Life Risk News

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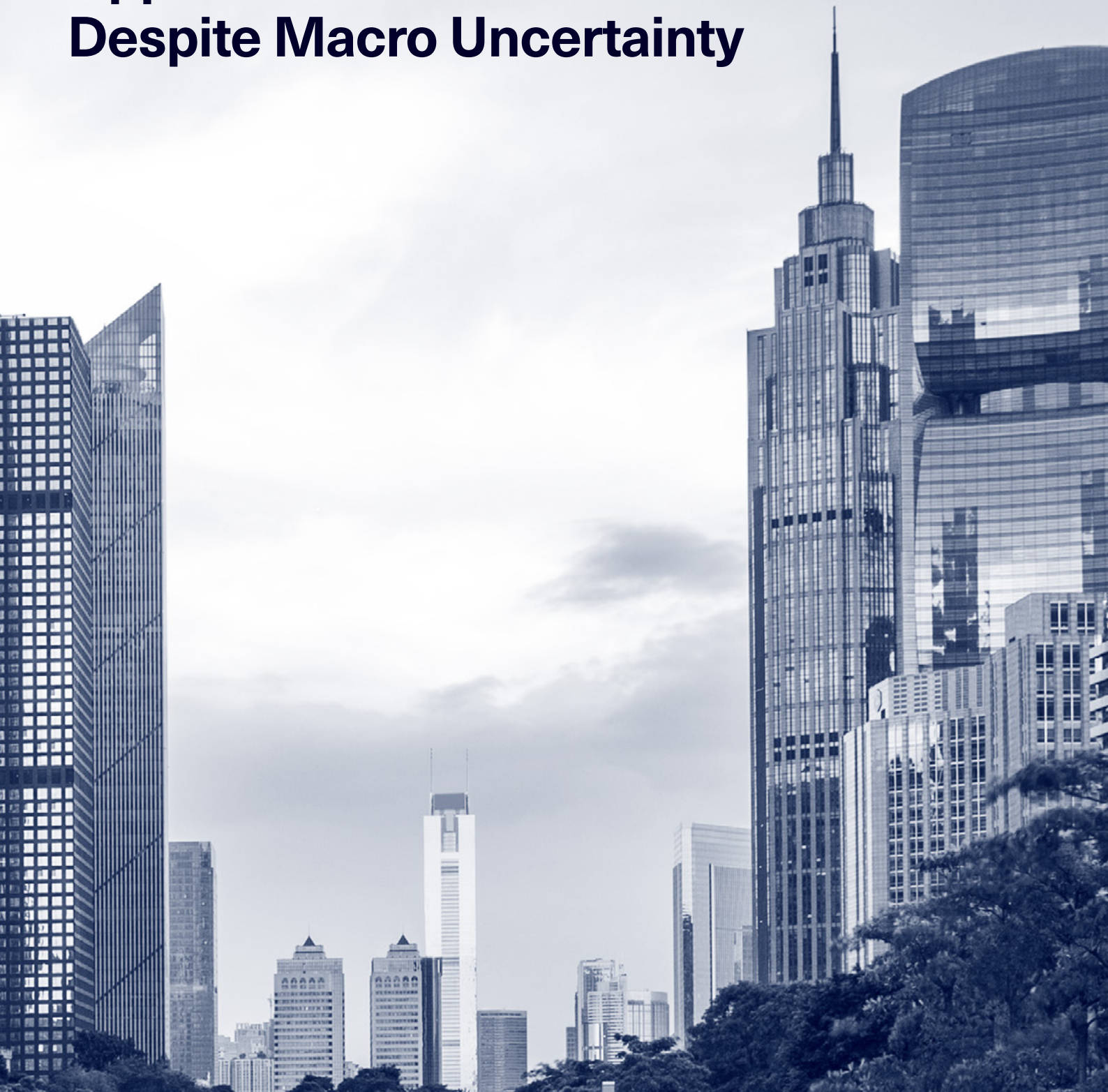
Life Insurance Companies Continue To Offer Opportunities for Private Debt Despite Macro Uncertainty



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Editor's Letter
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Chris Wells
Managing Editor
Life Risk News

Many direct lending strategies may face short term challenges as their portfolio companies feel the brunt of an expected recession. But life insurance companies are very different counterparties with features that could provide shelter from the storm. *Greg Winterton* spoke to **Dan Knipe**, CIO at **Kilter Finance** and **Luca Tres**, Head of EMEA Strategic Risk and Capital Life Solutions at **Guy Carpenter**, to get their thoughts for *Life Insurance Companies Continue To Offer Opportunities for Private Debt Despite Macro Uncertainty.*

Life settlement deal activity fell in 2021, according to data collected by The Deal. For this month's *Roundtable, Greg Winterton* spoke to **Rob Haynie**, CEO of **Life Settlements, Inc.**, **Jon Mendelson**, CEO of **Ashar Group** and **John Welcom**, Founder & CEO of **Welcome Funds** to get their thoughts on the current state of policy supply in the secondary market.

The pre-qualification process in life settlements can be tedious and costly. Former life settlements portfolio manager **Matthew Sheridan** explains how machine learning can be an ally to this process in a commentary piece, *Getting A Fast No: Machine Learning in Pre-Qual.*

The life settlement market is well-known to be lacking in publicly available data, but nonetheless, we wanted to try and take the pulse of the market for our monthly poll, asking our readers, *'What Is Your Best Estimate for the Total Value of Life Settlements in Assets Under Management (AUM) Across All Life Settlement Funds?'* Unsurprisingly, there is not much of a consensus.

The impact of Covid-19, both short and long term is a vital concern for life settlement industry participants. **Vince Granieri**, CEO of **Predictive Resources**, discusses the extent of the impact of the pandemic in our second commentary piece this month, '*Have We Learned from The Past or Are We Doomed To Repeat It?'*

New York state's highest court recently held that the First Amendment to New York Department of Financial Services' Insurance Regulation 187 is constitutional. *Greg Winterton* spoke to **Barry Flagg**, President, Founder & Inventor of **Veralytic**, to learn more about the implications of the ruling for this month's Q&A.

