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Translation of a Roundtable Discussion: Insurance Linked Strategien [Insurance-Linked Securities]

Swiss Pensions Conference, 9 March 2011, Zurich
Contributed by the Swiss CFA Society

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This session, originally presented in German, covers insurance-linked investments or securities (ILS) as an alternative asset class. While the most commonly known products are catastrophe bonds, the speakers describe the different types of perils covered, the instruments available to invest in, investment characteristics, and present market conditions. Current topics and the pros and cons of ILS are covered in a panel discussion.

Christian Brun's slides from his portion of this presentation are available for download (PDF) on our website. Please note that the slides have not been translated.

Christian Dreyer: I welcome you to the concurrent session on insurance-linked securities, which is the last session before the lunch break. Insurance-linked securities are one of various alternative asset classes that can claim that they can provide a, well, better long-term risk/return profile than long-only investments in equity and bonds. The point is: to what extent these investments could help the pension funds achieve their target return.

Before we get started, I would like to take the opportunity to thank Clariden Leu as one of our main sponsors for this session. I am pleased to welcome two insurance-linked securities professionals: **Christian Bruns** heads portfolio management for insurance-linked securities at Clariden Leu, and **Daniel Ineichen**, who is filling in for Peter Boller, who regrettably needed to cancel on short notice for family reasons. Daniel Ineichen heads insurance-linked securities portfolio management at Secquaero in Freienbach, Switzerland. And in a combination of presentation and dialogue, the two of them will now explain to us what insurance-linked securities are and what the advantages and disadvantages of them are.

Mr. Bruns: Thank you very much indeed. The presentation you will briefly hear now consists of two parts. I will take on the first part, which is actually about: Why is anybody interested in passing on insurance risks anyway? And after that, there is the second part, which Daniel Ineichen will take on, and that is the question: Why does it make sense to invest in these insurance risks?

So, initially you ask yourself the question: Why are there insurance-linked securities at all? Why would anyone be interested in passing on insurance risks? And you can visualize this now just like a cascade. You probably all have household insurance or private liability insurance. If damages occur, you will possibly look into your policy, you will find out that you are covered for it, and then you will turn to your primary insurer. The primary insurer will take a look at it and will say, "Well, the damage corresponds to what was agreed upon in the insurance contract. We can settle this accordingly." And ultimately, you buy insurance to keep major economic damages away from you, so to speak.

The question now is: What is the insurer ultimately going to do with it? It will then have an accumulation of a great many individual policies, a great many damages coming in, it will also collect a decent amount of premiums. That is to say, the insurer will keep part of the risk separately on its books and will work with it. It is also required to back, uh, back up the whole thing with equity. Respectively, there are respective provisions by the regulator, by the rating agencies, but it will also always pass on a part of the risk (i.e., cede it to a reinsurer).

This means now we passed along the risk from the private individual to the primary insurer and a part of it from the primary insurer to the reinsurer. Now, the question is: What is the reinsurer doing? The reinsurer is now somehow the last link in this chain, and the reinsurer also needs to meet requirements—for example, on behalf of rating agencies, to some extent on behalf of regulators (how much capital it needs to hold). As long as the losses are relatively small, this is not a problem. Everyone involved in this chain can easily absorb these losses. However, if there are major events—you probably all still remember Hurricane Katrina in 2005—then, it can be that the reinsurers have a problem, too, that they should, in fact, buy coverage as well. And there is the question: Where do they buy this coverage?

In this graphic *[Note: we did not translate slides.]*, you see what losses have looked like historically. There are several examples here: Here, on the left, you see Northridge; this was a big earthquake in the U.S. in 1994. You see Hurricane Katrina pictured, and first you see (in this blue color) the extent of the losses at the time. So, for example, here you see Hurricane Katrina with \$45 billion. And the question is simply: Is this the end of the flagpole now—meaning: Is this the worst event that could occur? And the answer is quite obvious: No, there absolutely may also be bigger events. And this you see being presented. For example, next to Katrina you see this bar; it has a size of \$110 billion. These here would be other events; these would be more hurricanes in the U.S., for example; in the Caribbean on top; then, thus you would have \$110 billion.

The original question actually was: What are the reinsurers doing? The reinsurers, being the last link in this chain, the reinsurers would have to bear the loss then. And as can already be seen in the past, there are certain bottlenecks for reinsurance—most notably, for these major losses. This means that reinsurers, in turn, are also interested in purchasing coverage. And now the capital market comes into play, which is a part, then, that can provide you this coverage.

