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Life Settlement Insights

Observations and Commentary on the Life Settlement Market

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Editor's Letter

Welcome to *Life Settlement Insights: Observations and Commentary on the Life Settlement Market,* a compendium of articles examining the life settlement market, kindly supported by ELSA, the European Life Settlement Association.

Fixed income investors are in something of a quandary; the zero lower-bound interest rate policies of western governments, designed to stimulate lending and therefore economic growth, has had a knock-on effect of dampening bond market volatility, and providing low – often negative – real yields. Many commentators are pointing out that inflationary pressures have returned, which may lead to a corresponding rise in interest rates; the consequence for government bond market investors of this being falling bond prices, and, therefore, underperforming fixed income portfolios.

Increasingly, investors are looking for other options when it comes to investing their fixed income allocation, and the Life Settlement industry is a growing sector of the alternative credit industry that offers yield and uncorrelated returns.

The Life Settlement industry is predominantly one that is U.S.-based, as life settlements policies in the U.S.A are legally classified as property and therefore can be sold by the owner. As the U.S. population grows, a corresponding rise in the number of life settlement policies taken out by Americans is a reasonable assumption, which will lead to a larger industry, both in terms of the dollar size and the number of deals that can be done by participants, in the coming years.

The industry has some interesting idiosyncrasies. There's no low-cost beta exposure available at all, and it's a relationship-driven industry, with deals being conducted over the counter with brokers. The nuances of the space are fascinating, and we've produced *Life Settlement Insights: Observations and Commentary on the Life Settlement Market* to provide our readers with a comprehensive overview of the Life Settlement market, detailing the pros and cons of allocating to these strategies, and the outlook for future growth.

Our thanks go to ELSA and all of the individuals, companies and organisations that have taken the time to contribute to the report. We hope you enjoy reading.

Greg Winterton
Managing Editor
AlphaWeek
November 2021

Life Settlement Market Set For Post-Covid Resurgence In 2022

The life settlement market is a thought-provoking section of the alternative investment space. A complex life-linked risk asset even in normal times, fund managers are required to utilize a range of specialist skills from analyzing longevity risk, cultivating origination channels, scrutinizing complex insurance products and managing liquidity risk. Managing these challenges during a once in a century global pandemic is especially challenging for life risk investors.

Active players in the life settlements industry would usually look at transaction volumes or capital inflows to gauge the state of the market. But the last 18 months have been far from normal, with longevity risk taking centre stage rather than occupying its historic position as a niche investment class. This time around, before trying to assess the current outlook for the sector according to the usual indicators, it is prudent to examine the trends that have emerged in life settlement investments since the start of the Covid-19 pandemic.

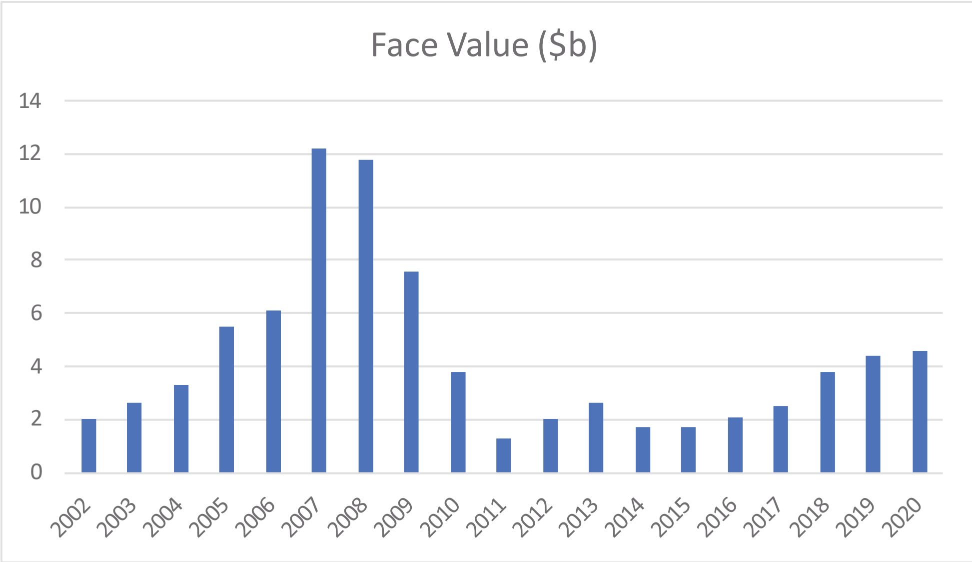
Looking back on 2020 and the first half of this year, established market participants noticed an increase in interest from capital investors for a variety of reasons, some more obvious than others. Firstly, cautious investors, uncomfortable with the volatile financial markets, began looking to diversify away from traditional assets into alternatives, including life settlements. The sector has often marketed itself as an asset class with low correlation to the mainstream financial markets. That move appears to be increasingly paying off. Additionally, as a US dollar-denominated asset, life settlement pools continued to provide a safe haven in times of economic uncertainty.

Despite an apparent upturn in investor appetite, some market participants noted a slowdown in market transactions in the first half of 2020. That was accurate, due in part to practical difficulties in completing what usually are consumer-facing transactions by phone or online. That said, interest remained robust and enquiry levels rose in the second half of last year as more policy owners opted for a life settlement as an alternative to lapsing their policy.

While it may be logical for consumers to hold onto longevity protection during a pandemic, many policy owners have, in fact, looked to the life settlement market for a cash injection to help weather financial difficulties. In that way, policy owners were able to reduce the cost burden of maintaining their policies without having to resort to a lapse.

Figures from the Life Settlement Report's Annual Secondary Life Market analysis show that prior to the pandemic, 2019 saw the largest number of life settlement policies sold in the secondary market since 2010, a total of 2,878 policies. Despite the slowdown at the beginning half of 2020 the life settlement market experienced further year on year growth. Experiencing a 13% increase in policy sales, representing a total of 3,241 policies. The aggregate face value sold in 2020 is still 40% of the total transacted at the market peak in 2008, when $12.2 billion was transacted, but represents steady year on year growth. As the baby boom generation progresses in age, the US life settlement market will continue to provide them a financial alternative to allowing their policies to lapse. There are expectations that transactions put on hold due to the pandemic will soon be completed, resulting in an additional flurry of activity in 2021.

Figure 1: Secondary Market Transaction Volumes In The Life Settlement Market



Source: Conning & The Life Settlement Report (The Deal)

In these exceptional times, ELSA and the life settlement market have shared our years of experience in understanding the nuances of pricing life risk for a wider, more engaged community. During that time, our industry has strived forward and provided a platform for life-linked risk experts to elucidate not only the impact of Covid-19 on our own markets but on the wider world.

Since its inception, the life settlement market has analysed how health events affect different demographic cohorts and the how condition-specific treatments impact health. This continuous study of life risk has led to far more vigorous underwriting when looking at the life expectancy of individuals. These skills developed and refined in the life settlement industry have never been more relevant to the market today and are now being included in life risk analysis across the insurance industry and beyond. While we take pride in those accomplishments, the life settlement industry will not rest on its laurels and ELSA looks forward to coordinating and sharing the powerful work the life settlement industry will carry out in the years ahead post-Covid and beyond.

Chris Wells
Executive Director
European Life Settlement Association (ELSA)
November 2021

Evolution Of The Life Settlement Market

Life settlement market participants are poised and prepared to accelerate industry growth in the coming years. This market growth will drive significant value for seniors that would have otherwise lapsed or surrendered in-force policies back to insurance carriers. The industry's recent past – which has seen consistent, year-over-year market growth in both the aggregate number of policies traded on the secondary market and the total dollar amount of settlements paid – and its collective response to the operational and societal impacts of the ongoing COVID-19 pandemic on life insurance policy holders will serve as catalysts for this further market evolution.

A life settlement is the sale of an existing life insurance policy to a third party for more than its cash surrender value but less than its net death benefit. In a life settlement transaction, the policy's owner transfers ownership of the policy to the buyer in exchange for an immediate cash payment and, in some instances, a reduced interest in the death benefit for the policy's beneficiaries. The buyer of the policy pays all future premium payments and receives the death benefit upon the death of the insured. Candidates for life settlements are typically 65 or older with a life insurance policy that has a death benefit of at least $100,000. The amount of their potential settlement will depend on several factors, including the death benefit, the annual premiums that the buyer will be required to pay, and the number of years the buyer can expect to continue paying those premiums (the insured's life expectancy). But on average, a life settlement yields seniors five to seven times the amount of the policy's cash surrender value.

The 1911 U. S. Supreme Court decision of Grigsby v. Russell established the market for life settlements. The Grigsby decision asserted that a life insurance policy is personal property and that a policy owner retains a right to transfer ownership of their life insurance policies to a third party that was unrelated to the policy owner/insured and did not hold an insurable interest in the policy owner/insured. Absent this right, a policy may be considered worth less.

Despite this long history, many seniors – and their financial and legal advisors — are unaware that a life insurance policy is in fact personal property and that their policies may be sold to institutional investors for a value greater than their cash surrender value. Due to the sustained efforts of many stakeholders within the life settlement industry, this lack of awareness is being addressed through direct to policy-holder marketing, public relations campaigns, and other means. The potential for growth is vast.

Life insurance policies are among many families' most valuable assets, with 138 million individual life insurance policies, with a total face amount of over $12 trillion, in force in 2018. Yet fewer than one in ten policies (by face amount) ever pay a death benefit, with over 90 percent ending in a lapse or surrender. In 2018, 7.7 million policies, with an aggregate face amount of $570 billion, lapsed, for which policyowners received nothing. That lapse rate that was 40 percent higher than just five years earlier, and, for retirees, the lapse rate is 25% higher than for policyholders generally.

In recent years, as the life settlement industry as steadily grown, robust regulations have been promulgated in the U.S. to ensure consumer protections and codify business practices for market participants. As of 2020, 43 states and the territory of Puerto Rico regulate life settlements, affording approximately 90 percent of the United States population protection under comprehensive life settlement laws and regulations. Of these states, 31 states have a statutorily mandated two-year waiting period before one can sell their life insurance policy, while 10 states have five-year waiting periods, and one state (Minnesota) has a four-year waiting period. Most states have provisions within their life settlement acts whereby one can sell their policy before the waiting period if they meet certain criteria (i.e., owner/insured is terminally or chronically ill, divorce, retirement, physical or mental disability, etc.). Moreover, 20 states follow the National Conference of Insurance Legislators (NCOIL) Life Settlement Model Act, representing almost 53 percent of the U.S. population. The continued advancement of effective regulation in the U.S. is a tool that can be used to further the growth of the life settlement market.

Companies engaged in the life settlement marketplace are also working through the continued impact of the COVID-19 pandemic in real-time. Many have referred to COVID as the ultimate change accelerant and disrupter. This phenomenon is being experienced across numerous industries. A post-COVID world will see life insurance policy holders re-evaluate end-of-life and financial planning decisions for a variety of reasons. As part of these discussions, the life settlement option is and will be a critical tool for seniors to consider.

