Life Risk News

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Life Risk: The Biggest Investment Market You Have Never Heard Of

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Welcome to the inaugural issue of Life Risk News

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Investors all over the world, both institutional and retail, have investment exposure to life risk. Hardly anyone calls it that, however, due to the industry consisting of numerous, siloed sub-sectors. But the foundation of investments such as life insurance company stocks, longevity risk transfer, life settlements and equity release mortgages (to name but a few) is life itself – or to be more accurate, the cessation of it.

Life Risk News is a new magazine, published by the **European Life Settlement Association** (ELSA), that is designed to help institutional investors – both those with and without existing life risk exposure – better understand the nuances of the numerous sub-sectors of this industry. *Life Risk News* will be published monthly, both in a digital magazine format and online, for you to digest however you prefer.

In this inaugural issue, we start with a question that is near and dear to our hearts: *Life Risk: The Biggest Investment Market You Have Never Heard Of* is this month's cover story, where we discuss some of the nuances of the space and its current and potential size.

We couldn't publish a life risk-focused magazine in early 2022 without referencing the Covid-19 pandemic, and our second feature article this month, *Life Risk Industry Resilience Provides Confidence to Market*, provides a comforting view of how the life insurance industry has withstood the Covid-19 pandemic – so far.

Like many trade magazines, *Life Risk News* will be publishing opinion and commentary pieces from industry insiders. Luca Tres of Guy Carpenter has provided his thoughts more generally on the Life Risk market in a commentary piece, *It's Just the Beginning for Life Risk*, and Cory Zass of Actuarial Risk Management has also contributed a commentary article; *Surviving the Below Normal Interest Rate Environment With Alternative Investments* explains how this asset class can help institutional investors and their search for yield.

We've a *Q&A* with Life Settlement investor SL Investment Management's Patrick McAdams – who was ELSA's founder and is still actively involved with the organisation; and for the final piece this month we've also interviewed Simon Erritt of Coventry Capital; Ann Juliano of D2 Alternative Investments and Luca Tres of Guy Carpenter to get their thoughts on *The State of the Life Settlement Market*.

We're already well underway with planning for next month's issue, so, if you're interested in getting in touch, whether that's with an idea for a topic that you'd like to see covered, or just to offer some feedback, please do so at greg@liferisk.news or send a note to the team at editor@liferisk.news. In the meantime, on behalf of ELSA, we hope you enjoy this inaugural issue of *Life Risk News*.

Life Risk: The Biggest Investment Market You Have Never Heard Of

Author:
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To the uninitiated, the 'Life Risk market' is an umbrella term those in investment circles use to describe the transfer of mortality or longevity risk from the primary market to the capital markets. It manifests itself as two sides of the same coin; 'mortality risk' refers to the risk of loss arising from a population that experiences a shorter than expected lifespan whereas 'longevity risk' considers the opposite, i.e., risk of loss arising from a population that lives longer than expected. It's a vast area of finance but one that has historically garnered relatively little attention as a coherent asset class, like commodities, real estate, or public equity.

Part of the reason why is a perceived lack of transactability.

"That's definitely been a factor in the perception of this market," said Douglas Anderson, Founder and Chief Visionary Officer of Club Vita. "And until recently it's been a viewpoint that's been difficult to argue against, as the rapidly growing needs for longevity risk transfer have been dominated by life reinsurers offering longevity swaps. In the late noughties, several investment banks were investing in developing alternative structures suitable for capital markets investors, but they lost their appetite after the global financial crisis. Since then, additional life insurers have entered the market, bringing new capacity and discouraging capital market investors from investing time and effort."

> **"Despite the perceptions – and the realities - about the life risk industry, it's one that's poised for significant, sustainable growth."**

Whilst the number of transactions in the life risk market – specifically, transactions where the ultimate bearers of risk are capital markets investors - has grown in recent years, another reason the phrase 'life risk' is not as commonplace in investment circles as its size would suggest is the siloed or bilateral nature of many life risk-based transactions. Even though there are a number of well-established secondary life markets, including the life settlement, structured settlement, and equity release (reverse mortgages in the US) markets - where there is a competitive and fluid bidding process - managers investing in these assets tend to be specialists with limited cross-domain capabilities.

