Life Risk News

Volume 1
Issue 8
December 2022

Solvency II Reform Proposals Could Drive Increased Pension Risk Transfer Activity

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Life Risk News
ISSN 2753-7374
Volume 1, Issue 8
December 2022

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Editor's Letter
Volume 1 Issue 8 December 2022

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Life Risk News

The U.K. Government recently published its response to its own Solvency II reform consultation, and the news is good for the country's pension risk transfer market. *Greg Winterton* spoke to **Chris Anderson**, Head of BPA Consulting at **EY**, and **Nicholas Bugler**, Partner at **Willkie, Farr & Gallagher,** to learn about the implications of the reforms in *Solvency II Reform Proposals Could Drive Increased Pension Risk Transfer Activity.*

U.S. life insurance trade body the *American Council of Life Insurers* recently published the 2022 version of its annual *Life Insurers Fact Book*. This year's edition shows lapse rates falling both in terms of the number of policies and face value, and *Greg Winterton* spoke to **Christopher Conway**, Chief Development Officer at **ISC Services**, **Jon Mendelsohn**, CEO at **Ashar Group**, **Rob Haynie**, Managing Director at **Life Insurance Settlements, Inc**. and **John Welcom**, CEO at **Welcome Funds** to get their views on the impact of lapse rates on the life settlement market in *Encouragement for Life Settlement Industry as Life Insurance Policy Lapse Rate Falls Again.*

The Cost of Insurance component of a life insurance policy in the United States is a perennial hot topic and *Jeffrey Davis* spoke to **Khai LeQuang**, Partner at **Orrick, Herrington & Sutcliffe LLP** and **Steven Sklaver**, Partner at **Susman Godfrey LLP** and **Jule Rousseau**, Partner at **ArentFox Schiff LLP** to find out the current CoI litigation landscape and its potential impact on the life settlement market in *Life Settlement Market Awaits Cost of Insurance Litigation Decisions.*

Our first commentary piece this month comes courtesy of **Hymans Robertson** quartet **Ross Murray**, Head of Longevity Consulting; **Ben Johnson**, Senior Consultant; **Megan Hart**, Senior Consultant; and **Shahrukh Nawaz**, Consultant, looking at what will drive future longevity trends in *Longevity Over The Next Decade.*

Our Poll this month asks, *'Do You Think Institutional Investors Will Pull Back on Their Alternative Credit Allocations in the Next 12–24 Months?'* Life Risk News readers are pretty sure about this one.

Our second commentary piece this month comes courtesy of **Beat Hess**, Founding Partner, and **Gabriel Maeder**, Partner, at **AA-Partners**. The duo look at some of the nuances of a life settlement investment manager's day job in *Life Settlements Portfolio Construction – Art or Science?*

Our *Q&A* this month is with **Ashu Bhargava**, Chief Origination Officer at U.K. pension consolidator, **Clara Pensions**. Clara recently celebrated its first anniversary of completing the assessment process for defined benefit consolidators in the U.K. and Greg Winterton spoke to Bhargava about the organisation's first year since completing assessment, the outlook for 2023 and the broader pension risk transfer market.

Whilst the life settlement market is by far the largest secondary market for life insurance policies in the world, a similar market exists in Germany. *Greg Winterton* spoke to **Christian Siedl**, Executive Director at **BVZL**, to learn about the German model and recent macro events have impacted the industry in *German Secondary Life Market Robust Amidst Cost-of-Living Challenges.*

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.

Solvency II Reform Proposals Could Drive Increased Pension Risk Transfer Activity

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Life Risk News

At the end of April this year, the U.K. Government published its Solvency II consultation, seeking views on the potential impacts of a variety of reforms to the E.U.'s 2016 flagship piece of insurance legislation. The consultation closed in July, and at the end of November, the consultation review was published.

The changes that the U.K. Government wants to implement are potentially good news for the country's pension risk transfer (PRT) market. The headline changes for life insurance companies are changes to both the matching adjustment the risk margin; these reforms could provide a tailwind to defined benefit pension plans (DBPPs) in the U.K. that are looking to close via the PRT market by entering into a full buy-out with an insurance company.

> "The PRT market in the U.K. was already enjoying a solid 2022 before the recent consultation review was published."

"Risk margin rules at the moment drives insurers to transact a huge amount of longevity reinsurance when they complete a PRT deal," said Chris Anderson, Head of BPA Consulting at EY in Edinburgh. "Two potential consequences of the proposed changes here are that first, it may encourage insurance companies to carry out slightly less reinsurance, which could be beneficial on price for pension schemes, and secondly the risk margin on what remains will be lower, which also should be beneficial on price."

