Staying one step ahead in the business of risk

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Walter B. Kielholz
Chairman of the Board of Directors

Dear shareholders,
This is the last letter to shareholders that I will write to you as Chairman of the Board of Directors of Swiss Re. As you know, I informed the Board of Directors last year that I would not stand for re-election at the next Annual General Meeting in April 2021. As I am turning 70 this year, it is time to hand over my responsibilities.

On this occasion, please allow me to reflect briefly on 45 years of working in the reinsurance industry and on 32 years at Swiss Re in various roles. Based on my past experience, I would also like to provide my insights into 2020, an unprecedented year, as well as on the COVID-19 pandemic and the ensuing health, social, economic and ultimately also political crises.

The COVID-19 pandemic – risk is our business

At Swiss Re, a major event like the pandemic, which has had both financial and operational consequences, is something we must always expect. During my years in the business, external upheavals in the 'real' world have repeatedly hit the 'financial' world with force. And on each such occasion, Swiss Re has had to react – and has done so successfully.

Sometimes, such upheavals were caused by fundamental changes, other times they were the result of predictable but exceptionally large events. Sometimes, they affected our investments, and sometimes our reinsurance and direct insurance business, but rarely all at the same time. It was extremely rare for events to come completely as a surprise. However, there often was at least one aspect of each such event that was not expected. This was no different in the case of COVID-19; I shall come back to this a bit later.

Liability claims and the origins of our commitment to sustainability

During the early years of my career, so in the 1970s and early 1980s, but especially after 1986, a massive wave of asbestos and environmental liability claims in the US crashed over the insurance industry. This resulted in huge claims payments around the world, especially for reinsurers. This also posed a threat to the future of your company, Swiss Re. We had to adapt to a completely new environment characterised by very aggressive plaintiffs lawyers in the US. It took years for the US to bring the excesses of a legal industry specialised in liability lawsuits under greater control.

As a result, prices for liability cover rose massively. Policies were restructured to allow for shorter run-off periods. To cope with the claims burden, Swiss Re had to take decisive action and divested its large direct insurance subsidiaries in Europe. The crisis also destroyed some of the largest corporate insurers in the US and a number of European reinsurers; the centuries-old Lloyds of London business model collapsed, and the Bermuda insurance market emerged. Swiss Re's share price rose by more than 500%, and the now smaller company took off.

Since then, one insight has always guided us – an insight that has become increasingly important and has defined us over time: unsustainable business practices in the real economy, whether with regard to the environment or when dealing with product risks, sooner or later lead to major losses on insurers' balance sheets. A resolute commitment to sustainability is a 'must' for Swiss Re, because sustainability means taking precautions and limiting future losses. This issue has become part of the economic mainstream, and our early commitment to sustainability thus greatly benefits the company today.

Natural catastrophes and the emergence of insurance-linked securities

In the mid-1990s, after almost 30 years with no major storm damage in Japan or on the East Coast of the US (Betsy, a huge hurricane, made landfall in 1965), Typhoon Mireille (1991) and Hurricane Andrew (1992) caused our clients, and by extension also us, massive losses. These storms were the harbingers of a greatly increased frequency of natural catastrophes in Europe, Japan, Australia, the Caribbean and, above all, the US.

Under the leadership of reinsurers – Swiss Re played a very important role here – the industry focused on better understanding these risks. Risk models for natural catastrophes were significantly improved. New capital, primarily out of Bermuda, was deployed to address the global natural catastrophe risks, which now consistently commanded significantly higher premiums. Swiss Re recognised the resulting opportunities early on, and the company's share price rose accordingly. Today, Swiss Re is a market leader in this business, which, when viewed over a period of years, more than covers the cost of capital.

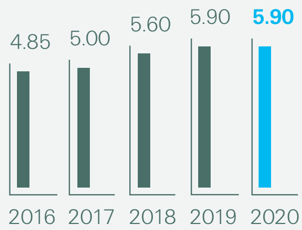
As a result of this experience, Swiss Re became the first reinsurer to start tapping additional sources of capital. The idea behind this was to securitise risks to make them tradeable. We developed – similar to mortgage-backed securities (MBS) – the first cat bonds, so-called insurance-linked securities (ILS). After experiencing growing pains for a number of years, this market has developed very well, and ILS are now a firmly established financing instrument for insurance risks.