"Investment managers in the life risk market don't pitch their products in the same way as, say, a sector-focused public equity manager. Those firms tend to suggest their expertise complements an investor's broader equity allocation," said Philip Siller, Co-CEO and Founder of BroadRiver Asset Management. "Life risk investment opportunities serve a wider, cross-portfolio purpose, as a non-correlated diversifier and volatility reducer with high risk-adjusted returns. As such, they don't have nearly as
defined a bucket for investors. Life risk-based managers compete on their expertise of pricing life risk more effectively, and specifically identifying mispriced risk."

Despite the perceptions – and the realities - about the life risk industry, it's one that's poised for significant, sustainable growth. In life settlements, for example, The American Council of Life Insurers *Life Insurance Fact Book 2021* says that Americans purchased $3.3trn of new life insurance in 2020 to take the total life insurance coverage in the country to $20.4trn. The lapse rate of this insurance – where individual Americans simply cease paying for coverage – has been between 4-4.5% in terms of the number of policies in force each year for the last decade. Consequently, between $0.9trn and $1.0trn of insurance face value has been lapsed every year in the decade to 2020. While not all of this has intrinsic value in the eyes of the life settlement market, without doubt there is a vast amount of value Americans are just walking away from each year that could be sold in a secondary market.

Further, according to LIMRA's *2020 Insurance Barometer Study*, there was a 'needs gap' of 16% - i.e., 16% of Americans, or 41 million of them, who say they need life insurance but don't have it. That's a lot of primary market origination, some of which could eventually make its way to the secondary market.

Other markets are similarly expecting future growth. The global mortgage equity release market is set to exceed $50bn by 2031 according to the *Global Equity Release Roundtable 2020 survey report*. Published by The European Pensions and Property Asset Release Group (EPPARG) and EY in January 2021, the report expects most of this growth to be driven by consumer demand, and the capital markets will need to be able to match this demand.

As we see more primary product origination, we will inevitably see more life risk transactions in secondary markets linked to longevity exposure of state-backed pension liabilities. Ageing populations in the West will push a higher percentage of the population into pensioner territory, and this demographic trend will provide an added need for capital market solutions in life risk.

"There is frequent media coverage about pension crises or inequality in mortality rate improvements in many countries," said Anderson. "But we often don't hear about solutions that can be provided by the financial markets. Life insurers – particularly the reinsurers specializing in biometric risk - have been the natural sellers of longevity hedging instruments, as it helps them to offset the mortality risk in their life insurance products. But now, as pension funds start to decommission en masse, the residual capacity on their balance sheets looks limited. Consequently, the playing field for capital markets investors is now levelling up."

> **"As we see more primary product origination, we will inevitably see more life risk transactions in secondary markets "**

Whilst life risk in capital markets refers to the transfer of risk via secondary market transactions, many investors hold life risk in its more traditional sense. How many investors own stock in publicly listed life insurance companies, for example? According to Statista, the market capitalisation of just the top ten life insurance companies in February 2022 was $652.35bn. Many of these investors own public equity index ETFs – some of which hold life insurance companies in them.

According to regulatory filings aggregator Docoh, passive investment behemoth Vanguard, across its myriad of products, held more than $3.5bn worth of stock in MetLife, a large originator of life insurance in the United States, in its most recent 13F filing. BlackRock held nearly $4.5bn worth of stock in the firm.

According to alternative investments data and analytics provider Preqin, the hedge fund industry managed some $4.3trn at the end of September 2021. The private equity industry managed $4.6trn, the private debt industry managed $1.2trn and the venture capital industry $2trn. These are all comparable to the life risk industry in the sense that they are vehicles that access a primary underlying market. Detailed figures aren't available for the secondary life risk industry and it's arguably impossible to put even a close-to-accurate figure on it given the siloed, opaque, nature of the market. But what if you could sum them all up? How big would this industry be?

"If you add together the capital markets participation in the various life risk-related silos that all ultimately have the same fundamental underlying exposure – life risk – then it's not as big as some of these other sectors – yet" said Scott Willkomm, CEO at Life Equity. "But the primary markets are massive. You're talking about potentially a multi-trillion-dollar industry."