The PRT market in the U.K. was already enjoying a solid 2022 before the recent consultation review was published. Data published in September by consulting firm Lane, Clark & Peacock suggested that £12bn of buy-ins and buy-outs were completed in the first half of the year, an increase of 50% on 2021. Part of the reason can be attributed to the rising interest rate environment, which reduces the amount of capital an insurance company needs in order to meet its future liabilities; Anderson says that this is analogous to a rising tide lifting all ships.

"The impact of the rising interest rate environment on well-funded schemes has been lower as they are typically in a well-matched position. But those that were further from buy-out funding levels have enjoyed strong improvements to funding ratios this year. Insurer capital is also sensitive to interest rates, and the rising rates therefore have resulted in lower capital requirements relative to scheme liabilities," he said.

The impact on funding levels from the rising interest rate environment means that the impact of the planned Solvency II reform on the PRT market won't be as pronounced as it would have been without the rate rises. But adding the two together provides significant fuel to power the U.K. PRT market.

There's always a bump in the road, however (sometimes, more than one), and in terms of what 2023 looks like for the PRT market, one of those bumps comes in the form of a lack of talent; not a lack of intellectual capital, more a lack of headcount amongst insurers to absorb the enlarged demand.

"Everyone is trying to find people," said Anderson. "Insurance companies need people to run the quotation process and to onboard schemes. Employee benefit consultants also need additional staff - everyone is resource constrained."

Another unknown revolves around the tussle between the U.K. Government and the Prudential Regulations Authority (PRA, the U.K.'s insurance industry regulator) over the sorts of assets admissible for the matching adjustment. Lawmakers in the U.K. want to broaden the types of qualifying assets – infrastructure investments in particular are seen to be a beneficiary of the reforms - although any investments must still have highly predictable cash flow profiles. Even so, limits to matching adjustment qualifying assets may still undermine some of the gains arising from the change in the risk margin.

Additionally, for the PRT market overall, increased activity in the buy-out and buy-in markets may indeed occur, but at the expense of the longevity swap leg of the PRT stool. The former two both obligate the insurance company to assume both the longevity risk and the asset risk previously held by the DBPP; a longevity swap only transfers the longevity risk to the insurance company.

It's a transaction common for DBPPs that are not funded sufficiently to be able to afford a buy-in or buy-out but one that may see reduced traction in the wake of the changing regulations and consequent insurance company balance sheet health.

"Longevity swaps from a pension scheme to an insurer are most likely to be negatively impacted by the Solvency II changes. Some pension schemes that were previously looking at the longevity swap option can now go straight to buyout because the pricing will be better," said Anderson.

> **"The PRA usually puts out a consultation of its own for matters such as these, but there are still potential banana skins for the life insurance industry if the PRA feels that primary legislation is too relaxed."**

Where longevity swaps could see increased activity is in the PRT reinsurance market. Most PRT deals already reinsure a good chunk of the newly acquired longevity risk and even though a reduced risk margin and a solidified balance sheet (due to rising interest rates) might reduce the need for reinsurance from a pure risk perspective, transferring some of the risk to the reinsurance market means more money for more PRT deals, which in turn creates more opportunity for longevity swaps. It's a virtuous circle.

Those in the U.K.'s PRT market itching to get a piece of this enlarged pie might have to reign in their enthusiasm, however; at least, for the time being.

"The two key reforms in the U.K. Government's response to the consultation relate to the risk margin and the matching adjustment. These rules are currently contained in the delegated act, the subordinate legislation of Solvency II that the E.U. originally wrote. To make these changes, the delegated act will need to be changed," said Nicholas Bugler, a Partner at law firm Willkie, Farr & Gallagher in London. "The government has stated that this will be done primarily by repealing the relevant retained EU law and then replacement of those rules by rules made by the regulators. This process could take several years."

The repeal of retained EU law in financial services will be done under the new Financial Services and Market bill, which is currently going through parliament and will be done piecemeal as and when new UK rules are ready to be put in place. This means that the PRA will have to change its own rules to ensure that the old EU derived rules are replaced by domestic rules. The PRA usually puts out a consultation of its own for matters such as these, but there are still potential banana skins for the life insurance industry if the PRA feels that primary legislation is too relaxed.

