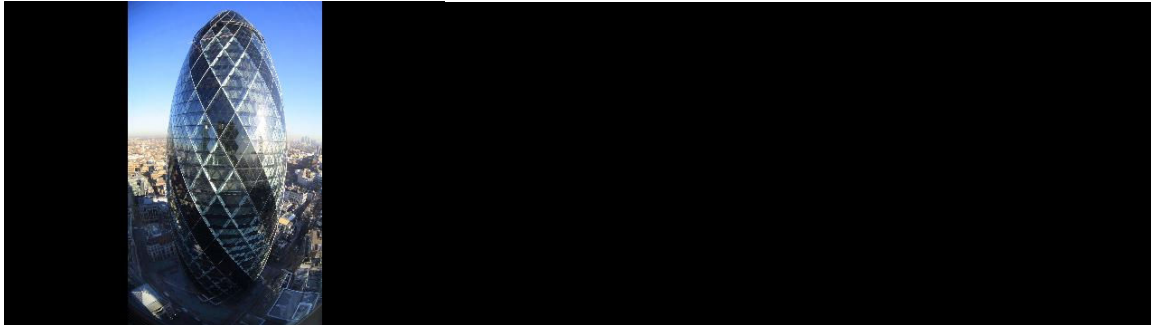




Death Bonds Drub Corporate Debt as Insurers Get Subprime Lift

By Oliver Suess



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Jan. 16 (Bloomberg) -- Betting against a pandemic paid off for Michael Stahel, who earned returns on so-called ``death bonds'' that were three times higher than those generated by corporate debt securities last year.

``The kind of event needed to trigger an extreme mortality bond would involve so many deaths that I'm not sure I would survive it myself," said Stahel, who manages 830 million Swiss francs (\$759 million) of insurance-linked holdings for Clariden Leu Alternative Investments in Zurich. ``Neither 9/11 nor World War II would have triggered the existing mortality bonds."

Stahel said his death bonds gained 7.6 percent last year. An index of corporate debt tracked by Merrill Lynch & Co. rose 2.5 percent in the same period.

Mortality bonds pay as much as 5 percentage points over an interest-rate benchmark such as the London interbank offered rate, unless a pandemic or other event raises mortality rates in a given population by a specified amount, such as 20 percent or more. If that happens, interest and principal payments revert to the insurer to pay claims. The securities are an offshoot of catastrophe bonds, which investors have used since the 1990s to bet against hurricanes and other natural disasters.

For companies such as Swiss Reinsurance Co., the world's largest reinsurer, and Paris-based Axa SA, France's biggest insurer, selling the bonds shifts some of their gravest risks to investors and protects earnings in the event of a calamity.

Swiss Re

``Issuers of extreme mortality bonds are increasingly aware of the potential impact of pandemics and the implications such events would have on their balance sheets," said Stephen Hadfield, an analyst at Standard & Poor's in

London. ``We expect to see more extreme mortality transactions in 2008."

Swiss Re, which gets more than a third of its premiums from covering life-insurance risks, sold the first mortality bond in 2003. The Zurich-based company then transferred \$705 million of extreme-mortality risk a year ago to bond investors in a nine-part sale of notes through Vita Capital III Ltd., the biggest offering of such securities to date.

The amount of mortality bonds outstanding rose to \$1.6 billion in 2007 from \$762 million in 2006, according to New York-based reinsurance brokerage Guy Carpenter, a unit of Marsh & McLennan Cos. Guy Carpenter forecasts more growth this year as investors seek investments that are uncorrelated with financial markets such as stocks and corporate bonds.

``Extreme mortality bonds are growing in importance for both insurers and investors," Guy Carpenter said in a report published this month. ``A payout is extremely unlikely and expected only for pandemic, widespread war or possibly terrorism on an unprecedented scale."

'Flying Colors'

Death bonds and catastrophe bonds tied to natural disasters both defied the collapse of subprime mortgages in the U.S. Declines in the mortgage market led to losses and writedowns of more than \$100 billion for the world's biggest financial companies.

``The subprime crisis was a test for catastrophe bonds, and they passed with flying colors," said Karsten Bromann, the Zurich-based chief risk officer for hedge fund Solidum Partners AG. ``Last year proved cat bonds aren't correlated with capital markets in general," said Bromann. His fund returned about 18 percent in 2007.

The only default on a catastrophe bond occurred after Hurricane Katrina struck New Orleans in 2005, triggering \$41 billion of insurance claims. Property damages exceeded the threshold that entitled Zurich Financial Services AG to keep investor funds from its Kamp Re cat bond.

Spanish Flu

The market kept growing, with insurers selling a record \$7.7 billion of cat bonds in 2007, up 57 percent from 2006, according to Swiss Re. The securities returned about 16 percent last year, a Swiss Re index shows. A lull in big storms since 2005 is pushing down the cost of reinsurance coverage and may lead to fewer cat bonds linked to hurricanes this year.

``You had what insurance execs call a softening of the reinsurance market," said John Brynjolfsson, who holds \$2 billion of insurance-linked securities at Pacific Investment Management Co. in Newport Beach, California. ``When that happens, cat bonds are unable to pay high premiums."

As for mortality bond, Swiss Re's latest issue is trading below face value, a sign investors are wary of the risks, said Stahel of Clariden Leu, a unit of Zurich-based Credit Suisse Group, Switzerland's second-largest bank.

``Extreme mortality bonds are not really high on investors' minds because

the modeling is still opaque," he said. ``The last real pandemic, the Spanish Flu, happened almost a century ago."

Pandemic Costs

A moderate avian-flu outbreak among humans, similar to the 1957 and 1968 flu pandemics, could result in \$31 billion in additional death claims for the life insurance industry, according to the Insurance Information Institute in New York. A severe pandemic like the Spanish Flu, which killed as many as 50 million people worldwide in 1918 and 1919, may result in \$133 billion additional life insurance claims.

Figures like that scare Nephila Capital Ltd., a Bermuda-based hedge fund that oversees about \$2.5 billion of insurance-linked securities. It has yet to venture into mortality bonds.

``There's a growing life market, but we don't participate at all in that segment," said Barney Schauble, a principal at Nephila. ``Extreme mortality is something we've looked at, but we continue to see enough opportunity in our core markets."

Munich Re, the world's second-biggest reinsurer, and Hannover Re have both sold cat bonds. Both are holding off on death bonds.

Insurance-Linked Fund

Still, some investors are comfortable with the risks. Coriolis Capital Ltd., a London-based hedge-fund company started in 2003 by former managers at Societe Generale SA, bought its first mortality bonds a year and a half ago and now has a fund dedicated to life-insurance products.

``The recent participation of top investment banks such as Goldman Sachs, Morgan Stanley, UBS and a few others is a good sign" for mortality bonds, said Diego Wauters, who worked at New York-based American International Group Inc. and JPMorgan Chase & Co. before founding Coriolis.

``Many funds that started as pure cat-bond funds are now changing their rules to be able to invest in life securities to diversify their portfolios," said Luca Albertini, head of European insurance-linked securities at Swiss Re.

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