



ILS market interests converge to cultivate growth

2018 Global ILS Market Survey Report

How do (re)insurers, fund managers and investors view the market and where do their interests converge? How will the sector develop over the next several years? To find out, we asked ILS stakeholders across the globe to weigh in.



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Table of contents

About the survey.....	2
Three converging viewpoints.....	3
ILS market observations.....	4
Survey highlights.....	5
End investors.....	5
ILS funds.....	5
Cedants.....	5
Survey response summaries.....	6
End investors.....	6
ILS funds.....	7
Cedants.....	10
Future opportunities.....	11
Glossary.....	12



About the survey

Willis Towers Watson's Global Insurance-Linked Securities (ILS) Market Survey Report offers a unique view of the ILS market, with multidimensional perspectives from the three main ILS market constituents:

- Users of ILS capacity (cedants/sponsors)
- ILS funds
- End investors

Survey objectives

- Understand the changing dynamics of the market from three key stakeholders
- Measure respondents' engagement with ILS and growth opportunities
- Gauge market participants' views of the topic and usage
- Provide participants with a clear perspective on how other constituents view ILS

Survey participation

Our web-based survey of 117 global ILS participants was fielded in June 2018.



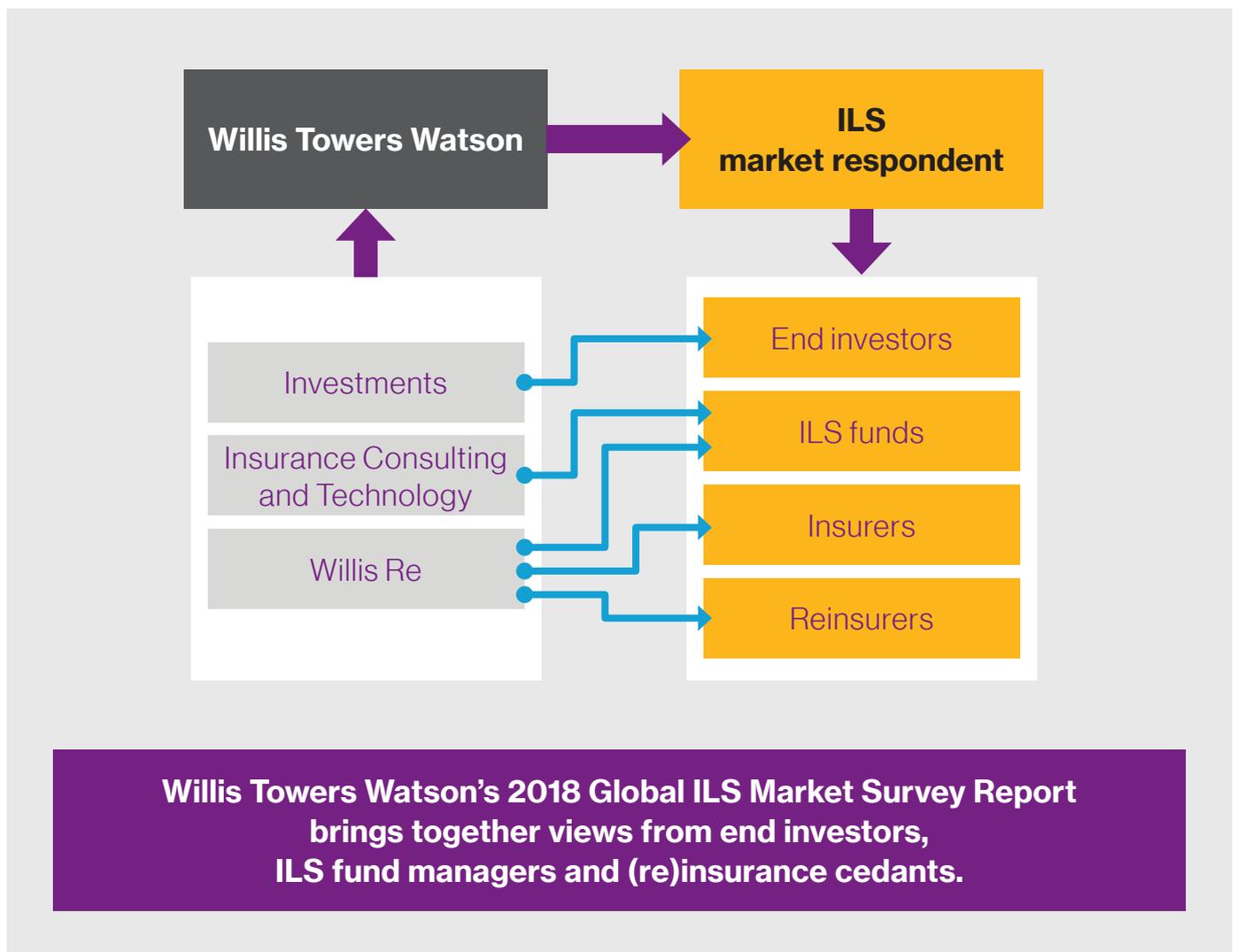
*The survey was launched after key 2018 renewals with post-loss pricing known.