"The PRA would obviously not be able to overrule legislation – for example, the new objective to facilitate the growth of the UK economy in the medium to long term. But if it feels that life insurance companies aren't paying attention to all of the risks they face and therefore are potentially not being managed prudently they could use other tools to influence behaviour. This is how they would likely approach it if they had concerns that the legislation was too risky. It'll be interesting to see how that plays out," said Bugler.

What might speed up the process is that there is arguably political will at the U.K. Government level to get this legislation passed so that they can 'sell' it as a Brexit good news story. That's a supposition, but not an unreasonable one, and Bugler says that in terms of timescales, the PRA might move reasonably quickly anyway.

"The PRA will try to prepare their new rules in parallel with the legislative process in the U.K., so they come into force as soon as reasonably possible. HMT says that "significant progress" on the changes to the Solvency II rules is expected by the end of 2023. But quite when full implementation will be is uncertain at the moment," said Bugler.

Whatever the PRA rules end up being, the headline reforms remain a good news story for PRT in the United Kingdom, which is currently enjoying its busiest period.

"Pipeline for PRT is at an all-time high. Some schemes that were only 85% funded are now nearly 100% funded and are coming to market, asking for pricing," said Anderson. "Also, insurers are more solvent – they have seen their excess capital levels increase which means more capital to write deals. It's the perfect storm of improved demand and supply across the board."

Encouragement for Life Settlement Industry as Life Insurance Policy Lapse Rate Falls Again

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Lapse rates – the percentage of in-force life insurance policies in the U.S. that insured individuals voluntarily stop paying premiums on, thus voiding the policy – for individuals in 2021 fell for the second consecutive year, according to the 2022 edition of the Life Insurer's Fact Book, the American Council of Life Insurers' (ACLI) annual report that provides statistics and information on trends in the life insurance industry in the U.S.

The life settlement market depends entirely on insured individuals not lapsing their policies - otherwise, there would be nothing for fund managers to buy - so, a lower lapse rate means more in-force life insurance policies which in turn means, ceteris paribus, a larger pool of policies that might come to market in the future. The lapse rate was 5% in 2021, down from 5.7% in 2020 and 5.9% in 2019; it's an encouraging statistic for the industry.

"It's good to see the lapse rate coming down. There are many nuances to the headline number, but directionally, it's encouraging," said Chris Conway, Chief Development Officer at ISC Services.

The falling lapse rate in 2021 coincides with a fall in life settlement deal activity in the same year. Industry publication *The Life Settlement Report, part of The Deal* suggested that activity in the life settlement market fell last year, with numerous reasons cited for the pull back, one being that an effect of the Covid-19 pandemic meant that more people held onto their policies in 2021 as opposed to letting them expire.

> **"A lower lapse rate means more in-force life insurance policies which in turn means, ceteris paribus, a larger pool of policies that might come to market in the future."**

"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," said John Welcom, Founder & CEO at Welcome Funds told *Life Risk News* in a life settlement broker roundtable recently.

The nuances to which Conway refers are many. One is that the life settlement market crosses over into only a small percentage of the overall life insurance industry in the U.S. The vast majority of transactions in the secondary market involve policies where the insured is over the age of 65, and even then, they focus on higher value policies in part due to the market being a heavily intermediated one, therefore transaction costs need to be considered. The ACLI data does not separate out lapse rates by cohort, so there is the possibility that lapse rates in 2021 might have increased in the area where life settlements and life insurance cross.

Another is that an argument exists that almost runs counter-intuitively to the data, which is that a falling lapse rate could have an adverse impact on the life settlement market because if more people are holding onto their policies, fewer would come to market for sale. The life settlement market promotes itself as an alternative to simply lapsing a policy so the implication here is that the message is not getting across.

Fortunately for the industry, life settlement brokers – those who conduct the auction for life insurance policies on behalf of the seller – say that 2022 has seen a significant uptick in activity.

"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," Rob Haynie, Managing Director at life settlement broker, Life Settlements, Inc., recently told *Life Risk News* in a life settlements broker roundtable.

"In the last 3-6 months or so, we've seen a 20-30% monthly increase in policies for review," added Jon Mendelson, CEO at broker Ashar Group at the same roundtable.

Another encouraging data point from the ACLI's Life Insurance Fact Book for the life settlement industry is that Americans reversed a five-year decline in the number of life insurance policies purchased. 2021 saw 10,401,000 new policies issued, the first rise since 2016 and the highest amount since 2017. Whether the drivers of this increase are simply more Americans becoming aware of their own mortality, or a general de-risking of an overall retirement plan, or something else, is unclear, but it's all potential future deal flow for the life settlement market.

