Life Risk News

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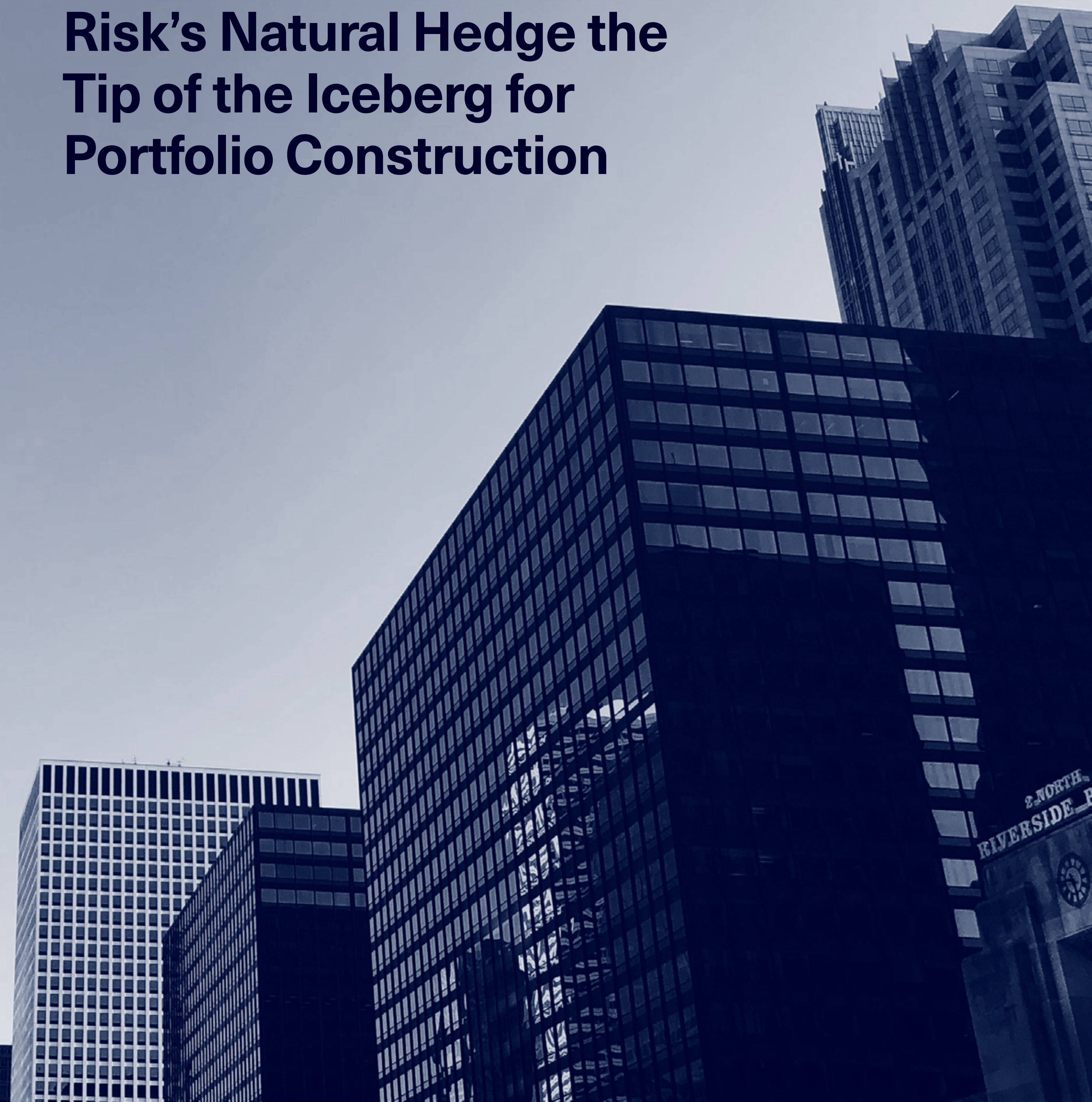
August 2022

Longevity and Mortality Risk's Natural Hedge the Tip of the Iceberg for Portfolio Construction



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Editor's Letter
Volume 1 Issue 4 August 2022

Greg Winterton
Contributing Editor
Life Risk News

Life risk-based investors ultimately boil down their underlying exposure to either longevity risk or mortality risk, and for life ILS funds, sometimes both. These exposures can act as a natural hedge to one another but constructing a portfolio of these products is a complex exercise. Life Risk News spoke to Olga Ho, Head Life Underwriting at Credit Suisse ILS and Anna Bailey, Managing Partner at Chestnut Capital Management to learn about these nuances for this month's cover story, *Longevity and Mortality Risk's Natural Hedge the Tip of the Iceberg for Portfolio Construction.*

Much of the coverage of the life settlement market involves the secondary market – the sale of an individual life insurance policy to an investor by the policy owner. The industry has a very healthy tertiary market, however, accounting for a significant chunk of overall activity. We spoke to William Corry, Managing Director at Corry Capital Advisors, Nate Evans, CEO at Maple Life Analytics and Boris Ziser, Partner, and Co-Head of Structured Finance & Derivatives at Schulte, Roth & Zabel to learn more about this part of the life settlement world - and its impact on both fund managers and investors in *Understanding The Tertiary Life Settlement Market Key To Success but Secondary Market Deal Flow Needs To Improve To Fuel Growth.*

ESG has moved forward in the financial markets dramatically in the last few years. ILS and (re)insurance is a part of this ESG movement, thus providing many opportunities for our industry. Phil Kane, Partner, Portfolio Management and Senior Credit Officer; Adrian Mark, Partner, Head of Non-Life Analytics; and Jillian Williams, Partner, CUO and Head of ESG at Leadenhall Capital Partners explain ESG in the reinsurance industry and what it means to them in *ILS and ESG – The Opportunities*, our first commentary piece this month.