Now, the extent of reinsurance coverage needed worldwide is unevenly distributed. Thus, the sought-after coverage is not the same in all regions. This is especially connected with how far the respective country is developed, how much insurance coverage they have there, how wealthy the people are. You will see this pictured here: There is a certain range you can calculate, where there is actually an optimum for primary and/or reinsurers to keep the risk on their own books and to ultimately then back it up with equity. You can see this now especially up here—for example, South Africa, Mexico, Israel, Portugal. There is enough capacity available in the market to offer this coverage.

Now, if you look at these so-called peak zones (i.e., the major regions, where a great deal of insurance coverage is sought after—above all, the U.S., Europe, Japan), then you will see there is a part that is still optimal, which is this section to the left, and then there's a part that goes beyond that, where the reinsurance market is ruled by scarcity. And here, now the capital markets come in appropriately to take on the role of the reinsurer. They now basically could—a Swiss Re or a Munich Re—now could pass on parts of the risk to the capital market, which is ultimately much bigger than the reinsurance market and much better suited to actually absorb such diversified risks.

Now: Why would a Swiss Re or a Munich Re pass these risks on in the first place? There are various reasons for this. For one, to have additional capacity; that is what you saw in the previous slide, that there are certain regions in the world where capacity in the reinsurance business is scarce. The capital market provides additional capacity. Moreover, they have a certain balance across different cycles, that is across different years. Due to the additional capacity, they get a more stable pricing.

You need to imagine that if there is a big event, the premiums will increase significantly; if there is a longer time period without any events, then the premiums will be coming down again slowly. Now, if I have the capital market in addition,

wherein the risks can be transferred by me, then I have a certain smoothing, and I have a more stable business for the primary and reinsurers in the end.

Another important point to be added is this: If Zurich today buys reinsurance coverage from Swiss Re—500 million Swiss francs, for example—what is it going to get from Swiss Re then? It is possibly going to get a 30-page contractual document wherein there is carefully regulated what will be covered, and Swiss Re will say, “According to Standard & Poor’s, I have a rating of A. And, dear Zurich Insurance, you simply have to trust me, that if the big event occurs at some point and you need the \$500 million, we will then be in a position to pay.”

And as long as we are considering these small losses, this contract is not an issue, but if we get to big events, such as this American hurricane and some hurricanes in the Caribbean on top of that (the \$110 billion you saw), then this may present a problem because we are ultimately running a full counterparty risk on the part of the primary insurer versus the reinsurer. That is to say, what actually is of interest is finding someone who is willing to take over this risk and who doesn’t come with a neat sheet of paper saying, “I have an A or a AA rating” but who says, “I am prepared to deposit these 500 million Swiss francs into an escrow account.” Interest will be paid for it at money market rates, and if the big event occurs, then the insurance holder can be sure that the capital is also actually available for being paid out.

This really is a major advantage from the insurance holder’s point of view, and it presents a big problem in the reinsurance market these days because if you look at the landscape, you will see that there are in the market very, very few players, which are all really large and are all highly concentrated. At the same time, logically, you have an opportunity for diversification, from the perspective of the party ceding the risk. It will be able to improve its books, more or less, will be able to balance them, so it does not have these extremely large exposures in the peak zones, but it will, rather, be able to cut these back some.

And ultimately, there is also an innovative element involved here. It is possible under Solvency II that primary insurers will participate in this market in a much more active way. And they are already trying to engage in the market today, simply by issuing catastrophic bond transactions or insurance-linked securities, or ILS, to also show that they would like to make use of this new risk transfer mechanism.

So, what are ILS? If you take out household insurance, then you have a contract, a piece of paper, and this paper, it is not tradable. This is the classical insurance business. Now, if you want to make this contract tradable, you need to securitize it. This will be the security then, which means it is a bond; this bond, it pays a coupon. The coupon has two components: It has a money market rate, which will always be adjusted to the current market environment, and it has a second part as an insurance premium.

These transactions now are tradable; these bonds have a price, which means we could purchase a transaction today and we could sell it to the firm Secquaero, or vice versa. That’s the beauty of insurance-linked securities. We do not have a contractual document which you cannot transfer but which is simply running and then will end sometime; you can sell it from one party to another.

