

# Insurance-Linked Securities Market Insights

Volume XXXVII, August 2022





# Table of contents

Introduction.....	5
Primary market.....	6
Deal spotlight .....	8
Focus: Inflation .....	9
Secondary market .....	10
Relative value analysis .....	13
Maturities and loss payments .....	17
For more information .....	18
Risk Factors.....	19
Disclaimer .....	21



# Introduction

The Insurance-Linked Securities (ILS) market has once again demonstrated its resilience as an asset class through a period of heightened volatility across financial markets. Over the first half of the year, the broader financial markets have navigated rising inflation, the conflict in Ukraine and interest rate fluctuations, and consequently, volatility in the equity, fixed income, commodity, and foreign exchange markets. Despite these factors, ILS markets have performed relatively well throughout the first half of 2022 with year-to-date returns only slightly negative for the year and the third most active H1 for new issuance on record.

With over USD 8bn issued in catastrophe bonds, the ILS market gave sponsors an alternative source of risk transfer capacity in a hardening reinsurance market. Some reinsurers have reduced capacity in peak zones or closed their natural catastrophe (nat cat) portfolios entirely, which has led to increased opportunities in the ILS market. Given the need for more overall reinsurance capacity, we expect the trend of increased new issuance volume to continue and result in further growth.

Investor returns year-to-date have been slightly negative (–0.35% as represented by the Swiss Re Global Cat Bond Total Return Index) but compared to global equity and bond markets, ILS has proven once again to offer relatively low volatility and very low correlations in times of wider market stress. The negative return was mainly driven by spread widening as a result of the hardening reinsurance market, suggesting an improved outlook for returns in years to come. Barring any major natural catastrophes which might cause principal losses, we expect performance should recover strongly in the second half of the year.

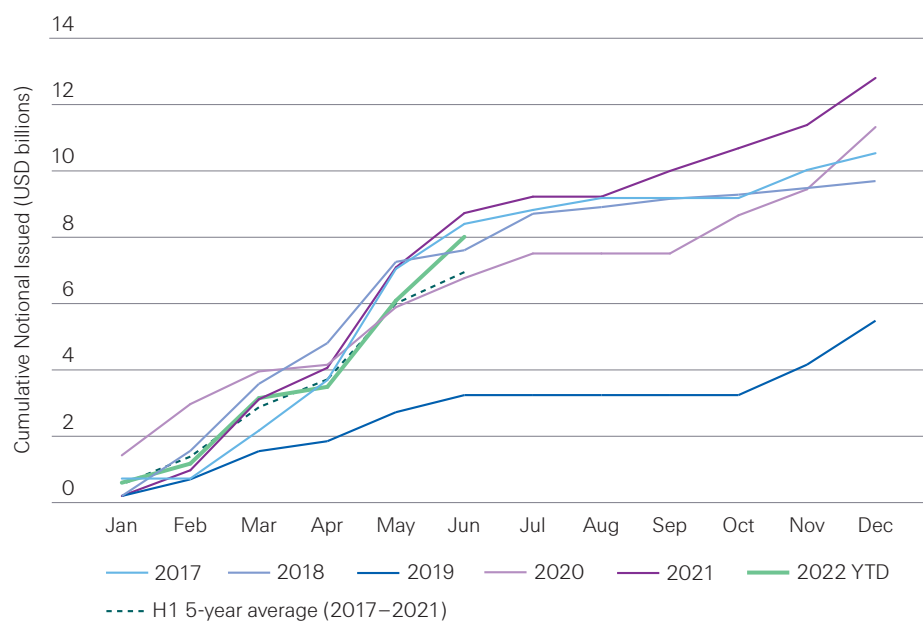
The six-month period has demonstrated the strengths of the asset class to investors and sponsors alike, positioning the market well for its next stage of growth. Swiss Re Capital Markets (SRCM) sees increasing interest from both new potential sponsors looking to diversify their risk transfer capacity sources, and from end investors who want to benefit from this historically lightly correlated asset class. Bringing both of these groups to the ILS market is a key objective of SRCM as we continue to lead the market forward.

# Primary market

In 2022, the primary market was quite active and provided investors with plenty of opportunities to pursue. However, the ILS market still experienced its fair share of challenges. Changing macro-economic conditions triggered a domino effect in the re/insurance industry. Inflation management, claims, and historic handling of key loss events came under intense scrutiny by those evaluating transactions. Even with external pressures coming from credit and equity market wide trends, the first half of 2022 saw 55 tranches issued in what is perceived as a hard/hardening ILS market. H1 2022 new issuances remained higher on average than over the last five years, even though they were down 8.9% compared to the same period in 2021. Overall, the cat bond market experienced its third most active H1 ever, with over USD 8.0bn of notional issued, as illustrated in Figure 1.