Last month our cover story looked at pension risk transfer, and so for this month's poll, we asked Life Risk News readers *Will Pension Risk Transfer Deal Activity in the U.K. Increase, Decrease or Stay Roughly the Same in the Next 5 Years?*

Our second commentary piece this month comes from life settlements investment manager BroadRiver Asset Management Managing Director Brendan O'Flynn, who provides something of a timeline of the evolution of the life settlement industry in *The Arc of Due Diligence – A Path to Institutional Acceptance of Life Settlements.*

Last month we wrote about the state of the life insurance related insurtech market and so this month we took a deeper dive into the digital transformation of life insurance companies in a *Q&A* with Tom Scales, Senior Analyst at Celent.

If you want to compare mutual funds or hedge funds, many databases are available to help individuals to screen for the right fund or funds for them. But comparing life insurance isn't nearly as easy. We spoke to Barry Flagg, President and Founder at Veralytic, and Keith Loveland, President at Loveland Consulting, for our final feature article this month, *Frustrating Headwinds in Quest To See Life Insurance Adopted as a Wealth Accumulation/Preservation Asset.*

As always, 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 new issue of Life Risk News.

Longevity and Mortality Risk's Natural Hedge the Tip of the Iceberg for Portfolio Construction

Author:
Greg Winterton
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Life Risk News

The life risk investment market ultimately comes down to two sides of the same coin: longevity risk and mortality risk. Holding both risks in a portfolio simultaneously are something of a natural hedge, like an equity hedge fund manager maintaining both long and short positions in public equity markets or a credit hedge fund taking long and short positions across the yield curve.

There aren't many similarities between public equities, government bonds and life risk. However, managers of life risk strategies take similar approaches to portfolio construction as equity and credit hedge fund managers do – namely, additional layers of diversification within the portfolio.

"When we're trying to buy policies from brokers, we look at what they have based on face value and age ranges. We want to ladder the portfolio based on life expectancies so that it matches the life of the fund and we look at different face values largely because we need to ensure that the capital we're deploying can access a diversified range of ages," said Anna Bailey, Managing Partner at Virginia-based Chestnut Capital Management, an OCIO for life settlement fund managers.

It's a similar approach that the insurance linked strategies team at Credit Suisse applies. The firm invests in a range of biometric-focused transactions that are exposed to either longevity or mortality risk, and Olga Ho, Head Life Underwriting at Credit Suisse ILS in Zurich, Switzerland, says that considerations are made across transactions to achieve both hedging and diversification.

> **"We seek to build a balanced portfolio that includes various types of risks such as excess mortality, excess morbidity, longevity, or shock lapse. Within each risk class, we seek to invest in different transaction structures, regions, and different trigger and pay-out mechanisms to further limit tail risk of the portfolio."**

"We seek to build a balanced portfolio that includes various types of risks such as excess mortality, excess morbidity, longevity, or shock lapse. Within each risk class, we seek to invest in different transaction structures, regions, and different trigger and pay-out mechanisms to further limit tail risk of the portfolio."

Life risk-related products are illiquid and over the counter, relying on relationships and networks to source deals and execute them, as opposed to the more easily accessible exchange-based nature of public equities. This makes product selection arguably more important to a life risk-based investment manager than stock selection in a public equity strategy because what goes into the portfolio is heavily dependent on supply and the fewer exit options make rigour a keyword in terms of portfolio construction.

"We don't have a strong bias to either longevity risk or mortality risk – portfolio construction is primarily a matter of the alignment of available investment opportunities and the suitability of those to the risk/return profile for the portfolio," said Ho. "Any investment we make is subject to a rigorous due diligence process that focuses not only on the ceding company and the underlying risk, but also on various external factors that may affect the long-term success of the business, such as the regulatory environment or market position. We also stress test these opportunities to obtain a clear perspective of the underlying risk."

In life settlements, the risk is exclusively longevity, so there's no hedging per se – diversification is the name of the game. And after Bailey's initial age and policy price screen comes the hard work to ensure that risk is mitigated.

"We won't buy any policies where the life expectancy is less than 36 months. That's too much risk if the policy holder outlives the expectation," she said. "But in terms of the details, you have to do a lot of the work yourself. You may get a life expectancy estimate from a supplier, but if your $400k policy is a 72-year-old lady in California who lives on a $5-million-acre plot, you might as well add five years to that estimate. Understanding socioeconomics is critical in life settlement and longevity risk investing."

Longevity risk isn't exclusive to life settlements and life ILS funds. Defined benefit pension funds are, by far, the largest company type that is exposed to this risk, and their entire investment program is designed to ensure that it delivers investment returns so they can meet the promises to their current and future pensioners.

On the surface, therefore, adding additional longevity risk to their investment portfolio might seem counter intuitive, but that is considered by some to be a misconception.

"Pension fund investors often overestimate the correlation of a balanced life ILS portfolio's longevity risk with their own longevity risk, especially considering that longevity risk constitutes only one risk type in an overall Life ILS portfolio," said Ho. "Also, and more importantly, a pension fund's longevity liabilities may be very different from the biometric risks to which a particular life ILS strategy is exposed to in terms of regions, health systems, and age groups."

> **"But there really isn't a definitive way to construct a portfolio in this space; it's more like a puzzle you have to fit together."**

Diversification is the only free lunch in investing, according to a quote attributed to Nobel prize laureate Harry Markowitz. It's as essential in life risk-based investing as it is anywhere else, but the understanding of the nuances of risk in this space is not as widespread as it is in more liquid markets. Consequently, investors looking to access the uncorrelated returns that longevity and mortality-based investment strategies provide should pay particular attention to a manager's approach.