However, the current cost of living crisis could impact next year's data. Higher than average inflation, a potential recession and consequent job losses could translate to a rise in the number of policy holders lapsing their policy in 2022 to save on the monthly premiums. That said, for American seniors, becoming something of a forced seller might support deal activity.

> **"One thing that the life settlement market is united about is the need for greater awareness that he life settlement option even exists."**

"Some seniors are bringing their life insurance policy to the life settlement market because of the cost-of-living situation," said Haynie. "But I don't think that will end up being the number one reason that drives deal flow in the coming 12-18 months. The main drivers of policies coming to market – medical bills and simply just not needing the policy anymore and therefore looking to get some cash for it – will remain."

Regardless of the drivers of supply, one thing that the life settlement market is united about is the need for greater awareness that he life settlement option even exists. It's a frustration as old as the market itself, and for Haynie, that's something that the life settlement market can control.

"We can't control interest rates, inflation, or global events," he said. "But we can influence awareness ourselves. There are still far too many life insurance policies that lapse because the insured didn't know the life settlement option even existed. Raising awareness is going to be the number one driver of increasing supply in our industry and it's something that everyone I speak with is committed to supporting."

Life Settlement Market Awaits Cost of Insurance Litigation Decisions

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Life Risk News

For life settlement investors, potential increases in the Cost of Insurance (COI) component of a life insurance policy represents a risk that needs to be considered when valuing a policy for a potential purchase.

That risk is very much on the radar of fund managers in the space. In recent years, COI increases from life insurance companies have been followed by lawsuits against the carriers; these lawsuits, which have tended to be class action lawsuits on behalf of a group of policyholders (before these policies even become life settlements) accused life insurance companies of illegally increasing this cost.

Specifically, plaintiffs argued that carriers should not have targeted certain age groups and raised rates as much as they did. Most of the increases, which did not happen frequently until around six years ago, were modest, ranging from five percent to ten percent, but in some cases, they reached triple digits; one case showed a 300 percent rise. And these increases were generally for insured individuals 61 years old and older, which is the target market for life settlement investors.

> **"In recent years, COI increases from life insurance companies have been followed by lawsuits against the carriers."**

It appears, however, that summary judgements are not being awarded for the most recent wave of COI increase cases, many of which were filed in 2015 and 2016. As United States District Judge Jesse M. Furman of the Southern District of New York warned in March 2022 regarding the closely watched Brach Family Foundation Inc., et al vs. AXA Equitable Life Insurance Company case, this could lead to a lengthy and costly trial for the parties involved, making forecasting difficult for the life settlement market.

"It's too early to see what insurers will do next, partly because litigation is still pending and partly because the insurance companies know they'd have a hard time justifying rate increases right after raising rates," said Khai LeQuang, Partner with Orrick Herrington & Sutcliffe LLP in Orange County, California.

Another area that life settlement investors have their eye on is a lack of policy illustrations. Many carriers have yet to unveil these as they work the numbers before making their announcements; mortality rates have improved for some class of insured individuals, rather than worsened, over the past three decades, and people are generally living longer than predicted several years ago when these policies were priced.

That would support a decrease, not an increase, in COI rates, but regardless, Steven G. Sklaver, a Partner with Susman Godfrey LLP in Los Angeles, said this could be an indicator of what is next:

"As often is the case, when a life insurance company stops illustrating policies, the carrier claims that it can't illustrate any further or can illustrate only to the guaranteed maximum - that's probably because a COI increase might be coming down the pike."

Other cases worth following will likely be tried in 2023 and depending how they are resolved, could lay the groundwork for what a potential second wave of COI litigation could mean for the life settlement industry.

In the closely watched AXA Equitable Life Insurance Co. case, AXA Equitable's motions for summary judgment were largely denied in March 2022 by Judge Jesse E. Furman of the U.S. District Court for the Southern District of New York in Manhattan. Plaintiffs The Brach Family Foundation Inc., et al. has alleged breach of contract when AXA Equitable raised the cost-of-insurance rate yet only applied it to a subset of the class that held AUL II policies issued to people at least 70 years old.

The plaintiffs also allege that AXA Equitable issued policy illustrations that were false or misleading in part because the illustrations failed to disclose the likelihood of a future increase in COI based on AXA Equitable's mortality experience.

In its motion for summary judgement, AXA Equitable said it presented the proposed COI adjustment to its primary regulator, the New York Department of Financial Services (DFS). After completing its review, DFS confirmed its view in writing that the COI adjustment was “unobjectionable” and “justified.”