Investment due diligence on alternative credit strategies does have commonalities with modern portfolio theory but in the ILS space, it's not that cut and dried. *Greg Winterton* spoke to **Rainer Gruenig**, Managing Partner, Senior Portfolio Manager and CEO and **Dirk Schmelzer**, Managing Partner, and Senior Portfolio Manager at **Plenum Investments**, for *Understanding Risks Means Understanding Opportunities in Insurance Linked Alternative Credit Strategies.*

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 drop the team a line at editor@liferisk.news. In the meantime, on behalf of ELSA, we hope you enjoy this new issue of *Life Risk News.*

Life Insurance Companies Continue To Offer Opportunities for Private Debt Despite Macro Uncertainty

Author:
Greg Winterton
Senior
Contributing Editor
Life Risk News

High inflation, the spectre of a recession and an increase in the cost of borrowing could put pressure on many SMEs that have taken out floating rate loans from private debt shops or that are looking to restructure existing debt or take out additional loans in the coming twelve to 24 months. It's an industry wide challenge that the private debt sector - by far the largest subset of the alternative credit market – will face in the short term.

Some of the nuances of the life insurance industry may provide some kind of insulation from the coming storm. Life insurance companies tend to make more money in a rising interest rate environment because the premiums received from any new business they underwrite can be allocated to higher yielding investments; ergo, they are healthier counterparties for investors and lenders.

> "Part of the reason that the insurance sector is less well served by private debt than, say, the manufacturing industry might be is because of the comparatively higher level of complication of the respective companies."

Despite this benefit, however, this subset of the direct lending market remains an under resourced one. Dan Knipe, Founder and CIO of speciality lender and KKR portfolio company Kilter Finance, says that there is a perception issue amongst investors that is a touch misguided.

"Investors tend to only see a handful of household names. This larger end of the insurance lending market is very efficient from a capital markets perspective as the issuers are generally listed and can tap the debt capital markets when they need to," he said. "But below that, it's super inefficient because private lending is out of scope for the investors in the large public bonds and traditional private lenders don't have the familiarity with the balance sheet side of the insurance sector. When you look at the amount of capital across European and US life insurers, there's in excess of $1.5trn worth of capital and surplus. The tail of potential borrowers for private debt solutions is really long."

Part of the reason that the insurance sector is less well served by private debt than, say, the manufacturing industry might be is because of the comparatively higher level of complication of the respective companies. Lenders to manufacturing or retail businesses, for example, understand where the revenue comes from, and they have a good sense of what needs to be done to engineer a recovery, if necessary. But life insurance companies are complicated businesses with additional layers of complexity over many others.

"A life insurer's balance sheet is very large and materially different to businesses whose revenues are derived from the provision of services for a fee. It's a heavily regulated sector, so debt underwriting, debt management and any debt workout requires specific and specialised experience and skills," said Knipe. "Private debt markets are available to insurance services businesses that don't need large balance sheets. For life insurers who have a material balance sheet the presence of complex regulatory, rating and accounting interactions opens up an interesting opportunity to earn excess returns as compared to lending to simpler businesses."

Investors looking at the life insurance sector as an alpha generator should also need to drill down on the differences in exposure to life and non-life carriers as Luca Tres, Head of EMEA Strategic Risk and Capital Life Solutions at Guy Carpenter, explains.

"On the life side, catastrophe risk tends to be fairly limited (we witnessed this during the Covid-19 pandemic), but the asset risk component is usually more prominent than for property and casualty carriers because of the longer duration of the life insurance liabilities and the savings components that many life insurance policies have. Also, it's very different to lend to a life insurance company with a traditional risk product mix and a conservative investment portfolio. And the jurisdiction of the borrower can have an important role itself, since capital requirements, investment and risk guidelines can be different."

Additionally, the wide range of debt financing opportunities in the life insurance market - reinsurance-based financing, senior bonds/loans, Tier 2 financing, RT1 financing, etc. – need to have the risk exposure analysed and understood.

"These are all insurance lending structures, but the risk can differ materially depending on the type of financing. Also, insurance holding company financing versus financing a transaction at the operating company again has a different risk profile," said Tres. "Insurance lending provides different risk/reward profiles suited to different investors' needs in different parts of the credit cycle, so every situation needs to be analysed on a case-by-case basis."

> "the regulatory framework tends to isolate an investment in a life insurer from many of the cyclical impacts you might see in other sectors. We'd encourage investors to take some time to understand the large opportunity set in the space."

Investors look to credit investing as a lower volatility yield generator that serves as a diversifier to public and private equity exposure. Tres says that in times of economic uncertainty, life insurance companies can provide a defensive element, too.

"Lending to highly regulated businesses like life insurance companies can make a material difference compared to non-regulated businesses. While one could argue that asset risk is one of the largest risks (especially in a volatile macroeconomic context) for insurance companies, in a stressed context, the regulation that insurers are forced to comply with by definition puts lenders in a better position compared to many other industries. In Europe for example, Solvency II forces insurance companies to have capital covering the 99.5% worst case scenario; if you exclude insurance and banking activities – where do you see anything that's comparable?"

For Knipe, those potentially interested in accessing the life insurance space for fixed income returns need to get comfortable with the potential correlation of returns in the space to the broader fixed income and equity markets, but he agrees that the regulatory situation can act as a defensive support and urges investors to take more notice.

"You can't say that there is a zero correlation between life insurance companies and financial markets – there is always some level of correlation," said Knipe. "But the regulatory framework tends to isolate an investment in a life insurer from many of the cyclical impacts you might see in other sectors. We'd encourage investors to take some time to understand the large opportunity set in the space. It's an opportunity to access a diversifying return stream to complement a broader private credit portfolio."