It's unlikely that institutional investors consider life risk as an asset class in the sense that they carve out a part of their portfolio for this specific risk exposure. What is life risk, however, if not an asset class? The products in this industry have the same ultimate drivers of returns.

Life Risk Industry Resilience Provides Confidence to Market

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In public and/or more liquid markets, at the onset of the Covid-19 pandemic, it seemed like everything was correlated; public equities and government bonds all fell sharply as investors sought to liquidate amidst the initial panic. But the panic also spread to the private markets, with private equity portfolio company valuations being written down as investors had to re-model their portfolio company forecasts to adjust to the lockdown environment.

Insurance company stock prices certainly took a hit. But in insurance circles, the big question was whether the pandemic was going to be so severe - and cause such an increase in population mortality - that it would damage the entire industry, leaving it in potential need of a government bailout akin to the one received by the banking sector during the Global Financial Crisis (GFC).

Since the onset of the pandemic, however, there has been not one bail out or bankruptcy of a major US or UK life insurance company. Nor has there been much of a discussion about the systematic collapse of the life insurance markets.

There are two main reasons for this. The first is that the pandemic did not trigger a 'once in a hundred years' event. According to medical journal The Lancet, the Covid-19 infection-fatality ratio was less than 1% for ages 59 years and below. It was 2.6% for persons of age 69, rising to 7.3% for persons aged 79. Those are arguably 'good' odds for a life insurance company when modelling a pandemic; at those levels, insurance company mortality risk exposure should be manageable.

> **"Since the onset of the pandemic, however, there has been not one bail out or bankruptcy of a major US or UK life insurance company. "**

Although the aforementioned fear factor affected all markets in February and March 2020, the realisation that Covid-19 was not a multi-sigma event came fairly quickly.

"Whilst there was an initial concern within insurers over the potential size of excess claims, this subsided as emerging data showed relatively modest impacts.

Around 60% of our UK clients saw no material impact in their portfolio experience in 2020, with no client experiencing deaths greater than 20% above pre-Covid-19 levels", said Mark Godson, Partner at EY.

"Additionally, for some firms, negative experience in their life insurance portfolios was offset by positive experience in their annuity portfolios."

The second reason is that the regulatory infrastructure of the life insurance industry proved to be robust enough to withstand the impact of the Covid-19 pandemic. Much of this infrastructure was implemented or strengthened following the global financial crisis, where governments and financial regulators around the world have sought to adjust the capital requirements of banks, insurance companies and other systemically important organisations to better withstand a multi-sigma event. In Europe, the Solvency II framework, brought into force in 2014, targeted insurance company balance sheets specifically. In the United States, Dodd Frank encompassed insurance companies. Both sets of legislation had - and still have - their critics, but Nicholas Bugler of law firm Willkie, Farr & Gallagher in London argues that what's not in doubt is that insurance company balance sheets are stronger from a resilience perspective than before the GFC.

"Certainly, that's the case," he said. "Purely from the perspective of balance sheet fortitude, the changes in the regulations have ensured that insurance company liquidity reserves are larger."

The main challenge in the life risk industry turned out to be the same main challenge in most other industries; the need to adapt to working in a lockdown-based environment. In the life settlement corner of the life risk industry, this was certainly the case.

"We saw some disruption to our interactions with some brokers, physicians and carriers in the first few months as they transitioned to remote working," said Simon Erritt, Managing Director at Coventry Capital. "But with the accelerated adoption of things like e-signatures, remote notarization and dedicated carrier contacts, the market is definitely operating more efficiently now than before the pandemic."

When reflecting on the importance of the life risk markets to the financial system, it is necessary to consider its resilience in the face of world events. Akin to how a devastating hurricane season is disastrous to catastrophe bond holders, a pandemic, in theory, would be similarly challenging to those holders of mortality risk. Life insurance companies provide trillions of dollars' worth of cover, and are therefore exposed, during a pandemic, to potentially billions of dollars of risk in the form of premature claims. If the underlying life insurance companies - arguably the most important counterparty in a life risk transaction, whether that be a secondary market transaction like life settlements or longevity risk transfer - fail, individual assets in a life risk investment portfolio would lose a substantial amount of their value.