Due to supply and demand imbalances, demand for new cat bonds was more saturated as investor capital was already raised and bound by transactions that incepted in either 2020 and 2021, which were both record breaking issuance years. The ILS market and comparable asset classes experienced a restricted amount of funds available for investors to deploy due to challenges of the macro-economic environment. This caused investors to limit their capacity and adopt extremely disciplined investing strategies. Some who remained on the sidelines in 2020–2021 returned to capitalize on the relative value of the cat bond market as a diversifying asset class with competitive returns. Simultaneously, cat bond supply remains high as sponsors are now more than ever in need of larger lines of capacity to support inflated claim costs and minimize earnings volatility.

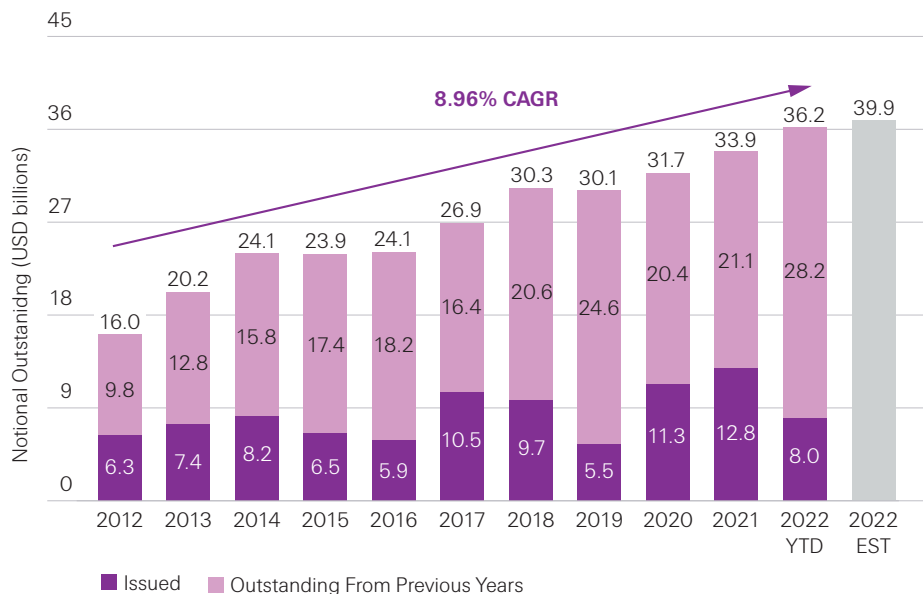
Figure 1:  
ILS New Issuance: Historical Cumulative Notional Issued



Source: Swiss Re Capital Markets Deal Database, as of June 30, 2022

Overall, the cat bond market not only sustained a Compound Annual Growth Rate (CAGR) of 8.96% since 2012, but also at the 2022 mid-point had just over USD 36.2bn notional outstanding, signaling another year of growth for the ILS market.

**Figure 2:**  
ILS Market Issued vs Outstanding  
Notional



Source: Swiss Re Capital Markets Deal Database, as of June 30, 2022  
 Disclaimer: 2022 Estimate is achieved by applying the 9.5-year CAGR to the 2021 EoY total notional.

Even though fewer catastrophe bonds were issued during H1 2022 compared to the prior year, a handful of new sponsors entered the ILS market. As summarized in Figure 3 below, the cat bond market had USD \$805m in debut catastrophe bond notional from new sponsors, all with multi-year protections with covered perils ranging from U.S. Wind, U.S. and Canada Earthquakes to Japan Typhoon and Japan Earthquakes.

This demonstrates that even during a hard market, catastrophe bonds remain an attractive source for alternative re/insurance capacity for both new and existing sponsors who seek to explore how these innovative and historically lightly correlated instruments could support their franchise.

**Figure 3:**  
New Catastrophe Bond Sponsors in H1 2022

Sponsor	Bond Name	Perils List	Trigger	Cover	Settlement Date	Notional USD	Issue Spread	EL
Inigo Insurance (Syndicate 1301)	Montoya Re 2022-1 A	US Wind, US and Canada Earthquakes, Japan Typhoon and Japan Earthquakes	PCS	Annual Aggregate	March 30	115	675	256
Kin Interinsurance Network	Hestia Re 2022-1 A	US Wind	Indemnity	Occurrence	April 14	175	950	226
SureChoice Underwriters Reciprocal Exchange (SURE)	Gateway Re 2022-1 A	US Wind	Indemnity	Occurrence	May 06	150	850	188
Core Specialty (StarStone)	Yosemite Re 2022-1 A	US Wind and North America Earthquakes	Indemnity	Occurrence	June 03	65	975	128
Peak Reinsurance Company	Black Kite Re 2022-1 A	Japan Typhoon	PERILS	Occurrence	June 02	150	690	322
The Hanover Insurance Group	Commonwealth Re 2022-1 A	Northeast US Wind	Indemnity	Occurrence	June 23	150	350	55

Source: Swiss Re Capital Markets Deal Database, as of June 30, 2022

## Deal spotlight

**Figure 4:**  
Transaction summary of  
Matterhorn Re Ltd., acting in respect  
of the Argon Segregated Account

Summary of Terms	
Issuer:	Matterhorn Re Ltd., acting in respect of the Argon Segregated Account
Ceding Reinsurer:	Swiss Reinsurance Company Ltd.
Format:	Senior Loan / 144A
Trigger Type:	Financial year whole account stop loss
Tenor:	5 years
Total Size:	USD 1.15bn

Source: Swiss Re Capital Markets, as of June 30, 2022

Following three active years of participation in the cat bond market through the issuance of many peak peril-focused catastrophe bonds from its Matterhorn Re SR144A program, Swiss Re brought an innovative product to the market through the newly established Argon program within Matterhorn Re.