Three converging viewpoints

Willis Towers Watson's Global ILS Market Survey Report offers a unique view of the ILS market across the ILS industry, comprising end investors, ILS fund managers and (re)insurance cedants. To our knowledge, our analysis brings together views from these three groups of stakeholders for the first time in the industry.

Our research finds that each of the three groups of participating ILS constituents has weathered recent loss activity with their enthusiasm for ILS intact. Almost all reinsurers and cedants surveyed now see ILS as a positive factor in the market and anticipate further growth in the years ahead.

This is made possible by the cross-business expertise and client relationships of Willis Towers Watson's Investment, Risk and Reinsurance business unit. The breadth of our organization provides singular access to all relevant ILS market participants (see diagram below).



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ILS market observations

ILS are becoming a major force within (re)insurance as well as within the broader alternative investment industry. According to our ILS Market Update Q2 2018,¹ underwritten non-life capacity has continued to expand at or near record levels, with over \$37 billion of new capacity issued since 2014, including \$4 billion in Q2 2018. Accompanying this growth, the market has also seen further innovation in risk structures and some moves toward expansion beyond natural catastrophe risk. Our 2018 Global ILS Market Survey Report offers additional insights on the state of the market.

Are ILS still seen as 'alternative' or are they now mainstream capacity?

The measured growth in ILS participation during the last 10 years has been cemented by the results of our survey, which show that one in four respondents derives more than 30% of capacity from ILS.

Cedants and ILS funds share the view that ILS will continue to grow, with part of the expansion arising outside property catastrophe.

How did ILS perform in the context of one of its first major test periods of catastrophe activity?

ILS came through the 2017 losses with ILS funds and end investors continuing to see ILS investments as an established asset class. Previous concerns over the ability to reload capital post-loss were addressed; Willis Re's estimate for ILS capital at the end of 2017 confirmed that capital dedicated to the ILS market has been maintained or increased since the Harvey, Irma and Maria (HIM) events.

Nonetheless, HIM has highlighted some isolated cases where the technical provisions of the contract allowed for early collateral release before the losses were fully developed.

Are end investors attracted to the ILS market primarily by yield considerations or by broader diversification benefits?

End investors perceive diversification and noncorrelation with financial asset classes as key drivers. Indeed, relative yield only ranked fourth as a motivation for investing in ILS.

How will the ILS sector develop in the next few years?

A broadening of product offering in the ILS sector has already occurred, and this is set to continue with other classes of business coming on stream, such as property per risk, cyber and marine. Recent transactions have included exposure to such areas as wildfire liability and motor third-party liability, and both investors and cedants continue to show appetite for these kinds of transactions.

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¹See <https://www.willistowerswatson.com/en/insights/2018/07/ils-market-update-q2-2018>



Survey highlights

Key findings from the constituent parts of the ILS market support a positive outlook for future growth.

End investors

- **ILS investors are not going away:** Over half of investors cited strategic allocation to ILS between 2% and 5% of total assets – with 76% of investors satisfied with funds and investments to date.
- **Portfolio diversification creates value:** Portfolio diversification benefits drive investment decisions, not solely pure return. The outlook for other asset classes will not have a major impact on ILS allocations.
- **Investors were ready for headline news catastrophe losses:** The majority surveyed are happy with their ILS returns and are not reducing their allocation. This suggests they understand the risk profile of the asset class.
- **Investors highlight peril diversification over cost reduction:** 76% cite diversification across perils as being important, whereas ability to reduce costs was cited by only 40%.