> "What is encouraging for the life insurance industry is that, so far, systematic losses have been mitigated"

But life insurance companies didn't fail. Whether that's due to the capital restrictions cushion imposed on insurance companies in the wake of the global financial crisis or whether it's because, so far, Covid-19 has not been the '1 in 100 years' event, is unclear. It's probably a combination of the two. And there is still a chance that new, more aggressive strains of Covid-19 might emerge – or, another virus or disease entirely – that provides a systematic challenge to the life insurance company sector.

That's not to say that the past two years has been all plain sailing for the insurance industry. The Omicron variant that emerged at the end of 2021 caused yet more disruption to markets and lifestyles, and beyond life risk, property and casualty insurance companies have been hit with business interruption claims.

For life risk, though, it's not been anywhere near as bad as it could have been. And what is encouraging for the life risk industry – and the investors, investment managers and service providers that make up the capital markets' participation in longevity and mortality risk investing – is that, so far, systematic losses have been mitigated.

"Understandably, many in the Life Risk industry were nervous at the outset of the pandemic," said Chris Wells, Executive Director of the European Life Settlement Association. "Systematic failure was a real threat and capital requirements had not been truly tested in this manner before. And while the Covid-19 pandemic is not over, and the threat of future pandemics is ever present, the Life Risk industry has demonstrated the ability to withstand these exogenous pressures."

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It's Just the Beginning for Life Risk

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"Not those who begin, but those who persevere" is the motto of the most beautiful sailing ship in history, the Amerigo Vespucci. If you are reading this first issue of *Life Risk News*, it is probably because you also embody this motto in your professional insurance, reinsurance or insurance-linked capital markets career.

The journey towards capital markets playing a role in life insurance risks started more than 20 years ago, but in reality, the harbour we left behind us is still in our sight; the course leading capital markets investors to play a key role in the life insurance risks arena is still at its beginning.

The life insurance landscape has changed in the last 10 years. Market needs are changing and M&A is morphing the landscape, but most importantly, players' mindsets are now different.

Life risk transfer transactions – i.e., structures where the key risk driver transferred by one party to another is a life risk - are now more frequent, with the global life and health reinsurance industry remaining the main beneficiary.

The macroeconomic backdrop and its uncertainties are exacerbated by equity investor pressure on return on equity, regulatory and rating concerns, as well as upcoming accounting changes, all of which provides fuel for what should translate to increasing reinsurance activity.

Today, as never before, reinsurance companies are starting to focus on their own capital optimisation and, more widely, on creating additional investment platforms with which to share risk. Sidecars for annuities reinsurance are just an example, but the depth of the trend goes much deeper than longevity risk.

Longevity has often been considered the obvious area where insurance meets capital markets.

The reason is actually very straightforward: there is a very sizeable gap between the longevity risk supply globally, and the capacity available in the traditional reinsurance market. Just to put some numbers out there: if we focus on the UK, where more public data is available, the pension and insurance annuity reserves are estimated by the market to be approximately £1.3tn. This compares to an estimated annual reinsurance capacity of US$40-60bn. If we zoom out of the UK, the imbalance becomes even larger.

This article does not want to be a celebratory piece about the capital market's involvement in the insurance space. Frankly, too many have already done that, and arguably, they did it too soon, especially on the longevity front.

So, let's be honest with ourselves. If you are presented with a long list of pension and insurance longevity deals done by capital markets investors over the years, it is actually a lie. A "white lie," admittedly, which is based on a generous definition of capital markets, simply because of the involvement of an investment bank or another non-reinsurance intermediary's balance sheet. Forgive me for being orthodox here, but I would not call a "capital market trade" a transaction where the final risk taker is actually a reinsurance company.

That said, various "genuine" capital markets transactions have actually happened: Aviva-RBS, Aegon-DB, and more recently, a couple of other longevity structures where the final risk taker has truly been a capital market investor. This trend is here to stay and will only strengthen.

"The journey towards capital markets playing a role in life insurance risks started more than 20 years ago, but in reality, the harbour we left behind us is still in our sight; the course leading capital markets investors to play a key role in the life insurance risks arena is still at its beginning."