Roundtable
Life Settlement Brokers

Author:
Greg Winterton
Senior
Contributing Editor
Life Risk News

Data from *The Life Settlement Report*, *a part of The Deal* suggests that 2021 saw a reduction in deal activity in the secondary life settlement market, the first such reduction in seven years. *Life Risk News'* **Greg Winterton** spoke to life settlement brokers **Rob Haynie**, Managing Director, **Life Insurance Settlements, Inc.**; **Jon B. Mendelsohn**, CEO, **Ashar Group**; and **John Welcom**, Founder & CEO, **Welcome Funds** to get their views on the current state of supply of life settlements in the United States, and what the picture looks like going forward.

GW: Did you observe a pullback in activity – i.e., life insurance policies coming to market – in 2021 and if so, what drove that retraction?

JW: We did. The most obvious issue was the Covid-19 pandemic. The past few years have probably been the most important time for a senior to keep their life insurance policy as opposed to sell it on the secondary market. Until the beginning of this year, there was also a historic run up in the stock market as well as real estate values, which drove consumer confidence amongst seniors and enabled them to continue to pay their life insurance premiums. Also, due to Covid-19 lockdowns, many advisors were unable to meet with their clients to discuss the life settlement option. Overall, it was a slight slowdown for a year or so to sell a product that frankly, seniors should have kept during this time, if they could afford to do so.

> "due to Covid-19 lockdowns, many advisors were unable to meet with their clients to discuss the life settlement option. Overall, it was a slight slowdown for a year or so"

RH: The market definitely pulled back in 2021 and I agree that Covid-19 was the primary driver of that. Different states had different approaches to lockdowns, so it wasn't that part of the pandemic that drove the pull back – it was the uncertainty. It seemed like every time that the data seemed to improve, another variant appeared, and it became something of a Groundhog Day experience. 2021 seemed like a year of false starts, for many people, of course, and certainly for our industry.

JM: It's important to point out that this transaction can be a very personal transaction. There is typically someone there to assist the senior through the process of selling their life insurance policy; when you would send a one-to-two-inch package of contracts to a client, and ask them to execute the documents virtually, that can be a difficult task. Obviously, there are electronic signature solutions in real estate and other sophisticated markets, so maybe there could have been opportunities to speed up the transaction, or at least, have it not stall. There was still the challenge that clients were unwilling to meet with their attorney to review the documents. This definitely held up activity for those who were still willing to sell during the pandemic.

GW: Have you seen deal flow return in 2022, and if so, what is driving the increase in activity?

JM: In the last 3-6 months or so, we've seen a 20-30% monthly increase in policies for review. We have a process to determine if the life settlement value will meet the client's expectations or whether there is a mismatch, but there's still a significant uptick in policy holders looking to sell.

In terms of what's driving an increase in activity, we're seeing advisors start to become re-engaged. Most importantly, we've seen a focus on best interest regulation and the potential liability on an advisor of not disclosing the life settlement option. There's a huge shift occurring in the financial planning space related to life settlement and the importance of disclosing all available options. This is signalling that we will receive an uptick in policy flow.

JW: I agree. When we go to producer networking events, while we typically have seen the same faces for the past decade, a good percentage of advisors are finally accepting the marketplace. Their change in view is most likely due to consumer awareness brought on by TV commercials or due to clients asking them about the life settlement option. They know it's a regulated industry, they know that consumers are educated, and this is almost forcing them to accept it into their practice.

Rob Haynie
Managing Director
Life Insurance Settlements, Inc

We're seeing a big pick up with first time advisors and also with distribution networks beginning to do RFPs so that they can conduct due diligence on brokers to become their premier partner on settlements.

Those are some great future indicators for the market.

RH: When the data comes out next year looking at 2022 as a whole, I'd bet heavily that we'll see a significant increase in transactions. I would also add that many potential sellers who choose not to sell their policy in late 2020 and into 2021 ultimately sold their policy after they became vaccinated, or they simply grew more comfortable living in a post-covid world – or both. There has been a significant backlog in our market and I'm sure that industry data for 2022 will show an element of catching up.

GW: When you take a policy to an investment fund or their provider, has the buy box shifted at all in the past couple of years?

RH: The parameters for the industry as a whole have expanded. Funds are buying longer life expectancies and smaller face values. This all stems from increased competition in the space – more buyers have entered, so funds are being more flexible in the sense that previously, they had a very defined buy box – it was much more rigid. Now, it's a bigger buy box and even then, the limits aren't as hard and fast as they were even a few years ago.

> "Now, it's a bigger buy box and even then, the limits aren't as hard and fast as they were even a few years ago."

JW: I think every policy is able to be sold if the economics are positive but there are those that are more attractive to investors, such as guaranteed universal life and return of premium products. Those policies garner increased competition and more aggressive discount rates. It's just the nature of those products and how well they are priced. These policies have low back-end tail risk, and typically never go negative, so that's a great investment for a fund. More of those products were sold over the last 5-10 years and I think that more will continue to come to market.

JM: We're seeing the acceptable range for longer life expectancies expand. There is a huge opportunity to purchase policies at a better IRR and at a lower spend. This could be a unique approach for investors grow the market, while building even larger portfolios. It still better than the policyholder surrendering a policy for minimal value. It's a binary decision – do they want more money or less?

GW: What kind of impact has the direct-to-consumer business had on deal flow? Is TV advertising driving enquiries to your businesses?

RH: TV, Radio and Social Media advertising has helped raise awareness for both the general population as well as the advisor community. Obviously, the advertising is primarily targeted at individuals to call up the advertiser and sell their life insurance policy directly to them but a range of people see the ads, including advisors.

Also, fiduciary duty concerns are also driving renewed interest from the financial planning community. It's becoming increasingly difficult, borderline ridiculous, to not have a life settlement strategy as part of your financial planning toolkit and we're seeing financial planners coming around to that now.