After receiving that “no objection” letter, AXA Equitable announced the COI adjustment, which became effective in March 2016.

“The vast majority (roughly 70%, and likely more) of the roughly 1,600 policies it applied to are held by sophisticated investors such as plaintiff Brach Family Foundation, Inc., who bought the policies from others in the secondary market and have no familial relationship with the insureds,” according to AXA Equitable’s motion. “These class members invested to speculate on the lives of strangers,”

“These COI cases are extremely important to the market, as the increases greatly impact investors’ returns.”

In a recent ruling on the case, Judge Furman said the parties should try to settle the case “without the need for an expensive and risky trial.”

AXA Equitable didn’t respond to a request for comment from *Life Risk News* in time for publication.

A second case on the life settlement industry radar is VICOF II Trust; VIDA Longevity Fund, LP; et al. vs. John Hancock Life Insurance Company of New York, also filed in the Southern District of New York. The plaintiffs allege unlawful increasing of the COI on a targeted group of their in-force universal life insurance policies owned by the plaintiffs, including certain Performance UL and Performance UL Core policies.

According to the lawsuit, “while Defendants have not disclosed the criteria used to define this targeted group, it appears to be comprised of disproportionate numbers of investor-owned policies and policies originally issued to older-aged insureds. By raising the cost of insurance rates without a proper basis and, on information and belief, only on the discriminated group, defendants have breached the terms of the Performance Policies.”

The plaintiffs also alleged that John Hancock designed and marketed its policies to stress lower-than-market premiums, particularly in older age groups, resulting in the lowest rates in the industry.

John Hancock had selected 1,500 policies for premium increases and varied the increases according to issue age of beneficiaries, according to the filing. No rate increases were assigned to policies with issue ages of 60 or below, or if the proposed increase did not equal or exceed 5 percent. This left 1,500 policies sold to issue ages greater than 60 and, on these, COI rate increases were imposed ranging from 5 to 75 percent, with an average of 32 percent - the older the age bracket, the higher the rate increase. In addition, policies with higher issue ages received higher average rate increases.

The policies gave John Hancock a limited right to adjust and increase the monthly premiums by changing COI rates according to defined factors: John Hancock’s future expectations of persistency, or the likelihood that a policyholder will hold onto the policy until maturity (death) rather than allowing the policy to lapse, mortality, expense and reinsurance costs, and future tax, reserve and capital requirements, and only if John Hancock imposed the increases on a uniform basis and without unfair discrimination as to a class of insureds.

In the latest filing, John Hancock requested summary judgment, claiming that the premium increases are consistent with the policies. The plaintiffs claimed the contrary and Senior U.S. District Judge Alvin K. Hellerstein held that the disputes raise genuine issues of material facts, rejecting the request for summary judgment. Judge Hellerstein set a March 2023 trial date for VICOF II Trust; VIDA Longevity Fund, LP; et al. vs. John Hancock.

“These COI cases are extremely important to the market, as the increases greatly impact investors’ returns,” said Jule Rousseau, Partner at ArentFox Schiff in New York. “I have encouraged the market to fight all increases and am encouraged that the market has taken a strong fight in both the AXA and Hancock cases. This sends a message to other carriers that they should expect a serious fight if they too try to impact the market with increases.”

A spokesperson for John Hancock wrote in an emailed statement to *Life Risk News* that it doesn’t comment on ongoing litigation matters.

Longevity Over The Next Decade

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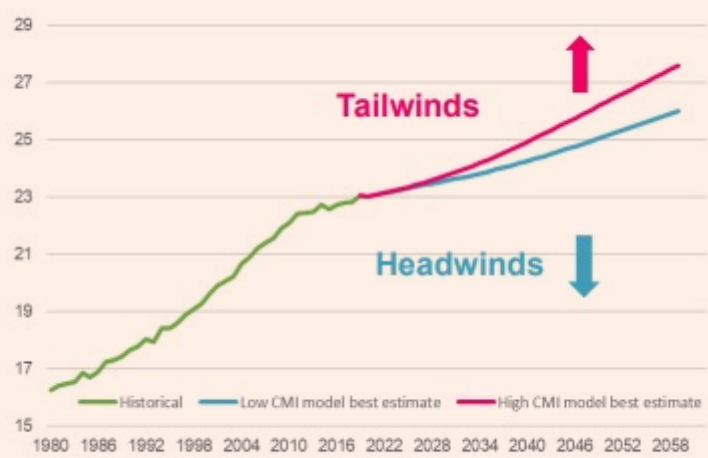
In the past 40 years, life expectancy has increased significantly as a result of a range of factors, including advancements in cardiovascular treatments and reduction in smoking prevalence. Looking forward, what will drive future longevity trends? Considering the main forces which are likely to affect mortality can be a beneficial exercise for firms when setting mortality assumptions. In this article, we consider the positive ("tailwinds") and negative ("headwinds") drivers, as well as the benefits of using this driver-based approach.