> "Growing capital markets participation in life risk necessitates involving more sophisticated and larger asset managers that have the appetite to walk a less-trodden path that still offers the destination of true alpha."

Here's why. Although our insurance and reinsurance industry is central to our lives and to the resilience of our societies, it is still a negligible fraction of the size of wider capital markets universe.

Capital markets involvement in the financial industry in general is not new, of course. Capital market investors have been a key partner for the banking industry for decades. I don't mean the so called "shadow banking" definition often used by detractors; I mean the credit funds playing a key role in supporting bank lending activity over the years across non-performing loans, consumer finance, RWA driven structures, etc.

There is also a general trend of capital market investors being active in direct lending activities, substituting for traditional bank lenders in supporting small and medium sized businesses.

Growing capital markets participation in life risk necessitates involving more sophisticated and larger asset managers that have the appetite to walk a less-trodden path that still offers the destination of true alpha.

First mover advantage will be there. We have already seen the first public life ILS notes issued at much higher credit spreads than their follow-ups. It is the novelty premium that first movers can harvest; the return on those standardised structures has now materially reduced.

Is there a secret sauce for an investor to have success in this area? Short version: no. There is common sense and market knowledge, though. Price-based competition was considered in the past to be the best way for capital markets to
"prove themselves" and become more relevant in the insurance space; in reality, this is not a sustainable option.

Reinsurance pricing has tightened with the general market trend and as a result of new market entrants. What (sustainable) value can capital markets bring to the table? Realistically, the flexibility across insurance and market risks, structuring skills and the ability to provide complex solutions. And execute these quickly compared to traditional players.

The opportunity is there, and it can be a win-win situation for investors and (re)insurers. Equally, and just as importantly, it can contribute to creating a more resilient society.

If not now, when? Let's persevere.

Surviving the Below Normal Interest Rate Environment With Alternative Investments

Author:
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> "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."

Over 409,000,000 results returned from an early April 2022 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.

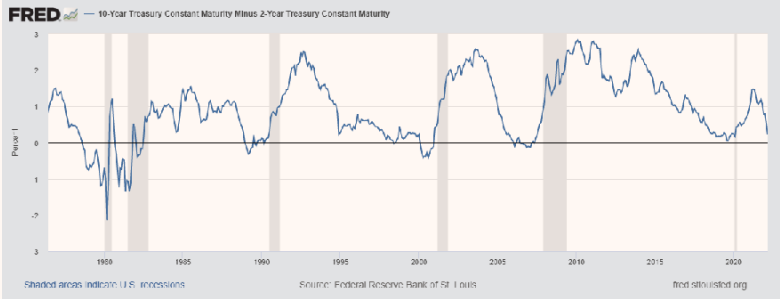
While the pandemic upended businesses and the markets in 2020 and shocked investment portfolios, investors worldwide have been contending with interest rate risk for several years, specifically the risk of persistently low interest rates. In fact, the 10-year bond yield in Germany has been negative since mid-2019 and currently sits at approximately -0.71%. In the US, Treasury rates along the entire yield curve have remained positive; however, the 10-year rate, despite a recent uptick, 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%.

Figure 1: Historical 10-year US Treasury Rate

Macrotrends.net (thru March 28, 2022)

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. The current spread, after crawling back to around 1.25% -which was still historically low - spreads have fallen again to close to zero.

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



Source: St. Louis Fed (thru March 1, 2022)

> "Mortality events generally are completely uncorrelated with the financial markets driving the returns of traditional asset classes."

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 obtain 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 investments whereby the core risk is mortality (or longevity), like life settlements, pandemic bonds, or a disaster like with catastrophe bonds.

While some of these investments can be less than fully liquid, they suit a more traditional buy-and-hold strategy. In all cases, these asset types 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.

As a way of an example, in the ILS space, 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.

As is the case with "insurance" related risks, classified as the transfer of risk from one party to a commercial insurer for a "premium", these ILS investments have some form of actuarial risk – like specific disasters (e.g., earthquakes), high health care (morbidity) claims vs expected, or a mortality event like with structured settlements, life settlements, equity release mortgages (ERM) and pension pay-outs.

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.

Looking at one ILS type, 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, for one primary risk – longevity.

