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Introduction

Riding the momentum from its resilient performance through 2020, the ILS market saw growth opportunities in the first half of this year.

ILS spreads started the year at relatively attractive levels versus credit spreads. After a robust performance through 2020 which demonstrated once again low correlation to other asset classes, conditions were ripe for new inflows of capital to the ILS market.

With new capital raised, many primary new issues were heavily oversubscribed and upsized, while also testing lower spread levels than originally announced. This trend continued through the first half of 2021, and when all was said and done the market saw USD 8.5bn in new issuance, a record for a half-year period.

With strong issuance recorded, it’s no surprise that the overall catastrophe bond market (measured by bonds outstanding) has also grown significantly over the period, by USD 2bn according to our calculations. This keeps the market on trend for nearly 10% growth per annum since 2011.

Looking forward we see encouraging opportunities for further growth across the market.

Pandemic exposed bonds have been a feature of the market almost since its inception, but that market has never grown like the natural catastrophe bond segment. Swiss Re recently returned with a new Vita issuance and we’re optimistic that offering pandemic risks will be an area of growth for the ILS market in the next few years.

A prominent trend in recent years has been towards ESG and sustainable investments. Given the social benefits and resilience that insurance provides, we foresee a strong rationale for inclusion of ILS strategies in sustainability focused investment mandates. To realize the full benefits of that trend we envision a need for more disclosure within ILS transactions, in particular on the underlying portfolios of risk being transferred.

We hope you find value in this latest report from Swiss Re Capital Markets (SRCM). As always if you have any queries or opportunities you would like to discuss with us in the Insurance-Linked Securities space, please do not hesitate to contact us.
Investor sentiment throughout the first six months of 2021 led to fund raising and large amounts of maturities, resulting in immense growth potential. Catastrophe bond market issuance amounted to approximately USD 8.5bn during 1H21, which demonstrates once again how alternative capital can be a reliable source of capacity for sponsors regardless of market conditions. We believe it makes sense for sponsors to have diversified capacity sources to avoid relying on one market.

In late 2020, investors showed signs of demand in the new issue market as well as in the secondary market, and this theme was sustained through most of 1H21. A total of 51 tranches from a variety of sponsors covering diverse perils and regions, priced throughout the whole of 1H2, broke issuance records, surpassing 2017 as the year with the highest 1H in the history of the market.

The figures below illustrate this record-breaking issuance, split by month in Figure 1 and compared to prior issuance years in Figure 2.
Throughout the first half of 2021, new sponsors contributed to the growth of the market and more new entrants are expected to again consider the catastrophe bond market for competitive pricing conditions through the second half of 2021. Figure 3 illustrates the new sponsors in the ILS market and the transactions they brought to the catastrophe bond market from January through June 2021.

![Figure 3](image-url)

**Figure 3**
New catastrophe bond sponsors in 1H 2021

<table>
<thead>
<tr>
<th>Sponsor</th>
<th>Bond Name</th>
<th>Peril</th>
<th>Trigger</th>
<th>Spread (bps)</th>
<th>Size (USD m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Universal</td>
<td>Cosaint Re 2021-1 A</td>
<td>US Wind</td>
<td>Indemnity</td>
<td>925</td>
<td>150</td>
</tr>
<tr>
<td>Vantage Risk</td>
<td>Vista Re 2021-1 A</td>
<td>US Earthquake, Canada Earthquake, US Wind</td>
<td>PCS</td>
<td>675</td>
<td>225</td>
</tr>
<tr>
<td>St Johns</td>
<td>Putnam Re 2021-1 A</td>
<td>Florida Wind, South Carolina Wind</td>
<td>Indemnity</td>
<td>550</td>
<td>120</td>
</tr>
<tr>
<td>Syndicate 1910</td>
<td>Titania Re 2021-1 A</td>
<td>US Wind, Earthquake, Canada Wind, Earthquake</td>
<td>PCS</td>
<td>450</td>
<td>150</td>
</tr>
<tr>
<td>Gryphon Mutual</td>
<td>Wrigley Re 2021-1 A</td>
<td>California Earthquake</td>
<td>Parametric Index</td>
<td>240</td>
<td>50</td>
</tr>
<tr>
<td>Vermont Mutual</td>
<td>Baldwin Re 2021-1 A</td>
<td>US Wind, Earthquake, Severe Thunderstorm, Wildfire</td>
<td>Indemnity</td>
<td>225</td>
<td>150</td>
</tr>
</tbody>
</table>