ILS funds

- **Risk expansion:** Funds expect ILS to incorporate new risks and believe investors have appetite for them.
- **Capacity growth:** Funds see ILS capacity growing in the next five years, with the vast majority of respondents anticipating growth greater than 10%.
- **Use of frontiers:** The majority of ILS funds use frontier arrangements to supplement investments with other arrangements (70%). These complement direct collateral (e.g., cat bonds, trust fund structures).
- **Third-party valuation review:** Only a third of ILS funds appoint independent third-party valuation agents for illiquid (Level 3) assets. After the events of 2017, it will be interesting to see if the governance demands from internal and external stakeholders increases.

Cedants

- **Increased capacity through ILS:** Approximately one in four cedants reports that capacity derived from ILS is greater than 30%.
- **Claim recoveries:** Close to half of cedants have recovered claims from ILS capacity providers. Almost all who recovered claims have had positive experiences.
- **Scope for non-property catastrophe risk use:** Over half of respondents consider using ILS capacity for non-property cat risks, either as part of a multiline cover or on a stand-alone basis (13% have already done so).

Survey response summaries

End investors

Core to institutional investors' portfolios

ILS are a core part of institutional investors' portfolios and are expected to remain so. Currently, over half of investors have a strategic allocation between 2% and 5% of total assets (Figure 1). Two-thirds of investors expect to maintain or increase their allocation in the near future, reflecting satisfaction with ILS investments. No surveyed investors expressed dissatisfaction with their experience to date.

That experience is already quite broad. Nearly two-thirds of investors surveyed have been invested for more than five years, and 88% have been involved in the market for at least two years. The main driver of investment is portfolio diversification, with 96% of respondents citing this as their primary motivation. The common perception that rises in other asset yields will have an adverse impact on inflows to ILS is clearly inaccurate. Only 12% are mainly focused on the return/yield potential of ILS, ranking fourth among responses behind diversification, noncorrelation and cost.

Investors reacted positively to 2017 losses

Despite high estimated insured losses of \$91 billion from U.S. natural catastrophes in 2017 (source: Insurance Information Institute), investors remained happy with performance. Some 80% agreed that 2017 ILS funds' performance was in line with expectations, given the scale of the natural disasters.

Indeed, almost half of investors tactically increased their allocation to ILS to try to take advantage of any near-term increases in premiums. A further 16% allocated capital to rebalance ILS to its long-term strategic weight. Only 20% made any reductions, and post-loss redemptions were also uncommon (Figure 2).

Figure 1. Strategic asset allocation toward ILS

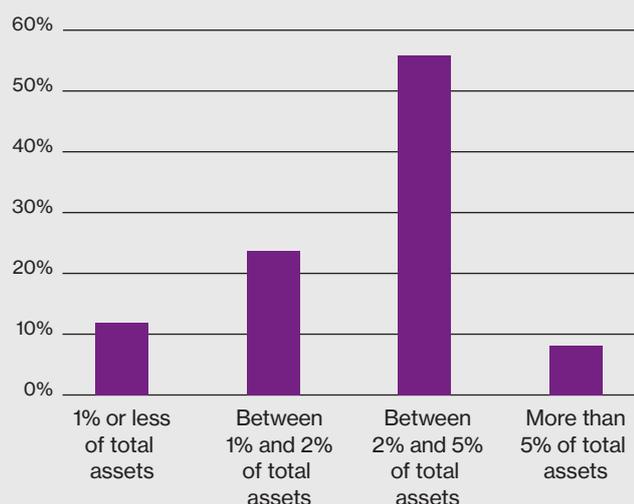
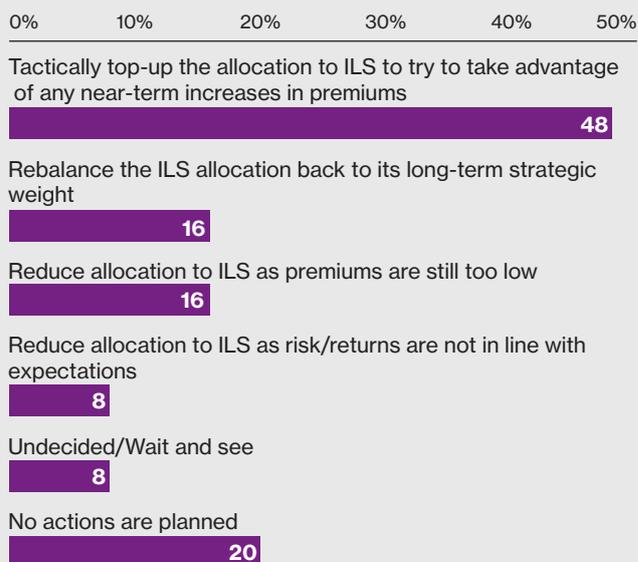


Figure 2. Actions taken as a result of 2017 losses (multi-response question)



Type of mandate and ILS manager selection

ILS investors typically pursue a combination of mandates (Figure 3). However, this means over 80% have at least some allocation to “alternative beta” ILS funds that are broad, scalable, flat fee and lower risk/return. This is consistent with the long-term trend away from traditional hedge fund mandates and the associated higher fees and expenses.