JM: It's had a significant impact. It's like a pharma company that markets direct to the consumer and then people call their doctors to ask, 'will this work for me?' We receive incoming calls on a daily basis telling us that 'my client saw a commercial on TV, and could this be an option for them, or could you give me an idea of what their policy could be worth?' DTC has positively impacted the industry. A rising tide lifts all ships.

GW: Let's move onto the other side of the table. Many funds think that the buying process is slow. How can it be sped up?

JW: Look - we're going to bring an excellent file to market with as much documentation as possible to price the policy quickly and accurately. And, since we have all of our historical trading data and an internal valuation completed when we take a policy to market, we already know the target discount rate that a policy is likely to trade at. So, when funds start the bidding off with low offers (at high discount rates), we know we have a long way to go. We think that funds and providers should make aggressive offers early on – it's the small incremental bidding that drags negotiations out for 2 weeks. The majority of these policies will sell for low double digit discount rates so when bids start out at 18-20% IRRs, that's just a placeholder to get the bidding started. I'd say to funds that want to speed up the auction process, they should consider sharing their maximum valuation with their provider and trust them to bid on their behalf as the price increases.

Jon B. Mendelsohn
CEO
Ashar Group

The bidding process will be expedited since the provider can immediately respond when new bids come in. That can save a week or 2. We understand the negotiation process is painful, but the incremental bidding is what causes that. We'd love to speed that up. The reality is that we represent the consumer, and it's our job is to get them the highest offer...and that's what we do.

RH: Closing documents often cause a hold up. Sometimes, I see documents in the closing packages that honestly, I feel are unnecessary. Some situations, for example when an offer is based on a longer life expectancy (and therefore the offer is lower) on a smaller face policy, require multiple designees to sign off on the deal versus a larger face value settlement where a larger sum of money is expected. But the client isn't always comfortable with sharing his or her personal business with multiple individuals, so this can cause days or sometimes weeks of delays. Another one is that I think that some contracts require too many pages to be notarised. It's pretty obvious that the faster the contracts are delivered to all parties, and the easier they are to execute, the more transactions we'll complete as an industry.

> "Many times, the initial offers are too low for an acceptance and issuing contracts. As the bidding and contracting process comes to an end, there can be some transaction fatigue."

JM: We all run analytics for what a policy could be worth. We have comps of similar policies and life expectancies. Our job is to manage the expectations of the client, as well as the advisor, the lawyer, or the CPA. We show those numbers up front. We invest thousands building a complete file before we send it to market. Many times, the initial offers are too low for an acceptance and issuing contracts. As the bidding and contracting process comes to an end, there can be some transaction fatigue. We've heard many times that it can take the client less time to sell their house, or their business. We have a lot of ability to compress time frames in a life settlement transaction; however, it would be helpful if the funds started bidding higher and responded faster during the policy auction process. That would speed everything up.

GW: Is there anything else that can help increase the supply of policies coming to market?

JM: More success stories from clients and advisors is the key. Also speeding up the transaction. It's not uncommon that providers will say something like 'our fund has a 5-7-day turnaround'. They feel that their hands are tied to some extent. I think that giving more authority to the provider in certain areas would be more efficient. If we can save 1-3 business days 4-5 times during the process, you have cut a couple of weeks off of the overall sales cycle.

We've heard talk of feeder funds where the investors can place policies that are just outside their main portfolio's buybox. Funds often say that a life expectancy is 2-3 months too long, even if we tell them that the policy will 100% close with a 1-3% total offer. If we get a couple wins just outside the traditional parameters, that could create a tremendous upside as billions continues to be lapsed or surrendered annually that our industry should be able to find a way to capture that value and help the consumer.

John Welcom
Founder & CEO
Welcome Funds

JW: I think more success stories will help. When we go to a smaller study group of advisors with, say, 50 people, and 80% of them have been against life settlements for the past 15 years, all it takes is for a couple of them to have done a deal for advisors to start sharing stories. You call out someone, 'hey, Jim, you did your first deal, you got commission and your client got $900,000', Jim says their 20-year client is thrilled, and all the advisors start talking. Success stories are huge and can play a big part in advisor awareness.

Getting Fast No: Machine Learning in Pre-Qual

Author:
Matthew Sheridan
Former Life Settlements Portfolio Manager and Author of 'The STOLI Worm'

Most of the activity in the life settlements market today consists of tertiary blocks of business re-trading into increasingly stronger hands at increasingly fairer prices. Fresh capital continues to flow in and, since tertiary brings no new supply, secondary origination ought to be the natural home for that money. For some reason the secondary market falls short. Consumer education and marketing costs are often cited as major headwinds to growth in the secondary market, but there's a more local, intrinsic effect which tends to be less obvious, especially to those on the buy side.

Basic life settlements probabilistic pricing tells us that cases with a premium stream greater than the death benefit will have a negative present value. If, like me, you were buying policies in the mid-2000's, negative valuation wasn't an outlier, it was the norm. Hours were wasted loading case after RSI-inducing case into a spreadsheet, typing in AV and CSV through to age 121, only to bin most of them because the first two LE50s were five years apart.

To be a viable life settlement, a case almost always needs to show a material change in the policyholder's health since the policy was issued. A second supporting factor is a low premium rate on the policy, maybe due to some aggressive assumptions by the carrier at issuance in order to print business. If neither of these are present, the case will more than likely have a negative present value from an investor's standpoint. And that's before fees — and fees are key.

Buy-side pricing was tedious but at least all the information was provided. Secondary market originators face their own triage pain, but they often don't have the source information. Given that most cases will not ultimately qualify as life settlements, originators must deploy resources carefully, be that dollars to buy LE reports, or time in calling an uncooperative carrier for an illustration. Origination fees only come from cases that actually settle, but this income then has to cover all costs incurred -- the successes and the failures. It follows, then, that a relatively high number of failures drives fees up in the aggregate. If we imagine the universe of candidate life settlements, some cases would be successes if not for the fee load. So, a more efficient triage process leads to lower fees which in turn leads to increased supply.