Source: Swiss Re Capital Markets Deal Database, as of June 30, 2021

With an impressive start to the year, the ILS market could once again post a year-end issuance total above USD 10bn, well in sight of the record set last year. With high issuance levels surpassing the level of maturities, the overall market continues to grow and the market is on track for its third consecutive year of growth. Since the end of 2011, the catastrophe bond market has achieved a Compound Annual Growth Rate (CAGR) of 9.9%, as shown in Figure 4. At this rate of growth, a USD 50bn market is possible by the end of 2025.

![Figure 4](image-url)

**Figure 4**
Catastrophe bond market issued vs. outstanding notional, 10.5 year compound annual growth rate (CAGR)

Source: Swiss Re Capital Markets Deal Database, as of June 30, 2021
Deal spotlight: Residential Re 2021-1

Figure 5
Residential Re 2021-1 transaction summary

<table>
<thead>
<tr>
<th>Key Terms</th>
<th>Class 11 Notes</th>
<th>Class 12 Notes</th>
<th>Class 13 Notes</th>
<th>Class 14 Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original Principal Amount (USD)</td>
<td>100'000'000</td>
<td>100'000'000</td>
<td>100'000'000</td>
<td>100'000'000</td>
</tr>
<tr>
<td>Issuer</td>
<td>Residential Reinsurance 2021 Limited</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ceding Insurer</td>
<td>USAA</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subject Business</td>
<td>Homeowners Policies, Dwelling Policies, Condominium Owners Policies, Renters Policies and Automobile Policies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trigger Type</td>
<td>Indemnity; Annual Aggregate</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scheduled Redemption Date (Risk Period)</td>
<td>June 6, 2025 (4 years)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Final Extended Redemption Date</td>
<td>June 6, 2028 (in the event of an Extension Notice in connection with an Earthquake Loss Occurrence, the Final Extended Redemption Date will be June 6, 2029)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Covered Perils</td>
<td>Tropical Cyclone, Earthquake (including Fire Following), Severe Thunderstorm, Winter Storm, Wildfire, Volcanic Eruption, Meteorite Impact and Other Perils (including, in each case, flood Losses arising from Automobile Policies and Renters Policies)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Covered States</td>
<td>The 50 states of the United States and the District of Columbia</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initial Trigger Amount (USD)</td>
<td>1'625'000'000</td>
<td>1'775'000'000</td>
<td>2'175'000'000</td>
<td>2'675'000'000</td>
</tr>
<tr>
<td>Initial Exhaustion Point (USD)</td>
<td>1'775'000'000</td>
<td>2'175'000'000</td>
<td>2'675'000'000</td>
<td>4'000'000'000</td>
</tr>
<tr>
<td>Initial Event Deductible (USD)</td>
<td>50'000'000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initial Modeled Expected Loss (Base / Sensitivity)</td>
<td>4.32% / 4.96%</td>
<td>2.35% / 2.79%</td>
<td>1.31% / 1.55%</td>
<td>0.61% / 0.75%</td>
</tr>
<tr>
<td>Initial Modeled Trigger Probability</td>
<td>5.28%</td>
<td>3.43%</td>
<td>1.72%</td>
<td>0.97%</td>
</tr>
<tr>
<td>Preliminary Rating (S&amp;P)</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>BB-(sf)</td>
</tr>
<tr>
<td>Initial Risk Interest Spread</td>
<td>9.25%</td>
<td>5.25%</td>
<td>3.75%</td>
<td>2.50%</td>
</tr>
</tbody>
</table>