In April 2022, Swiss Re completed a first of its kind transaction combining bank financing and insurance-linked securities to secure USD 1.15bn in protection from the capital markets for severe underwriting-related losses over a five-year period.

To achieve this landmark hybrid transaction, Swiss Re partnered with J.P. Morgan, which provided USD 1bn in financing via a senior loan and various institutional investors who participated via a USD 150mn investment in junior insurance-linked notes.

The scope of the transaction was much broader than typical issuances from the Matterhorn Re SR144A program, as it provided Swiss Re with a whole account financial year stop loss, covering underwriting risks across the Swiss Re group. The transaction supports Swiss Re's growth opportunities in the insurance and reinsurance markets and is expected to have positive impacts on its ratings and regulatory capital requirements.

In line with recent cat bond transactions sponsored by Swiss Re, the proceeds from the senior loan and the sale of the junior notes were invested in notes issued by the European Bank for Reconstruction and Development (EBRD). The transaction was well received by ILS investor community and received support from a range of institutional investors.

This transaction once again highlighted Swiss Re's tradition of innovation in the alternative capital space. Swiss Re Capital Markets leveraged its strong capital market expertise and relationships to bring together the complementary nature of two sources of capital – bank financing and insurance-linked securities – to provide valuable additional capacity to the reinsurance market.

## Focus: Inflation

With inflation being a significant concern for investors and sponsors alike, it is important to understand the dual impact of inflation on the ILS market.

Increased claim costs (replacement costs for raw materials and labor costs) have created higher ultimate loss amounts for indemnity-based structures in both the traditional reinsurance and ILS market. The implication of inflation on expected losses is not uniformly captured in the risk models, therefore inflation adjustments have become a key area of focus this year. As a result, some issuing sponsors have chosen to provide investors with projected insured value data based on an upward trajectory of inflation. As a result, investors sought to gain insight to better understand inflation assumptions taken by sponsors. In some cases, this led to increased scrutiny of growth strategies and whether insurance penetration was increasing at an appropriate level in catastrophe prone areas.

With increased claims costs leading to larger amounts of notional being issued, we are also seeing inflation impacting risk interest spreads. Besides the impact of loss amounts, inflation also leads investors to require higher nominal returns to maintain their real returns. Since most cat bonds use a floating rate – typically money market funds plus a fixed spread – the nominal returns naturally increase with rising interest rates. This partially ensures both higher nominal and less heavily impacted returns when inflation increases.

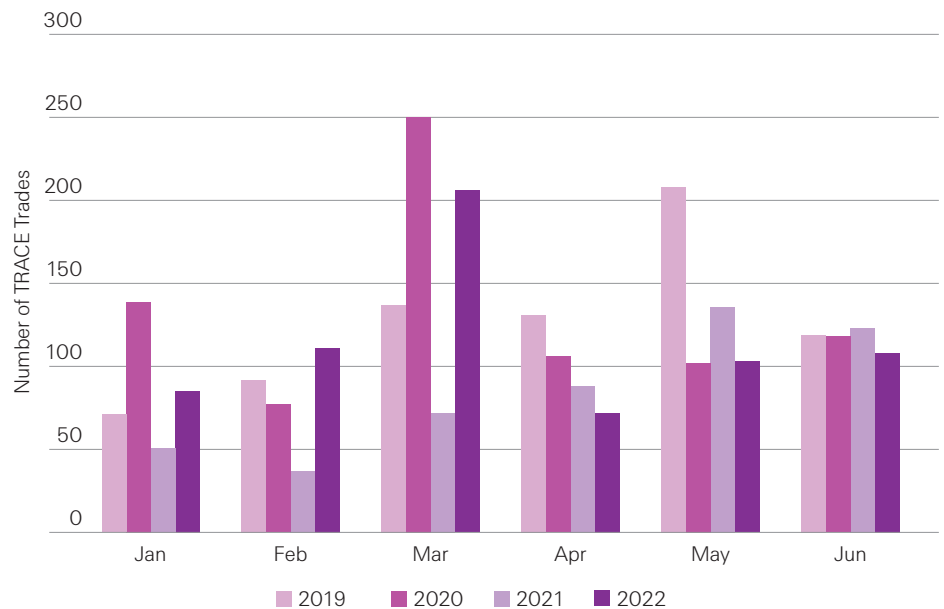
Central banks have largely communicated rate rises to combat inflation, which was in part exacerbated by government stimulus plans and supply chain interruption. However, the reality of inflation increasing beyond already historically high levels is forcing central banks to accelerate interest rate hikes, particularly in the US, UK, and Euro zone.

