

Convergence: What's the story?

It's all happening in Bermuda at the moment, evidenced by the dynamism and innovation present within its financial services sector, which in turn has created 'convergence'. ISIS partner Sharon Beesley explains what all the fuss is about

Ask anyone in the Bermuda reinsurance industry what the hottest topic in town is and they will all tell you the same thing - "convergence". Ask what on earth convergence actually is, and many will have more trouble answering. The word gives a broad description of a whole new approach to the management of assets of insurers and reinsurers and a possible new means of distribution for investment managers generally. It extends further to cover convergence between other disciplines, such as the insurance market and the e-commerce sector, but in the context of this article, we will be considering convergence from the perspective of the partnership between investment management companies and insurance companies in order to create new products, which combine the elements of both disciplines.

ISIS Limited, a boutique corporate finance and consultancy firm based in Bermuda, estimates that over 70% of their current work flow is in the area of convergence, with large banks and investment management firms looking at ways that they can combine forces with the Bermuda reinsurance market.

ISIS is in itself an example of convergence. The partners behind ISIS are two structured finance lawyers by training, Audette Exel and Sharon Beesley. Exel ran one of Bermuda's

banks for a number of years and Beesley headed the banking department of one of Bermuda's law firms. Three years ago, they teamed up

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with a doctor to establish ISIS Limited as a boutique corporate finance consultant and insurance intermediary with the aim of generating sufficient revenue to fund the administration costs of The ISIS Foundation, a charitable foundation with a focus on primary health care and education projects

in Uganda and Nepal and their administration. By separating administration costs from The ISIS Foundation, the partners sought to ensure that donations from third parties are applied entirely to the actual projects.

It is therefore appropriate that ISIS, a convergence vehicle between business and the charitable world, has been very involved in the convergence of insurance and the alternative investment world. Similarly, Bermuda is the ideal place for convergence as the site of innovative change in the insurance and reinsurance markets for several decades. Today Bermuda has over 1500

insurance and reinsurance companies domiciled there, which have combined capital and surplus of over one hundred billion US dollars. Bermuda is the largest captive market in the world by several times its nearest competitors and one of the largest reinsurance markets. Many of these large reinsurance companies are physically based and managed on the ground in Bermuda, and listed on the New York Stock Exchange.

Bermuda's insurance market began with the establishment of captives, which are usually formed to insure or reinsure the risks of the captive's parent and affiliates. This self-insurance concept was then expanded to "rent-a-captives" where third party risks are grouped together and managed with lower administrative costs than traditional commercial insurers can provide. The concept of captive was primarily developed to assist with risk management and pricing concerns. Thus Bermuda began life as a niche market and this approach has been expanded with the development of "speciality insurance markets", such as: property catastrophe reinsurance; political risk insurance; and alternative risk transfer products. The last in particular involves the use of insurance to help manage financial and business exposures of companies in the different areas of their business. It is in this area where we see the convergence of insurance, capital markets and banking techniques. One of the first leading insurers in the area of financial line products is the Bermuda-based Centre Solutions, a wholly owned subsidiary of the Zurich Group. Centre Solutions was established about 11 years ago with its principal focus being to write finance related insurance risk. Bermuda now sees many of its largest players working in this area, including XL Insurance, Alliance,

ACE and others.

The most recent innovation in the Bermuda market place is the convergence of the insurance market and asset management. In particular the products Bermuda is seeing discussed and developed currently are the development of so-called "hedge fund insurance companies" and the use of insurance guarantees for investment funds.

In the Bermuda marketplace, there are now a number of insurance/reinsurance companies that have partnered with top hedge fund managers and there are other developments in the pipeline. Max Re Limited is perhaps the flagship of the hedge fund insurance company. Max Re has developed a high profile largely because of its 'all star' cast, with the combination of a leading insurance team headed by veteran reinsurer Bob Cooney, combined with the power of the largest macro hedge fund manager in the world, Moore Capital. ISIS was one of the Private Placement Agents behind its private equity raisings, which resulted in Max successfully raising \$360 million, in addition to the \$150 million in capital injected by its hedge fund partner, Moore Capital. This gave Max Re in a combined equity start base of \$510 million.

The key to the insurance/asset management partnership concept is that an offshore insurance or reinsurance company is a very efficient vehicle to gather and manage assets in. Insurers have large capital bases, often combined with many hundreds of millions of dollars of premium flow. Traditionally, insurers invest the vast majority of their assets in traditional "safe" fixed income investments. If they are writing low volatility, long payout pattern business (such as life and annuity business), then the opportunity arises for them to invest in alternative investment strategies and receive higher returns. If they do this, and they are legitimate active insurance companies (i.e. not a Passive Foreign Investment Company or a Controlled Foreign Company), then the income of the investment portfolio accrues in a tax neutral jurisdiction. In addition, if these companies choose to list on an exchange the possibility arises for investors to be holding an



Sharon Beesley and Audette Exel

investment that is accruing income tax free and possibly get a multiple on that investment if it trades.

The concept sounds simple - but the practical implementation is a great deal more difficult. To successfully create such a structure, a first class insurance team must be in place, together with first class asset management skills. In addition, risk management

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for the company requires an understanding of both sides of that equation - more volatile risk on the asset management requires a skilled understanding of the underwriting risk on the other side of the balance sheet. In addition, asset managers who are seeking to create a structure that is a sham in any form - a "hedge fund dressed up as an insurance company" if you like - would be well served to consider the tax consequences of falling afoul of the PFIC and CFC rules. The insurance company must be a legitimate insurance company, taking legitimate insurance risk and real risk transfer.

In the case of Max Re, it was incorporated and licensed in Bermuda as a Class 4 insurer. This means it is licensed under Bermuda law to carry on both general and long-term reinsurance business and it must maintain minimum capital and surplus of \$100 million and comply with various statutory financial ratios and margins, including a solvency margin of 50% of net premiums written. Max Re has a first class insurance management team with many years experience, led by the former CEO of XL Insurance, and is rated A

minus by Bests and A by Fitch.

Max Re was set up to write long-term mature life business, and some property and casualty business that has a capped limit, sometimes referred to as finite risk insurance. It is only 12 months old - but wrote over 450 million in premium in its first nine months of operation. Max is widely expected to go to IPO this year.

In the Max Re structure only 40% of its assets go into hedge fund strategies - but because of the leverage gained by the premium, which is paid for reinsurance obligations to Max Re, the amount of money invested in those strategies is likely to grow exponentially. Of course, they must be sure to actually write insurance business that is likely to give them early payment - hence their focus on low volatility, long payout pattern business.

The alternative assets in this insurance structure are managed by Moore Capital in a wide variety of strategies and have quarterly liquidity. The reason for 60% of the assets remaining in fixed income is that reinsurance contracts typically need to be collateralised with letters of credit. Letter of credit issuers give much higher weighting to fixed income portfolios, as they are more difficult to value and to liquidate.

The market will follow the fortunes of Max Re with great interest: both as to its success at IPO and its success in managing a balance sheet with a large allocation to alternative strategies.

The other main example of the convergence of asset management and insurance, concerns the use of an insurance guarantee instead of a bank guarantee to return to investors the principle invested in a mutual fund at a specified date. More and more we are seeing investment product in the market.

This convergence of insurance and hedge fund managers is a very innovative area. Bermuda's involvement to date serves to highlight how well it is positioned to be at the heart of new developments with its highly sophisticated insurance community and hedge fund community both substantively on the ground in Bermuda. Keep your eyes on this area - there is much more to come, if the early days are anything to judge by.