As of one the top five sponsors in the history of the ILS market, USAA has been a prolific sponsor of catastrophe bonds and has sponsored more than USD 8.5bn of notional since 1997. In recent years USAA has come to market consistently, offering two investment opportunities annually: one on an annual aggregate basis and one on an occurrence basis. While the occurrence structure has retained favor among ILS investors, the annual aggregate classes have received less support following a series of losses from events in 2017 and 2018. Thus, as a response to market feedback and to maximize the chances of success, SRCM advised and guided USAA through a simple but substantial structural change for the Residential Re 2021-1 issuance.
Capacity for multi-peril annual aggregate transactions, heavily favored by US nationwide writers, has been increasingly difficult to source following several consecutive years of loss experience. Most aggregate structures have employed franchise deductibles, which due to their binary nature have been difficult to accurately model, especially for low severity, high frequency events. There has been a consensus view among the investor base that current vendor model frequency assumptions for secondary perils, such as severe thunderstorm, have led to an underestimation of the modeled average annual loss. This has led many investors to use historical event frequency and burning cost analyses rather than rely on the modeled results from third party modeling firms.

Given these challenging conditions, most nationwide writers have not returned to the market with their annual aggregate structure in 2021, choosing to abstain completely or to source per-occurrence capacity instead. Identifying an opportunity for USAA to be a market leader, SRCM encouraged the company to consider fundamentally restructuring its existing aggregate structure by introducing an event deductible in lieu of a franchise.

The introduction of the event deductible appears to be a significant factor in alleviating investor concerns with annual aggregate structures, and USAA benefited substantially from the positive reception. Essentially, this new structural feature has allowed USAA to eliminate the binary nature of the franchise and improve vendor model adequacy for assessing high frequency events, as only the portion of losses in excess of the event deductible are now ceded to the aggregate loss tower. In other words, when losses from a particular event are near the franchise deductible level, a few hundred thousand dollars in losses can be the difference between a multimillion-dollar recovery and no loss recovery. Such a structural change has thus boosted investor confidence in the modeling risk metrics and reduced investor reliance on the historical loss experience of USAA.

All in all, the event deductible has enabled USAA to source meaningful aggregate capacity in a previously skeptical market, resulting in the largest Residential Re aggregate transaction since 2017 while also simultaneously achieving considerably favorable pricing execution.
Ultimately, USAA was able to upsize from initial guidance of USD 275m to USD 400m while still managing to obtain execution at the low end of the revised price guidance. With a USD 400m total issuance size spread across four classes, the Residential Re 2021-1 issuance is the fourth largest multi-peril annual aggregate indemnity transaction ever. As shown in Figure 7, the final pricing was reduced to levels comparable with 2018 and 2019, showing how effective the event deductible can be in mitigating investor concerns. To further illustrate the success of the transaction, Figure 8 shows the pricing of the 2021-1 issuance is relatively below most of the previous Residential Re classes issued since 1997, with the Class 14 being the lowest risk interest spread achieved in USAA’s catastrophe bond issuance history.
Trading volumes were lower in 1Q21 than the same period in 2019 and 2020. Observed trade executions occurred at a premium to par value with the exception of potentially loss-impacted bonds exposed to catastrophe events like the Texas winter storms of February 2021. Trading in Life and Health risks continued their trend from 2020, trading at discounts to par as investors were seeking higher multiples when taking on the risk during the ongoing pandemic.

Though it’s not unusual for US wind exposed cat bonds to trade at a premium during the off-peak season for Atlantic hurricanes, all perils saw traded prices increase, with catastrophe bonds issued during 2020 seeing the most noticeable impact.

Consistent with prior years, trading activity picked up in May and June as investors sought to balance their portfolios in a very busy period of new issuance activity.

Heading into the heart of the Atlantic hurricane season, the secondary market is active with stable volumes of weekly secondary trading. During the first half of 2021, the secondary market proved to be a dependable source for investors seeking opportunities and liquidity from the growing market.