Three-quarters of survey respondents rate diversification across perils and regions as well as flexibility across a full range of instruments as the most important characteristics of a good ILS fund. Linked to the expenses issue, 60% also see low management fees as a key characteristic.

ILS funds

Fund dynamics

Pension funds remain the dominant source of capital for ILS funds (Figure 4). As for where these funds are allocated, 46% go to North America with a balanced spread of investment in other areas of the world.

By type, investments are focused on reinsurance. The average portfolio has a 48% allocation to direct reinsurance, 25% to retrocessional reinsurance and 8% to insurance. Four in 10 (44%) managers have some form of life insurance allocation, but for the majority of these (75%) the allocation is under 25%.

Figure 3. Types of ILS mandates pursued

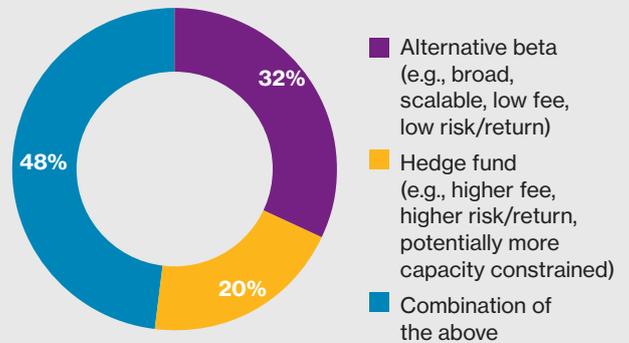
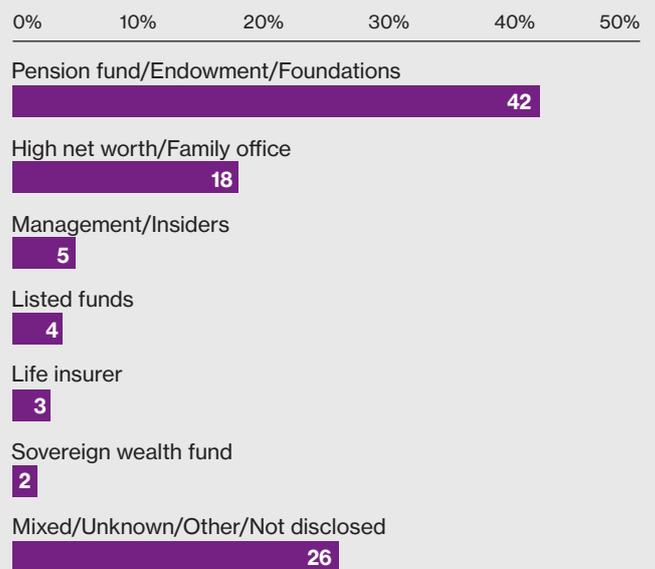


Figure 4. Percentage of assets under management by investor base



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Figure 5. **Portfolio allocation by ROL band**