Dividend policy

Swiss Re's dividend policy is a central element of Swiss Re's capital management priorities.

The Group aims to grow the regular dividend with long-term earnings or, at a minimum, maintain it.

Dividend per share (CHF)



> Swiss Re has an excellent reputation around the world, and its market position, strategic focus, the quality of its employees and its capital base are outstanding.

The dot.com crash, expansion in life reinsurance and disciplined asset-liability management

Towards the end of 2000 and the beginning of 2001, the dot.com bubble burst. This marked the end of a euphoric period for investors in stock markets, driven by exorbitant valuations for companies that, in one way or another, were doing something related to the internet, and often came up with the most abstruse business plans. This had to end badly – and it did, taking everything down along with it.

Many institutional investors participated in the bull market, and most of them benefitted from the bubble. Although everyone was talking about the high level of risk in the markets, only very few managed to exit them at the right time. European and Asian life insurance companies. in particular. had disproportionately large equity investments relative to their shareholders' equity. They did not have the financial strength to absorb the shock of the collapse in prices. Swiss Re, with a bit of luck, realised its gains in time and was able to walk away with a relatively small loss. We consistently expanded life reinsurance through further acquisitions, and a second, strong pillar was thus created alongside the property/casualty segment.

As a result of the financial market turbulence during those years, asset-liability management became an indispensable instrument for mitigating balance sheet risks in the insurance industry. This process aims to match maturities and liquidity needs on the asset side of the balance sheet with the liability side. Swiss Re, which has a larger balance sheet (or more asset leverage) than most of its clients due to its business portfolio, helped develop this tool from the ground up and began to use it with increasing frequency. This development encouraged a departure from the notion of always trying to time the market correctly. But it was only after the global financial crisis of 2008/2009 that the company began to systematically manage its balance sheet risks through asset-liability management.

Terrorism and the limits of insurability

The industry had just come to terms with the dot.com crash when the terrorist attack on the Twin Towers in New York occurred on 11 September 2001. Terrorist attacks were not new territory for us. Time and time again, Swiss Re had covered losses caused by terrorist attacks. The sheer scale of the attack on the World Trade Center, however, exceeded our scenarios many times over. Only very few people had the foresight to ever imagine such an event would happen.

Swiss Re was the leading (re)insurer of the World Trade Center, and the claims payments it made were correspondingly large. At the same time, however, Swiss Re made a name for itself far beyond the industry by successfully defending itself in court against excessive, even exorbitant claims – something that many other companies subsequently benefitted from.

9/11 is probably the insurance event that is most comparable to COVID-19. It demonstrated to the industry, but also to regulators and policymakers, that certain things can simply not be insured by private capital alone: namely, when their magnitude cannot be rationally defined (for example, in the case of a dirty bomb) and they are ultimately caused by politically motivated reactions of governments. It is not without reason that terrorism is described as a continuation of war that uses asymmetric means.

Swiss Re therefore had to systematically exclude terrorism risk from its coverage. After this tragedy, you as shareholders would never have been prepared to use your capital to cover such risks. No risk model, no matter how elaborate, would have made it possible to price such a risk. Something very similar is currently happening with regard to pandemic risk.

The financial crisis, or why a strong capital base is essential

So much has been written about the global financial crisis of 2008 to 2009 that I can be brief here. Institutional investors were massively impacted, banks went under and individual investors lost money on a very large scale. Again, the event itself was not unexpected. But the magnitude, the interdependencies and the speed with which the entire financial market collapsed took us by surprise – as it did many others.

The entire insurance industry was massively impacted on the investment side. Fortunately, the insurance business was very stable at the time. If I am to give an honest assessment, I must include the observation that Swiss Re did not fare particularly well during this crisis. A balance sheet inflated by operating debt left the company vulnerable. The situation was further complicated by the transition to fair-value accounting, which had recently been introduced, and which transferred market volatility one-to-one to the balance sheet.

The measures we introduced at Swiss Re as a result of the crisis were unequivocal: on the one hand, a disciplined approach with regards to very strong risk-based capitalisation and excess liquidity; on the other hand, strict limits on our debt-to-equity ratio. In other words, no extension of the balance sheet that is not driven by the core business, no matter how low interest on debt may be. Despite this deleveraging of our balance sheet – or perhaps precisely because of it – the Swiss Re share price recovered several times over in just a few years.