Bryan Nicholson, Executive Director, Life Insurance Settlement Association (LISA)

Myths About The Life Settlement Industry

A "life settlement" is the sale of an in-force life insurance policy to an unrelated party, typically for investment. That party continues to pay the premiums and collects the death benefit when the insured passes away.

Over the past 30 years, a niche industry has emerged around this practice in the United States. In the industry's early days, one might have heard, on occasion, the seller of life insurance ask, "Is my policy being sold to The Sopranos?"

While this question was asked tongue in cheek, it was a reflection on the market during its infancy. In those early days, the life settlements sector could be characterized as reminiscent of the "Wild West," governed by few rules, and where you survived by your own initiative and perseverance.

While The Sopranos quip may be a myth, today it is perhaps also a myth that life settlements are unregulated and somehow "unsafe". In fact, what was once an unconstrained, rough and tumble landscape, has matured: on one hand, into a highly regulated business that provides newfound liquidity to consumers, and on the other hand, into an exciting institutional market for biometric insurance risk.

Oversight and Regulation

Virtually every participant involved in purchasing life policies from consumers is subject to comprehensive oversight. Life insurance agents who represent life policy seller, life settlement brokers who source policies for sale, and life settlement providers who purchase policies on behalf of investors are all regulated by a web of state and federal laws and regulations that cover consumer protection, market conduct, and privacy.

In addition to regulating transaction participants, the states oversee certain aspects of transactions. At a high level, officials approve forms used for purchasing a policy, just as they have to sign off forms issued by insurance companies. Different states have different rules on which policies can be purchased in certain circumstances. For example, some states require a five-year waiting period after a policy's issuance, but some only require two.

The bottom line is that life settlements are regulated using much of the rubric used to regulate life insurance.

The Covid-19 Pandemic Has Not Had The Perceived Impact

In terms of the fallout from the Covid-19 pandemic, the near-term impact will likely be less significant for the industry than widely assumed. We have certainly seen individuals in a life settlement setting die from Covid. But on average, Covid-related deaths have not materially increased the level of claims relative to what would have been expected.

A lot of the people who are in the life settlement pool tend to be healthier and wealthier than the general population. While Covid doesn't care how much money you have, insured people who comprise life settlement portfolios have better access to healthcare and can afford to work or live remotely; this means that life settlements managers haven't, by and large, been paying out early, which would hamper returns.

What we don't have a good grip on at present, which has the potential to be substantially more impactful on the industry's performance, is the long-term impact of Covid on morbidity. We know of people who recovered from Covid quickly and six months later suffer from lingering effects. You also have other issues at play, such as mental health problems, which may not be directly due to Covid but are a by-product of the environment. While these issues may have a longer-term impact on the performance of our business, the direct impact from Covid hasn't been significant.

Models and Returns are Improving

Talking about returns in a credible and consistent fashion has always been a challenge in this industry. However, much has changed in recent years. Some investors got burned in the early days of the market. They were looking at outsized returns and were sold on the idea that as everybody dies, the investments always pay off. However, you have to bear in mind that these are negative carry investments – in other words, you have to pay to keep the policies. While everyone dies eventually, you can actually pay a lot more than you get back, if you are not careful.

Life settlements are a long duration asset and as such the performance takes decades in some cases to emerge. The industry has only been around three decades and does not have a long history to look upon. Investors should be aware there is a difference between the return on an investment and the implied return on a particular policy or portfolio.

In any case, the level of knowledge around longevity is evolving every day. Modelling it isn't the hard part, rather it is what assumptions go into the models and much of that is based on experience. The most important assumptions are those that describe the longevity profile. In the early days, medical underwriting and longevity modelling by life settlement market participants was rather unsophisticated compared to that done by life insurers and reinsurers. Yet, that too, has changed over the years. Now, the life settlement industry is home to life actuaries, home office underwriters, demographers, and other professionals with deep roots in the life insurance business.

Transparency has also bought discipline to the marketplace. They say transparency is the best antiseptic. For example, disclosure regarding compensation, which is generally required in transactions with consumers, has helped the industry grow up a bit.

Investors have also evolved in their level of sophistication. Few investors today do not have their own underwriting views. They might not go to the extent of completely re-underwriting a policy, but they have a reasonably informed opinion on what the underwriting of a particular case should look like.

Institutional Choice Isn't Limited

The investor mix in the life-settlement arena may surprise people. In the old days, there were a lot of retail and near-retail investors at large in the market but that is no longer the case. Today, the sector has evolved into a largely institutional investor space, with a wide range of investment managers from which to pick.

For example, many US pensions, endowments, and foundations have life settlement investments, although it took some time for these to become commonplace. In addition, pension funds spanning the Asia- Pacific region have put substantial capital to work in the sector.

Presently, there is little take-up from European pension funds…but that may be changing. As is widely known, some pensions in Scandinavia, Belgium and The Netherlands got into the market too early and got their feet trampled.

However, there is increasing interest across the continent, as well-respected institutional managers are proving and validating themselves and the asset class with the European set. Many of these managers now have 10-year plus track records in life settlements. If you asked about track records a decade ago, there would be few managers who specialize in this space who would have been able to advertise 10 years' experience.

In general, pensions have been allocating more and more to alternative asset classes, and in that bucket to insurance-linked securities and other insurance-related risks. That is a general trend and is leading reluctant folks to take another look at life settlements, not just in Europe but globally. They are able to see that certain segments of the market have performed well over the past decade or so.

Life Settlements Can Fit Into The ESG Box

People may not know that life settlements have a lot to offer under the ESG banner. Not every investment ticks every box, but they tick certain boxes. For example, life settlements can play a pivotal role in plugging US retirement deficits. Over 40% of Americans have zero retirement savings and 80% of Americans have retirement savings less than their annual salary. Social security cannot make up the difference – the program is projected to have insufficient funding to pay more than 79% of entitled benefits after 2034.

Life settlements can help fill long-term care gaps. Some 95% of Americans over 65 are covered by Medicare which covers major costs due to acute illness or manifestations of chronic illness, such as surgery. However, Medicare was not designed to pay for long-term care, which approximately 47% of men and 58% of women of retirement age or older will need in future. The average annual cost of a shared room in a skilled nursing facility is $80,000, a punitive amount to pay out of pocket on a limited income.

Additionally, insurance premiums are a significant financial burden for seniors on a fixed income. According to LIMRA (Life Insurance Marketing and Research Association), 4.5% of American policyholders over age 65 lapse their policy each year for which they are not paid a benefit, after paying decades of accumulated premiums.

The Covid-19 crisis has triggered unprecedented economic chaos for millions of Americans, including seniors. Market volatility and uncertainty is impacting household savings and financial resources. Life settlements can be a solution to these significant ESG issues providing a non-traditional source of capital and liquidity and a consumer-friendly choice.

In Conclusion

The life settlements industry, like many industries, endured difficulties in its early days, something that many emerging industries go through. These difficulties gave rise to certain views about the industry; views which are now little more than myths. Life settlements has evolved in the past thirty years into a mature, well-regulated asset class; indeed, one can argue that there is nothing 'mythical' about this asset class at all as we finish 2021 and enter 2022.

Scott Willkomm, Chief Executive Officer of Life Equity and Chair of the European Life Settlement Association (ELSA)

The Similarities Between Equity Release And Life Settlements

Investors around the world have traditionally used a mix of equities and government bonds - the classic 60/40 portfolio model - with the aim to provide diversification, growth and yield. However, of late, the low-yield environment in many developed markets has made adding value through traditional investment options less attractive. In addition, the current high degree of correlation between traditional assets is not helping investors achieve the benefits of portfolio diversification, and as a result, the attractiveness of alternative investments is on the rise.

Allocating to Equity Release Mortgage (ERM) products is one alternative investment option which provides both diversification and attractive yield benefits. Investors around the world have been allocating to ERM products for a while, and they carry an added bonus; they are a 'PR-friendly' investment. The concept of enabling a person to remain in the home they have worked hard to be able to afford carries a certain amount of nobility, something that is additive to the financial considerations like uncorrelated returns and yield.

Allocating to life settlements products is another alternative investment option which also provides diversification and yield, but this industry hasn't enjoyed some of the positive media coverage that its ERM peers have. As more seniors become aware of the fact that their life insurance policies could be assets that they can sell to generate immediate cash, the life settlement industry is expected to continue to enjoy steady growth as an alternative to lapsing or surrendering a life insurance policy.

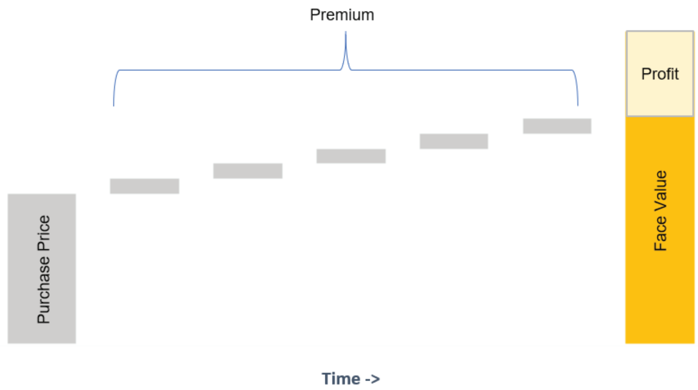
What is an ERM?

An ERM allows pensioners to remain in their own homes and familiar surroundings for longer; the pensioner sells a share of their home to an investor in exchange for a cash sum or to draw down over retirement. ERMs also benefit governments due to the lower cost of domiciliary care, which reduces the demand on already stretched government budgets.

What are life settlements?

Life settlements are life insurance policies where the policyholder has chosen to sell their policy to a third party rather than accepting the surrender value from the insurance company (or having the policy lapse completely with no compensation). The policyholder receives a cash lump sum which is greater than the surrender value, but less than the net death benefit. For investors, life settlements provide an opportunity for institutional investors to diversify their portfolio with returns that are linked to demographics rather than market fluctuations / uncertainty. The largest and most active market is in the United States, where life insurance policies are property. A typical cashflow profile for a life settlements transaction is presented below

Life Settlement: Cashflow Profile



ERM and life settlements have more in common than might initially appear. There are three main areas of similarity – financial, social and regulatory.

Financial

Yield: Both ERM and life settlements provide investors with above average yield to compensate for the additional risk. Another similarity, and a crucial element behind the growing attractiveness of these assets, is that the risk adjusted returns compare favourably to other alternative assets. For example, ERMs have an average spread of more than 3% over the risk-free rate whereas internal rates of return (IRRs) are usually in excess of 10% for life settlements. Investors in life settlements rely on the precision of life expectancy (LE) estimates provided by third party medical underwriters. These investors need compensation for the risk that these estimates are incorrect; even allowing for this risk, the returns appear favourable compared to other alternative investments.