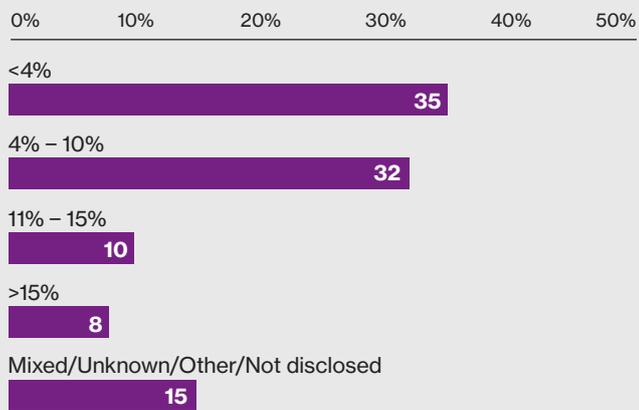


Figure 6. **Areas of non-life risk seen as most attractive for future growth**

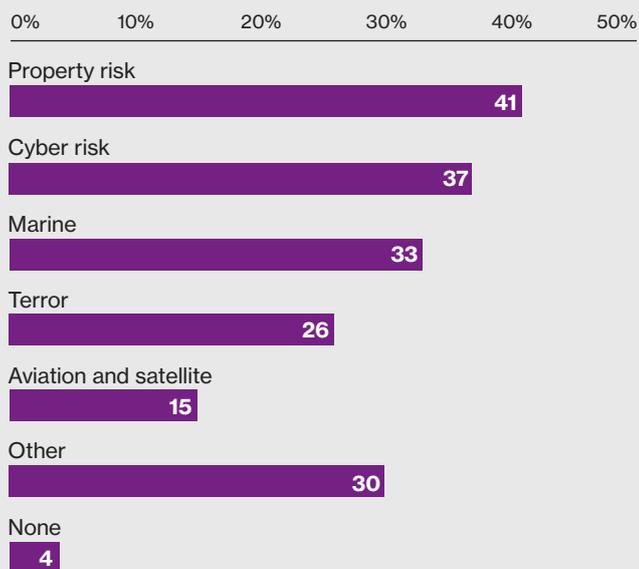
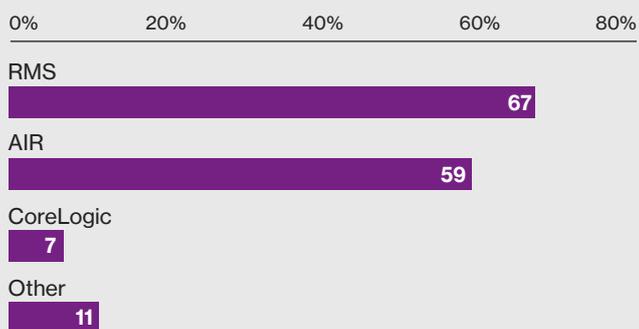


Figure 7. **Vendor models licensed**



Risk appetite

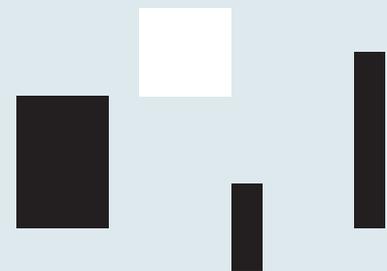
Two-thirds of funds that are allocated by rate on line (ROL) band with respect to excess of loss investments can be seen in the less than 10% ROL band (Figure 5).

For now, property catastrophe is the dominant class of risk in which ILS funds invest and the most attractive for future growth. But there is appetite for broadening of risk types. Nearly three-quarters of funds believe their investors would support investments in other risk categories. Areas of likely interest include cyber risk and marine (Figure 6).

Modeling

All ILS funds surveyed use vendor models such as RMS and AIR, with 41% of funds using two or more models (Figure 7).

Nearly three-quarters of funds believe their investors would support investments in other risk categories.



Governance

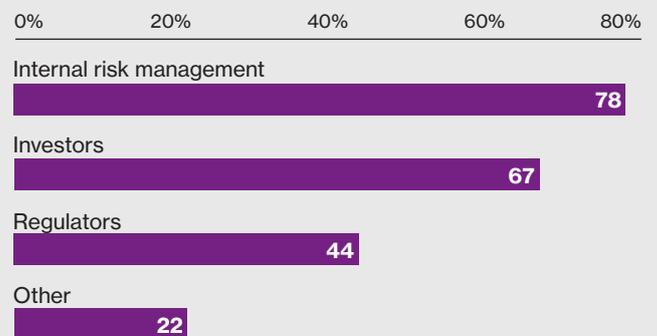
Net asset value reporting most commonly takes place on a monthly basis (52%) with some funds (11%) reporting on a daily basis. The remainder of funds report as a result of a funds structure or mandate.

Only a third of ILS funds appoint independent third-party valuation agents for illiquid (Level 3) assets. The common drivers for appointment (*Figure 8*) are internal risk management (78%), investors (67%) and regulators (44%). Some funds also said they would undertake a third-party valuation to ascertain better information. Such independent valuations are most commonly conducted monthly (44%), post-event (33%) and quarterly (22%).

For non-modeled (no vendor model), non-property cat risks, independent third-party reviews of the pricing are not common with 16% undertaking such a review.

After the events of 2017, it will be interesting to see if the governance demands from internal and external stakeholders increases.

Figure 8. Drivers for appointment of independent reviewers





Cedants

Trends in ILS use

Over half of survey participants (58%) access ILS capacity of which nearly one in four derives over 30% of its capacity limit from ILS (*Figure 9*). The most common forms of capacity used are fronted capacity on a traditional program (71%), collateralized capacity on a traditional program (53%) and collateralized backed by catastrophe bonds (37%).