Once understood, these unique forms of alternative assets can provide investors with a yield-generating outlet in this likely persistently below normal interest rate environment.

"With life settlements, as opposed to traditional asset classes, we are trading out core risks for one primary risk – longevity. Once understood, these unique forms of alternative assets can provide investors with a yield-generating outlet."

Q&A

Patrick McAdams

Investment Director
SL Investment Management

Patrick McAdams, Investment Director at SL Investment Management, was a founding member and first Chairman of the European Life Settlement Association. McAdams spoke to *Life Risk News* to explain the genesis of the organisation and his hopes for the future.

LRN: Patrick – you were part of the founding of ELSA in 2009 but the Life Settlement industry is based in the United States. Why did you think that an association for European firms was necessary?

McAdams: Prior to ELSA's formation, the only association in existence focused solely on U.S. life settlements was the Life Insurance Settlement Association (LISA). LISA is based in the U.S. and most of its members at the time were also U.S. based and primarily concerned with the sourcing of policies from U.S. policyholders. As a result, LISA's activities/initiatives largely centred on policy procurement. However, European investors had been supplying the bulk of the capital used to acquire U.S. policies during the 00s and many of these investors felt that issues important to them were being ignored.

Consequently, the idea of ELSA was born from the need for investors in Europe to have a voice via an association singularly focused on issues important to them such as transparency, education, conflicts of interest and best practices, to name but a few.

LRN: What were some of the teething troubles in the first couple of years and have they been ironed out?

McAdams: With any new initiative there are always going to be problems – it goes with the territory. With the formation of ELSA, the fundamental issue was getting enough like-minded parties onboard and commercially committed to make it happen.

We were fortunate enough to work with Paul Winner, of PWCL Consulting, at the time, and he was instrumental in bringing together the founding members and getting us all on message. Once this was achieved, the challenge was getting our message out there to a captive audience. Arguably easier in today's world of LinkedIn and Twitter, but a task not to be underestimated 12 years ago. I'm glad to say that these initial teething problems were successfully ironed out, and the association has continued to go from strength to strength, with over 30 members today.

LRN: What are ELSA's accomplishments during your tenure as Chair of which you are most proud – and why?

McAdams: Similar to other young and evolving markets, the life settlement market has been plagued by subpar practices from a handful of bad actors with little regard for the interests of investors.

To make matters worse, many investors considering an investment in a life settlement product either did not have access to sufficient resources to make an educated assessment or the product provider failed to provide the investor with appropriate and relevant levels of transparency and information – or both.

As a result, I sadly witnessed, on multiple occasions, investors making poor investment decisions which inevitably resulted in disappointing investment performance. From this experience came my strong desire to provide investors with the requisite resources to make sound investment decisions and to recognise both good and bad practices in the market. This initiative is today known as the ELSA Code of Practice, to which all ELSA members must sign up to when joining the association. Now in its sixth edition, the Code of Practice is a must read for any investor considering an investment in life settlements.

LRN: You've stayed close to the organisation since your time as ELSA Chair, of course. Now that the Life Settlements industry has matured somewhat, what are the current challenges facing the organisation and the industry?

McAdams: From an investor perspective, the life settlement industry is in a far better place than when ELSA was founded. I confidently believe that ELSA's existence and that of the Code of Practice has played a major part in significant improvements to the investor experience. That said, challenges and issues remain and as a result ELSA is now more relevant than ever. The last few years have been a boomtime for the market, with significant capital flows putting downward pressure on yields and motivating the supply side to find more policies as transaction volumes continue to increase.

However, although far fewer in number than historically, bad practices persist. Investors were unfortunately reminded of this recently when a large open fund was found to be significantly overvaluing its portfolio when redemptions forced policy sales. There's a very good reason why the Code of Practice has a section devoted to valuation.

Patrick McAdams
Investment Director
SL Capital

LRN: And what about the opportunities?

McAdams: Thankfully opportunities far outpace challenges. The primary opportunity right now is that this market has fantastic growth potential. Now more than ever, investors seek non/low-correlated investments that still provide attractive performance. This demand for policies, which is expected to increase even further over this decade, can be satisfied by a substantial untapped supply of policies – many of which are owned by policyholders unaware that their policy can be sold and provide a living benefit.