# Secondary market

The ILS secondary market saw substantially higher trade volumes during Q1 2022 compared to Q1 2021. Throughout January and February, bonds traded at uncharacteristically high values, with most trades occurring at or above par value. Despite March being the busiest month for the secondary market so far this year, trading volumes fell drastically in April, with average trade values well below par value. In Q2 2022, SRCM observed a much less active secondary market than in each of the preceding three years. During May and June, bonds traded closer to historical averages, as Q2 concluded with prices well below par value.

In our view, the most relevant activity observed on TRACE took place in June 2022, when investors sought liquidity to manage redemptions. This pressure and a demand for rapid liquidity created spread widening in a relatively short period of time.

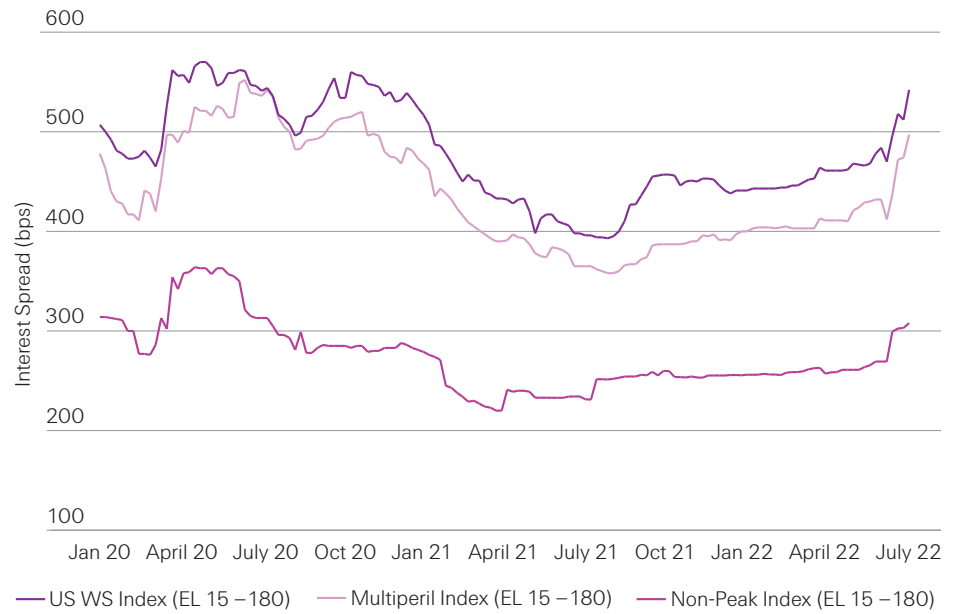
Figure 5:  
Historic TRACE Trade Volume by Month



Source: Trade Reporting and Compliance Engine (TRACE), as of June 30, 2022  
 Note: Trades eligible to be reported to TRACE primarily represent the US market.

SRCM believes that since March 2022 most bonds were sold at a discount due in part to low levels of deployable capital. This has led to a rebalancing of portfolios as the primary market environment presented higher yielding investment opportunities.

**Figure 6:**  
Cat Bond Secondary Spread  
Development by Peril



Source: Swiss Re Capital Markets Indicative Pricing, As of June 30, 2022

Notes: All Indices contain cat bonds with at least 1 year to maturity and an EL between 15-180 bps (or with an actual BB rating, regardless of EL). Bonds with an interest spread movement since issuance of more than 75% are excluded. US WS Index contains cat bonds that have exposure to US WS. Multiperil Index contains cat bonds with exposure to both US WS and US EQ. Non-Peak Index contains cat bonds that have no EL contribution from US WS or US EQ, and excludes all wildfire only bonds. Bonanza Re 2020-2 B, Bonanza Re 2021-1 B; Sanders Re 2018-1 A, Sanders Re 2019-1 B, Sanders Re 2020-1 B, Sanders Re 2021-2 B; Sanders Re 2021-2 B, Sanders Re 2022-1 B, Sanders Re 2022-1 C; Topanga Re 2021-1 B and Herbie Re 2020-1 A are excluded from all indices. Seasonally adjusted spreads used.