For this group, the greatest attractions of ILS are diversification (74%), pricing (58%), credit quality (47%) and innovation (32%).

Among cedants that are not using ILS, the main reasons given are loyalty to reinsurers, frictional setup costs and pricing (*Figure 10*), indicating areas that ILS sponsors may need to address. Going forward, more of these current non-participants expect to engage with the ILS market: 19% of them anticipate using ILS capacity in the next three years, with more saying they will seek more information before making a decision.

Figure 9. Capacity limit originated from ILS

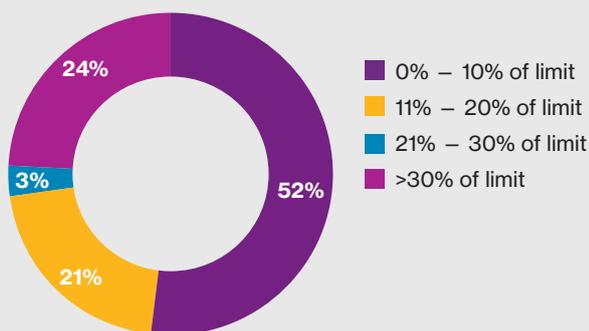
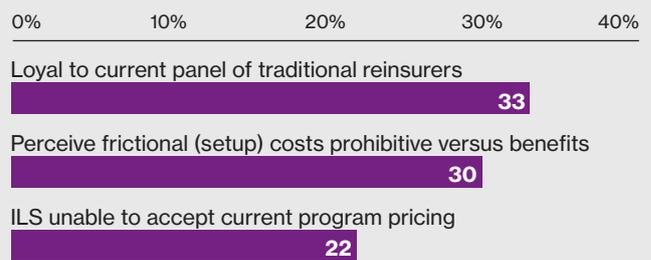


Figure 10. Reasons for not using ILS capacity



Future opportunities

The overriding conclusion of the survey, representing all three sets of ILS market participants, is that ILS have become increasingly mainstream. This positive market sentiment has survived a stiff test from the high level of natural catastrophe losses in 2017.

Nonetheless, the survey points to opportunities to further develop the ILS market and to foster additional comfort for both investors and cedants.

Identifying and facilitating growth

With continued growth in ILS capacity anticipated, new business origination will grow in importance for investors. Market participants, including intermediaries, will need to direct risk in a mutually efficient way from cedants to investors. One way to do this is to enhance cedant understanding of the potential uses of ILS within a well-designed and efficient reinsurance program. This enhanced understanding should help the quite high proportion of cedants that have yet to dip their toes into the waters of ILS but who, our survey suggests, are favorably disposed to the opportunities they may present. Furthermore, the ILS industry will need to continue to demonstrate an ability to innovate and offer solutions that meet the ever evolving needs of cedants and their insureds.

