Andre has over 20 years of experience in insurance, reinsurance, and alternative risk transfer.

**Q** HFMWEEK (HFM): WHAT ARE THE MAIN REASONS WHY FUND MANAGERS CHOOSE TO INVEST IN THE REINSURANCE SPACE?

**A** ANDRE PEREZ (AP): Since 2005, Hurricanes Katrina, Rita and Wilma resulted in somewhat of a distressed situation in the reinsurance space. Capacity was constrained and reinsurance rates were increasing sharply. As a result, several hedge funds looked to invest in this space either through direct underwriting vehicles known as sidecars, or through capitalisation of new reinsurance companies. Insurance linked securities (ILS) provide portfolio diversification that is uncorrelated to traditional markets, making it an attractive asset class to fund managers who have been struggling with navigating the volatile traditional markets for the past several years.

**Q** HFM: WHAT ARE THE ADVANTAGES FOR FUND MANAGERS OF CONVERGING THE REINSURANCE AND CAPITAL MARKETS?

**A** AP: Aside from the obvious advantage of broadening the asset class offering, because of ILS' low correlation with a broad investment portfolio, the cost of capital allocated to the reinsurance space is lower for fund managers than it is for insurers. Therefore, at the same pricing level, fund managers can generate higher risk-adjusted returns than reinsurers. The capital markets and the reinsurance industries have a long standing mutually beneficial relationship. The reinsurance industry provides risk protection to individuals and companies while the capital markets provide the insurance industries with a plethora of options to earn attractive investment profits and manage reserve funds. Further, ILS are an additional source of capital for the reinsurance markets which comes from the capital markets and supplements traditional reinsurance company capacity. Reinsurance buyers particularly like that ILS capital is fully funded (not dependent upon a specific company's rating or ability to pay claims) and comes with no credit risk. Both fund managers and investors are always looking for creative ways to transfer portfolio risks to asset classes that have low volatility and low correlation to traditional assets. ILS appear to be their 'pot of gold', as fund managers are able to offer true alpha to their investor base. ILS have emerged as a dynamic new asset class with great appeal to a wide range of investors, including hedge funds.

**Q** HFM: OUT OF THE DIFFERENT OPTIONS AVAILABLE TO FUND MANAGERS INVESTING IN THE REINSURANCE SPACE, WHAT IS THE APPEAL OF CHOOSING ILS?

**A** BRIAN DESMOND (BD): Unlike traditional debt and equity reinsurance investments, which often include both legacy issues and operation risk of the underlying company, ILS products, including catastrophe bonds, can provide rated debt instruments that are more cleanly tied to specific portfolios of natural catastrophe risk such as windstorm and earthquake. Sidecars can provide equity like investments but are also tied to specific portfolio risk and for limited duration. Industry loss warranties (ILWs) further provide investment opportunities in clearly specified property risk tied to industry-wide losses (index or non-indemnity).

**Q** HFM: WHAT ARE THE DIFFERENT FORMS OF ILS?

**A** AP: We like to consider a broader nomenclature, ILA, for insurance-linked assets. The most common forms of ILA we have seen hedge fund managers utilise include: cat bonds, industry loss warranties, other derivatives including catastrophe futures, but also illiquid instruments such as sidecars and traditional collateralised reinsurance.

**Q** HFM: WHAT ADVANTAGES DOES BERMUDA OFFER AS A JURISDICTION IN THE CONVERGENCE SPACE?

**A** BD: Bermuda is one of the largest (re)insurance markets in the world and is also a leading center in the international investment fund industry. The country's strong position in both these industries puts it in the heart of the convergence of the capital markets and the (re) insurance markets and makes it a natural jurisdiction for the development of ILS products. Because of the country's strength in both these markets, it has been able to attract talented, qualified people to the island with the expertise necessary to navigate through the ever-evolving asset class; has the support of the Bermuda Monetary Authority (BMA) and thus strong, yet flexible, regulations have been put in place to demonstrate the country's commitment to and also to gain the trust of investors who invest in ILS; and has been an innovator in creating legal structures that are tax efficient and able to capitalise on the traditional strong returns of the ILS asset class. Importantly, in 2009, the BMA passed legislation to create special purpose insurers (SPIs). SPIs were created to provide a capital efficient and appropriately regulated and streamlined corporate vehicle for fully collateralised insurance transactions, mainly catastrophe bonds and sidecars. SPIs have proven to be very useful for these and other fully funded and sophisticated products.

**Q** HFM: TO WHAT EXTENT HAS THE PARTICIPATION OF HEDGE FUNDS IN THE CONVERGENCE MARKET GROWN IN RECENT YEARS, AND WHY?

**A** BD: It has certainly grown in the past three years. The main drivers behind the increased popularity of ILS include: (1) portfolio diversification; (2) historical high returns generated by this asset class; and (3) the desire to attract institutional investors (for example pension funds and endowments) that may be interested in or already have experience investing in these types of securities. ■