

# TRUE CONVERGENCE: A REVOLUTION FOR ILS FUNDS

**22 NOVEMBER 2018**

Richard Sharp, Partner at Bedell Cristin, explains insurance-linked securities (ILS) and explores their origins, before Mark Helyar, Of Counsel, and a leading Guernsey legal practitioner in the ILS sector, reveals the 'Fund of One' concept he devised and has been working on with industry, investors and the island's regulator.

Insurers assume risk under the insurance policies they write in return for the premiums they receive. They manage that risk by diversifying over a large number of policies and the types of events they insure and also by re-insuring with other insurers. Insurance-linked securities (ILS) are one way in which insurers and reinsurers reduce risk by using financial instruments to securitise the risk and transfer it to investors in the capital markets.

In short, ILS are simply financial instruments whose value is linked to an insured event. An example would be where a life insurer reinsures some or all of the risk under its customers' life policies with a Guernsey special purpose vehicle (SPV) insurer. The SPV raises the collateral it needs to cover any pay outs under the reinsurance it has provided by selling securities to investors.

This transfer of risk to the capital markets first started following hurricane Andrew in 1992, one of the most expensive storms ever. After Andrew, there was a demand for greater levels of cover, but this demand outstripped the capacity in the traditional reinsurance markets. This led to the first catastrophe bonds – a type of ILS that raise capital to cover losses associated with natural catastrophes – being issued in the 1990s.

Having started with catastrophe bonds, the ILS market has since developed and expanded rapidly and now includes a wide range of securities, structures and insured risks. Where catastrophe bonds saw risk looking for capital, collateralised reinsurance now sees capital looking for risk.

ILS are particularly attractive as a way for traditional investors to diversify and receive returns that aren't correlated to the usual factors that cause volatility in financial markets, such as interest rates. Indeed, ILS returns have been relatively high in recent times compared with traditional capital or debt markets.

ILS structures typically use offshore finance centres and Guernsey has a reputation as one of the pre-eminent centres for ILS business. Guernsey's position has been built over decades on its range of cellular vehicles, the expertise of its insurance managers and other professional advisers, and a flexible and proportionate approach to regulation.

The 'Fund of One'

The structures being utilised in the ILS market are always evolving as jurisdictions look to remain competitive by being more efficient. At the moment, you may see a fund structure for ILS investors, perhaps based in Bermuda, investing into a Guernsey ILS SPV reinsurer. Inherent in that is a layer of duplication caused by the involvement of multiple jurisdictions and separate investment and insurance vehicles. This adds complexity and challenges, such as a double layer of regulation and different time zones, and creates extra costs in areas such as audit and administration.

The 'Fund of One' concept proposes that the same structure will act as both the investment vehicle and the insurance vehicle.

This single Guernsey vehicle would look to take advantage of both of Guernsey's highly developed funds and insurance offerings at the same time, but only be regulated in respect of its insurance activities and not subject to separate additional regulation as a fund. The Fund of One would also offer the possibility of using the investor-friendly Guernsey limited partnership as the structure vehicle.

In addition to adding value for ILS investors by increasing efficiency and reducing costs, the Fund of One will also increase transparency for ILS fund managers. A simplified structure allows greater visibility and control on the investment chain. The Fund of One is, therefore, ideally suited for larger investors and their managers who want more control over their investments and aren't simply content in the role of typical passive private investors.

At present, the first Funds of One are being discussed with the Guernsey Financial Services Commission.

The coming together of the insurance and capital markets has been referred to as convergence. The Fund of One

takes will take this one step further and represents true convergence. With the total ILS market expected to continue to grow, the Fund of One is an exciting development in Guernsey's ILS offering and one which will no doubt reinforce its position as a leading jurisdiction of choice for ILS business.

An original version of this article first appeared in [BL Global](#).

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