"In life settlements specifically, we look to diversify across age, gender, life insurance carrier, state of residence, impairments and net death benefit of the policies we buy," said Bailey. "But there really isn't a definitive way to construct a portfolio in this space; it's more like a puzzle you have to fit together. Investors doing due diligence on longevity or mortality risk-based investment managers need to ask how a manager diversifies their portfolio and be sure they are understand and are comfortable with the answer."

Have you registered yet for the Secondary Life Markets Conference?

Date: 20th September 2022
Location: EY, Canary Wharf, London, UK
Conference & Registration details at elsa-sls.org

Understanding The Tertiary Life Settlement Market Key To Success but Secondary Market Deal Flow Needs To Improve To Fuel Growth

Author:
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Life Risk News

Life Settlements industry publication The Life Settlements Report, part of The Deal, publishes data each year on the size of the secondary market in life settlements, where individual policies are purchased by investors from the original owner through intermediaries. Much of the data comes from freedom of information requests to state insurers, and only a small percentage is contributed directly by providers.

Unfortunately, little to no data exists about the industry's tertiary market, where life settlements are traded both individually and in blocks between investors; investment managers are not under any obligation to disclose their activity in this market. But what is well understood is that the tertiary market comprises a significant chunk of the overall market activity and value, making understanding this part of the life settlement market of significant importance for institutional end investors analysing existing or potential life settlement allocations.

> **"The tertiary market comprises a significant chunk of the overall market activity and value, making understanding this part of the life settlement market of significant importance for institutional end investors**

One of the main differences with the tertiary market is that buyers don't have the same access to information that they do when dealing in the secondary market.

"In the secondary market, you're in direct contact with the insured individual and their advisors. Medical records are up to date, for example," said William Corry, Managing Director at life settlement investment manager Corry Capital Advisors. "But in the tertiary market, you can't talk to the insured. The documentation you have to conduct your analysis on is from someone who has already bought the policy. Depending on the length of time that has passed since the initial life settlement, that information could be good or spotty."

The lack of information does impact the valuation of the policy and is something essential for the manager to consider when offering a price.

"If the documentation is not up to date, then you'll need to price the risk into the value offered as a buyer," said Corry. "You don't know if a previous health impairment is not as bad today as it was when the secondary market deal was done, so their health might be better. Or it might be worse. That pendulum can swing easily both ways, so it's something that needs careful consideration."

Pricing life settlement policies accurately is a difficult task in the secondary market, let alone the tertiary one, and managers' approaches vary. Nate Evans, CEO at Maple Life Analytics, says that the size of the manager also has an impact.

"Larger buyers have access to information based on other portfolios of policies that they will have seen historically. They also have access to databases that others might not, and this allows them to price differently."

The portfolios referenced above provide another notable difference between the two markets. The tertiary market is block trading. Reasons abound for these sales: a closed-ended fund manager winding up their fund by selling the remaining policies in their portfolio; a manager of an open-ended fund looking for liquidity or to rebalance their portfolio; or a market player simply looking to exit the industry. Naturally, the reason behind the block sale drives part of the marketing logic, and Evans identifies three sale types, each of which see notable differences in price.

"On one end, there are bankruptcy sales. The administrator has to publish the sale, and this makes it public, available to anyone that can participate. You might see 30 to 40 bidders here and you see the initial bids, the highest x% move to the second round and then the bids are binding. Then there are the deals who go to all the people active in the market. A good sales agent will know the best buyers based on the characteristics of the portfolio. There are also sellers who wish for a smaller / less public process. These sellers will ask their sales agent to approach 2 or 3 of the most aggressive buyers to quietly get best execution," he said.

Regardless of the reason for a portfolio coming to market, Evans says that currently a typical discount range is around 9-12% for a generic portfolio. Whilst he says that some portfolios with 'origination risk' – mainly the original purchase structure as well as the legal situation of the state in which the life settlement is domiciled – have seen discounts approaching 30% or even being unsellable.

Most blocks hitting the market have benefitted from IRR compression due to the large amount of deployable capital in a sellers' market.

"I think we have seen more compression in the "vanilla portfolios"," he said. "That suggests pressure in that segment is affected the most by the competitive landscape. But origination risk is very large in the tertiary market. We continue to see portfolios with high origination risk get no bids at all."

Corry goes further and says that there isn't much of a discount at all in the tertiary market for quality portfolios. The driver of higher pricing for him, however, is a familiar gripe about the industry's secondary market.

"There aren't really any discounts to be had in the tertiary market. There may have been before, but not today. Prices can be held by sellers because of the lack of deal flow in the secondary market which filters to the tertiary market," he said.

"Competition for deals in the tertiary market is set to increase, making increased deal flow from the secondary market even more important"

Competition for deals in the tertiary market is set to increase, making increased deal flow from the secondary market even more important. Carrier encroachment – the term life settlement industry players give to insurance companies that are essentially buying back policies they wrote – is on the rise.

"Some tertiary market buyers are in the market quietly, and we're starting to see more insurance companies in the space on that basis. These types of buyers tend to buy and hold the assets to maturity - that will have an impact on tertiary market volumes," said Evans.

Increased competition for life settlements in the tertiary market will likely have an impact on pricing but without access to reliable data, it's difficult to predict the extent. Still, going forward, the main obstacle to tertiary market growth is deal flow in the secondary market.

The Life Settlements Report's figures suggest that 2021 saw a contraction in the number of deals done in the market; that could be feeding into the tertiary market this year, according to Boris Ziser, Partner, and Co-Head of Structured Finance & Derivatives at law firm Schulte, Roth & Zabel.

"It feels like this year has seen fewer deals than last year. I think the pandemic had an impact and I think what we're seeing in the capital markets has had an impact. Investors are picking their spots – there are more opportunities to make similar returns in more traditional asset classes than there were before."