The payout of these insurance-linked securities depends upon whether insured events will occur, meaning there is a precise definition for: What does it cover? Will earthquakes be covered, will hurricanes be covered, will floods be covered? And once a certain level has been crossed, then a payout follows.

What I have just described is one part; it is what you see being pictured to the left. These are the catastrophic bonds or cat bonds or also insurance-linked securities. You have this coupon. These bonds are tradable, they have a price, they have a certain lifetime (typically, their lifetime runs between 12 and 36 months), and if the clearly defined event occurs, then you have a payout to the insurance holder. If it does not occur, then you as investor simply have the premium, and at the end of the transaction, you will get back your capital.

The second part of “how else I can invest in insurance risks” is actually on the right-hand side. This is the classical reinsurance business. We are talking about financial insurance contracts here, which means a fund would actually more or less take over the role of the reinsurance and would enter into a reinsurance contract with, for example, a primary insurer. The difference between insurance contracts and cat bonds is tradability. Otherwise, the structuring of the underlying contracts is, in fact, very similar. You can trade a cat bond; you cannot trade the insurance contract.

That also means if you are an investor who says, “I can live with quarterly liquidity,” for instance, you can invest very much into these financial insurance contracts. If you are an investor who says, “But I need biweekly liquidity or monthly liquidity,” then you will need to resort to the cat bonds side.

Briefly, just one more comparison: What do the different market segments look like? You see, the global reinsurance market—what is being bought, is, in fact, about \$170 billion. A big portion of it is in this financial insurance contract, which is what you can see on the left side. This is just the portion that is not tradable. The smaller portion is momentarily inside the insurance-linked securities area, which is what you can see on the right side.

We believe that the total market will only be growing relatively slowly, perhaps at 3–4 percent per year, depending on how insurance demand increases. But what will change . . . there will be a shift, with the result that the ILS portion will grow and the classical reinsurance market will be pushed back slightly. The main reason being that I have full, with an insurance-linked security, I have fully secured coverage. This \$100 million or \$200 million coverage that I have is fully deposited, while in the classical reinsurance market, as insurance holder, I am running the full counterparty risk.

Mr. Ineichen: Well, I would like to take a short look at why insurance-linked securities are interesting for institutional investors like you, and thereafter, we would then like to also perhaps kindle a discussion, where you will be involved with certain questions that we come upon repeatedly, and to rebut “Yes, but . . .” arguments this way, because in our daily work, we get to see a lot of these questions over and over.

But first things first: Why is it at all interesting and worthwhile? There are various points, five in particular, and we want to look at two in more detail, one of which is: The risk/return profile is very stable.

Stable Risk/Return Profile. I can show you this in the next slide. This is the Cat Bond Index, which is the small upper portion at the top right of Christian Bruns’ previous graphic, cat bonds. This is the only index (it is one from another broker, from Aon Benfield) that is put together in the market right now; it is not tradable but serves very well as a proxy actually. And if you compare it with the results that the fund industry generates, it is also very comparable. And one can very nicely see a very stable profile; it is not quite a straight line, so it has fluctuations. And we can see afterwards what kind of fluctuations these are, but generally, this looks pretty good. At least, good enough that one should take a closer look.

What happened? So, on the left side, beginning in December 2001, January 2002 as well, that is just the inception of the index. Then, there was a big blip; this is Hurricane Katrina, this was within two months when the index lost 4 percent, a little more, 4.1 percent, and then it also lost during the financial crisis in September/October, 3.3 percent. We can put this in relation to the other asset categories, and we will do this shortly, that was also . . . within two months it was negative there.

However, in lockstep with the financial crisis, Hurricane Ike marched in the direction of Galveston, on the Texas coast. Perhaps you still remember. The pictures—it was, at least for Christian and myself probably *[laughs]*—as exciting as watching the financial crisis. Where will it pass through? Because it was really huge, and actually had a relatively large damage potential. It turned out to be a loss of \$10 billion—a moderately large storm but with huge damaging power, size-wise. If it had struck somewhat more to the other side, it would probably have turned out way worse. There, we were quite lucky in the market.

The comparison with bonds: For us, well, they [ILS] are a securitized instrument; they are tradable, and according to this, belong in this category of bonds. There is no need to shy away from that. Anyway, from the rate of return, they are similar to high-yield bonds. You need to realize here that high-yield bonds have a duration of a little more than four years, if you subtract

the interest . . . the swap rate yet, and then come back to the money market, just like what the insurance-linked securities have. There is even a premium over the high-yield bonds that have a comparable rating, and it is also surprisingly stable versus investment-grade bonds—in fact, also comparable with its volatility.