Diversification Benefits: Life settlements and ERMs both provide investors with an opportunity to diversify their portfolios as both asset classes have other drivers impacting their risk and return profile which have less correlation to movements in capital and money markets. For example, longevity risk is the key risk factor for life settlements, and the interaction of house price inflation, early repayment and mortality risk are the key risks for ERMs.

Liquidity: ERMs and life settlements are both illiquid – they are multi-year duration products with a lack of an exchange or market maker to provide the liquidity found in public equities, for example. Investors are rewarded for holding the assets to maturity with a liquidity premium.

Social

Equity release mortgages and life settlements policies can also offer something to Environmental, Social, and Governance (ESG) conscious investors. The primary demand for both products is driven by senior citizens' need to extract value from personal property to free up cash in their retirement years.

ERMs enable borrowers to release equity from their property, usually on a fixed interest rate for life (although variable rate variants are also available), with no requirement to make interest or capital repayments, unlike mainstream mortgages. An ERM must have a safeguard for the borrower should the value of their property go down. This safeguard ensures that the amount of the mortgage, plus any accumulated interest, can never be higher than the value of the borrower's home and protects the borrower if there is a downturn in the housing market. The ERM market therefore provides a social good because it enables people to remain in their homes whilst releasing cash.

The life settlements market also provides a social good. Life settlements policies are property in the United States, and the law in most States allows policyholders to sell their policies to a third party. The policyholder can often recover a larger share of their life insurance investment by selling to a life settlements investor than they would receive from the insurance company by accepting the surrender value of the policy. There are many reasons why life insurance policyholders may want to convert their life insurance policies into cash - they simply may no longer need the policy (because it was designed to support a spouse or their children) or they may need funds to support their day to day living, including paying their mortgage.

Regulation

Both the ERM market and the life settlements market benefit from strong regulatory oversight. In the UK, the Financial Conduct Authority (FCA) regulates most types of residential mortgages. The Equity Release Council (ERC) is the industry body for the equity release sector and works to ensure a safe equity release market for consumers, by operating rigorous standards for the provision of advice and products which guarantee security of tenure and financial protections.

In the life settlements industry, most of the US States now regulate life settlements. The laws provide rules and conduct standards for the industry and add significant protection for all participants in a life settlement transaction. There are also active trade associations, promoting best practice within the life settlements market, both in the US and further afield.

Conclusion

ERMs possess characteristics which are likely to be helpful to many investors in terms of diversifying risk and providing returns, as do life settlements. While there are differences between the two asset classes – for example, it is commonplace for people to release equity from their homes, but far fewer take advantage of the opportunity to sell a life assurance policy - ERMs and life settlements have more in common than most realise.

Chris Anderson, Head Of Life Settlement Advisory, EY
Paritosh K Srivastava, Senior Manager, Investment Advisory, EY
Smriti Sethi, Private Credit Specialist, Investment Advisory, EY
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Life Settlement Underwriting - What Is It, And How Does It Compare To Its Life Insurance Counterpart?

LE Providers play a vital role in life settlement transactions by providing a critical data point; the life expectancy (LE). The LE is a statistical calculation of the probability distribution of death for a person, usually expressed in shorthand as a number of months. The LE is used as part of a predictive modelling process to forecast potential cashflows and ultimately determine the value of a policy. So, it's imperative for life settlement participants to understand how life settlement underwriting fits into this process.

The predictive modelling process, which generates the LE, requires three areas of expertise: clinical underwriting, actuarial science, and programming. Professional underwriters sift through pages of medical records to extract and normalize all the conditions documented in the subject's medical history. The actuary has studied mortality data for the relevant population and, using appropriate technical tools such as a Cox Proportional Hazard Model, creates standard mortality tables and the appropriate risk factors for each condition. The standard table and risk factors interact through the underwriting system to create the LE. Of course, IT professionals are utilized to automate this process and allow for consistent, accurate results. Our discussion will focus on the underwriting component but for further details on how the three knowledge areas are integrated, please read *A Disruptive Perspective*, in the June/July 2018 issue of The Actuary Magazine, published by the U.S. Society of Actuaries (also available on their website).

The best way to understand life settlement underwriting is to compare it to life insurance underwriting. Life underwriting or risk selection is how insurance carriers evaluate a potential insured's mortality risk. The insurance industry has relied on the proven debit and credit methodology to help the underwriter complete this task. Debits are assigned to a medical condition(s) that represent excess mortality. The debits convert the excess mortality to a percentage of the standard mortality. For example, if we expect 100 deaths per thousand and a particular disease results in 75 extra deaths per thousand, we will assign 75 debits. A person with this disease will experience 175 percent of standard mortality.

This debit and credit approach has performed well for the insurance industry, especially for identifying excess mortality. However, this approach presents challenges when underwriting life settlements. These challenges include:

1. The life insurance industry's population is younger, with an average age of less than 50. Conversely, the life settlement population is older, with an average age greater than 75.
2. Applicants for life insurance are not only younger; they tend to be from a healthier population with few impairments. The life settlement population is highly impaired with multiple chronic conditions.
3. Life insurance underwriting is designed to protect carriers from excess or early mortality - a short LE. Therefore, when presented with a highly impaired or a substandard life, such as severe dementia, the life insurance underwriter can postpone or decline to offer coverage. Life settlements pose a different risk to the funder; the risk of outliving the LE. Life settlement underwriters do not have the option to postpone or decline. Therefore, a highly sophisticated and trained professional underwriter is needed to review and assess the risk properly. Life settlement underwriters are required to accurately identify the risks, evaluate the severity of the impairment(s), and determine comorbidity factors. They cannot decline cases under all but the most extreme circumstances.
4. The life settlement demographic sometimes presents impairments where the debit and credit approach doesn't work. Conditions like metastasized cancers and ALS (Amyotrophic Lateral Sclerosis) require the traditional system to be augmented with clinical research.

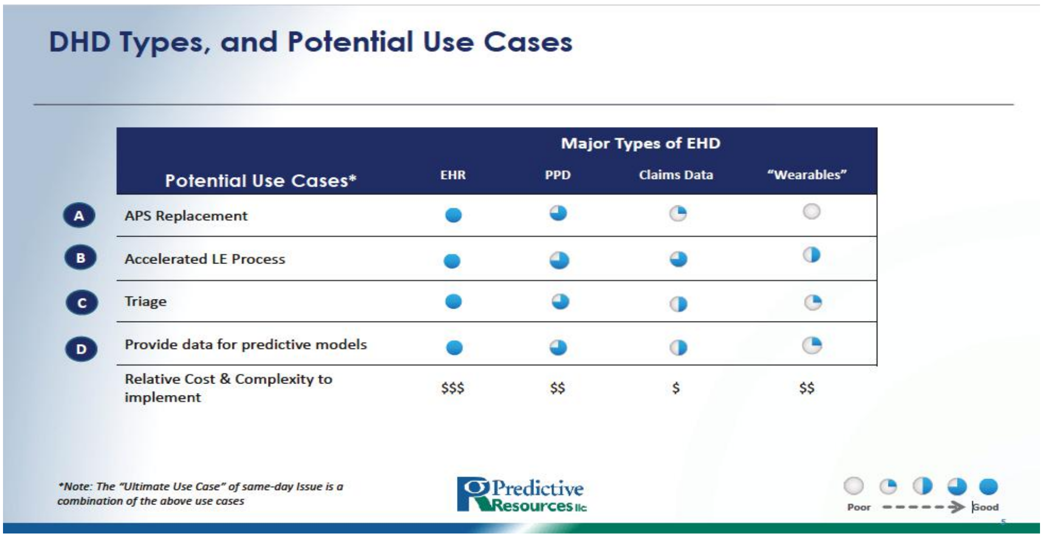
To effectively overcome these challenges, the life settlement underwriter must create predictive models, rules engines, and algorithms that ingest quantitative data and subjective information that augment the traditional debit and credit approach to ensure accurate and consistent results are generated. These technical tools allow the LE Provider to use granular data and information not previously available and correlate it to historical data, like A to E (actual to expected) analysis, to fine tune their model.

Disruptive technologies make it an exciting and threatening time for the underwriting communities. The underwriting paradigm is changing at a rapid pace, not previously experienced in the life insurance industry. Since the passage of the 2009 American Recovery and Reinvestment Act (ARRA) and the Health Information Technology for Economic and Clinical Health Act (HITECH Act), Electronic Health Records (EHR) are quickly replacing traditional medical records as inputs in the underwriting process. Not only is the rate at which interoperability is expanding, but the amount and type of digital health data are growing. The recent health crisis, COVID-19, has accelerated the transformation.

An EHR provides a longitudinal view of the patient's medical history. The information provided is in both a structured and unstructured format. Information includes diagnostic codes, prescriptions, family history, treatment plans, allergies, radiology images, laboratory, and test results.

The challenge for underwriting is how to utilize the new information. There is a vast amount of digital data available. However, not all digital data has the same utility. Currently, there is EHR, PPD (patient portal), claims data, and wearable. "Use" cases are being developed across the life insurance industry to determine the best way to leverage this data, see diagram below:

Figure 1: DHD Types, and Potential Use Cases



Source: Predictive Research

However, this requires models and sophisticated algorithms to manage and process a large volume of data and new attributes about the individual risk that may affect their longevity. Currently, the data is more readily used in the life insurance market as opposed to the life settlement market. This is primarily due to the demographics, where the life insurance population is younger and healthier than the life settlements population. Successful navigation of the new underwriting paradigm will be completed by those who are able to adapt and evolve. LE Providers with significant experience working with EHR in the life insurance context will likely lead these efforts in the life settlement space.

Vincent Granieri, CEO, Predictive Resources LLC

Predictive Resources llc

Who We Are

Predictive Resources, LLC is an independent consulting firm providing longevity, life settlement and related expert witness services. With offices in Cincinnati, OH, Charlotte, NC and Myrtle Beach, SC, Predictive Resources serves an ever-expanding client list. Predictive Resources provides innovative Longevity Assessment products supported by peer-reviewed academic research.

Predictive Resources is proud to offer two new, industry-first products:

Rapid Accelerated Longevity Estimator

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Today, according to research firm Conning, an estimated $22bn is currently "in-force" in the life settlement asset class. That is almost exclusively from so called real money investors, usually institutional investors with long investment horizons and plenty of patience.

Most histories recognize the life settlement market began in the 1980s, associated with the AIDS epidemic. The rationale behind such transactions seems sadly clear – policies of those suffering from AIDS presented a source of cash for a condition that was considered to be a death sentence, providing vital funds for the purchase of extremely expensive medication or the abatement of suffering.

But when we look back from the current standpoint, as an institutionally recognized asset class, another event surfaces as a more important moment of innovation. The first non-viatical policy is reported as having been traded in the late 1990s. The logic of settling a policy was applied to the context of an insured person of standard or moderately impaired health, without overriding concerns of terminal illness. An insurance policy could be settled for the more mundane purpose of simply extracting liquidity from an otherwise illiquid financial instrument.