Despite the slowdown in activity in the past twelve months or so, Ziser says that interest in life settlements is generally growing.

"One trend is that over the last several years, more and more investors have come to the market who were not comfortable with the asset class before but are now. There has been an expansion in the types of institutional investors deploying capital in the life settlement market. And recent market volatility has highlighted the benefits of an uncorrelated asset class like life settlements, so I'd expect activity to pick up again. Investors are coming around to the fact that ultimately, the credit behind their investment is a highly rated insurance company. Not many asset classes provide double digit returns from an uncorrelated investment where the credit is a AA-rated insurance company."

The life settlement market will be keeping a keen eye out over the next twelve months to see if there is a rebound in activity in both the secondary and tertiary markets, and if so, to what extent. Corry agrees that capital market volatility supports the life settlement pitch, but regardless, the message to investors is one of encouragement.

"The capital markets being choppy helps life settlements. But the secondary market is fundamentally very healthy, healthier than it's been in years. Expanded regulation, more states regulating the asset class, more consumer education and financial advisors understanding the applicability of the market are all driving that health. And that in turn fuels the tertiary market," he said. "But life settlements are complex, so the key from an LP perspective is finding an investment fund manager who has proven track record and experience in the secondary and tertiary markets because while they are symbiotic, there are nuances to each that require specific skills and experience to generate success."

ILS and ESG – The Opportunities

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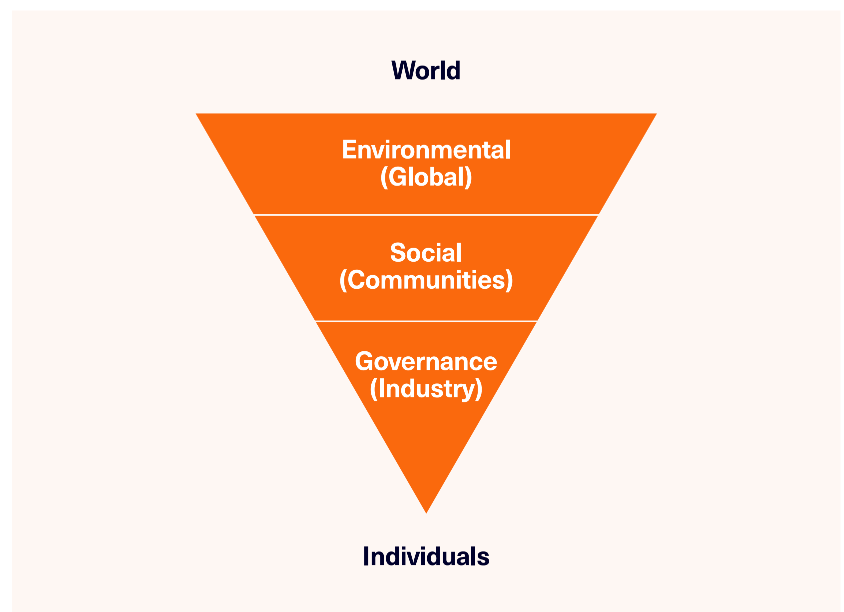
ESG has moved forward in the financial markets dramatically in the last few years. ILS and (re)insurance are a part of this ESG movement, thus providing many opportunities for our industry.

Every industry views ESG through its own lens but what does ESG mean to the (re)insurance industry?

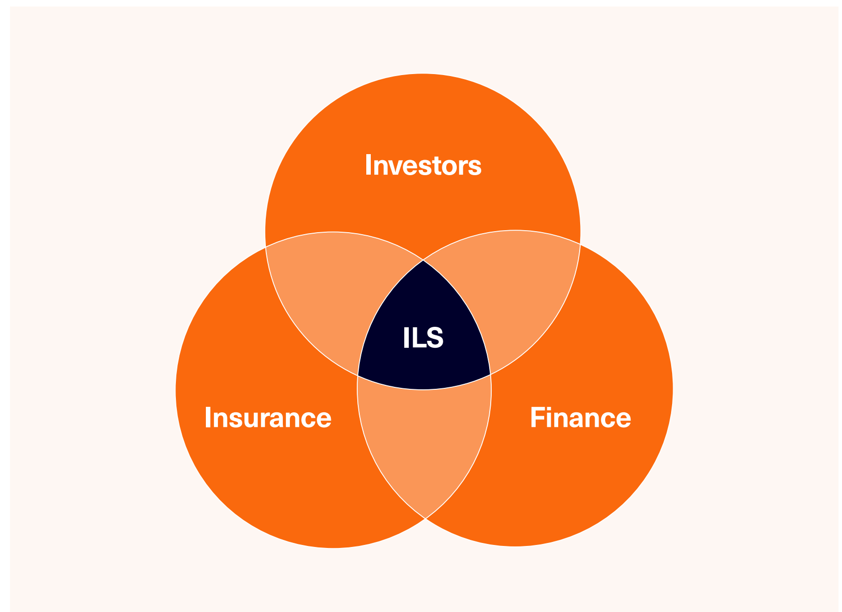
- **Environmental** – For example, Climate Change, Natural Resources, Pollution & Waste, Low Carbon Transition, Risk Protection Gap
- **Social** – For example, Human Capital, Product Liability, Stakeholder Opposition, Social Opportunities, Financial resilience for all, Human Rights
- **Governance –** For example, Corporate Governance, Corporate Behaviour, Anti-corruption, Anti-bribery.

It is important to look at all 3 areas individually, but we also believe that it is important to look at them as an interlinked process. One way we view the components, and their scale of influence, are as a “cone.” From global to local impact and the effects on corporations and individuals, all three parts are linked, and it is important that we have a balanced view across them.