Same difference with stocks. Of course, stocks clearly are much more volatile. Since its inception, one big difference: Of course, there certainly are phases when stocks are better recommended than ILS. This is quite obvious. Also of interest is a comparison with the S&P 500's Insurance Industry Index, which has been suffering a little more, but there are also specific reasons why this is the case. And we will probably answer this, why this is the case, in the questions.

Now, if we go one step further. The main argument, which you surely heard about already: Cat bonds are diversifying, and they positively affect the total volatility of the portfolio, and there is only a low correlation with other investments. Fair enough. Let us take a closer look. I am always careful with the term “correlation” because correlation is something not constant. And what you actually want as investors is just any correlation in bad times, which right then in a crisis, when my traditional investments correct, would actually have a positive diversification effect. Whereas when everything is working well, I would actually also want to do well with my diversification investment and do not want to lose money there.

And this is just the case with ILS, as we will presently see, that the bad times are not such a bad thing for ILS. The rate of return, if we first look at the yields, we looked at it before already, which is now from the inception of the index to February of this year. Volatility—let's leave it aside for once. I think it is clear to everybody that, as we saw previously, the losses are very few and far between. Thus, the damage curve also is—this probability of occurrence is not normally distributed—and so volatility probably, too, is a bad risk measure for ILS, and thus much lower than for other investments.

What is important is the number of positive months one has . . . since inception, in 94 percent of all cases, one has had a positive monthly contribution, whereas with the other investment categories, this lies in a range of mid-60 percent to somewhat over 70 percent with high-yields.

Now, we come precisely to this interesting point: What does the investment do when my traditional investments are doing badly? And we calculated this here. We took each negative month of an asset category—so, for example, for stocks, it was the S&P 500 Total Return Index—and we looked: If the S&P 500's monthly performance was negative, what was the percentage of cases where cat bonds provided security for exactly this downside and handed me a positive result for my total portfolio? And it is astonishing, that since its inception, across all categories, it has roughly been in the 90 percent range.

What happens in the next month then? It is principally the worst month. There you see that cat bonds, the worst month, I can anticipate it, this was the Katrina month, September 2005. You lost about 3 percent. Stocks minus 16 percent, bonds minus 15 percent, hedge funds minus 10 percent (this depends a little on the index as well), commodities extremely volatile and minus 28 percent, high-yield bonds also minus 17 percent. If you now look at the timing, there comes the big “Aha” moment. In the great financial crisis in October 2008, everything has . . . all other investments were . . . this was the worst month.

It is not surprising, then, that correlations or diversification do not play along as one would expect, because the underlying return drivers are just the same—that is to say, the economically and liquidity-driven arguments. Cat bonds also had a negative month in October, lost 1.6 percent, it needs to be said, so they were not totally insulated from the financial crisis. But compared with all others, it developed relatively well. The worst month actually was the month when a fundamental event occurred in the cat bond market and took place.

We also did the same analysis—by the way, I always call it the “fair weather situation” or the “fair weather position”—we said, “Surely, the financial crisis . . . this is a very rare event; let's leave it aside, and let's look at the statistics until the financial crisis—up until December 2007 since inception of the index.” I don't have the slide here (I can gladly supply it later), but the chart looks just the same, just that the red row. The worst month simply won't be the same month across all investment categories, but the diversification lies a little higher than 90 percent still.

Then three additional important arguments to follow the asset class. (Of course, Christian Bruns mentioned it already.) It may be a good time perhaps for allocating even now because it has an element of the money market plus a risk premium. Thus, it offers excellent protection against inflation, should the interest rates rise, unlike my whole bond portfolio, which actually tends to be rather fixed to the interest rate and, therefore, also is exposed to interest rate risk, which is not the case here with ILS.

Transparency. This is also a question that is becoming more and more important: The point here is, of course, transparency at the managerial level, which is probably very high in general. Transparency at the instrument level is also surprisingly high. If you have the abilities and if you bring a solid insurance background with you in your pocket, the ILS defines very clearly which events trigger which losses and what the real parameters around the transaction are. And thus also very clearly defined is what causes a bond to lose money or to be drawn or not. It is somewhat complex if you do not have the knowledge, and it is a little less transparent. However, if you have it, you can determine it very precisely, and thus from the same point of view as an insurer or an issuer—look at the risk in isolation.