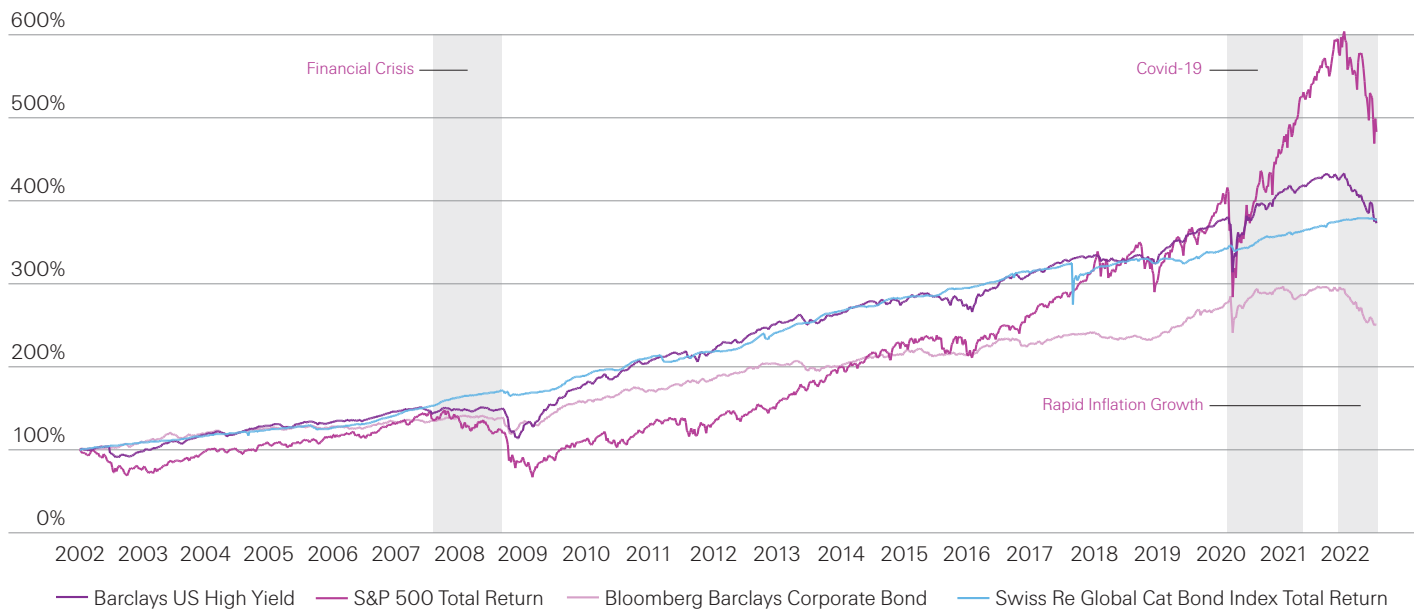
Towards the end of Q1 and throughout Q2, most secondary trading occurred below par value and presented a possible value opportunity for new investors to enter the ILS market. As the lack of liquidity continued to affect valuations, new investors found themselves a position to acquire bonds at discounted prices. Additionally, with the US Wind season already underway, there are likely to be few new primary market deals entering the pipeline.



## Relative value analysis

Given the volatility across financial markets, the demand for diversifying high-yield assets offering low correlation with traditional asset classes is increasing. Over the last 15 years, cat bond total returns have provided stable returns during periods of crisis and demonstrate much lower volatility during these capital events, as illustrated in Figure 7 below.

**Figure 7:**  
Swiss Re Global Cat Bond Total Return Index (SRGLTTR) vs other relative benchmarks

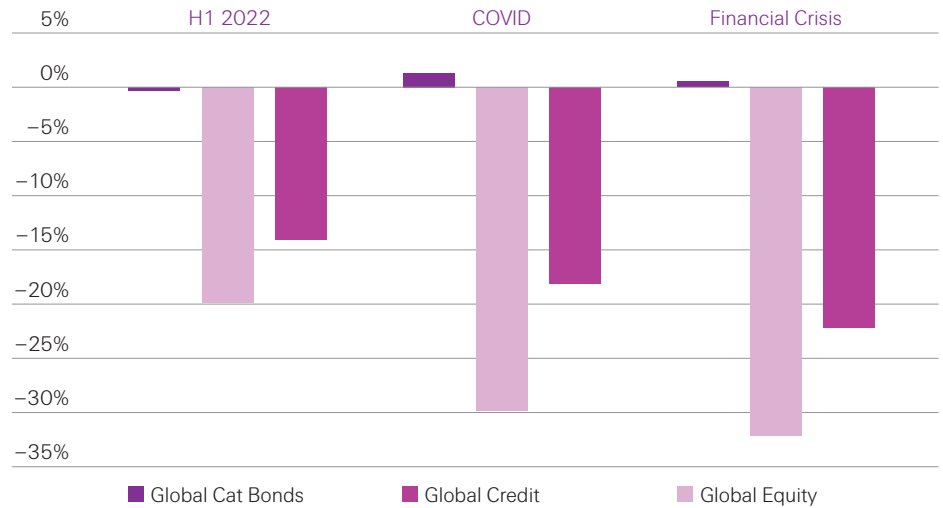


Source: Swiss Re Capital Markets and Bloomberg LP, as of June 30, 2022

Notes: 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.

In this context, we believe the ILS market offers a valuable investment opportunity due to its many diversifying characteristics in that cat bonds represent an investment in natural catastrophe or event risk as opposed to financial market risk. As a result, investments in the ILS market should inherently act as a diversifier to a traditional investment portfolio. Figure 8 highlights the diversifying effect at three periods of stressed financial markets and illustrates how cat bond total returns have shown incredible resilience when other asset classes saw large drawdowns.