This process is known as pre-qualification ("pre-qual"). If we know most cases will be a No, how do we get to that No as fast and cheaply as possible. There are two distinct unknowns to estimate: the insured's health status and the policy's premium profile. These are the two main inputs to a life settlement's future cashflow profile, so they have a connection in prequal. The more certain we are that one of them is at an extreme, the less we need to know about the other. To see this, take a boundary case. If a policy is paid up, i.e., the future premium stream is zero, then we really don't need to know the LE to conclude the case will price positively in the market. Similarly, though less extreme, if we know an insured is experiencing, say, some form of cognitive decline then the policy is likely to qualify regardless of the premium structure. Keep in mind that prequal, like life settlements is probabilistic in nature. We're not looking for perfect accuracy on each case, and nor are we looking for a valuation. It's more a binary yes/no over whether a case will achieve a certain threshold price.

"To be a viable life settlement, a case almost always needs to show a material change in the policyholder's health since the policy was issued. A second supporting factor is a low premium rate on the policy, maybe due to some aggressive assumptions by the carrier at issuance in order to print business."

> "The model had learned a solid representation of market-wide COI structure and was effectively detecting cases that were priced far from a fair value level."

The realisation that machine learning could be useful in prequal came around 2016 when carriers started to increase cost of insurance ("COI") rates. COI is the main input a carrier uses to set premiums levels. Retroactive increases in COI were economically devastating for life settlement investors but were more like drone strikes than carpet bombing. And fund managers found themselves suddenly having to explain a risk that never was, and then figure out where the next strikes were going to be. I looked at this prediction issue for a major manager, and it had the feel of a classifier problem in machine learning.

At a non-technical level, we show a model a few thousand life settlement cases. We provide features for each case, e.g., age, sex, smoking status... and the (pre any increase) COI curve. We also tell the model whether the COI on that case was increased or not. The model then tries to separate the two classes – increased and not increased – using a mix of the input features. Setting this up is a delicate balance. Ideally, we'd have millions of cases for model training and a meaningful number of COI increases. We didn't, so feature selection must be judicious, or the model will lock onto some chance relationship that explains the cases its seen but doesn't generalise to the future unseen cases – which is the entire purpose of the exercise. There's also a problem that negative cases aren't quite a "no", they could potentially be a "yes but not yet."

Early results were patchy but there was some hint of predictability. There then followed another wave of increases by other carriers which focussed attention more giving us an expanded training set, more positive cases to train with, and a more corrected target set. Model performance increased dramatically, and John Hancock Performance UL was spat out as a very likely candidate for increase. The next question was, if you can predict where the increases will come, can you also predict how much they'll be. Yes, we could. The model had learned a solid representation of market-wide COI structure and was effectively detecting cases that were priced far from a fair value level. The gap to fair value gave the magnitude of a likely COI shift, and from there it's just maths to get to the premium effect the policyholder will face. When looked at this way, the seeming mystery about why increase amounts varied so widely dissolved.

The final step was to realise that with enough training examples, the model could learn the COI structure of the entire market. Suppose you're looking at a Transamerica Trans-XYZ from 2008 on a 76yr old male preferred, and you can't get an illustration. At an intuitive level, the model looks at surrounding cases that it does know about. It "knows" the relative cheapness of cases in that 2008 vintage versus others. It knows how Trans priced against, say, AXA at that time; it knows how preferred vs standard risk is priced, etc. It synthesises these weak relationships, and, in the aggregate, they become strong -- coalescing on a COI estimate that's, probably, good enough for prequal.

November 2022 Poll Results

What Is Your Best Estimate for the Total Value of Life Settlements in Assets Under Management (AUM) Across All Life Settlement Funds?

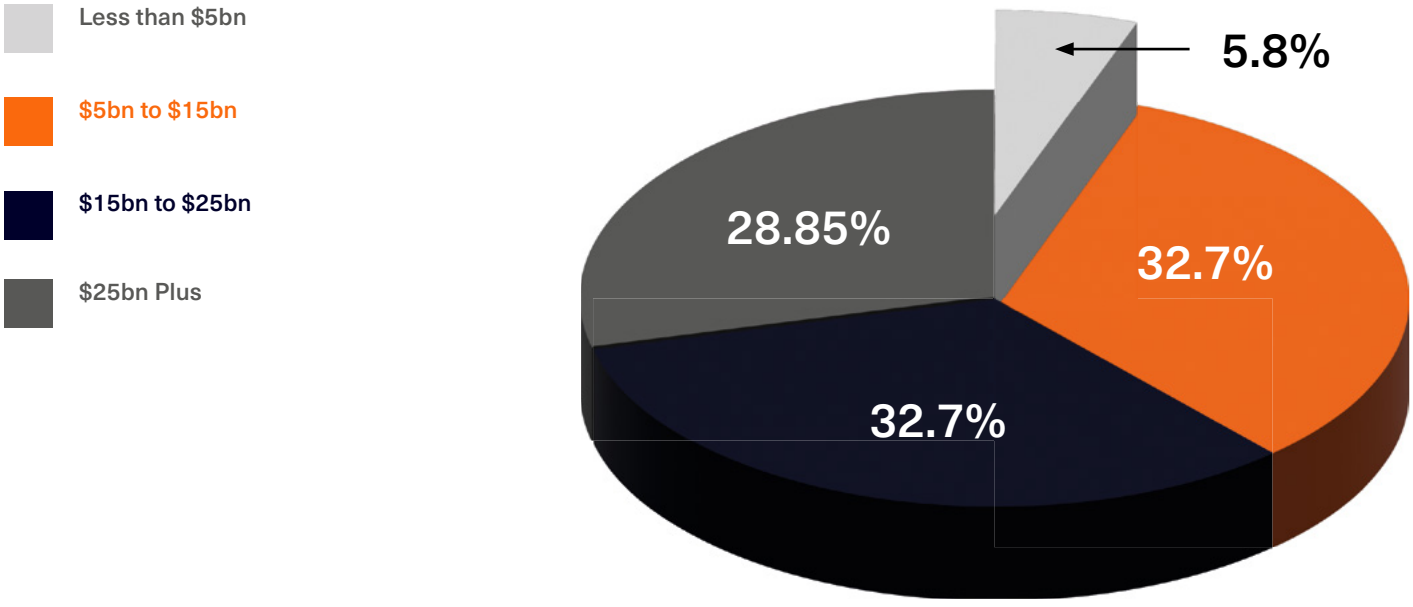
Author:
Greg Winterton
Senior
Contributing Editor
Life Risk News

The size of the life settlement market is difficult to measure, given the lack of both publicly available and industry-produced data when compared to other alternative asset classes.