> “The ILS industry is in a unique position as it is at the crossroads between many financial sectors”

The ILS industry is in a unique position as it is at the crossroads between many financial sectors. The strategy is based in (re)insurance, but has investors from other sectors, as well as dealing with the banking arena. One other uniqueness is that ILS in the EU will be regulated for ESG before other financial products, like (re)insurance, which sets some challenges, but also creates opportunities.



> "In terms of ESG, insurers score highly on social impact. Although, not often perceived as social impact investments, insurers have as their core modus operandi that they provide financial stability to families in times of need"

The EU's Sustainable Financial Disclosure Regulation ("SFDR") came into effect on the 10th of March 2021, as part of the EU's efforts to ensure financial firms such as fund managers, insurers, and banks that provide financial products and services within the region are comprehensively disclosing just how committed to sustainability they truly are. The SFDR defines a three-tier classification for financial products based on several aspects of both the product and its investment process. This classification comes with differing and increasing levels of disclosure requirements.

Article 6 – financial products which do not integrate sustainability into the investment process, with disclosure requiring an explanation of sustainable risk integration into investment decision-making;

Article 8 – financial products promoting environmental and/or social characteristics, with disclosure requiring information on how those characteristics are met;

Article 9 – financial products with a targeted sustainability objective, with disclosure requiring information on how the sustainable investment objective will be attained.

The new SFDR regime provides a framework in the EU for investment managers to be able to classify their funds as promoting environmental and social characteristics, rather than having a passive approach or disregarding them. Below is how we look at ESG based on these categories.

Life

In terms of ESG, insurers score highly on social impact. Although, not often perceived as social impact investments, insurers have as their core modus operandi that they provide financial stability to families in times of need, be that due to the impact of natural catastrophes or matters related to health and mortality.

Across the globe, the Covid-19 pandemic and the risks associated with it have highlighted to individuals the need to be better prepared in case of contracting a debilitating disease or death. Closing the protection gap has the potential to be a powerful business plan for newer entrants, and Life ILS plays a critical role in supporting the expansion of coverage through new and existing enterprises.

The US in particular has undergone significant changes to the accessibility of health insurance through the implementation of 2009's Affordable Care Act and many investment opportunities abound for ILS investors to support the

> "For insurers and ILS it is necessary to understand the current and future quantum of risk, so that risk can be appropriately priced, and portfolios managed effectively"

broadening of the penetration of health insurance in the US. For the elderly, the baby boom generation has created a tidal wave of demand for medicare options, providing ILS investors the opportunity to support greater health insurance accessibility for both working age Americans and retirees.

Such examples of social impact investing are material in the US, but in Europe the main investment opportunities are found in the support of the transition from corporate pensions to private, savings-oriented insurance. Although less focused on accessibility, investment opportunities in Europe facilitate the successful provision of financial planning options to provide greater security to retiring Europeans.

Focusing on "E", life and health insurers are not unexposed to climate change, but these issues typically arise from their investments. In many cases, insurers have begun offering ESG-oriented funds and impact investment options through their savings products, particularly in the UK and Europe. Many ILS investments that support the growth of such policies are therefore also supportive of ESG principals. However, in general, life and health insurers typically have limited direct weather risk or impact to their business models, being based in electronic financial contracts and a largely developed country workforce.

Non-Life

When it comes to natural catastrophes, non-life insurance is vital for reducing the protection gap. This is the difference between the total economic cost of a natural disasters and the support provided by the (re)insurance industry through claims payments. Insurers provide vital financial support that helps communities recover and rebuild after such events.

Non-life insurance is perhaps more sensitive to the "E" component of ESG, as an element of the protection offered generally relates to climate perils like windstorms, floods, drought, and other meteorological perils. This can be viewed through two lenses. Firstly, for insurers and ILS it is necessary to understand the current and future quantum of risk, so that risk can be appropriately priced, and portfolios managed effectively. But more importantly, climate change will likely change the frequency and/or severity of natural hazards experienced by communities around the globe, and insurance represents a vital source of financial support to aid recovery after such events.

A simplistic summary of the way we think about climate change at Leadenhall is:

Risk AND opportunity:

- It is vital to understand the changing natural and financial 'climates'
- This is required to inform a flexible and evolving strategy, so that we can adapt to the changing 'climates' and take advantage of the opportunities that arise from those changes

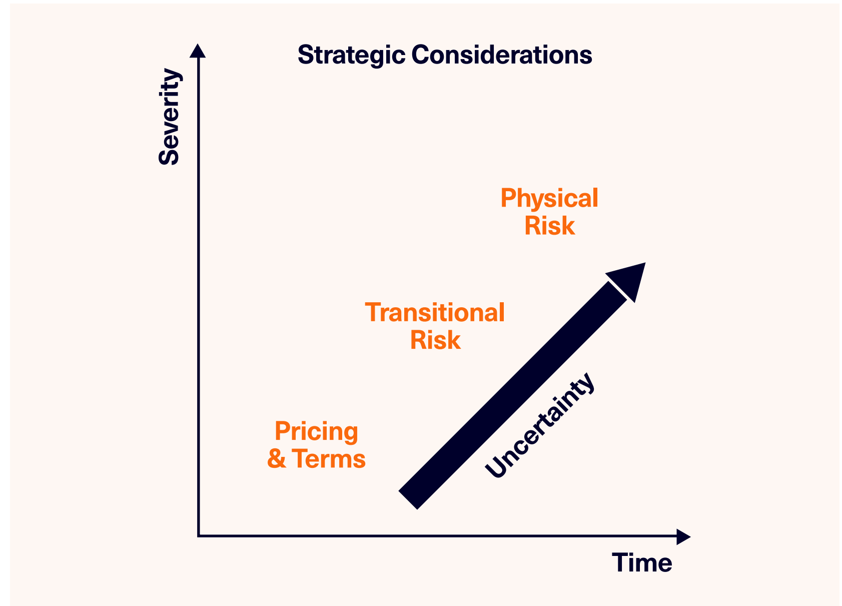
Natural hazard changes:

- Significant uncertainty exists depending on the hazard considered; potential changes in temperature (e.g., drought) are better understood than extreme weather (e.g., windstorms)
- The timescales of change are also important to define a complete forward-looking strategy, (i.e., current vs. medium-term vs. long-term)

Financial changes:

- Some classes of insurance may become unsustainable without adjustment in premium and/or risk evaluation
- New classes of insurance or products may become available providing further investment opportunities

With the above in mind, climate change should be viewed as a risk that needs to be managed and understood, but also an opportunity to expand on the protection offered to the community through greater insurance penetration, particularly in developing economies. Insurers can also endeavour to influence larger environmental shifts, by supporting greener technologies and industries through the provision of insurance solutions and allocations within their own investment portfolios.