Matching nascent supply and demand

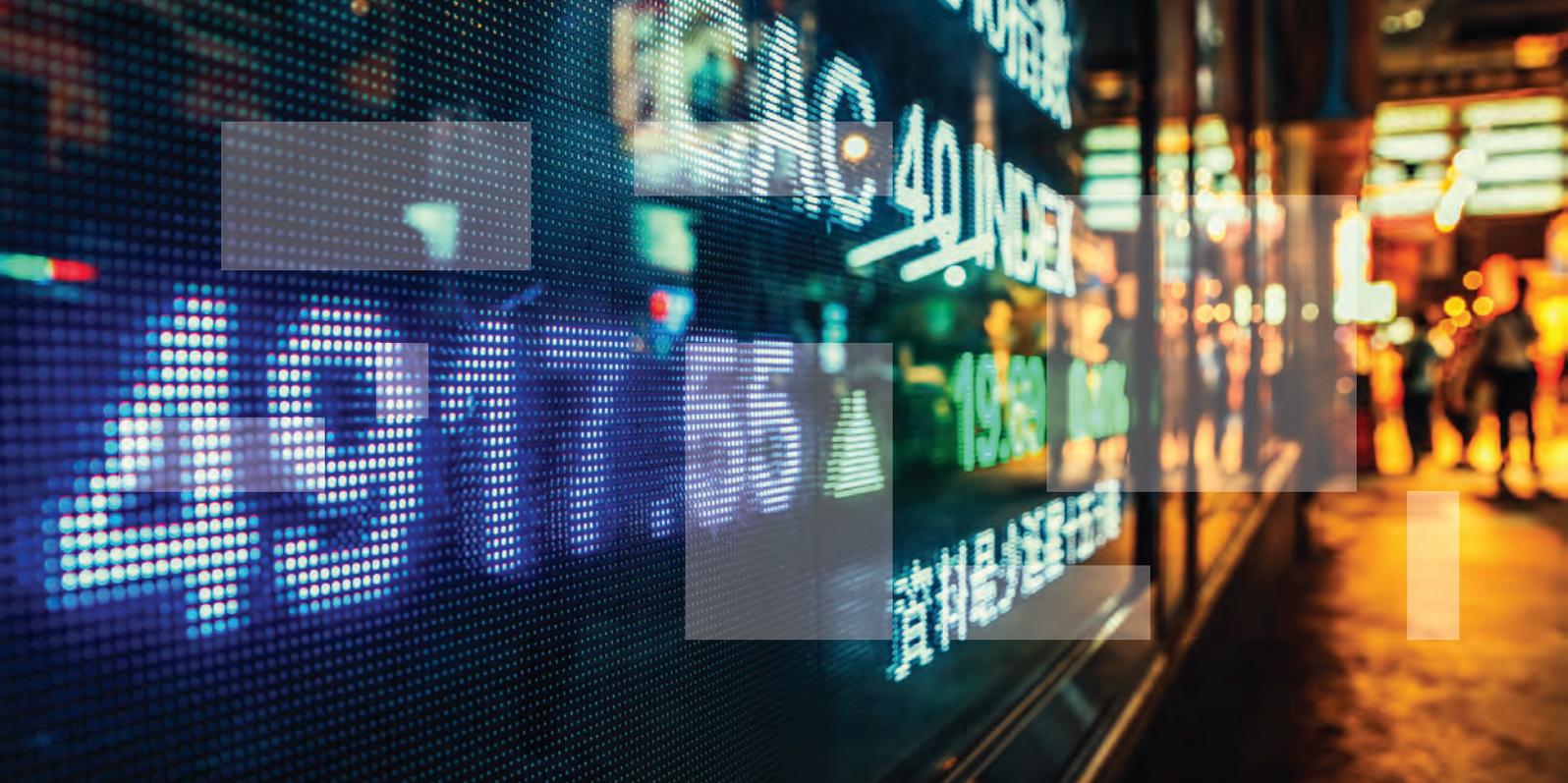
Cedants may want to respond to the apparent appetite for ILS in a broader set of risk classes, such as cyber and marine. This requires closely matching cedants with ILS investors that share similar views on the attractiveness of new products/risk areas. The availability of either robust modeling or valuation techniques could prove essential in greasing the wheels for expansion into these new risk classes.

The true test of course is that capital continues to flow to the ILS market to the mutual benefit of cedants and insureds. As it continues to mature, the industry can, we believe, look forward to further growth and interesting developments that will offer further opportunity for all three groups surveyed.

Further information

For more information about survey results, or to discuss the findings and our observations, contact your Willis Re client advocate or Willis Towers Watson consultant.

You can also learn more at [willistowerswatson.com/ILSmarketsurvey2018](https://www.willistowerswatson.com/ILSmarketsurvey2018).



Glossary

Alpha: The manager's return less an appropriate benchmark return.

Assets under management: The total market value of assets that an investment company or financial institution manages on behalf of investors.

Beta: Commonly used to refer to the extent that the return of an investment is driven by market returns rather than the manager's skill (alpha).

Cedant: A ceding insurer or a reinsurer. A ceding insurer is an insurer that underwrites and issues an original, primary policy to an insured and contractually transfers (cedes) a portion of the risk to a reinsurer. A ceding reinsurer is a reinsurer that transfers (cedes) a portion of the underlying reinsurance to a retrocessionaire.

End investors: Institutions like pensions, endowments, life insurers and sovereign wealth funds as well as wealthy individuals and family offices that tend to invest in ILS indirectly through ILS funds rather than directly on their own behalf.

Frontier arrangements: The use of a licensed, admitted insurer to issue an insurance or reinsurance policy backstopped by someone else. For example, ILS investors may back up a frontier with either direct ILS investment or collateralized reinsurance backed by ILS.

Institutional investors: A financial institution, such as a bank, pension fund, mutual fund or insurance company, that invests large amounts of money in securities, commodities and foreign exchange markets, on its own behalf or on the behalf of its customers.