In summary, the increase in new issuance activity coupled with high demand for ILS assets led to a low level of trading in the secondary market, as seen in the reported trades available through TRACE in Figure 9. SRCM observed that the secondary trading market has been overly one-sided during the first six months of the year, causing spreads to decrease as buyers have been more willing to pay a premium to deploy capacity and sellers have been taking advantage of higher prices seen on open market bids.
Nearly USD 6.5bn of catastrophe bond notional matured or was partially redeemed over the first half of this year. Of that amount, over USD 2.0bn (31%) covered diversifying, non-US perils. The IBRD 116, 117, and 120 notes covering earthquakes in the Republic of Chile, Republic of Colombia and Republic of Peru, respectively, represented over USD 1.0bn of this maturing notional, taking into account the USD 60m sponsor payment after an Mw 8.0 quake struck Peru in May 2019. While 2021 has seen a very strong new primary market so far, with over USD 8.5bn issued, less than USD 700m of that new issuance covered diversifying non-US perils, leaving strong demand from investors for these perils. As noted in Figure 11, overall the market has grown by USD 2.0bn in capacity in the first half of this year.
Bond payouts from loss events

The first half of 2021 saw just over USD 150m in payments to sponsors, less than half the notional paid to sponsors in the first half of 2020. As seen in Figure 12, nearly 68% of the notional paid out was at the final extended maturity date of its respective bond, and all payments are for events that happened in or prior to 2018. The 2020 hurricane and fire seasons were active and there were some additional cat events in the first half of 2021. Each of these recent events likely would not have been large enough to trigger sponsor payment on its own; however, they add up to significant losses to insurers in the aggregate. Based on loss estimates released to the market, it is expected that they will result in principal reductions and large payments to sponsors in the future.

Figure 12
Breakdown of sponsor payments in 1H 2021
New issue spreads

New issuance spreads continued to tighten, a trend that started towards the end of 2020. Today, for certain types of transactions, we see catastrophe bond pricing approaching historic lows. As demonstrated in Figure 13, spreads have diminished within the six months and now can be compared to hot market years like 2018, when there was strong capital reload following the catastrophe losses of 2017.

Transactions during the first half of 2021 received tremendous support from investors. SRCM observed most transactions executed below their initial guidance, and in some cases with high levels of oversubscription even after raising notional targets. With demand high, new issue multiples and spreads decreased while the average EL remained relatively constant. This can be seen in Figure 14.

Source: Swiss Re Capital Markets Deal Database, as of June 30, 2021
Note: Excludes all bonds with zero US WS exposure

Source: Swiss Re Capital Markets Deal Database, as of June 30, 2021
Note: Excludes all Life and Health, Wildfire Only, Sanders Re 2018-1 A, 2019-1 B, 2020-1 B, and Bonanza Re 2020-2 B. Effective spread used for zero-coupon bonds, sensitivity EL used where applicable
Secondary market spreads

At the beginning of the year excess capacity tried to find a place in the secondary market, but investors were faced with a secondary market that was actively pursued. SRCM observed prices bid up in the secondary market trading, which was especially evident when there was no active primary market pipeline to rely for new assets. The secondary market tightened aggressively over a short period of time, impacting secondary spreads across all perils.

Figure 15 shows the comparison of spread indices for catastrophe bonds where SRCM observed this tightening trend across all perils. A noticeable trend on the chart shows California earthquake spreads converging with non-peak spreads during 2021, as investors were willing to pay a premium to diversify away from peak US wind.

Source: Swiss Re Capital Markets Indicative Pricing, as of June 30, 2021
Note: All Indices contain cat bonds with at least 1 year to maturity and an EL between 16-180 bps (or with an actual BB rating, regardless of EL). Bonds with an interest spread movement since issuance of more than 75% are excluded. CA EQ Index contains cat bonds that have at least 80% EL contribution from CA EQ. Non-Peak Index contains cat bonds that have no EL contribution from US WS or US EQ, excluding all wildfire only bonds. US WS Index contains cat bonds that have exposure to US WS, excluding Bonanza Re 2020-2 B, Sanders Re 2018-1 A, 2019-1 B and 2020-1 B. Seasonally-adjusted spreads used. Excludes all Life and Health, Wildfire Only, Sanders Re 2018-1 A, 2019-1 B, 2020-1 B, and Bonanza Re 2020-2 B. Effective spread used for zero-coupon bonds, sensitivity EL used where applicable.