Liquidity. We see an increase of liquidity in the market. It is certainly not the most liquid asset class; however, the liquidity is actually comparable to high-yield bonds, with an advantage that it will not dry out in case the market corrects. We have, for example, in 2008, in the crisis between September, October, November, nearly a quarter of the total cat bond volume had been traded in the secondary market, and the market was pretty stable, weakened only slightly. You saw it with the performance—minus 1.6 percent or minus 3 percent over the whole period. So, it reacted very well and resolved the liquidity very elegantly.

There are also various reasons why: ILS are of relatively short duration. They come with just a money market rate plus a risk premium. And thus they also should not be expected to deviate much from its 100 percent level, as these factors also help to peg the price. Moreover, there are also strategic and opportunistic buyers. Reinsurers, for example, like to make use of cat bonds if “relative value” is available. The biggest insurance companies are active in this market as well.

So, now we have . . . we want the discussion group, and Christian will come forward. We thought of a few questions ourselves, there are 10 of them. We hope that we don't have to address all 10, but maybe we can also address questions from the plenum first and maybe enter into a discussion, too. Otherwise, we simply would go through this here and put in both of our, maybe, opinions. Perhaps we shall begin with the first, for once. This is something we always see.

Mr. Bruns: Or should we maybe first ask if there are any questions?

Mr. Ineichen: Yes, there are, I think so.

Mr. Bruns: Ha!

Mr. Ineichen: There are already . . . well, then . . .

Mr. Bruns: Very good! Can we start with this question? *[murmuring]* Well, ILS are a young market. Is it to be expected that as the market matures, as a result, the yields will be decreasing in the future? May I ask you that?

[Mr. Ineichen laughs.]

Mr. Ineichen: Yes, you may gladly ask me. Yes and no. Well, the market is relatively young. In comparison with the insurance industry, it is very young for the insurance industry has experience of more than 100 years going back. The premiums, too, have . . . I think there is an element that if the capital market is present and develops larger volumes, it would absorb the \$140 billion that we saw, that it would be prepared as well to accept some smaller premiums, probably. There are nice traits of the cat bonds and the ILS: that they are fully collateralized, they stand for a very specific segment (that is very far out there), they insure against very rare catastrophes, and they have a price they cannot fall below. It must also be said that most market participants, in the meantime, are specialists who did this for years on the part of the insurance companies, and they are certainly not willing to underwrite insurance risks at any price.

I don't know, maybe you want to add something?

Mr. Bruns: Yes, well, I agree. The only thing I would like to add is that what drives the market very strongly are, of course, events, which means insured events that exist in the world. They have a very big influence on the premiums, and the fact that the premiums might come down some once this market eventually really becomes a commodity, this will probably be the case, but it is a process that will probably take 10 to 20 years.

Mr. Ineichen: Do you have anything else? A question?

Mr. Bruns: This is a point we can actually mention, too. I would like to answer the question this time—namely, the increase in the future number of damage claims. This is a question that occurs frequently. This also has . . . actually comes along with the question: What's the deal with climate change? Aren't there ever more disasters? And these days you open up the newspaper on a daily basis, and somewhere you see a flood or a hurricane or an earthquake.

What needs to be borne in mind is that: To begin with, these events, they again go back into the premiums that the transactions are paying for. That is to say, if I saw an increase of events or the fact that the events were getting stronger, that I had stronger hurricanes, stronger earthquakes, then ultimately the insurance premiums would increase as well.

So, the reinsurance and primary insurance industry, for them you can, I believe, really imply that it executes this really, really well—actually to reclaim the money from its insurance holders. And one can see this very nicely, for example, with Katrina. This was indeed an event that cost the industry about \$40 billion. And the industry reclaimed this \$40 billion ultimately within about 18 months from the, let me just say, end customers simply by a very large increase in premiums.

In the end, it also represents a chance for the ILS market. Because I think you have the fact that . . . you probably have the same point of view: It is an actual fact that there is climate change. But this also means there is an ever increasing interest for making risk transfers to the capital market, which means it is ultimately also a growth factor for the market.

Mr. Ineichen: Yes. And I think it is not simply the question of does global warming exist but what is the pricing for the risk. If the price can be adjusted, then you really are well compensated for it.