Lack of awareness, favourable U.S. senior population demographics and growing investor demand means this market is primed for significant expansion.

LRN: The Life Settlement industry, like all others, is beginning 2022 against the backdrop of heightened uncertainty due to Covid-19, although, at press time, there is continuing positive news around hospitalisation and mortality rates. What lessons have Life Settlement industry participants learned from the pandemic so far?

McAdams: You may find this surprising, but I believe the biggest learn from Covid-19 is that life settlement transactions can be undertaken effectively in a virtual environment. Historically, the process of selling your policy involved a lot of face-to-face interactions; in particular, notarisations. Faced with lockdowns and policyholders uneasy about leaving home, the market quickly pivoted to online notarisation and video/digital verification of policy transactions and related documentation.

As for the pandemic itself, I believe the case remains that it is virtually impossible to predict when the next one might strike, how virulent it will be and how it might impact the life settlement cohort.

LRN: Finally, Patrick, what's your message to the industry for 2022? What does the life settlement industry need to improve on, and what provides you with encouragement?

McAdams: My message is simple: It's all to play for. The life settlement market has huge potential on all sides and for all participants, including investors, policyholders and market service providers. The one area I would like to see improvement on in the industry is for market service providers to continue to hold each other accountable, and to continue to drive forward on transparency and standards.

On too many occasions in recent years there have continued to be instances of bad practice in the market, but human nature can be to take the easy option and stay quiet. What encourages me the most is that the market has demonstrated an ability to adapt, evolve and overcome; characteristics that will serve it well in the years to come.

Have you registered yet for the Life ILS Conference?

Date: Tuesday May 24th 2022
Location: EY, Canary Wharf, London, UK
Conference & Registration details at LifeILS.London

The State of the Life Settlement Market

Author:
Greg Winterton
Contributing Editor
Life Risk News

The life settlement market has had more than its fair share of challenges in the past decade or so. PR issues plagued the sector as many investors – at least, publicly - stayed away from the perceived negativity attached to longevity risk, and the global financial crisis saw some open-ended funds gate their investors as redemption demands threatened their liquidity – and existence.

In the last five years or so, the industry had been on something of an upward swing as investors were forced into looking at alternative investments, like life settlements, that can provide an acceptable yield for their fixed income allocations.

Then the Covid-19 pandemic hit. At the time, the entire insurance and investment management industry was in a state of shock, but what impact did the pandemic have on the life settlement market specifically?

> **"In the last five years or so, the industry had been on something of an upward swing as investors were forced into looking at alternative investments."**

"There was a lot of uncertainty about mortality. As you can imagine, this was truly unprecedented in our professional lives. As a result, various insurance players started looking at transactions aimed at reducing volatility and creating some element of resilience on their balance sheet," said Luca Tres, Head of EMEA Strategic Risk and Capital Life Solutions at Guy Carpenter. "But most of the transactions that started in March were pulled by summer because, with more mortality data coming in and with more clarity about public policies, insurers didn't feel the need to act as urgently as they did in March. This said, something permanent still happened: the pandemic opened up the minds of many players in the insurance industry to what they can do about volatility and balance sheet resilience so that they can withstand a similar situation in the future."

Short-term dislocations provide opportunities, of course, and pricing for life settlement policies was affected in the immediate aftermath of the first wave of the pandemic, with opportunistic investors looking to pick up assets cheaply, although this was short-lived.

"I saw a few players that tried to take advantage at the start of Covid-19 of the market shock to the lock down and opportunistically pull out of transactions or drastically change pricing. This ended up working against them as the behavior shut them out of transactions later in the year when the market swung the other direction and assets were challenging to access," said Ann Juliano, Managing Director at D2 Alternative Investments.

The move to remote working had a significant impact on the life settlement market. Buyers of these policies on the secondary market regularly engage with the insured party's physician, their insurance company, their broker, the list goes on – all of these actors in the space had to adapt to working from home, causing delays in the general communication chain.

Simon Erritt, Managing Director at Coventry Capital, says that there was an increase in individuals looking to sell their insurance policy directly (as opposed to through a broker) due to being at home more and seeing more TV advertising. Something that didn't change, however, was changes to medical underwriters' life expectancy estimates.