**Figure 8:**  
Index returns during times of crisis

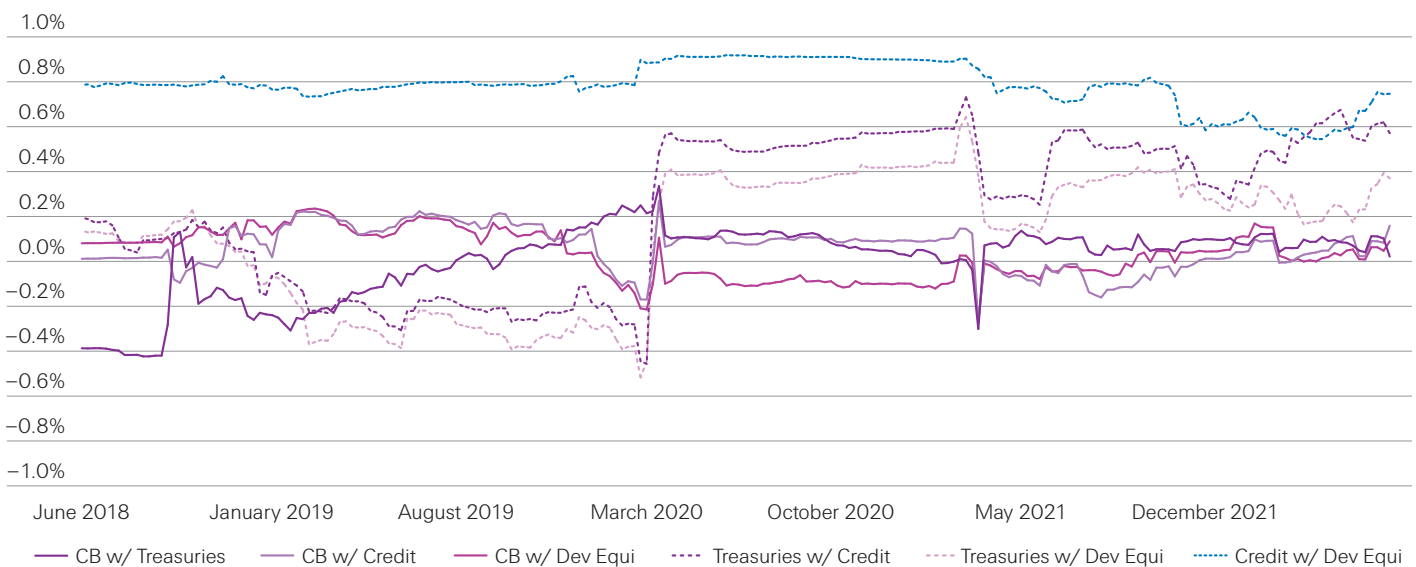


Source: Swiss Re Capital Markets and Bloomberg LP, as of June 30, 2022

Note: Swiss Re Global Cat Bond Total Return Index (SRGLTTR), MSCI Developed Equities Index, Bloomberg US Corporate High Yield Bond Index. The financial crisis is defined as April 1, 2008 to October 31, 2008; COVID is defined as December 31, 2019 to March 20, 2020 and H1 2022 is defined as December 31, 2021 to June 30, 2022.

In times of high volatility and crisis, correlations between asset classes tend to increase significantly; however, our data indicates this hasn't been the case for cat bonds when compared to other asset classes (Figure 9), which further strengthens the argument that the ILS market is a diversifier. The correlation between cat bond returns and other asset classes has historically remained between +0.2 and -0.2. SRCM has observed that even during times of broader financial market stress, other asset classes tend to become strongly positively correlated, whereas cat bonds remain minimally correlated or even become slightly negatively correlated, reaffirming their value as a portfolio diversifier.

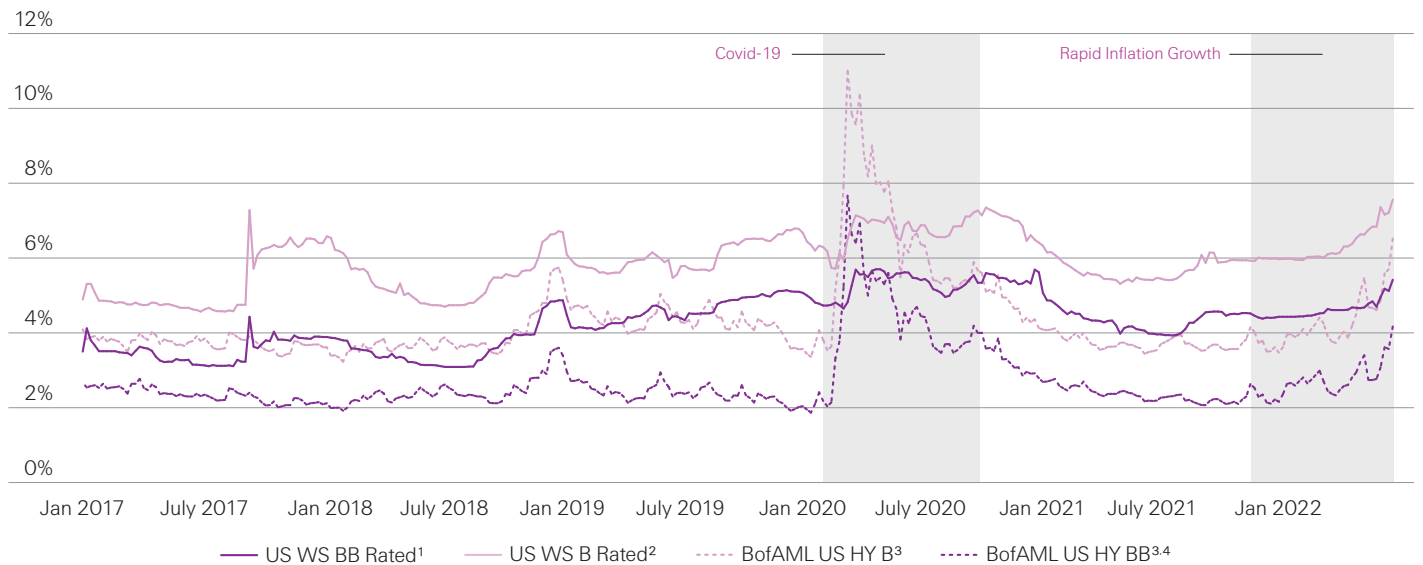
**Figure 9:**  
1-year rolling window correlation of the Global Cat Bond Index with traditional asset classes