This innovation opened the vast store of insurance policies on senior citizens who were not terminally ill to the mechanism of settlement. This is arguably the turning point that led us to where we are today, where the asset class is overwhelmingly occupied by institutional backers taking exposure to exactly this type of policy. How has the profile of investors changed as the market has developed? How have institutional investors approached the asset class over the years, and what due diligence questions have they focussed on along the way?

Origins

Soon after the turn of the millennium, during the market's earliest stages, questions understandably focused on transactional validity. Can you legally buy a policy? How do you execute a transfer in ownership? How do you settle it? Where is the ownership instantiated and held? Can you deploy a few million?

The question of legality was answered by the classic legal precedent from a 1911 US Supreme Court case, Grigsby v. Russell. In this landmark case, the U.S. Supreme Court found that notwithstanding the age-old principle that one cannot take insurance on the life of another person without an "insurable interest" in that person's continued life (such as a family bond or financial dependency relationship), once a policy is issued it is legal to transfer an interest in that policy to another person who has no insurable interest. Additional answers focussed on the emerging mechanisms for transaction and settlement, including the development of escrow mechanisms and the role of securities intermediaries.

But at that time, there was a limited supply of policies and not enough volume for institutional players to become involved in a significant way.

Regulatory Drive

As time passed, and as market trading volumes increased to levels that might support ticket sizes consistent with institutional appetites, we began to see more focus and attention on insurance underwriting, mortality projection methods, and policy origination methods. In parallel, there emerged a small coterie of sophisticated asset managers, including BroadRiver's predecessor firm, equipped to source, analyse and price these assets at a standard suitable for institutional investors.

A critical feature of life settlement investing is ascertaining the likely survival of the person insured under the policy. In the first decade of the 2000s, three or four "life expectancy underwriters" were the main source of data on these insured persons. In 2008, two of them, 21st Services (now named ITM 21st) and AVS Underwriting, implemented a substantial re-evaluation of their underwriting methodologies in conjunction with the release of the 2008 Valuation Basic Tables from the US Society of Actuaries. These re-evaluations resulted in a significant extension of these underwriters' predictions of longevity for many types of insureds persons, with a concomitant reduction in the value of the polices on their lives. The 2008 extension, as it became known, sent a shockwave across the adolescent industry.

Asset owners absorbed these re-evaluations in their asset valuation with few reference points for marking assets to market. Some managers were affected more than others, especially those that consumed the life expectancy (LE) providers reports at face value, without their own internal tools for analysing longevity. For example, in Australia, according to reports, a Victorian state government pension fund manager, VFMC, invested over AUD$1bn of public funds in Life Settlements Wholesale Fund, a previously little-known life settlement fund manager in the state of Queensland. VFMC booked an unrealized loss of AUD$500mn, sparking political turmoil and a formal state enquiry into the investment process.

After the 2008 extension debacle, we observed many more questions from institutional investors with intense focus on LE providers. How reliable are they? Is this likely to happen again? How much more is under the hood?

Over time, most LE providers did indeed release further extensions, as they gained more and more experience data from their own underwriting durations and insight into the relative strengths and weaknesses of their underwriting methods.

Concurrently, we also began to see states introduce legislation to cover secondary market transactions and more questions generally about regulation.

At the time of the first non-viatical settlement, there was a regulatory void covering life settlement transactions. Secondary transfers were not covered by existing insurance legislation, which focussed only on the primary issuance of policies. Further, transactions were not captured by financial markets and securities regulation, as policies are distinct from financial securities in the eyes of the law.

This created space for unscrupulous actors. With no obligation to disclose their fees, it was common for intermediary fees to consume 50-70% of the purchase price of the policy, leaving only modest amounts for the policy seller.

It also gave pause to institutional investors, who were understandably cautious about entering a market with an absence of regulatory ground rules and with incentives for originating unattractive assets merely for the purpose of distribution. Additional questions surfaced. How do you ensure consumer fairness and transparency? Are you betting on death and is that ethically sound?

During this time, numerous investment banks entered the market seeing a lucrative opportunity, and the chance to develop and professionalize the market along the way. Credit Suisse, Goldman Sachs, and Deutsche Bank, among others, all established desks in the market, first testing the water buying policies on balance sheet and moving further to develop structured products and financial derivatives associated with the market.

The global financial crisis made clear that bank balance sheets are not a natural home for life settlements. In the aftermath of the crisis, with life settlements treated as a level 3 asset under IFRS, these desks attracted increasing capital charges, whilst having risk limits cut by bank management. All the banks that were active during this time have since closed their active operations. Any legacy assets held are typically in run-off and held in non-core banking units.

Their retirement from the field notwithstanding, the banks helped the market grow in two ways. First, they put considerable resources into supporting a regulatory drive in the industry. Between 2000 and 2010, the most robust period of regulatory development, the number of US states that had active legislation covering secondary market transactions went from five to 40, according to the Life Insurance Settlement Association. Today, 43 states (along with Washington DC and Puerto Rico) regulate settlements, covering some 90% of the US population.

Second, while this regulatory framework was being crafted, banks added the weight of their platforms to developing market standards and investor norms. Credit Suisse and Goldman Sachs, for example, established their own provider networks, maintaining quality control over origination practices and standards. These and other institutional investors eschewed any settlement origination that did not involve full disclosure of intermediary fees to the policy seller, whether or not mandated by regulation. In 2009 a number of these organizations gathered to found ELSA, a trade association focused on developing best practice, education, and research in the life settlements industry. In so doing they did much to set a bar for consumer treatment and could make representations to institutional investors that may have been critical component of their decision to invest. Credit Suisse also established desks located in the UK, US, and Asia, drawing in institutional investors from London to New Zealand, who might not otherwise have been exposed to the asset class.

Insurers Push Back

In 2013 we began to see signs the market was doing something right, with sustained pushback by insurers to deter investment in their policies, accelerating in the next few years. The first barrage was a series of attempts to increase the Cost of Insurance (COI). This is the element of pricing construction for premium payments that reimburses carriers for absorbing the insured's mortality risk and comprises the primary driver of the amount of policy premiums. Carriers began undertaking targeted campaigns to increase these costs, often on spurious legal grounds, as a means of placing roadblocks before investors. While these efforts rightly raised questions from investors about impact on returns, the impacts of COI increases have not been the panacea the carriers hoped. A market-wide legal response has led to the abandonment or wind-back of many of these practices and has taken the wind from the sails of future COI increases. We still receive questions about the current state of COI increases but these issues are well understood now.

Mature Asset

Today, the preceding questions of regulation, longevity projection, and COI increases generally arise much less frequently, especially as they relate to transaction legality, consumer standards, or questionable practice in policy origination. Such issues are either long settled or their impact is well understood. And where they do crop up in due diligence, they tend to have little of the prior urgency of tone. It is this asset-class level maturity that has led to the presence of top-tier investment pools of capital in the market – PIMCO, KKR, Berkshire Hathaway, Apollo, Blackstone and an A-list of major corporate and public pension plans – are all life settlement investors.

The most common questions we hear today focus on portfolio construction, returns and deployment. Is the asset class performing as expected? Are market IRRs elastic to investor demand and capital supply, and by how much? Can you deploy the "typical" ticket sizes of an institutional investor without unduly hurting returns?

With the intrinsic illiquidity of the underlying asset, and its long duration, some investors are concerned about visibility of the anticipated returns. Where are the demonstrated fully realized returns? Can they be repeated? But then, these are questions that we associate with any mature asset class.

Additional questions we receive pertain to cashflow duration, often in the context of asset-liability management. The combination of excess yield and a medium-to-long term asset duration can be attractive for liability matching purposes. In BroadRiver's case, most of our assets under management are sourced from investors with substantial long-dated liabilities, having a focus on liability-driven investing. We regularly field questions about cash flow weighted average life, and pool life expectancies, to inform such management.

Just over two decades since the first non-viatical policy was transacted, the life settlement market has come of age.

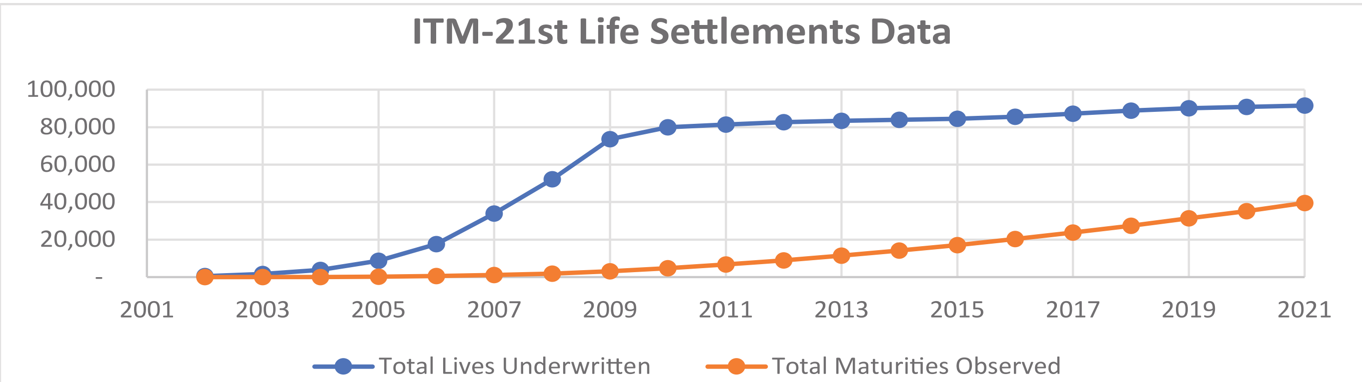
Brendan O'Flynn, Managing Director, Strategy, BroadRiver Asset Management

Institutional Might Enhances Life Settlement Valuations

The life settlement market has come a long way since its genesis in the 1980s AIDS epidemic and subsequent renaissance during the booming financial markets of the 2000s. The market grew dramatically during the mid-2000s, from $5bn of face amount purchased in 2005 to a record $13bn in 2008, before the financial crisis severely curtailed market activity. The market back then was fragmented, with a wide range of retail life settlement funds, hedge funds, banks, individual investors, and family offices all competing for policies. Since the financial crisis the market has come to be dominated by larger private equity companies such as Apollo Global Management and The Blackstone Group. This has led to a more institutionalized, professional marketplace.