I have a very interesting question here that we see and hear time and again. The first question is: Short foot? Fat tail? Is it working, until it doesn't work anymore? *[laughs]* Uh . . . well, you do it! *[laughs]*

Mr. Bruns: Well, I, uh, this is also a question that comes up very frequently. This is, as the saying goes in the English-speaking world, "Picking up nickels in front of a steamroller," as a hedge fund manager, I believe, once said. That is to say that you are picking up pfennigs in front of a steamroller. The point is simple: What is absolutely essential in this business is diversification—namely, not that the ILS portion is part of the diversification of a larger portfolio but that the insurance-linked portfolio is diversified. And when you look at the funds in the market as well, then you will observe that actually all managers always work with limits.

Which means, for example, you only have a maximum of 30 percent exposure to U.S. hurricanes. If you take a look at the USA, then you have several thousand miles of coastline there. Now, if you take a hurricane, you will find that it always only hits a small area. With that, you can now cut off this tail, this fat tail, which means you can significantly bring down the risk of losing a significant amount of money in an event. And the interesting part in the ILS sector is the fact that you actually hardly need to give up on return for it.

In a way, this is somehow associated with the question . . . time and again, we especially also have institutional customers from the pension fund side, and they then say, "Well, what you are telling me here is all very exciting, but your management fees are way overpriced. I am going to buy two or three cat bonds instead." And here at the Zurich Financial Center, uh, there are investors who are doing this. This is then more like you are doing the "picking up nickels in front of a steamroller" routine,

because if something happens, then you simply have all of your capital at risk as well. Therefore, this is something we would not necessarily recommend.

[Mr. Ineichen murmurs approval]

Speaker: May I just ask a follow-up question to . . . Maybe one can still quantify this. We previously just saw this Swiss Re Cat Bond Index, with such pathetic drawdowns of 4 or 3 percent. If you now simply assumed the worst case (i.e., an event of some sort that simply did not happen historically), what would be the drawdown that could be expected in a truly extreme event?

Mr. Ineichen: I will gladly take this question on. What we do, of course, and Christian Bruns with his team is doing the same thing as well, is the following: We actually have a license for modeling . . . there is modeling software, the same software that the insurance industry uses, too. And there you can actually optimize portfolios and model portfolios very well. Well, then there is a Monte Carlo analysis, and there is the 10,000 year data and there is loss distribution, and what we are actually looking at is: We optimize the same distribution, so that one does not lose this distribution, a lot of money in really bad cases. Well, for example, we speak of a real bad case—for example, if a 100-year event occurs. So, once in a 100 years, a big catastrophe. That could have been this hurricane with \$110 billion, where something happened in the Caribbean to boot.

And if you undertake such analyses, which we can see, if you take the cat bond universe, for instance, and you add one of each bond, you will approximately lose in a range of 30 percent. Now, if you look at funds that are only investing in cat bonds but that perhaps choose the cat bonds a little smarter, they can reduce this loss by a good 10 percent.

We have a broader understanding: Like, these still are financial insurance contracts, which are a little more flexible, slightly different risks we, uh, securitize. We also invest in life risks. If you take such a portfolio that actually is optimized, you get to almost under 10 percent for such an event. We are, I think, now at 11 percent that you would lose. We saw that this is not even the half a month you can lose with stocks in a worst case. And thus, it is quite, quite relevant, too. This needs to be borne in mind. If an event happens, not all the money will be lost, but only maybe 5 or 10 percent. And perhaps, this is just the rate of return for a year. And under this aspect, it is just such a rare event, if you do a good job building up the portfolio, you can cope with that.

Mr. Bruns: I think this is, well, I think you simply need to bear in mind that, now, Swiss Re, for example, here in Zurich or the Munich Re in Munich have demonstrated this. The insurance business is a very interesting business. It is a very profitable business. And if you execute everything well—if you really are well diversified, ensure that you underwrite business in the right regions, that you receive decent premiums, that you have a grip on your model—then this is a business where you can truly earn money for years and years. And these companies, let me say this, have actually demonstrated it for a period of far in excess of 100 years.

Speaker: Can private investors also acquire ILS, perhaps through structured products?

Mr. Ineichen: Yes, there are, I think, both. There are funds that were issued, the . . . so, Clariden Leu may also do some self-promotion now. You have a fund for private investors? Starting at 100 francs or at 1,000?

Mr. Bruns: Yes. At 100.