> "Most insurance enterprises support diverse workforces similar to the communities they serve, and human resource departments typically are very aligned with the most current best practices"

Not Just E

Besides such external social impacts of insurance, the investments themselves should be viewed for their internal social impacts alongside their governance frameworks. Most insurance enterprises support diverse workforces similar to the communities they serve, and human resource departments typically are very aligned with the most current best practices given the businesses are related to social benefits.

From a governance perspective, entities in the insurance value chain are typically regulated by at least one or more regulators providing a high degree of both behavioural and fiscal oversight. Given many of the ILS investments are in smaller entities, sometimes these private businesses may lack independence in the majority of Board seats. Such a detriment is, however, offset by typically direct representation of the major owners on such boards.

More broadly, comfort can be taken from the fact that many insurers are signatories to the UNPRI or utilise asset managers who are. There are geographical differences in attention levels applied to climate change issues in their investments, with Europe and the UK insurers leading. This is in part driven by the local regulators who have begun greater disclosures and risk assessments of global warming and sea level rise on insurers investment portfolios. Many European insurers have begun to provide emissions tracking of activities and CO2 footprint analysis. Outside of Europe, there is limited environmental impact or risk disclosures.

Covid-19

The Covid-19 pandemic has very much focused people's minds on ESG. Most insurers have adopted climate friendly business processes, particularly during the current pandemic, including efforts to reduce business travel, broaden work from home policies and promote virtual sales processes.

> **“The pandemic has highlighted the need to work together to solve climate change. Industry will need to collaborate with communities and governments across the globe with ESG”**

In terms of interest in ILS investments, Leadenhall has observed an increase of inquiries from investors over the past year. The pandemic has been like a rapid climate change. The numbers of fatalities have been so stark to the extent a government or industry alone cannot hope to solve the pandemic - it has to be a worldwide effort.

The same is the case with climate change. The pandemic has highlighted the need to work together to solve climate change. Industry will need to collaborate with communities and governments across the globe with ESG. While not always “impact” investments, insurance ILS can be aligned very comfortably within an ESG framework as a notable promotor of these essential standards, promoting initiatives to create new ‘green’ products to enhance the positive impact the industry has worldwide.

August 2022 Poll Results

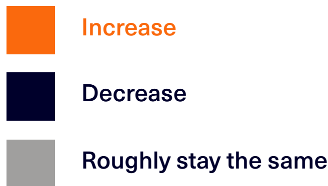
Will Pension Risk Transfer Deal Activity in the U.K. Increase, Decrease or Stay Roughly the Same in the Next 5 Years?

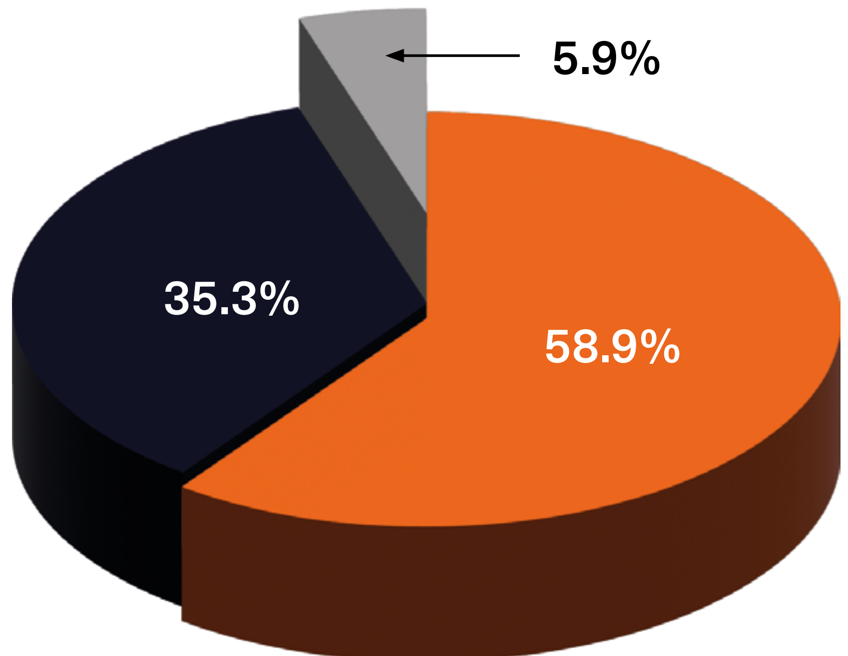
Author:
Greg Winterton
Contributing Editor
Life Risk News

The United Kingdom has the most active pension risk transfer market but despite it being more than a decade old, growth has been slow. We recently looked at a development in the U.K.'s pensions industry which could expand the market, so this month we wanted to see whether our readers felt that growth was indeed likely to accelerate.

The results aren't definitive. Whilst 58.82% think there will be an increase, 35.29% think activity will stay roughly the same. There could be many reasons for this, but two impediments to growth are a lack of talent and experience (from a number's perspective, not a skill level perspective) and the time it takes to complete a pension buy-out, buy-in or longevity swap (not to mention the current uncertainty facing global markets and geopolitics).