One of the key drivers in the early 2000s was aggressive life expectancy estimates. The shorter a person's life expectancy, the more an investor will be willing to bid for their policy as they will assume they can collect the death benefit sooner and pay fewer premiums. While some market participants trusted the estimates being provided, others were sceptical – however at the time the lack of available data made it nearly impossible for anyone to truly make an objective assessment of performance. However, as the industry has matured the amount of data regarding the mortality of the life settlement population has grown exponentially. At ITM-21st, one of the Longevity Holdings Inc companies, by 2007 only 1k deaths had been observed on approximately 18k lives reviewed. Now in 2021, taking ITM-21st as an example underwriter, they have observed over 90k lives and 40k maturities. With this much data available it is much easier for investors to make objective assessments of life expectancy underwriters' performance, and for the life expectancy underwriters themselves to develop more accurate estimates. Indeed, it is impossible to imagine any serious investor in the life settlement market using any underwriter who does not have such extensive historical data available for analysis, as they would otherwise be relying on guesswork as investors did in the early 2000s.

Figure 1: ITM-21st Life Settlements Data



Source: ITM TwentyFirst, LLC

Another significant development in the life settlement following the credit crisis was the development of the tertiary market, where investors would purchase entire portfolios of already settled policies, often from portfolio owners facing financial distress due to poor mortality experience and an inability to raise more capital.

Secondary vs Tertiary Market

Investors of any size can invest in life settlements via two routes, which each have their own advantages and disadvantages. An investor can aggregate a portfolio by entering the secondary market, where policies are bought one by one from families or individuals looking to sell them for various reasons, or they can acquire portfolios of already aggregated policies from other investors in the so-called tertiary market. To acquire policies in the secondary market, an investor would need to work through a Life Settlement Provider, a company which has the required regulatory licenses to acquire policies directly from individual policy owners, such as Maple Life Financial, a Longevity Holdings company. For tertiary investments, investors can rely on their own networking or engage with portfolio brokers. Maple Life Analytics, another Longevity Holdings company, is an example of a company that markets tertiary market portfolios to life settlement investors on behalf of portfolio owners.

An investor buying policies individually in the secondary market can very much tailor a portfolio according to specific criteria, which could include the health status of the policy holder or the size of a policy. An investor is able to pick a portfolio à la carte as opposed to selecting what is available on the shelf. An investor in the secondary market also gets better control of provenance. It is very much like buying a bottle of wine, if you buy it directly from the wine producer when the wine is released, you know exactly what you are getting, as opposed to buying years later from another owner where you cannot be sure of how they have kept it.

Alternatively, an investor can invest funds in the tertiary market. This market is generally favoured by the larger institutions, as it enables funds to deploy larger amounts of capital in a shorter timeframe. If you have a significant fund size, compiling a suitable portfolio of around 300 to 400 policies to invest that capital, can take months or even years. Additionally, when an investor is looking to buy a portfolio, there will be information available on how that block has performed over time. The investor will be able to get a sense of how well that particular manager was able to select policies and see the characteristics of what they have sourced.

On the flip side, an investor buying a portfolio which has been held for a decade may not be privy to how it has been kept and how it was originated. It is not uncommon for pieces of the documentation from the original purchase of policies to be missing, potentially leading to more questionable provenance.

Nonetheless, when investors are presented with policies that were sold a while ago there can be an actuarial effect as there is a generally held view that people who feel healthy are more likely to sell their policies, whereas unhealthy insureds would feel they should hold on to their coverage. Again, with the benefit of a deep dataset of experience, some life expectancy underwriters are able to take this anti-selection phenomenon into account when issuing life expectancies. For example, ITM-21st is able to issue both standard life expectancy reports that assume this anti selection bias occurs, or “tertiary” reports which specifically take into account when a policy was sold and the time it takes for this affect to wear off.

Returns

In the tertiary market, returns can be lower because managers of large blocks of institutional capital are often chasing a limited number of portfolios, driving prices higher. There is also what can be described as a volume premium. In many businesses, a volume discount exists – if you buy more of something, it is cheaper. In the life settlement industry, the opposite can be true because there is a premium to be paid for avoiding the difficulty of aggregating a portfolio over time. A volume premium is often paid for the ability to buy a block en masse as opposed to building up individual policies.

But ultimately the return depends on the risk level of a policy. Portfolios with a smaller number of large face value policies are likely to trade at a cheaper level than a portfolio with a large number of smaller face value policies, reflecting the higher risk of a small number of large policies.

For example, take a portfolio of ten policies, each of which have a $10mn value. The returns are going to be higher but more volatile. If a policy holder passes away after two years, there will be a huge upside. If they live long past their life expectancy, the impact of that can be much greater than on a small policy.

Also, some portfolios have been originated out of more aggressive programmes that carry legal risk and those are often discounted to account for such additional risk.

Modelling

The modelling of these portfolios can assist in predicting returns. There are three modelling methods commonly used in the industry - deterministic, probabilistic, and stochastic modelling.
A deterministic model assesses the premiums assuming a person lives to their life expectancy and calculates the return given that scenario. When the market first began, this simplistic method was how a lot of people looked at pricing. Even today, it is still used to get a sense of how a policy will perform, particularly on shorter life expectancies.

The probabilistic method which produces a person's survival curve is the more generally accepted standard form of evaluation. Most market participants use the Society of Actuaries 2015 Valuation Basic Table (VBT) which is an industry standard set of survival tables. An investor can pick the appropriate table which matches the insured. For example, if the policy holder is an 80-year-old male and the VBT shows that life expectancy is 11 years but the life expectancy certificate you have is 9.5 years, you increase the probabilities of that person dying each year until the total reaches 9.5. This will give you a survival curve which shows the probability of a person passing away in a particular year. You then weight the cash flows of the policies to that survival curve.

The stochastic modelling is something of a blend of both of these, where a large number of random simulations are run, and the results averaged out to see expected cashflows. For each simulation run, it is assumed each individual lives for a randomly generated number of months based on their survival curve, and the corresponding cash flows are calculated. With thousands of runs it is possible to see not just the average case (which will approximate closely with the probabilistic method) but also how extreme cases can potentially impact returns.

As with all modelling techniques, the key to good output is having good data inputs. If an investor runs models with overly aggressive life expectancy assumptions, they are going to see overly optimistic output. It is critical to only use life expectancies from providers with a strong track record and the data to prove it.

Pandemic

The Covid-19 pandemic has clearly had an impact on mortalities but not all portfolios have had an equal increase in mortalities. Longevity Holdings subsidiary LexServ services around 75 percent of all life settlement assets in the business and has consequently had great insight into results. Some clients experienced a very high increase in mortality due to Covid-19 while other's have seen less significant impact, with no clear patterns.

However, Covid-19 has not at this point impacted the way that policies are being evaluated. Life expectancy has not (at least yet) changed in relation to the pandemic. At this point in time, it is hard to say if Covid-19 will result in a long-term impact on maturities. It is something that the industry is still monitoring. For instance, investors have not been bidding more aggressively because they think there is a higher chance policy holders may die of Covid-19 over and above their normal chances of dying.

One concern early on in the pandemic was that sellers would hold out due to concerns around the virus.

However, 2020 turned out to see the market reach a decade highpoint in volume, and so while things may have slowed down briefly, like many other financial markets the life settlement market came roaring back over the year. At this point in time, Covid-19 risk has not really been priced into the life settlement market, as it is being regarded as a temporary blip. We will have to see how things settle over the longer term.

Philip Hall, Manager of Product and Business Development, Longevity Holdings

Longevity Holdings' brands are market leading providers of data, analytics, & services focused on our senior population

The Longevity Holdings family of companies has the combined technology, data, and team experience capable of delivering the best-in-class experience for life settlement market.

The Critical Nature Of Due Diligence In The Life Settlement Asset Class

Many investors in the life settlements asset class do not fully grasp the complexities underlying the asset before making the decision to invest in it. On its face, a life settlement appears relatively simple – it is effectively a negative carry, discounted cash flow that matures at some future point – not dissimilar to a zero-coupon bond. A closer look at the asset, however, reveals it is more complicated to acquire and manage than other comparable discounted cash flow assets. Hence, it is critical that careful diligence be undertaken before an investor makes the decision to invest in life settlements and begins deploying capital. This article presents an overview of some of the issues associated with the life settlement asset class that a prudent investor should address with careful due diligence, specifically, financial due diligence by the fund manager in order to understand each specific asset.

Guaranteed/Non-guaranteed Cost Of Insurance (COI)

From a financial viewpoint, a life insurance policy is composed of two "legs," - the "face value leg" on the assets side and the "premiums leg" on the liabilities side. While these elements are already stochastic in nature as the actual reception/payment depends on the future realizations of a random variable (length of the reference life), buying non-guaranteed products that will be carried on a 'current assumptions' basis adds a source of uncertainty to the investment.

Universal life insurance products, which are overwhelmingly the most purchased life settlement asset, were launched in the United States in the 1980s as a more flexible (and cheaper) form of permanent life insurance as compared to whole life insurance products. While whole life products have fixed premium payments that are calculated by the insurance carrier to build up substantial cash value over time, universal life products leave it to the policy owners to decide whether they wish to build up cash value in the policy (reducing the net amount at risk and therefore premiums due in the future) or not. Most importantly, though, for universal life products, the COI rates actually applied by the carrier (referred to as "current assumptions COIs") are generally lower, and in certain cases much lower, than the guaranteed maximum COIs that are written in the policy contract. Insurance carriers may, under certain conditions and subject to regulatory supervision, adjust their COI rates upwards.

The market recognized this, especially after the COIs increase waves of the mid/late 2010s, when dozens of universal life insurance products experienced COI increases imposed by insurance carriers that in certain circumstances exceeded +200%, therefore causing the impacted products to lose value significantly or even entirely. As mentioned, the market seems to show some level of sensitivity to the COI-increase risk component and guaranteed products tend, everything else being equal, to trade at more aggressive IRR levels, even if these "IRR corrections", as discussed later in the article, may be misleading. We obviously recognize the value of guarantees, especially taking into consideration the long-term nature of an investment into a life insurance policy, which often entails a decade(s)-long horizon.

There are different diligence procedures that we follow to reduce the risk of suffering losses as a result of a COI increase on policies purchased and kept in force on a current assumptions COI basis. Among these, when buying policies on a non-guaranteed basis, we look for the existence of secondary guarantees in the policy contract. While these secondary guarantees may be less attractive on a present value basis as compared to keeping the policy in force on the basis of current assumptions COI rates, they represent an option that can be exercised (i.e., the option to switch from current assumption-based premium optimization to secondary guarantee-based premium optimization) should a COI increase be implemented in the future. This would provide a better "backstop" as compared to the one foreseen under the policy contract for the "main account", i.e., the maximum (guaranteed) COI rates.

While it is true that in the past, very few products were subject to COI increases implemented by carriers to the fullest extent possible (applying maximum contractual COI rates), the option of switching to secondary guarantees-based premiums also proved valuable for increases that weren't even close to the maximum possible, which increased the importance of looking for them carefully during the diligence process even if the policy is being purchased on a non-guaranteed basis.