As the market continues to demonstrate its cycles, spread movement through the mid-point of 2021 for all perils has returned to levels last observed in 2017 and 2018. Following a higher than expected level of hurricane activity in both the Atlantic and Gulf basins, a readjustment to the spread cycle took place and investors faced losses and started to demand higher spreads to support new issuance. After the trifecta of hurricanes Harvey, Irma and Maria, as well as California wildfires, an ample amount of catastrophe bonds either triggered or faced mark downs and were carried at significant discounts to par value.
ESG developments in the ILS market

Across all asset classes and geographies there is a strong trend to incorporate environmental, social and governance ("ESG") criteria into investment decisions. Although there are differing opinions on the application of ESG investing, there is no doubt ESG is an increasingly important topic. This is driven by the broader focus of fund managers to more readily evaluate and incorporate ESG factors into investment decisions and by emerging regulatory requirements, notably the Sustainable Finance Disclosure Regulations in Europe.

Swiss Re Group has a long-standing commitment to sustainability and was an early mover in systemic integration of ESG criteria in its businesses. This commitment has been recognized across the industry and is evidenced, among other ratings, by its AAA rating by MSCI. Swiss Re Capital Markets (SRCM) has carried this leadership into the ILS market, continuously exploring ways to move the integration of ESG forward in the ILS market, engaging with sponsors, investors, regulators and rating agencies.

By providing capacity to (re)insurers for nat cat risks which are increasingly climate change related and helping build societal resilience, the ILS market demonstrates inherent sustainability benefits and therefore could prove to be a compelling complement for a broad range of ESG focused investors. To take full advantage of this trend, the ILS market must develop further to allow for more detailed quantification of relevant factors on a transaction-by-transaction basis.

Key ESG elements in a transaction could include:

- **Sponsor:** Sponsors are increasingly providing ESG disclosures within transaction documents to proactively provide transparency, with Swiss Re being the first such sponsor to do so in its Matterhorn 2020-5 cat bond issuance in 2020.
- **Collateral:** Ensuring that the collateral is invested in a sustainable way and ideally with a distinct green purpose. Going one step further than typical IBRD or EBRD notes, the Lion III Re cat bond invested proceeds in a distinct green portfolio within the EBRD.
- **Underlying portfolio:** When providing capacity to (re)insurers, investors will want to weigh the sustainable qualities of the underlying portfolio. Investors are issuing ESG related questionnaires and while this assessment is largely qualitative to date, it is a positive development.
- **Service providers:** The set-up and ongoing function of ILS transactions involves a number of service providers and other parties. Currently, we see limited developments in the evaluation of the sustainable qualities of these service providers but expect this to be a trend in the future.

Through discussions with ILS managers and end investors, SRCM believes that the most critical driver of advanced ESG in the ILS space will be the ability to conduct qualitative assessments of the ESG qualities of the underlying re/insured portfolio. Looking ahead, we will work to advance the market’s adoption of further disclosures and criteria in this area.
Relative value analysis

Swiss Re Cat Bond Index

The Swiss Re Global Cat Bond Total Return Index continues to demonstrate value versus other asset classes. Low correlation continues to be observed and with higher spreads and lower volatility than similar asset classes, and as a result the cat bond market saw more allocations from end investors. Unlike previous years, there were no major natural catastrophe events except the Texas winter storms in February, which did not greatly disrupt the cat bond market. Thus, overall value was maintained and improved as the year progressed.