Source: Swiss Re Capital Markets, as of June 30, 2022

Compared with the BofAML High Yield indices below, catastrophe bonds have widened and provided competitive returns to traditional fixed income. With the exception of elevated activity during the peak of the U.S. Wind season, SRCM believes current ILS spreads and ILS market performance will attract new capital to the market.

**Figure 10:**  
Relative value indices: Swiss Re composite <sup>1,2,3,4</sup>



Source: Swiss Re Capital Markets, as of June 30, 2022; Bank of America Merrill Lynch US High Yield B and BB Indices

Note: <sup>1</sup> US WS BB Rated Comp contains bonds with at least 1 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)

<sup>2</sup> US WS B Rated Comp contains bonds with at least 1 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)

<sup>3</sup> BofA Merrill Lynch High Yield Option Adjusted Spread via the Federal Reserve Bank of St. Louis website

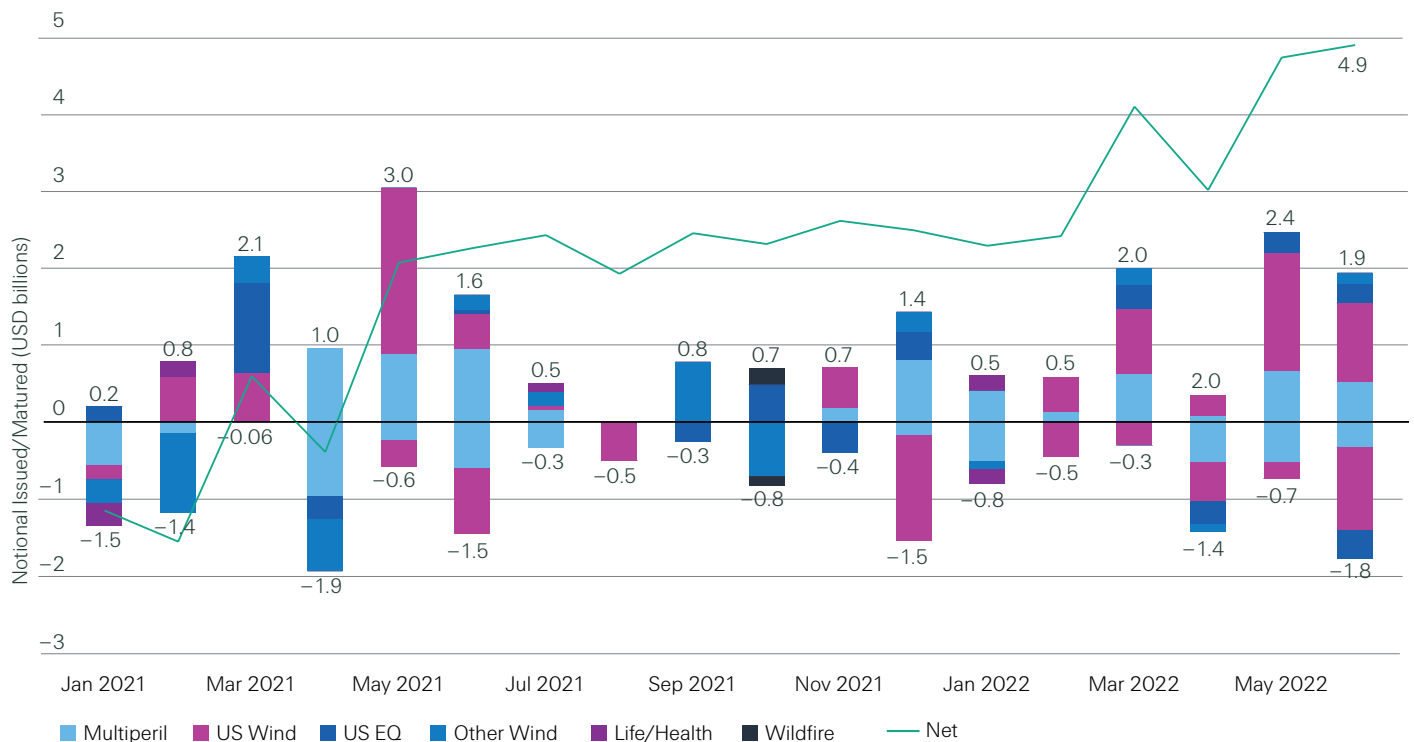
<sup>4</sup> Swiss Re Capital Markets pricing indications only. Average seasonally adjusted spread used.