However, against the backdrop of the experience gained during the financial crisis, it is surprising to see the degree to which the level of indebtedness is rising again around the world. Even if this chapter appears to be closed, the end of the story has not yet been written.

Climate change and the narrowing the protection gap

In the years that followed, climate change became increasingly prominent in the public consciousness. The frequency of small- and medium-sized loss events caused by storms, tidal surge and floods (referred to in the market as 'secondary perils') increased markedly. This development and population growth in urban centres located by the sea make for a dangerous mix.

Surprisingly, the industry did not react immediately but with a delay of several years. As is often the case with an increased frequency of mid-size events, hope springs eternal. It was not clear if this increase was just a phase in the cycle or – as we now know – whether it was a long-term trend. Due to the numerous medium-sized losses, not enough premiums remained to cover major events. It took several years for the industry to respond to pressure from reinsurers and set about adjusting risk models and thus premium levels worldwide. The market correction is still underway and has gained further momentum.

Climate change has become a key risk management issue, and this is something that everyone should be taking into account. As the market leader in businesses compensating for losses related to climate change, Swiss Re will be needed even more, since the protection gap, namely the difference between insured losses and actual total losses, is still large and is growing.

The COVID-19 pandemic, monetary and fiscal policy interventions, and their potential consequences

This brings us to the present – to 2020 and the COVID-19 pandemic. Our Group CEO, Christian Mumenthaler, explains the consequences of this event in detail in his letter. But allow me to make three general observations.

First, the pandemic scenario for many years has been one of the key scenarios in Swiss Re's risk assessment. So the pandemic was no surprise. In fact, due to our leading global position in life reinsurance, we were prepared for far worse pandemic scenarios. However, to our surprise, the majority of losses did not originate in this segment. Instead, the main losses originated in property and specialty lines. Because of the simultaneous responses of governments around the world, the losses accumulated as mitigation measures were imposed, such as lockdowns, travel restrictions and a full freeze of economic activity. We had to immediately restructure our risk portfolio based on this realisation (by excluding pandemic risk), which we achieved to a significant extent in a short period of time.

Second, the industry withdrawal from pandemic coverage was unavoidable because we once again reached the limits of insurability. Without rapid and radical countermeasures, we would have lost the support of investors, or in other words, your support. On the other hand, the massive government support measures in so many countries demonstrate how urgently we need to develop a plan to better cushion the economic impact of another pandemic. Our societies must increase their resilience. Swiss Re sees private-public partnerships as an opportunity to work with governments to develop new types of coverage. At the same time, however, we must be clear in stating that such approaches cannot work without a government backstop.

Third, money arising from fiscal measures has flowed in unimaginable quantities; money no longer costs anything, for many nations it costs less than nothing. This has resulted in enormous disincentives and massive market distortions. So how can national balance sheets be brought back on track? How can this excessive liquidity be siphoned off? Which government dares to raise taxes in the near future? Which central bank dares to raise interest rates anytime soon? Politicians who wish to be re-elected will not support such actions. This leaves only one way out: the classic, tried-and-tested option of inflation, through which the owners of nominal financial assets (savers, insurance companies) are slowly expropriated and debts are reduced just as slowly. This is also called the erosion of the value of money. I am certain, for various reasons, that we will experience inflation. Not immediately, but soon. Not everywhere to the same extent, but certainly in the US. Swiss Re is preparing for this scenario – as always in an effort to protect the capital of its shareholders.

Thank you

And now the time has come for me to say thank you. My thanks go to the employees of Swiss Re, who have supported me during all these years and have always been committed to advancing the company. My thanks also go to the business partners and the global network of representatives from business, academia, politics, international organisations, NGOs and the media who have worked with Swiss Re and me in a critically constructive and respectful manner over the years. Above all, however, I would like to thank you, our shareholders, who have remained loyal to Swiss Re all these years, supported us through difficult times and shared in our successes in good times.

I will be handing the reins over to Sergio Ermotti, whom I wish every success in his role – just as I wish the company as a whole every possible success. And I am convinced that this success will be achieved. After all, Swiss Re has an excellent reputation around the world, and its market position, strategic focus, the quality of its employees and its capital base are outstanding. All we need now is a bit of luck. I will keep my fingers crossed for you and Swiss Re!

Zurich, 18 March 2021

Walter B. Kielholz
Chairman of the Board of Directors