![Figure 16: Swiss Re Global Cat Bond Total Return Index (SRGLTTR) vs other relative benchmarks](image)

Source: Swiss Re Capital Markets and Bloomberg LP, as of June 30, 2021
Note: The Swiss Re Global Cat Bond Index Total Return is a market value-weighted basket of natural catastrophe bonds tracked by Swiss Re Capital Markets, calculated on a weekly basis; past performance is no guarantee of future results. Underlying data for Barclays Capital High Yield Index provided by Barclays Capital. Underlying data for the S&P 500 Total Return Index and the Bloomberg Barclays Corporate Bond Index is captured from Bloomberg LP. Underlying data for Swiss Re Global Cat Bond Index Total Return is based on indicative prices only.

As mentioned earlier, US wind exposed spreads have steadily decreased through the mid-point of 2021, which is the same general trend seen in corporate bond spreads, as shown in Figure 17. Throughout the past year and a half, the capital markets experienced volatility from COVID-19 uncertainties and heightened inflationary pressure; however, cat bond spreads did not see the same magnitude of volatility as other asset classes. Spreads did not spike to the same extent as in 2020 and have not fallen as low in 2021 for similarly rated bonds, remaining attractive to investors seeking stability. The cat bond market has continued to show its value to investors, with higher and more stable spreads compared to other asset classes.
Figure 17
Relative value indices: Swiss Re composite

Source: Swiss Re Capital Markets, as of June 30, 2021; Bank of America Merrill Lynch US High Yield B and BB Indices

Note: US WS BB Rated Comp contains bonds with at least one year to maturity that have exposure to US WS, and an EL between 16-180 bps (or with an actual BB rating, regardless of EL)
US WS B Rated Comp contains bonds with at least one year to maturity that have exposure to US WS, and an EL between 18-375 bps (or with an actual B rating, regardless of EL)
BofA Merrill Lynch High Yield Option Adjusted Spread via the Federal Reserve Bank of St. Louis website
Swiss Re Capital Markets pricing indications only. Average seasonally adjusted spread of all ILS bonds with at least one year left to maturity
Specialists throughout Swiss Re Capital Markets are available for consultation on bespoke ILS solutions, and they invite a dialogue on the subject with sponsors and investors alike. For more information, please contact any of the individuals listed below in your jurisdiction.

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An investment in Insurance-Linked Securities involves potentially significant risks for an investor. In summary, these risks include (but aren’t limited to):

- Investors may lose all or a portion of their investment in Insurance-Linked Securities if a natural catastrophe or other event triggers a payment by the issuer of the Insurance-Linked Securities under the underlying risk-transfer agreement to which the Insurance-Linked Securities relate.

- The maturity of the Insurance-Linked Securities may be extended without the prior consent of the investor.

- The Insurance-Linked Securities may be redeemed before their maturity date (including before any extension of such maturity date by the issuer).

- If the Insurance-Linked Securities are redeemed before maturity, the interest rate payable to you under the Insurance-Linked Securities will be reduced.

- Investors have limited recourse to assets of the issuer of the Insurance-Linked Securities and no recourse to assets of the counterparties to the underlying risk-transfer agreements to which the Insurance-Linked Securities relate.

- If the issuer of the Insurance-Linked Securities becomes insolvent, investors may lose some or all of their investment.

- Investors may be required to consolidate the issuer for accounting purposes under certain circumstances.

- An investment in the Insurance-Linked Securities may have adverse tax consequences for investors.

- Any claim you have against the issuer in the event of the issuer’s insolvency will rank below any claim a counterparty to the underlying risk-transfer agreements, to which the Insurance-Linked Securities relate, has against the issuer.

- Enforcement of security interest granted to a trustee for the benefit of the investors may be limited.

- The Insurance-Linked Securities may not have a secondary market or the secondary market for the Insurance-Linked Securities may have limited liquidity and the market and market price of the Insurance-Linked Securities in the secondary market may be highly volatile.

- The Rating Agency(ies) (if any) may change any rating assigned to the Insurance-Linked Securities. Any credit rating given in respect of the Insurance-Linked Securities may not reflect the potential impact of all risks related to the Insurance-Linked Securities. A credit rating is not a recommendation to buy, sell or hold the Insurance-Linked Securities and may be revised or withdrawn by the rating agency at any time.

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