# Maturities and loss payments

With less overall maturing notional in 2022 compared to 2021, new issuance completely outpaced maturities over the first 6 months of the year. As seen in Figure 11, the net cash flow (new issuance minus maturities) into the market from the beginning of 2021 through the first half of 2022 was nearly USD 4.9 bn. This number represents the direct inflow from investors and also helps explain the spread widening seen in market this year.

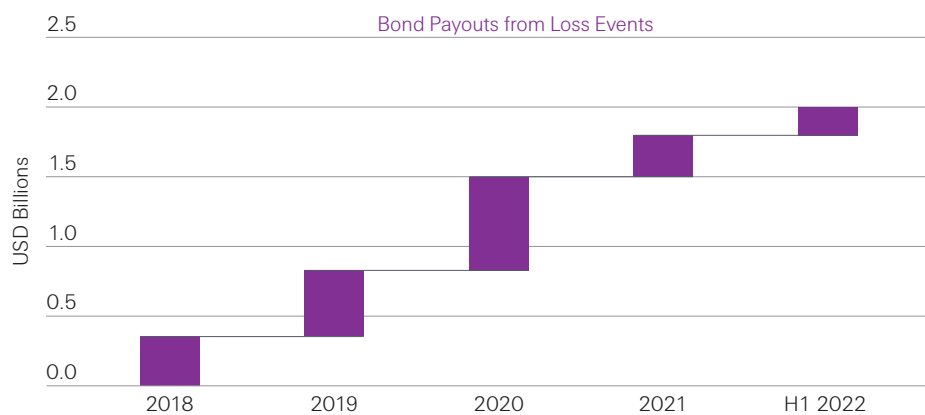
**Figure 11:**  
Issued and Matured Notional by Peril (in USD billions)



Source: Swiss Re Capital Markets Deal Database, as of June 30, 2022  
 Note: Bonds with over 90% contribution to EL from US Wind are classified as US Wind.

The values shown in Figure 11 only pertain to new issuance and maturities. Just as in recent years, loss payments to sponsors have also impacted net cash flow to investors. Bond payouts in H1 2022 from loss events in prior years reached nearly USD 230m. This year, the catastrophe bond market has paid recoveries for recent loss events such as Hurricane Ida and Typhoon Rai as well as events from prior years such as Hurricanes Florence and Michael. As illustrated in Figure 12, in the last four and a half years sponsors have received nearly USD 2.0bn in loss payments. This also represents cash flow out of the market that must be replenished by investors to maintain the same level of coverage for sponsors. As a result, the market has seen spreads widen across all perils as the mismatch between demand for coverage and supply of available capital deepened.

**Figure 12:**  
Bond Payouts from Loss Events



Source: Swiss Re Capital Markets Deal Database as of June 30, 2022

Note: Represents the net payment to sponsors.

## For more information

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 region.

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- 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 an issuer of Insurance-Linked Securities under the underlying risk-transfer agreement to which such Insurance-Linked Securities relate.
- Maturities of Insurance-Linked Securities may be extended without the prior consent of the investor.
- Insurance-Linked Securities may be redeemed before their maturity date (including before any extension of such maturity date by the issuer).
- If Insurance-Linked Securities are redeemed before maturity, the interest rate payable to investors under the Insurance-Linked Securities will be reduced.
- Investors have limited recourse to assets of an issuer of Insurance-Linked Securities and no recourse to assets of the counterparties to the underlying risk-transfer agreements to which such Insurance-Linked Securities relate.
- If an issuer of Insurance-Linked Securities becomes insolvent, investors may lose some or all of their investment.
- Investors may be required to consolidate an issuer of Insurance-Linked Securities for accounting purposes under certain circumstances.
- An investment in Insurance-Linked Securities may have adverse tax consequences for investors.
- Any claim you have against an issuer of Insurance-Linked Securities in the event of the issuer's insolvency will be junior to any claim of a counterparty to the underlying risk-transfer agreements to which such Insurance-Linked Securities relate.
- Enforcement of security interests granted to a trustee of Insurance-Linked Securities for the benefit of the investors may be limited.
- A secondary market for Insurance-Linked Securities may have limited liquidity or may not even exist, and the market and market price of Insurance-Linked Securities in any secondary market may be highly volatile.
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Title:

Insurance-Linked Securities

Market Insights

Volume XXXVII, August 2022

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