"We may see some changes in the future, though, because of the impact of so-called long-Covid and the delays in unrelated operations and treatments caused by resource shortages in hospitals over the last couple of years," he said.

Despite the short-term tumult, the life settlement market has arguably weathered the Covid-19 storm fairly well, and, like many other corners of the investment management industry, has settled into something of a 'new normal' and is better placed to tackle potential future disruption caused by new variants of Covid-19.

Other headwinds have recently presented themselves, however. Since late 2018, the industry has been battling what some in it call 'carrier encroachment' – that of an insurance company offering a cash sum directly to an insured party, which means the life settlement policy would not hit the open market. More recently, in November 2021, the industry was dealt something of a blow when the Supreme Court of Delaware issued an opinion in *Lavastone Capital LLC v. Estate of Beverly E. Berland* ("Berland") which essentially concluded that certain policies issued in the mid-2000s using non-recourse premium finance lacked an 'insurable

interest' and that the estates of the original policyholders were entitled to the death benefits associated with these policies. The ruling puts into question the value of any non-recourse, premium financed policies with a nexus to Delaware.

For Juliano, however, there is something of a silver lining coming from the ruling.

"We've heard about Delaware being a controversial state for years now, but I do think this ruling highlights the value of good investment managers or having a good advisory team behind you. Having transparent conversations and talking about what's happening avoids the risk of surprises. It's surprises that can scare off investors; as long as you understand the different types of risks that you're taking on, you won't be over affected by any kind of 'little' movements that are happening within your portfolio," she said.

"In the last five to seven years we've seen an increasing element of institutionalisation – improved governance and better practice around valuations. This is key to growing the market further"

These setbacks aren't putting the brakes on the industry, however. Since 2014, the number of policies coming to market has increased every year and has tripled during that time. Investors looking to access the benefits of life settlement exposure – uncorrelated returns with drivers unrelated to public equity markets and competitive yield – means that debt providers are increasingly casting their eyes towards the space.

"There's been a big increase in interest in lending against life risks in general; firms are looking to strengthen their war chest as they think about acquisitions and use leverage to increase their returns," said Tres. "In life settlements specifically, the more granular and the larger blocks are, the cheaper financing becomes and the easier it is to find interested lenders. But we're seeing interest in lending money on smaller blocks, too. And the typical structures tend to be 'payment in kind' notes, with some element of flexibility to allow the fund to have the liquidity ready when they need it."

Other flowers of maturity are blossoming. The increase in the availability of data and the number of firms using it is a rising tide that is lifting all boats.

"More time has passed since the industry began, and so we have more mortality data to work with," said Erritt. "And managers are increasingly investing in underwriters' databases and spending time analysing them – perhaps, making adjustments to the life expectancies that they received based on that analysis – and using the analysis to differentiate themselves as managers."

Juliano agrees.

"I think there's a huge data play. The fact that we can get access to such large data sets will give confidence around the industry and the investment," she said.

Tres is also seeing green shoots in terms of the environment.

"In the last five to seven years we've seen an increasing element of institutionalisation – improved governance and better practice around valuations. This is key to growing the market further because you can't do so without an element of certainty in the foundations," he said.

In any sector of the investment management industry, the ultimate paymasters are the asset owners / end investors; for a sector to grow, there must be interest from these constituents in allocating capital to the space. Fortunately, for the life settlement industry, it's good news.

"Life settlements is a lot more of a known asset class than it was in 2007/08. I've seen about 75 to 80 real money players that haven't necessarily fully engaged in the market yet become at least more engaged as they are looking for an interesting, long-term asset that wouldn't take big volatility swings," said Juliano. "There's a lot of curiosity out there – it's a trend that's in line with the growing appetite for alternative investments generally. Investors have a lot of choice in terms of finding a good partner now."

At the midway point of 2022, supporters of the industry have plenty of reason to believe that it cannot only continue to survive, but flourish. A robust response to the pandemic and continued enhancement to mortality assumptions based on ever increasing experience and better data set the market in good stead for the year ahead, even with more macroeconomic risk uncertainties.

ELSA

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For more information please reach out to
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