So, for this month's poll on Life Risk News, we asked our readers for their best guess; the results were fairly evenly distributed.

Perhaps unsurprisingly, a small percentage of readers felt that the total size of the industry was less than $5bn AUM. After that, however, opinion was fairly evenly split. 32.7% of readers think that life settlement industry AUM is between $5bn and $15bn; the exact same percentage think that industry AUM is between $15bn and $25bn; and 28.6% of readers think that it's over $25bn.

What's generally accepted is that the life settlement market is the largest of the various life risk-based markets. But clearly, putting even a directionally accurate figure on the size of the market is difficult even for industry insiders.



Have We Learned from The Past or Are We Doomed To Repeat It?

Author:
Vince Granieri
CEO
Predictive Resources

Like many things in life, longevity markets have followed broad cycles. Industry veterans will remember a particularly painful turn in late 2008, when new information regarding life settlement population mortality was reflected in industry life expectancies. In response, some industry players adapted better than others. In 2019, there was another market downturn, and those who learned from 2008 were rewarded.

Covid-19 has provided an opportunity for the industry to demonstrate what we have learned – but will we? We have been recently inundated with data about Covid-19 and its effects on mortality. Some of this information is applicable to life settlements, but some is not. Yet there is no broad recognition of that fact. This paper presents a general overview of the situation. Specific details and calculations are beyond its scope but are available upon request.

> "Covid-19 affected nearly every element of life for nearly everyone. Increased mortality was observed among most populations. It was critical for both investors and policyowners in life settlements to assess the proper response."

The Issue

When the industry initially shifted from viatical settlements for HIV patients to impaired seniors, folks presumed that life settlement population mortality would resemble that of the life insurance population and life insurance mortality tables would properly reflect this. That made sense, as both populations underwent the life insurance underwriting process and owned policies. But it was not a good assumption and it led to a market crash in 2008, for three main reasons as outlined in a paper I wrote in 2011:

1. The insured had better information about their health than was contained in their medical records and they would select against the investor, selling if their health was better than expected and vice-versa.
2. The life settlement industry, with its fragmented sources of data, did not have statistically significant data bases to prove this phenomenon until 2008.
3. Use of the 2001 VBT without adjusting for mortality improvement, would have led to issues even if these two populations had very similar mortality.

The lessons of 2008 included understanding that the life settlement population is somewhat unique and certainly different from the US general population and the US life insurance population, and it was necessary to assume future mortality improvement in valuing policies.

Current Environment

Covid-19 affected nearly every element of life for nearly everyone. Increased mortality was observed among most populations. It was critical for both investors and policyowners in life settlements to assess the proper response. Given the uncertainty of the situation, initial responses from all parties were to delay or forego transactions. With the rapid resolution and binary outcome of Covid-19 infection, this was a perfectly logical response. Over time, two important issues emerged – the lasting effect of Covid-19 on mortality rates, and the emergence of so-called 'long Covid' (cases where victims survived but symptoms remained). Given the widespread impact of Covid-19, studies were plentiful and prioritized. It was only a matter of time before these studies were completed. This is the news that everyone was waiting for.

> "The impact of Covid-19, both short and long term is a vital concern for life settlement industry participants. Properly judging its impact is a key task that is made more difficult by the myriad of data that is being disseminated."

Information Overload

As I looked at the myriad of information being disseminated, it was difficult to hold back from leaping into action. Soon, statistics were being widely quoted in industry gatherings about Covid-19's effects. But did we learn from the past? Perhaps it's too early to tell. Let's review the important lessons from the past.

The life settlement population is different from the US general population and the US life insurance population. The studies are clear – Covid-19 increased mortality by 15-20%. A closer look reveals that this applies to the general population, not the life settlement population. Further, by isolating Covid-19 as a cause of death, the fact that deaths from another cause, the flu, virtually disappeared. The Society of Actuaries published a study that suggested that the life insurance population suffered 15% excess mortality from Covid-19. Again, this is not our population in life settlements. The SOA study did provide insight that might be useful for life settlements. At ages above 65, excess mortality was far lower than the rate for the overall life insurance population.

But when we look at data from life settlements' populations, the Covid-19 effect is negligible. In the Predictive Resources data base, raw mortality rates hardly moved throughout 2020 and 2021. In fact, the 2017-18 flu caused a bigger mortality ripple in our data. Other industry participants have echoed this finding. Yet the talking heads at industry meetings still quote either population data or life insurance data when talking about Covid-19's effect on mortality. You know better than to listen. Someone may know the general population inside and out, but if they don't understand the life settlement population, they are of little help.

Long Covid. I have also seen and heard quoted, studies from respected institutions of higher learning that place the percentage of Covid-19 cases that will eventually become long Covid cases at 30-40%. Those figures are shocking until you carefully read those studies and realize they define long Covid-19 as symptoms lasting over 2-3 weeks. Again, the lessons learned from the past can help us today.