Medical Underwriting and Life Expectancies

Medical underwriting of the insured life – and the life expectancy estimate of that life – is the most important variable in determining whether a life settlement policy has value and, if so, how much. A significant portion of the life insurance policies shopped on the secondary market show meaningful differences in value associated with relatively small variations in life expectancy assumptions. The variability around life expectancy estimates is a key indicator of the riskiness of the transaction, and this variability must be specifically analysed. However, having a clear perception of said variability is often problematic and getting a proper reward for this risk (i.e., being able to purchase at appropriate discounts) is even more so, for various reasons.

This problem is aggravated for investors by the sophisticated "life expectancies selection mechanism" sourcing intermediaries have developed over time, combined with the fact that in most of the cases only one life expectancy is actually presented to the market during the bidding process. Also, for cases that are underwritten clinically- i.e., even when the life expectancy estimate is highly sensible to the underwriter's judgement and therefore a secondary, additional source of uncertainty is added to the game - in the current market, six life expectancy underwriters account for more than 90% of the life expectancy underwriting market. They employ different proprietary mortality tables (meaning: one life expectancy underwriter could assign a 90-month life expectancy. and another a 80-month life expectancy to the same 89 year old, non-smoking male even if they both assigned a mortality multiplier of 100%) and different proprietary underwriting manuals; hence, they often end up with different views (i.e., different mortality multipliers and life expectancies) on the same life, even starting with the same medical information set.

For instance, the combination of different tables and views on the same life and given the same medical information set could generate a range of "potentially admissible values" that ranges from $20,000 to $250,000 on a policy with a face value of $400,000. Absurd as it might seem, this scenario is not rare. This situation obviously embeds a high level of risk in addition to the possibility of excess longevity risk (i.e., the risk of seeing the individual surviving the life expectancy, assuming the life expectancy was correctly underwritten), and simply taking the average of the extremes does not provide any appropriate reward for the extra risk, especially when in presence of a potential life expectancies selection bias. In these circumstances, greater control by the investor of the medical underwriting, however achieved, is essential.

Another interesting area is that of lives that are underwritten by life expectancy underwriters at close-to-standard mortality ratings (up to 150-175%). It appears there is a sourcing/sell-side's push to make policies viable that might not really "price", and this needs to be taken into consideration each time these cases are reviewed. In the end, sourcing policies is a tough and costly job: once an intermediary has worked several weeks on a file, after many calls to the potential sellers – likely many of them ending up in the voicemail – to try to obtain medical records, illustrations, policy contracts and so on, it is understandable that they will try all available routes to make the case work.

For these policies, on top of all the other due diligence steps and the analysis of the insured's health status, a closer look at the history of the life policy itself, including issuing assumptions, product type and vintage as well as the initial table ratings, is prudent and necessary. As an example, life insurance policies issued a super preferred mortality rates to wealthy individuals in California will likely price – even if these life insurance policies weren't originally issued several years prior – if valued at a 150%-or-so rating applied on a table that's based on nationwide, non-wealth specific historical survivorship data.

However, this isn't necessarily a no-loss, stochastic arbitrage. Also, in this case, we believe that looking at how the present value of the policy behaves by changing life expectancy assumptions helps in understanding the riskiness of the transaction. Although the industry seems to lack a "unifying theory" about life insurance policies valuation and riskiness, certain aspects should, in our opinion, at least be considered in a practical way. Life insurance policies whose present value (at the buyer's representative IRR) varies by, say, –50% or more (in dollar terms) because of a variation in the life expectancy that implies a mortality multiplier lower by, say, 50 percentage points (as compared to the mortality multiplier presented by the selling party, e.g., a mortality multiplier of 125% instead of a mortality multiplier of 175%, both associated – although with different degrees – to minor health impairments), implies a less severe health impairment and therefore a longer life expectancy. These situations are, in our view, very risky and should, in our opinion, be avoided unless the price can be adjusted to embed a proper remuneration for such a coin flip-like game. This scenario is all but uncommon in our experience and the best way to deal with it is in our opinion to always have the ability to ditch all the cases that show similar characteristics without embedding a proper reward.

IRRs and Model Sensitivity

The industry's standard valuation methodology relies on a discounted cash flow model that weighs future cash flows on the basis of an actuarial array – the appropriate age-, gender- and smoking status-specific line of an (insured) population-wide table, frequently extracted from the select/ultimate Society of Actuary's Valuation Basic Tables (VBT) – that is fitted to the specific life by the application of a mortality multiplier that forces the probability distribution to have an expected value (the expected duration of the reference life) equal to that of the life expectancy report(s) obtained from third party life expectancy underwriters. Probability-weighted cash flows should then be discounted at an appropriate discount rate. As mentioned above, a naked investment into a life settlement policy generally implies an exposure to one single, stochastically distributed positive inflow (the death benefit, on the asset side) and to a series of outflows (the premiums due, on the liability side).

On policies that are kept in-force on a current assumptions basis following a minimum premium approach, liabilities tend to significantly increase over time. However, if the selected discount rate (is level for both sides of assets and liabilities and) is high enough and the LE employed is short enough, the pricing model "won't see" far liabilities clear enough to properly reflect them into pricing until they become closer, i.e., after years of carrying. In short, the exponentials employed in the discounted cash flows model may amplify the effects of wrong assumptions.

Interestingly, while when using a discounted cash flows model to price an asset-only instrument (i.e., embedding only positive projected cash flows, like for bonds) adding the right amount of basis points to the base discount rate could be an effective way to better reflect volatility/riskiness in the projected future cash flows, when a discounted cash flows model is employed to price liabilities adding basis points to the base discount rate reduces the present value of the liabilities and therefore results in a more aggressive, and not more conservative, estimate of such liabilities. If a single level discount rate is employed across assets and liabilities to value life settlement policies without making distinctions between their assets and liabilities components, a net mixed result is obtained.

How misleading the net mixed result will depend on several characteristics of the life settlement policy at hand, and in our opinion a key variable is the shape of the projected premium streams. In our view, therefore, transaction-implied IRRs (level across assets and liabilities) should be handled with care especially if one wants to use them to compare the relative value of life insurance policies that embed drastically different features. This is of course true also when it comes to ongoing book valuations.

Life insurance policies and the mathematical formulae upon which they are based, are inherently and surprisingly complicated. Policies are designed by insurance actuaries, who spend years studying mortality and other risks using mathematics, statistics, and financial theories, and who then must take a series of tests that extend over several years to become a certified actuary. Life insurance companies have been very profitable because the actuaries who design the products that are their stock in trade have a deep and comprehensive understanding of mortality and statistics. It is, therefore, advisable for investors in life settlements to also have an understanding of these disciplines and their application to the asset class.

Maurizio Pellegrini, Life ILS Manager at Azimut Investments, Azimut Group

In addition to the important diligence issues associated with the pricing and valuation of life settlements, life settlements have characteristics that make thorough legal due diligence particularly important. Unlike stocks or bonds, there are no widely accepted exchanges across which life settlements trade, nor are there regulatory agencies, such as the Securities Exchange Commission, that mandate standardized disclosures to investors in the asset class. Hence, transactions tend to occur on a one-off basis, and are frequently subject to information asymmetry between the seller and the purchaser, heightening the need for robust due diligence.

Some of the issues associated with life settlements that require diligence include certification of title to the asset; regulatory compliance with origination of the asset; and insurable interest issues.

Verification of Title

Certification of title for life settlements is more difficult than typical assets. The life insurance policy may have been owned by an individual or entity, usually for a period of several years, prior to being sold as a life settlement. As a result, it may be subject to liens, loans, divorce decrees, judgments and other encumbrances. If these encumbrances are not discovered prior to an investor's purchase of a life settlement, significant impairment to the value of the asset can result.

A policy can be owned by an individual, a corporate entity or by a trust, often an irrevocable life insurance trust, also known as an ILIT. ILIT's can be complex and are usually structured by trusts and estates experts. Whenever the purchase of a policy owned by a trust is contemplated, the trust agreement must be reviewed carefully for two particular issues: the state of the trust's situs or location and whether the current trustee(s) of the trust are properly authorized to act on behalf of the trust. The situs of the trust is important as it will determine the law that governs the transaction, and if the trustees are not properly authorized to act on behalf of the trust, the validity of the sale could later be called into question.

Even where a policy is owned by an individual, it is necessary to perform careful diligence to ensure there are no unseen pitfalls. A life insurance policy can only be obtained by individuals making representations about their health and financial status, hence running a basic background check on the policy owner is a simple step that can help ensure the quality-of-life settlement assets. For instance, a background check can reveal whether a policy owner has a judgment or liens levied against them that cloud title to the policy to be sold. If the seller does not affirmatively disclose this fact, it could remain undiscovered until some later date, causing serious issues for the then-owner of the policy. A background check can also show if the policy owner has filed for bankruptcy. And, notwithstanding a specific exemption for life insurance policies in the bankruptcy code, if the owner is currently in bankruptcy an order from the court approving the sale should be obtained to confirm that the bankruptcy trustee approves of the transaction and will not later try to unwind it.

It is also not unusual for one party to a divorce decree to have an obligation to keep a life insurance policy in force, with the other spouse as the beneficiary. Case law holds that the beneficiary spouse has an equitable interest in any life insurance policy subject to such an obligation, and it is probable that the insurance policy sale transaction could be unwound by the beneficiary spouse if it is undertaken without his or her consent. Similarly, in states that have martial property laws, if the existence of the policy was not disclosed to the court and addressed in the property settlement agreement, the former spouse will retain an interest in it. If that former spouse learns of the sale of the policy, he or she might have a cause of action to challenge the sale of the policy to an investor. Thus, any divorce decree must be carefully reviewed in order to ensure there is no cloud on the policy's title.

Regulatory Compliance

In the United States, life insurance is regulated by state governments, rather than by the federal government. As a result, and through the vicissitudes of the legislative process, it is the insurance departments of each state that regulate the life settlement industry. While the life settlements industry is only regulated at the level of the secondary market (the sale by the original policy owner to a licensed provider, not the sale of the policy from the provider to a fund), it is nevertheless critical to ensure that the original sale transaction was undertaken in compliance with pertinent law. The upside of state regulation is that transactions undertaken in compliance with pertinent law have the imprimatur of approval from the state; but there are downsides too. Chief among the downsides is the fact that, while the states' laws are based on one of a few model acts, no state's law is precisely identical to any other's. As a result, there are forty-five states that regulate life settlements transactions, but the specific law of each state varies from state-to-state. The failure of parties to comply with pertinent state laws during the origination process, such as proper licensing, mandatory disclosures, pricing regulations, etc., in the secondary market can result in challenges to the ownership and validity of the asset. Again, having counsel with experience with the differences between the states' laws, and the ability to determine if transactions were undertaken in compliance with those laws is imperative.