Investment mandates: The right of an ILS fund or other money manager to manage investments on behalf of a third party, such as an end investor.

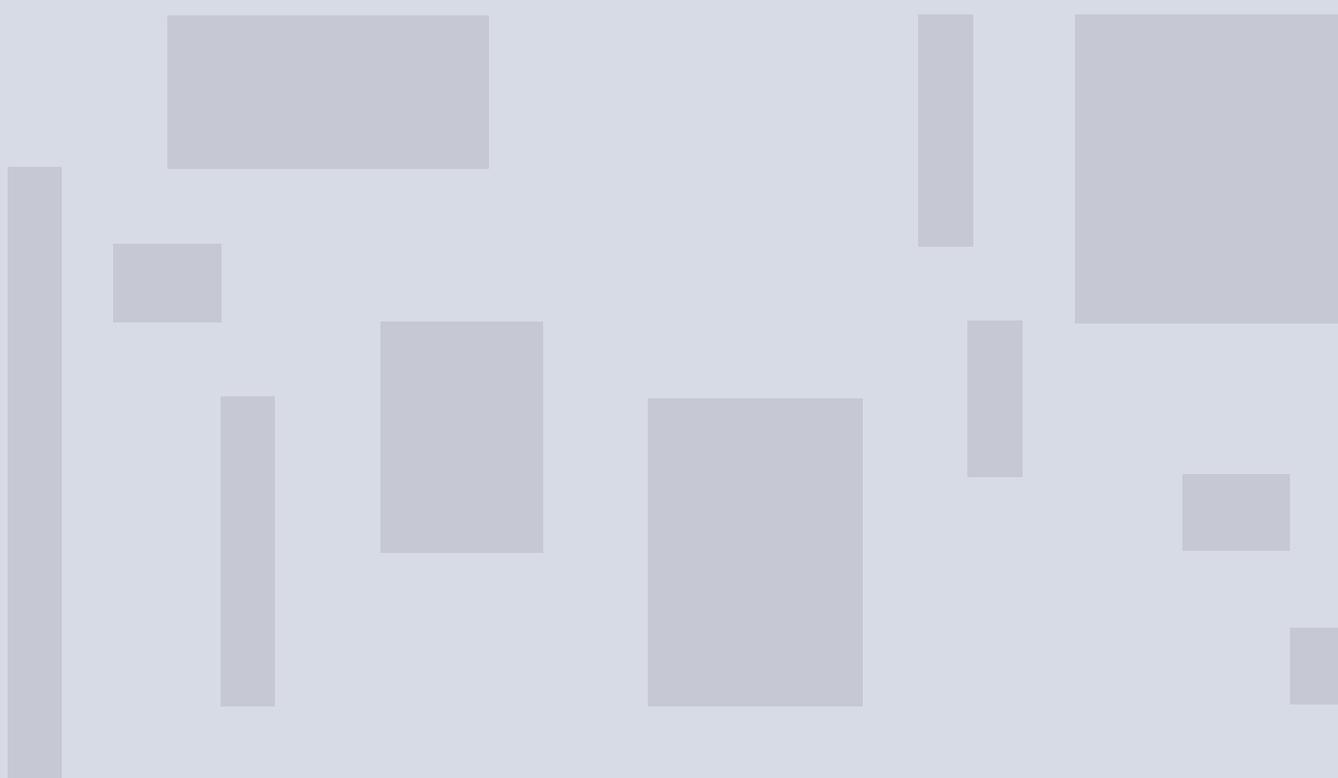
Retrocession: Retrocession is reinsurance for reinsurers, where reinsurance firms purchase coverage for their own portfolios of risk.

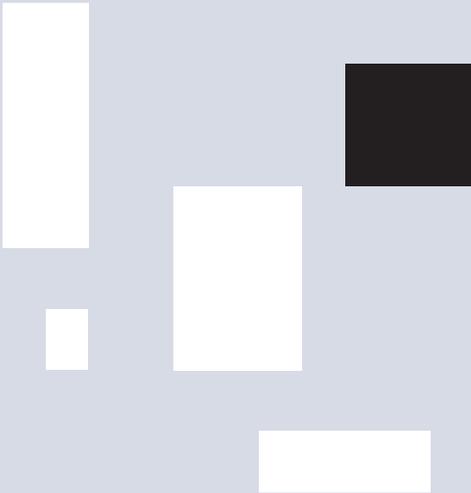
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