Mortality improvement. Covid-19 has hampered researchers studying mortality improvement in the general population, as it presents a one-time blip that may or may not continue. Since life settlement populations are so small, it's not possible to extract statistically significant mortality improvement statistics. In those instances, give careful consideration to other populations, and take care to not rely too heavily on the conclusions. Recent research by Predictive Resources suggests both age and birth era are appropriate independent variables from which to derive mortality improvement statistics. Given recent trends in obesity and other factors, it is quite possible that, for the first time in centuries, mortality may no longer be improving.

Conclusion

The impact of Covid-19, both short and long term is a vital concern for life settlement industry participants. Properly judging its impact is a key task that is made more difficult by the myriad of data that is being disseminated, much of which needs to be judiciously evaluated in order to avoid similar mistakes of bygone eras in life settlements.

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Q&A

Barry Flagg

President, Founder & Inventor, Veralytic

In a unanimous decision on October 20th, New York state's highest court recently held that the First Amendment to New York Department of Financial Services' Insurance Regulation 187 is constitutional. Life Risk News spoke to Barry Flagg, President, Founder & Inventor of Veralytic, to learn more about the implications of the ruling on the life insurance industry.

LRN: Barry, the to-ing and fro-ing around New York state's Reg 187 has finally come to an end. In your view, what is the immediate implication for the life insurance industry now that it has clarity going forward?

BF: Now that the to-ing and fro-ing around New York state's Reg 187 has finally come to an end, the life insurance industry can begin the transition towards serving client's best interests in ways more consistent with the meaning of client's best interests for every other asset on clients' balance sheets. The immediate implication is the industry will start learning a "new language". I believe this difference between the "old language" and this "new language" is the reason industry participants argued that Reg 187 was "unconstitutionally vague". If you asked me to follow instructions written in some language I don't speak, I'd also find those instructions at least "vague", if not down right impossible, for me to follow until I learned that other language. Now that we have clarity for this "new language" going forward, more and more financial services professionals will be speaking the same "language" resulting in better cooperation and coordination between insurance and investment professionals, and better integration of insurance and investment products in ways that better serve the client's best interest.

LRN: Do you think that New York-based RIAs will now begin to incorporate life insurance into their client's overall financial and estate plans now that there is clarity around the 'best interest' rule, and therefore, a fiduciary duty?

BF: Perhaps, but I also think many RIAs could still be slow to incorporate life insurance into client's financial and estate plans for a couple reasons. First, because the "old language" for talking about insurance products didn't even include the words essential to performing fiduciary duties, I think many RIAs will be sceptical and getting past that scepticism will take some time. Second, while the meaning of client's best interest under Reg 187 includes important similarities to most fiduciary rules, because the duties prescribed in Reg 187 are still somewhat different than the duties prescribed under most fiduciary rules, those differences will need to be reconciled, which will also take some time. All that said, I know of forward-thinking insurance professionals who see the business opportunity in serving RIAs as their outsourced insurance desk (OID) by speaking their language.

I also know The Center for Board Certified Fiduciaries is teaching a program at Wake Forest called InsuranceMetrics that reconciles these differences in these different regulatory regimes. For all these reasons, I think it's only a matter of time until RIAs begin to incorporate life insurance into their client's overall financial and estate planning.

LRN: What about other states? Could this act as a catalyst for other states to follow suit?

BF: I do think other states will adopt a Best Interest Rule for life insurance in some form or fashion. For instance, the NY Department of Financial Services (DFS) was first to propose a Best Interest Rule just for annuities. The National Association of Insurance Commissioners (NAIC) has now also promulgated a Best Interest Rule for annuities that includes many of the provisions of the original NY DFS annuity rule. This NAIC Best Interest Rule for annuities has now been adopted by some 30 states. NY DFS then expanded their Best Interest Rule for annuities to include life insurance. The SEC also issued Reg BI which also applies best interest principles to certain life insurance policies. As such, I believe it's just a matter of time before other states adopt a Best Interest Rule for life insurance in what I call on LinkedIn the #RelentlessMarch towards #ClientsBestInterests.

LRN: In the life settlement market, many asset managers highlight how high lapse rates in policies adversely affect deal flow. Do you think that increased RIA participation in the life insurance industry will have an effect on deal flow coming to market for life settlement brokers?

BF: Absolutely, due to a couple of motivations. First, RIAs generally pride themselves on being able to advise their clients on all things financial and more in some cases. Life insurance has been the glaring exception, albeit because RIAs have not had access to the information essential to fiduciary advice. Best Interest Rules like NY Reg 187 and SEC Reg BI are rectifying that, and I expect will result in increased RIA participation in providing life insurance advice to their clients. Advising clients over time (i.e., beyond the initial placement) in response to inevitably changing needs will invariably result in more opportunities to sell client's policies on the life settlement secondary market. Second, selling a policy on the life settlement secondary market that is or will soon otherwise become worthless increases the AUM for the RIA.

Barry Flagg
President, Founder & Inventor
Veralytic

As such, now that RIAs have access to information essential to fiduciary advice, many will be motivated to advise clients both about life insurance and life settlements both for the "psychic income" from being even more of an expert in serving clients' best interests and for the additional "financial income" from more AUM, thereby increasing the deal flow coming to life settlement market.

LRN: Finally, Barry, what else is still acting as a headwind to better performing life insurance policies and what can be done about it?

BF: Life Insurance is the last, largest, most neglected in client's financial and estate plans. As with anything else, neglect more often than not results in poor-performance. Life insurance is no different and as a result is arguably the worst performing asset relative to client's expectations. I believe this poor performance and high lapse rates are due to the fact that life insurance has been almost completely left out of the wealth management process. Wealth management involves both the management of assets (i.e., investment management) and the management of liabilities (e.g., income needs beyond retirement, income taxes, estate taxes, etc.).

RIAs are currently best at investment management. Insurance professionals and products are best at managing liabilities. Anything that's catalytic to bringing these professions and professionals together (e.g., like Reg 187) will result in better overall wealth management, increased use of insurance products in clients' financial and estate plans, increasing consideration of life settlements that benefit both the insurance professional and the RIA with more AUM, and better serve client's best interest. Anything that maintains the status-quo is a headwind.