Only 5.89% of respondents think the market will contract in the next five years. The pension risk transfer market will be hoping that they don't know something that everyone else doesn't.





The Arc Of Due Diligence – A Path To Institutional Acceptance Of Life Settlements

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

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 terminal, 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?

> "Soon after the turn of the millennium, during the market's earliest stages, questions understandably focused on transactional validity"

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, 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 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"

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.

> "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"

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?

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

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.

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Q&A

Tom Scales

Celent

Insurance companies are generally considered to be laggards in terms of their adoption of technologies, and life insurance companies especially so. But change is happening, and Life risk News spoke to Tom Scales, Senior Analyst at research and data provider Celent, to learn more about what he is seeing in terms of the digital transformation of life carriers.

LRN: Tom, 'digital transformation' is one of those buzzwords that consulting firms love to throw around, but they tend to do so quite flippantly. Tell us what this means precisely for a life insurance company.

TS: I suppose that is up to the interpretation of each company, to a point. My definition would be movement away from an aging infrastructure that forces the customer to work with an actual human. Whether it be the agent or the post-sale service center, life insurance is both sold and serviced primarily by people. In a digital transformation, much of the interaction between the consumer and the insurance company would be electronic. From their computer, or more commonly, their phone.

We've seen this transformation in other parts of financial services. I recently sold a car, so I went onto the carrier's site and removed the car. I had my first ever homeowners claim and filed it electronically. I pay my bills through my bank's website.

The number of life insurers that can provide this level of service online is small. We're seeing that change, but not very fast. As they say, life insurance is sold, not bought, which means the amount of online sales is small too.

LRN: Why has the insurance industry historically been so slow to change?

TS: It is complex, but to me the number one reason is how long life insurance policies last. For your auto insurance, you renew every year and might even switch insurers. Even your health insurance, you sign up every year. For life insurance, you buy a policy and it is on the books for literally decades.

That's the challenge. Insurers are running back-office systems that are aging and that's a polite way to say it. Even those companies that have installed modern, API-equipped systems, most have not converted their entire book of business. They're selling using the new system, but older systems have been pushed into a corner and are still running. It is tough to web-enable a system written in mainframe assembler language that went into production in the 1960s. Those systems really still exist. They're still in production.

Converting a complex book of life business is not easy and generates no revenue. Better to leave those systems running until there are no more policies.

This means that many companies are approaching their digital transformation with only their more recently sold policies.

The problem is the risk of this approach continues to grow. Often the older systems are maintained by people at or well beyond their retirement date. They run on costly mainframes managed in enormous data centers. They're just old.

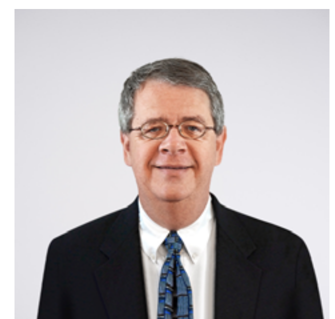
For post-sale service, there also isn't a huge incentive. I interact with my bank every week. With my auto insurer less often, but I'm always printing insurance cards. My life insurer basically never. I pay my bill annually and I've moved since I bought the policy, but I don't have any other reason for service. So why digitally enable a rare occurrence? If the insurer automates address changes, bank account changes, and beneficiary changes, and maybe a few more, they've done a high percentage of their transactions.

LRN: What's driving this investment in technology? Is it one main factor or a confluence of them?

TS: Business risk. I mentioned aging systems. We also cannot forget potential new entrants to the market. The barrier of entry to life insurance is not that great. Newer companies are already coming into play. Most are in the distribution arena, but that was true for health insurance too, and new insurers have started up. The same with auto insurance.

Let's face it, there is a lot of room for improvement and starting fresh has its benefits.

In digital sales, the difference maker is economic. The cost of sales is quite high, with a huge percentage going to agents. The same with underwriting. Newer approaches to underwriting both shorter the time, but also lower the cost. I believe we'll continue to see big investments in sales.



Tom Scales
Celent

LRN: What are some of the key domains in the life insurance space that are seeing activity in the digital transformation journey and which ones are having the largest impact right now?

TS: This is a hot topic here at Celent. We recently published our research themes and their tightly tied to our beliefs in the direction of the industry. For 2022, we broke it down into five basic areas: Customer and Distributor Experience, Data Analytics and AI, Digitization: Today and for the future, Digital Innovation and the insurtech ecosystem, and Legacy Transformation.

We discussed Customer and Distributor Experience, and it is a huge area of investment. As mentioned, it all comes back to increasing their share of the market. We see the same priority in health insurance.

Data Analytics and AI is an area that's white hot. Insurance companies have an extraordinary amount of data about their customers. The insurers are also incredibly focused on the security of that data. But the aggregated data has such power. From better underwriting decisions, to predicting the next best product to sell the customer, mining this data has a huge impact.

The Digitization: Today and for the future theme has overlap across the themes. The industry is rapidly reaching the point where customer expectations will not be met without a true digital experience across the value chain. After she had children, I spoke to my daughter about her need for life insurance. I described the process of an agent coming to her home, then a paramed, then gathering all her medical records, then wait a month or two and then they'll tell her the final price.

She couldn't stop laughing. She thought I was kidding. Her response sums it up.

"If I can't buy it on my phone, I am not buying it."

In terms of Digital Innovation and the insurtech ecosystem, what the startups out there focusing on insurance are accomplishing is simply amazing.

Celent spends a lot of effort focusing on the companies that have the potential to revolutionize our industry. These small, nimble companies are looking at problems in unique ways and often bringing expertise from outside of insurance. There are thousands and thousands of these companies, and they are making an impact. Insurance companies even have venture capital arms investing in insurtechs. One insurer provides them office space in their headquarters. It's game changing.