Insurable Interest

For a life insurance policy to be lawfully issued, a valid insurable interest must exist between the policy owner and the insured at the time the policy is issued. A person or entity has an insurable interest in another person where there is a special relationship between them such as marriage, family or certain financial relationships such as partners in a business. If there was not a valid insurable interest between the owner and insured at the time the policy was issued, then the policy is considered void ab initio (from the beginning) and can be declared void and rescinded by the issuing carrier, even decades after the policy was issued. Concerns about insurable interest were particularly prevalent as a result of the profusion of non-recourse premium-financed policies that flooded the secondary market in the early and mid-2000s. If a policy was originated from an improperly structured premium finance program, the owner may not have had an appropriate insurable interest at the time it was issued, thereby potentially rendering it null and void. This is another reason to ensure that experienced legal counsel assists investors in acquiring life settlements assets.

Thorough due diligence is a basic tenant of virtually every corporate transaction. Because of the relatively informal origin of the secondary market for life insurance, and its comparative nascency, however, the life settlement industry is only beginning to embrace a comprehensive due diligence regimen designed to ensure that the life settlement assets purchased by investors are of the highest quality possible. Any investor considering deploying capital into life settlement assets is well advised to make certain that any participants in the life settlement industry with whom they work has implemented a robust diligence program.

James W. Maxson, Partner, EM3 Law, LLP

Surviving The Low Interest Environment With Alternative Investments

Over 75,000 results returned from a late January 2021 Google search of these key words, “Low Interest” & “Environment” & “Alternative Assets”. If you refine the search and look only at the results from 2012-2014, the headlines look a bit different, yet the theme is the same. The bigger question is what unicorn investments are available to accrete when rates remain for some time at these current levels or begin to increase. With global debt levels at multiples of GDP in some countries, the quiet consensus is that rates are not “reverting to some normal levels”, which is difficult to even consider since my norm is different than your norm. Now is the time to step out of the hope strategy and focus on the fundamentals.

While the pandemic upended businesses and the markets in 2020 and shocked investment portfolios, investors worldwide have been contending with interest rate risk for several years, specifically the risk of persistently low interest rates. In fact, the 10-year bond yield in Germany has been negative since mid-2019 and currently sits at approximately -0.50%. In the US, Treasury rates along the entire yield curve have remained positive; however, the 10-year rate has remained below 2% since mid-2019 and has been below 4% since 2008. Figure 1 below shows the historical downward trend since 1981 when the 10-year Treasury rate peaked at almost 16%. For comparison, the average 10-year US Treasury rate since 1962 has been 6.02% which is almost 500 basis points higher than the current 1.12% rate.

Figure 1: Historical 10-Year US Treasury Rate

Source: Macrotrends.net (thru Oct 20, 2021)

Not only has the 10-year US Treasury rate been persistently low, but the entire yield curve across all maturities has also flattened providing little opportunity for fixed income investors to achieve higher yields by extending the maturity of their portfolios. As shown in Figure 2, a large part of the past five years has been marked by an extraordinarily flat yield curve measured by the spread between the 2-year and 10-year Treasury rates. While the current spread has crawled back to around 1.25% (which is still historically low), there was even a very brief period in August 2019 of yield curve inversion whereby the 2-year rate exceeded the 10-year rate.

Figure 2: Historical 10-Year minus 2 Year US Treasury Yield Spread

Source: St. Louis Fed (thru Oct 20, 2021)

The persistently low interest rate environment has been especially problematic for fixed income institutional investors like pension plans and insurance companies who rely on asset yields to meet their liability obligations, some of which date well back in time and include promises made when interest rates peaked in 1981. Traditional fixed income assets such as bonds and mortgages only provide a spread over Treasury rates; however, a few asset classes offer portfolio diversification, and a special subset offer low correlation to traditional financial markets.

This special subset is perhaps best known as alternative assets. Some are possible to retail yet most fall to institutional investors and/or (U)HNW investors. Most popular among alternative assets are private equity and hedge fund investments. Even less familiar to some are alternative assets ranging from art and wine to bitcoin to insurance linked securities (ILS). Specific examples of ILS include life settlements, pandemic bonds, and catastrophic bonds. In all cases, alternative assets are characterized by low or even negative correlations with the traditional asset classes, which allows them to reduce the overall portfolio risk through diversification. When the traditional asset classes underperform, alternative investments can continue to produce more stable returns which cushions the impact of traditional investments.

This low correlation is produced through the return generating mechanism of alternative assets. For instance, the returns on life settlements are generated by the mortality event of the underlying insured life that triggers a death benefit payment by the life insurance company (who underwrote the original policy), and ultimately to the life settlement "investor". Mortality events generally are completely uncorrelated with the financial markets driving the returns of traditional asset classes. All ILS investments have some form of actuarial risk – the risk of these securities link to events like specific disasters (e.g., earthquakes), high health care (morbidity) claims vs expected, or a mortality event like with structured settlements, life settlements, and pension payouts. The analysis and evaluation of potential returns (and losses) on ILS investments is well informed by knowledgeable actuaries with a basis of relevant selections from a rich body of data. It is these same ingredients that have been well-modelled for decades by the insurance industry. As such these "insurance" themed alternative assets provide a different source of yield as compared to traditional asset classes.

Focusing on life settlement investments specifically, the industry has evolved to allow investors to access their return potential and portfolio diversifying benefits through several vehicles including direct ownership in life settlement policies (equity), ownership in a security with the collateral being life settlement policies (debt only or some combination of equity & debt), and ownership of derivatives that are linked to the performance of underlying life settlements.

Regardless of the vehicle, life settlement investments can be described as a hybrid of an asset-backed security and a zero-coupon bond. The general economics of a life settlement, whether individually held, packaged as a pool for direct securitization, or held as collateral, requires an up-front acquisition payment to the policyowner followed by on-going life insurance premium payments to the insurance carrier who issued the policy. Ultimately upon the death of the insured, the insurance carrier provides a mortality-based benefit payment. During the period from the initiation of a life settlement transaction until the insured's death, premium payments that potentially continue beyond the expected premium paying period may serve to add drag thus reducing the return for investors – this extension could be from the insured living longer, the need to pay more premiums into the policy due to policy changes, or some combination.

While sounding easy in principle to evaluate, the most critical aspect relating to life settlement investments is accurately predicting an insured's date of death, and unless you have a great crystal ball, it is not possible to accurately predict that date for specific individuals. In the absence of precise predictions, investors rely on actuarial methods and assumptions to develop estimates of the expected remaining time to death of the underlying insureds based on professional underwriters performing an assessment on the insured's health records and other pertinent predictable data points. While an actuary may not be able to precisely predict the date of death of a particular insured, the Law of Large Numbers enables actuaries to predict the expected remaining lifetime more accurately for a pool of insureds. Therefore, life settlement investment returns also involve a trade-off whereby a smaller number of policies supporting the investment result in a wider expected variance in returns (excluding the idiosyncratic mortality risk). So, with life settlements, as opposed to traditional asset classes, we are trading out core risks, like credit, market & interest rate, while the life settlements have one primary risk – longevity. Once understood, these unique forms of alternative assets can provide investors with an outlet in this likely persistently low interest rate environment.

Corwin (Cory) Zass, Principal Founder, Actuarial Risk Management

Life Settlements Portfolio Construction – Not As Simple As It Seems

Life settlements is a fascinating asset class. Its dimensions are unlike every other asset– life expectancies, age of insured persons, genders, projected premium streams and so forth. Furthermore, a life settlement portfolio comes with a different set of challenges as, for instance, the ongoing premium payments, which is again uncommon with other asset classes. The construction of a successful portfolio is therefore far from a trivial undertaking.

The investment 'buffet'

The concept of a life settlement investment is quite simple: the collected death benefits must exceed the cost (premium payments, fees etc.). A positive balance can be used to pay back to investors the initial investment and to realise a positive return for the investors once the initial investment has been paid off.
In order to achieve the investment goal, the investor has to pick and choose policies available in the market. Figure 1 below shows a section of the secondary market deal flow. The age of the insured persons [years, x-axis] is as low as in the 50's and goes up to close to 100 years of age. The life expectancy estimates [months, y-axis] reflect age, gender and individual health of the insured persons. The size of the policies relates to the size of the dots. Policies referring to male insureds have grey dots, policies referring to female insureds have yellow dots.

Gender: roughly two thirds of the policies in the chart refer to male insureds, roughly one third to females. In addition, there are joint policies.

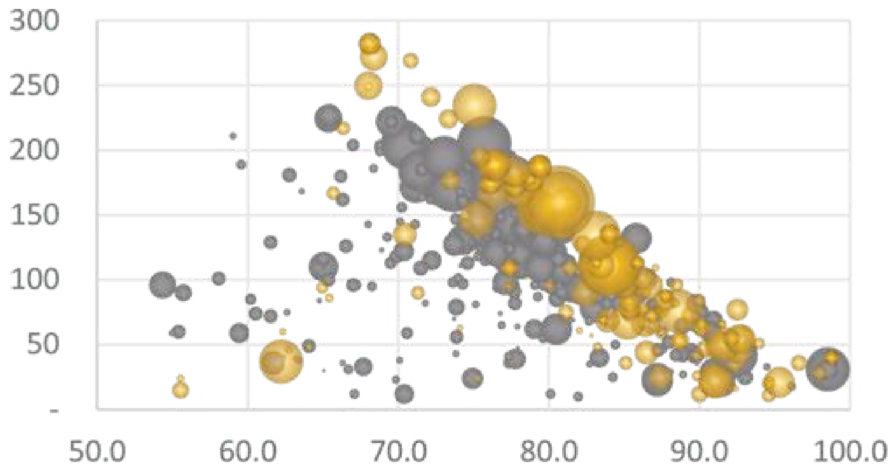
Life expectancies ('LE'): the range of life expectancies in the market is large. The shortest life expectancies are a few months and the longest can be more than 240 months. Furthermore, the life expectancies stem from various medical underwriters with various methodologies.

Size of policies: the range is exceptionally large. There are small policies with just a $50'000 face value, and on the other hand side policies with face amounts in excess of $25million.

Additional features and criteria which need to be carefully considered are the policy types, the premium finance status, the smoker status of the insured persons, the quality of the documentation, and so forth.

The universe of available policies is rich. Each policy represents a unique combination of the various dimensions (face amount, age etc.). And there is plenty of paper available in the secondary market (buying directly from the original owner) as well as the tertiary market (buying from other investors).

Figure. 1: Offered policies, July to November 2020



The accuracy of used life expectancies

The main issue in life settlement investing is that the accuracy of the life expectancy estimates is uncertain. The face amounts do not necessarily come due when they should according to the obtained life expectancies. Consequently, the future cashflows are uncertain, which is a challenge since the premium payments are crucial to keep the policies in force. An investor can tie up higher cash reserves in order to deal with this uncertainty, but a higher cash reserve detracts from the performance.

The accuracy of the life expectancies is linked to other issues. There is still no requirement and standard for the medical underwriters to disclose the accuracy of their life expectancy estimates. Furthermore, the information for a transaction is provided by the sell side. The interest of the sell side is to achieve the highest possible price for a given policy which depends ultimately on the life expectancy of the individual – the shorter the life expectancy, the higher the achievable price. The non-alignment of interest in combination with the information asymmetry between the sell side and the buy side overlays therefore the life expectancies which are the most important variable of life settlement investments.