Understanding Risks Means Understanding Opportunities in Insurance Linked Alternative Credit Strategies

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When conducting investment due diligence on a strategy for inclusion in their portfolios, one of the first things that investors look at is the volatility profile of the return stream. It's understandable, because timing an investment is one of the hardest endeavours in finance - just ask people who bought Bitcoin in 2017 and 2021 – and if attractive medium-long term returns seem to be influenced heavily by timing, that's a tough sell to an investment committee.

It's also understandable because most investors have public equity and/or public/liquid credit experience. So, it makes sense to apply this logic to alternative credit strategies too, right?

In some parts of the industry, like private debt, perhaps. But not so much in the insurance-linked securities space. That's according to Rainer Gruenig, Managing Partner, Senior Portfolio Manager and CEO at Zurich, Switzerland-based Plenum Investments, who says that ILS products need to be viewed through a slightly different lens.

"When you talk about insurance-based risks, we are actually talking about tail risks. Analysing insurance-based strategies needs approaching from a completely different angle as opposed to equity and bond portfolios where you are dealing with modern portfolio theory. Drawdown risk is the predominant risk here. Many investors struggle to understand that volatility is not one of the main measures for risk in the insurance linked securities space."

> **"Digging into the nature of expected drawdowns, necessitates an understanding of expected losses, another critical aspect in the investment due diligence process on an ILS strategy."**

Digging into the nature of expected drawdowns, necessitates an understanding of expected losses, another critical aspect in the investment due diligence process on an ILS strategy.

Gruenig highlights drawdown risk because tail-risk events affecting insurance companies can take longer to unwind, and consequently, investment returns from insurance-based exposures can take longer to recover but normally go in line with higher risk compensation (premiums) that again shorten the recovery time. It's another area of Investment Due Diligence (IDD) that Gruenig says requires a different view.

"Investors looking at any product with non-normally distributed loss events should be looking at the maximum drawdowns usually modelled on the basis of historic events and the resulting average expected yearly loss. The portfolio manager's task is to minimize drawdown risk at a given premium income level," he said.

Other risks in the IDD process includes counterparty risk: in private equity, that's the portfolio companies; in equity hedge funds, it's the public companies they have a stake in; and so, in insurance linked securities, it must be...the insurance companies?

Yes, in life settlements and life ILS strategies generally. In the former, one of the two main counterparties, alongside insurance companies, is the individual insured person – if they live longer than expected, that will impact returns. In the latter, most of the transactions carry mortality risk – the risk that the individuals who are the underlying policyholders that the life ILS funds have exposure to live a shorter life than expected.

But in the catastrophe bond market, insurance companies aren't the risk counterparty: the U.S. Government or the World Bank is. That's because the special purpose vehicle that holds the catastrophe bonds invests in U.S. Treasury Money Market Funds or IBRD notes, and if there are no disasters, the principal is returned to the investor at maturity. It's another common misconception in the space, say Dirk Schmelzer, Managing Partner, and Senior Portfolio Manager at Plenum.

"For every cat bond you create, it's an SPV, and its fully collateralised. The risk is transferred from the insurance company completely to the SPV. Insurance companies are not a counterparty risk in catastrophe bond investing – the risk for a cat bond strategy is the insured natural disasters."

Understanding the nuances of these risks also helps to understand the opportunity. From a counterparty perspective, life insurance companies offer a significant benefit.

"Life insurance companies are controlled by a regulatory regime that helps protect against insolvency, like Solvency II in the E.U. And in the U.S., even though many insurance companies are regulated at the state level, similar measures apply and in the worst-case scenario, the ultimate measure is to hand over a non-solvent carrier to one that is solvent or distribute the book to several solvent carriers. That's never happened, which shows that the measures work. The counterparty risk for the book of the life insurance company is very, very small which makes a strong case for life insurance linked securities," said Gruenig.

> **"The diversification aspect is one of the main reasons for including either life ILS strategies or non-life ILS strategies – or both, because they have different risk exposures and drivers of returns - in a diversified portfolio."**

In the catastrophe bond market, the risk counterparty is a natural disaster. They are incredibly difficult to predict, and devastating natural disasters like Hurricane Ian carry headline risk for the catastrophe bond market, but Schmelzer says that investors should take comfort in the availability of incredibly complicated but reasonably accurate models, and the infrequency of large-scale events like Ian, as well as the independent and uncorrelated nature of these events, that enable the creation of well diversified portfolios.

"There are decades of data and there have been millions of dollars invested by the insurance industry in developing models that can quantify the financial risk of a natural disaster. What investors would struggle with is if Ian cost more than what was modelled, but it didn't - the losses are in line with expectations.

That's a testament to the accuracy of the models we have available," he said. "Investors are willing to accept that and they're not moving out of the segment because of that terrible event. The drawdown is in the range of what is to be expected. Investors look to strategies like cat bonds for the long term and it's our job to set their expectations accurately."

The current macroeconomic environment presents investors with a short-term conundrum – do they pause their alternative credit allocations to take advantage of the current higher yields from government debt before resuming again in the future when rates come down, or do they persevere with their original plan? For Schmelzer, those that are keen to learn more about insurance-based strategies could benefit whether these be life- or non-life based.

"Cat bonds are floating rate instruments – if the fed changes rates, that trickles into the coupon payments. There is no price reaction in ILS generally, they're not exposed to credit risk or interest rate risk, and the drivers of return are different. Life settlement prices are not directly driven by interest rates, either. The influence comes indirectly via the level of demand. Therefore, adjustments to higher interest rates may be delayed or don't happen at all, provided the existing demand faces scarce supply that drives IRRs (the discount rate) down while interest rates are flat of rising," he said. "The diversification aspect is one of the main reasons for including either life ILS strategies or non-life ILS strategies – or both, because they have different risk exposures and drivers of returns - in a diversified portfolio."

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