Legacy Transformation is the most complicated of the five areas we have identified. I won't restate what has been discussed but will add that a true legacy transformation is complicated, time consuming, and expensive.

LRN: What are the next few years going to look like in terms of digital transformation in the life insurance industry?

TS: Ah, the big question. I've predicted a digital transformation for too long, but we're finally seeing it come true. We'll certainly see new and innovative ways to sell life insurance, including embedded insurance. We'll see even better ways to underwrite that allows instant underwriting. We're already seeing that, and the scope will grow. We'll see better customer service. Hopefully we'll see more effective cross-sales, since today they're virtually non-existent.

What I think we'll see fewer of is agents. The direct-to-consumer push is finally gaining traction. Don't get me wrong, an agent brings huge value, particularly for complex financial situations. For a 30-year-old that needs a $100,000 term policy, that's going to move online.

It is fun to see the activity.

Have you registered yet for the Secondary Life Markets Conference?

Date: 20th September 2022
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Frustrating Headwinds in Quest To See Life Insurance Adopted as a Wealth Accumulation/Preservation Asset

Author:
Greg Winterton
Contributing Editor
Life Risk News

On the surface, Registered Investment Advisors (RIAs) in the United States are a natural home for life insurance advice. They advise their clients on pretty much everything else – tax planning, estate planning and investing, to name but a few – so, life insurance makes a lot of sense here. Right?

Sadly, not so much. RIAs often steer clear of life insurance advice; part of the reason is because they might not be licensed to sell life insurance in the first place. And part of the reason why they might not be licensed to sell life insurance is because their fiduciary duty to their clients can't be satisfied under the current structure.

"Current regulations in most states for most product types permit agents, brokers and insurers to 'quote' low premiums and project high account growth, while charging high costs without disclosing either those costs nor the correspondingly high(er) risks of under-performance, additional future 'premium calls', or even policy lapse," said Barry Flagg, CEO, President and Founder at Tampa, FL-based insurance research and analysis firm Veralytic. "This lack of transparency, uniformity, and consistency makes it impossible for an RIA to discern between agents, brokers and insurers engaged in such misleading sales practices versus those agents, brokers and insurers offering products in their best-interest."

> "Evaluating if or when a life insurance policy is in the client's best interest has been comparatively more difficult, providing another reason for an RIA to stay away."

There are many databases that enable easy analysis of mutual funds and ETFs for their retail clients, and those that enable screening of sophisticated investments like hedge funds and private equity funds for their accredited investor clients are an ally to the RIA that needs to be able to quickly and easily find the products that satisfy their client's risk appetite and return expectations. Evaluating if or when a life insurance policy is in the client's best interest has been comparatively more difficult, providing another reason for an RIA to stay away.

"Because RIAs haven't had a reliable means of measuring costs, performance and risks as is required by their operating model, they haven't been able to even think about their clients' life insurance the way they already think about every other asset on their clients' balance sheets. They all have clients who already own life insurance, so they certainly would talk with clients about life insurance if they just had the same access to research that they already have for every other asset on their clients' balance sheet," said Flagg.

RIAs are itching for change in this market. Keith Loveland, President at Loveland Consulting in Minneapolis, Minnesota, said that the current situation is holding them back from providing a holistic look at a client's retirement and estate planning needs.

"It's frustrating for a few reasons, but mainly because life insurance is a critical component of an overall solution for our clients," he said. "If the current situation was easier to navigate then we would be able to provide a better service for our clients."

Despite the challenges, there are some green shoots. In New York, for example, the state's financial services regulation 187, which was drafted to ensure that a "best interest" standard will be imposed on all life insurance sales in the Empire state, came into force on February 1, 2020 for life insurance sales (and August 1, 2019 for annuity sales). The Supreme Court Appellate Division struck the ruling down in April 2021, but the DFS has appealed to New York Court of Appeals. Flagg says that some version of the ruling is likely to go through.

"If the NY Court of Appeals upholds the 'unconstitutionally vague' verdict by the Appellate Division, then NY DFS can/will almost certainly re write NY Regulation 187 to eliminate "unconstitutionally vagueness". Either way, given NY DFS has taken this matter all the way to NY's highest court, NY Regulation 187 will almost certainly go into full force and effect in some form or fashion sooner or later. That's good news for the consumer," he said.

Life settlement investors cite a lack of awareness amongst the insured that selling their life insurance policy is even a possibility as being one of the main drivers of the lack of deal flow coming to market.

If RIAs were more involved in the life insurance space, that could be a significant boon.

> **“Studies suggest that wealthy clients need and want advice about life insurance more than financial advice about almost anything else. Life insurance is among the last, largest, most-neglected and worst performing assets according to client expectations”**

“Studies suggest that wealthy clients need and want advice about life insurance more than financial advice about almost anything else. Life insurance is among the last, largest, most-neglected and worst performing assets according to client expectations,” said Flagg. “So, if or when RIAs get the ‘inputs’ needed to start thinking more about their clients’ life insurance, they will naturally start including life insurance advice in their ‘output’, talking more and more about life settlements as one of the policy management options (PMOs) in their clients’ best interest, thereby increasing the supply of policies for life settlement.”

Change is slow in the insurance world. It’s also slow in the legal world, so any excitement around the possibility of regulatory change to enable more RIAs to get more involved in the life insurance advice game in the United States should be tempered. But for Loveland, it can’t come quick enough.

“It makes all the sense in the world for the industry to change to a best interest model,” he said. “It would remove barriers to RIAs including insurance as part of their advice model, and the nature of the RIA model means that clients would be getting independent advice and analysis around what’s best for their clients. This would be a significant win for the consumer.”

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