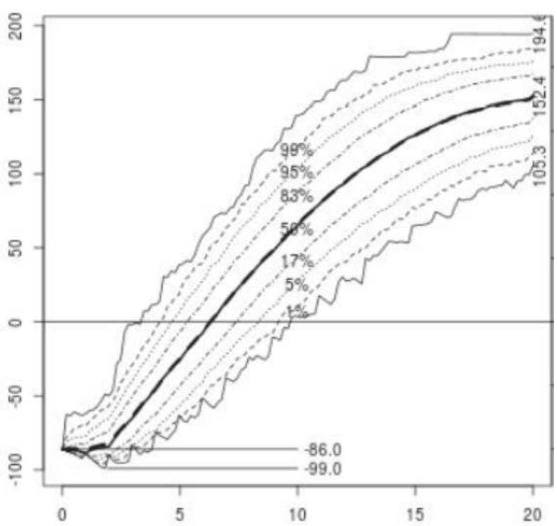
The key to success

History teaches us lessons. This is true for life settlements as it is for any other asset class. It is therefore important to review and understand information regarding past life settlement investments in order to avoid the mistakes of the past.

When it comes to the physical investment it is all about the accuracy of life expectancy estimates and the risk management. The importance of knowhow about the accuracy of life expectancy estimates cannot be overstated – this element was a dominant driver behind the investment results in past and it will be the most important factor for investments today and in the future. And the accuracy of life expectancy estimates is linked to risk management. The absence of thorough information about the accuracy of life expectancies makes it hard to establish a robust risk management overlay.

The accuracy of life expectancy estimates, and the risk management challenges are combined and visualised in Monte-Carlo simulations, as can be seen in Figure. 2 below. This is a great tool in order to understand the capabilities of an asset manager and how an investment could perform. The chart illustrates that life settlements can be a great addition to a well-diversified portfolio - if done properly.

Figure 2: Monte-Carlo simulation of a life settlement portfolio



The investment starts with an initial USD $86 million for the acquisition of the portfolio. The repayment of the initial investment is achieved via excess cash from collected death benefits over expenses (premium payments, fees etc.) after about seven years. Further excess cash leads to a positive return for investors. The bold line in the middle indicates the 50% probability under the assumption that the life expectancy estimates are correct overall. The other lines give an idea of the stochastic behaviour of the portfolio, i.e., the 83%/ 17% net cashflow probabilities assuming no longevity, and so forth.

It is not a challenge to buy policies - the markets are there; investors can help themselves. The challenge is to buy policies which ultimately allow to collect more cash from death benefits than an investor must pay for premiums and fees. And this is the art of life settlement investing.

Beat Hess, AA Partners
Gabriel Maeder, AA Partners

How to choose an asset manager?

Key is that an asset manager can illustrate that he is able to make money for the investors

- Ask for a few examples of life settlement funds which reached the end of their investment period.
- Ask for the investment results of all investments/ funds from the asset manager which reached maturity.
- Ask for the 'cash-on-cash' balance of running investments i.e., how much death benefit is collected versus expenses per time period.
- Ask for information about the accuracy of used life expectancy estimates, Monte-Carlo simulations and the risk management framework.

In addition, it is crucial to review the information of an asset manager about the accuracy of used life expectancy estimates which he uses for the investment decisions, and the risk management framework. Last but not least an asset manager should provide Monte-Carlo simulations with stress tests in order to give an idea how he expects an investment to perform.

Risks In Allocating To Life Settlement Managers

There are risks that come with allocating to external life settlement investment managers, like there are with external managers of all asset classes. And like with all asset classes, the Life Settlement industry contains specific risks that must be heeded by institutional investors looking for exposure to these products. AlphaWeek spoke to Jonas Martenson, Founder and Sales Director at Ress Capital and Patrick McAdams, Investment Director at SL Investment Management, about the risks idiosyncratic to life settlement investing, and what investors need to be aware of – and understand – as they navigate through the process.

Valuation Risk

How an investment manager values the life settlement policies they buy is the fundamental driver of the returns that life settlement strategies will deliver to their investors; each manager's underwriters will have a different view, and each manager a different risk appetite. McAdams said that analysing the risk/return profile of the fund can help an investor to understand a manager's approach to valuation.

"There is no standardised valuation methodology; you have a range of approaches that can satisfy auditor sign off but it's a wide range. The best performing fund you're looking at could be employing the most aggressive valuation method. The one you're looking at with the lowest returns could be making more prudent assumptions. At a high level, investors obviously look at performance; but in this asset class, there is so much more going on underneath and valuation is the biggest risk that investors need to understand before allocating to this asset class. Investors must do their homework and determine what's driving the performance: an aggressive valuation method or actual policy maturities delivering realised cashflow profits," he said.

Longevity Risk

Alongside valuation, longevity risk is another key risk that, if mis-calculated, has a significant impact on returns. After all, if a policyholder who sells their policy lives longer than is expected, the life settlement fund is on the hook for the premiums until the policy matures.

Modelling this risk accurately is difficult, and investors should attempt to drill down on the managers' actual policy pay-outs versus expected pay-outs during due diligence, according to Martenson.

"We are buying life insurance policies from wealthy Americans, who live longer than the average American. The policy sellers are wealthy, they are well educated, they live longer. We've seen fund managers who have underestimated this and consequently produced lower returns. Producing accurate life estimates is an incredibly detailed exercise; investors should ask the manager which company they use for life expectancies," he said.

McAdams says that his firm bakes in longer life expectancy into their model.

"You need to start from the view that your underwriting will be off. You can't accurately predict when a policy will mature," he said. "We focus heavily on the term to loss ratio - you need to assume that people will live longer, but how much longer do they have to live until our discount rate goes to zero? One early maturity can offset multiple later maturities, but you can't rely on that to mitigate a rightward shift in your duration curve. We invest in policies with the highest possible term-to-loss to mitigate that shift."

Liquidity Risk

Life settlement funds are available in both closed-ended and open-ended structures; both have benefits, both have drawbacks. Liquidity risk is a common one for investors looking at products which have an open-ended structure and mitigating that risk in life settlement investing, of course, has nuances specific to the asset class.

McAdams has experience managing both closed and open-ended funds and adds that there is more to the liquidity management aspect of a life settlement policy than meets the eye.

"There are two parts to liquidity risk with open-ended funds: situations you can control, and situations you can't, like what happened in 2008 and more recently with the Covid-19 pandemic. Valuation is something you have an element of control over, but something that I've seen from other open-ended funds is that they offer redemption terms that you would expect to see from an open-ended fund, but they value the policies in their portfolio on a closed-ended basis. This means that in a situation where they receive redemption requests in excess of surplus liquidity, they would have to liquidate some of their policies at well below market value or alternatively gate/suspend redemptions. That impacts the returns, of course. The other thing you can control in an open-ended fund is to target shorter duration life expectancy policies because they provide quicker cash flows. It's riskier for open-ended life settlement funds to go for longer duration policies because they won't receive policy cash flows from maturing policies as quickly and pay premiums on those policies for longer. That's not a good match when your investors can ask for their money back at any time," he said.

Martenson manages an open-ended fund, and adds that redemption terms are important, but the bigger picture should be considered.

"It's important to look at both the investor base and the redemption terms closely; my view is that a three-month notice period is insufficient," he said. "Another consideration is that life settlement investing is not a retail investor asset class. It's one that is for long term, and institutional investors who are looking at allocating to the space should be doing so for the medium-to-long term."

Experience Risk

Becoming an underwriter in the insurance world requires years of both study and on-the-job training; it's not something that someone can come in and pick up in a few months. Indeed, established asset managers of all strategies tout their experience as a reason to allocate to them, and in life settlement investing, Martenson says that this experience is something that's necessary in order to succeed.

"The barriers to entry in the life settlement industry are quite high because at the end of the day, you need to understand longevity and that's not something that you can translate like a systematic trading model might from one asset class to another, say equities to cryptocurrencies. Every single manager in this space is buying individual life insurance policies; you have to understand a lot about longevity or mortality to do this effectively," he said.

Origination Risk

Life settlement managers rely on local brokers in the various states of the U.S. to bring them life settlement policies to analyse. The importance of this component of the life settlement investing industry can't be understated, with nuances aplenty for investors to consider.

"How the manager sources policies is important for any investor doing their due diligence. You want to make

sure the manager has a diversified network of licensed provider relationships and coverage across the U.S. But what's also important is that some people think that because the provider is on the side of the buyer that they have a fiduciary responsibility to the buyer; they don't. They will sell for the highest price they can get, and so you have to treat them as an arm's length counterparty," said McAdams.

Martenson adds that the manager needs to ensure they uphold their end of the deal.

"One thing that's critical to understand is that this is an OTC asset class; there is no recognised exchange, so broker relationships are very important. These brokers are not large firms and so they have to know that you are a reliable buyer. If you say you're going to buy, then you buy. It's important that you're seen as a long-term, reliable buyer, otherwise you won't see as much deal flow as a competitor, which impacts your ability to create robust portfolios."

Insurance Company Risk

Insurance company risk is a well-understood risk in the sense that if the insurer can't pay in the event of a pay-out claim, they are technically insolvent, which has a domino effect on everything else they cover. McAdams says that whilst investors tend to be clued up on insurance company risk, cost of insurance implications also need considering.

"A lot of investors ask about counterparty risk in U.S. insurance companies because they have bought bonds and generally, they understand credit risk. But I think the risk is lower for life settlements than bonds because insurance companies' capital reserves are generally good, and they also put policy holders above all other creditors (other than the IRS) in the event of a default," he said. "It's more the 'cost of insurance' risk that's the one to look out for. You want to be well diversified in terms of insurance companies – if you have, say, 15-20%+ of your portfolio exposed to only one insurance company, that's an elevated risk from a cost of insurance perspective."

The Bottom Line

Given the nuances of the industry, intensive investment due diligence is critical for investors looking to allocate to life settlement products. Is there a bottom line, though?

"With low correlation and the possibility of achieving attractive returns, life settlements can be a welcomed addition to an investor portfolio heavily laden with traditional asset classes such as stocks and bonds," said McAdams. "However, the life settlement market is not as well developed and therefore requires investors to do more homework to select the right fund that has the best chance of achieving the desired investment outcome. The bottom line: Don't take the manager's performance stats at face value and instead look through to determine what is driving performance, the valuation method creating unrealised gains or actual maturing policies delivering realised profits."

For Martenson?

"I really believe that an asset class that can produce attractive risk-adjusted returns of 7-8% net in US dollars over the long term with no correlation to major asset classes merits more attention from investors."

Jonas Martenson, Sales Director and Founder at Ress Capital and Patrick McAdams, Investment Director at SL Investment Management were talking to Greg Winterton

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