Mr. Ineichen: At 100. So, you can also get into a regulated environment. There are UCITS funds; we have a UCITS fund that we issued. Clariden has a UCITS fund. You can actually already invest with relatively little money. Uh, yes?

Mr. Bruns: But perhaps a follow-up question. This is also a point that is frequently related to this one: Yes, this is now all modeled, and I actually know this from the area of mortgage-backed securities, everything was modeled there as well. This is precisely the question: you had a bad experience with MBS, why should it be better with ILS?

And I think the answer for it is, that, to begin with: This industry has been around somewhat longer, it was not just invented two days ago. Then you have . . . I was always wondering that, what happened in the area of MBS or ABS because I believe that, had this been done by reinsurance people who understand something about the business, then this would have been impossible. Here's why: This conflict of interest you have in the area of ABS is that I have someone shuffling his complete risk over to me and actually no longer cares what happens on the other side after that. This actually does not happen in the insurance sector if you do it the right way; it does not exist.

Because if we lose money in a transaction, we then will always make sure that the one who ceded the risk loses a good deal of the money himself before we need to pay in the first place—this so-called deductible. And moreover, that there is a so-called coinsurance, which means from the moment we would pay out, the . . . this insurance holder would also invariably still lose money, dollar by dollar. And this way, you can actually avoid this moral hazard, as they say, if it exists at all, that somebody passes risks on to me that it ultimately does not even hold on its own books anymore.

Christian Dreyer: As we are supposed to have lunch now in two minutes [*general cheerfulness, relaxed tension*], I would perhaps ask the audience at this point if there are still questions, urgent questions, that presently have not yet been answered.

Mr. Bruns: Well yes . . .

Speaker: I would take a great interest in the question: Is it worthwhile for a pension fund? . . . life insurance risks which actually probably—? [*Mr. Ineichen cuts into the question, so the last part is not audible.*]

Mr. Ineichen: Yes, a good question. I will quickly answer it. And after that we probably are not so hungry and will still be here afterwards for the remaining questions, because we really have many questions here yet that also are good.

Uh. Life risks, this is always . . . pension funds naturally are exposed to longevity, as we all know. And if we talk of life risks here, there are always two life risks that we are referring to. One being precisely the longevity risk, and the other one being the secondary market policies of the U.S. life settlement business, as it is called. Interestingly enough, these are actually sideshows for us, if you like. We have . . . we distinguish still many more categories that are all exposed to mortality risk, meaning risk of death. There . . . it is actually nice when the people live longer, because one can simply earn more money in that case. And this is actually perfect for a pension fund, as you cannot only just hedge the liability side, but you also get paid for it on the asset side. That being the case, a life portfolio, if correctly constructed, is extremely well suited for a pension fund.

You simply need to see that the life insurance market—which, by the way, is the same size as the whole market for catastrophe risks if you look at it from the securitization side—with it, you have also a much larger array of how you can invest. And if it is well constructed, you have positive diversification effects.

I also still have a question here about longevity, how we see it, and maybe I can still quickly say two sentences about it yet, and then we stop. Longevity is a difficult market. Naturally, there clearly is demand for risk coverage for longevity. The problem is that the industry, the banks are involved in designing a great number of products and attempting to launch this market. We, for us, we are very conservative on that score. There is yet a large price discrepancy between the buyers or investors in the longevity risk and the people who would like to cede it.

Of course, this is, in part, also time conditioned, because it utilizes very long time horizons, and one hopes that one can sweat out the whole thing. Also I think, uh . . . then, it has maturity issues. So, a pension fund that wants to cede longevity risks ideally wants to do this for several decades. Needless to say that the capital market cannot do this at all in its present

shape. So, I still see big difficulties there until a real liquid market can be put in motion there. There are first attempts that are interesting. To some extent, there are also attractive premiums if you look long and hard.

However, for example (I can now speak for us), we have one single longevity risk position in our portfolio, and it is not very big. So this is, uh . . . this shows, also already from the assessment, that it is simply very difficult to make the risk tradable for funds.

Christian Dreyer: So, in this case, thank you so much, Christian and Daniel, for an interesting presentation and for the good team play. And thanks again to Clariden Leu for being the sponsor. And then I wish you all a good luncheon. The two will still be here and will then be available for further questions.

[Applause from the audience]

*****THIS DISCUSSION HAS BEEN TRANSLATED AND EDITED*****

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