Future Trend Expectation

The CMI Mortality projection model is the tool predominantly used in the industry to express mortality trend assumptions. This data driven model, projects short term assumptions based of recent trends and long-term assumptions based on parameters set by the user. The graph below shows historical male period life expectancy from age 60 in England & Wales. The range of projections for the next 40 years reflects the best estimate assumptions used by insurers and reinsurers (using responses from our most recent benchmarking survey).

Figure 1: Historical and Projected period life expectancy (males, age 60)



> **"Considering the realworld factors which could drive future improvements will improve the user's understanding of a CMI model-based projection."**

In the last 40 years, we can see this metric has increased by 6.8 years. Historically, mortality improvements have been driven by significant strides in cardiovascular surgery, statins being available and reductions in smoking prevalence. In the last 10 years, the pace of mortality improvement has slowed, which has coincided with a decrease in NHS spending increases (above inflation).

Considering the assumptions used in the insurance industry, the best estimate life expectancy growth for the next 40 years is within the range 2.9 - 4.5 years. This is notably lower than that seen in the past 40 years. This expectation is partly driven by an assumed continuation of the slowdown seen in the last 10 years, and that the big improvements seen in the past are generally not thought to be repeatable.

The CMI model is driven by parameters which are set by considering a user's perception of the future. Considering the realworld factors which could drive future improvements will improve the user's understanding of a CMI model-based projection.

Here we consider some key examples of “headwinds” and “tailwinds”, namely real-world drivers which could respectively increase and decrease future life expectancy.

Headwinds – COVID-19, dementia & Alzheimer’s challenges and NHS Funding

There are many reasons why life expectancy increases might be limited when compared to that seen historically. One obvious reason for this is the ongoing excess mortality from COVID-19. Despite the severity of COVID-19 reducing in recent months, expectation is that it will continue to circulate in the community. If COVID-19 becomes another endemic disease, with similar severity to the flu, this would mean an additional 20,000 – 30,000 death each year. According to the ONS, deaths year to date due to COVID-19 in England & Wales are of the order of 20,000.

Another key headwind is the limited progress seen in improvements for dementia & Alzheimer’s disease, which are major causes of death in the UK. The number of people dying from these diseases is increasing. This is partly due to progress in reducing deaths from other causes, as well as changes to regulations on how deaths are recorded. However there has been very limited progress in treatment for these conditions. Currently the drugs used to treat Alzheimer’s in the UK help alleviate symptoms, but do not slow down the progression of the disease. Unless effective treatments can be found that do change the course of the disease, dementia & Alzheimer’s will hold up improvements in longevity over the next 10 years.

Recent clinical trial results from a new drug called Lecanemab have shown a modest slowdown in the progression of Alzheimer’s. However, there is no guarantee that it will be approved for use in the UK. Last year, another Alzheimer’s drug, Aducanumab, was refused approval by the European regulator due to side effects which included brain swelling or bleeding in 40% of patients. Even though the new drug is performing better, 20% of patients in trials experienced similar side effects.

Furthermore, the cost of the drugs is another barrier for material progress. If Lecanemab is priced the same as Aducanumab, then a year’s supply would be around £25,000, which may limit the extent to which it is available through the NHS.

> “If future mortality improvements are to continue at the current pace, there will likely need to be increases to NHS spending which are significantly above inflation.”

More generally, the NHS faces significant long-term challenges. Historically NHS funding has increased at an average 3.5% above inflation, which has supported the introduction of new treatments and meeting the needs of an ageing population. An Institute for Fiscal Studies report in 2018 projected that spending would need to increase at 3.3% above inflation until the 2030s just to maintain the level of NHS services. Subsequently there have been additional pandemic related costs, for example addressing the backlogs of procedures, which will have added to the challenges. The rate of increases to NHS spending has been shown to be related to mortality improvements. A University of York study published last year aimed to quantify this relationship, concluding that for every 1% real increase in healthcare spending related to a 0.5% improvement in population mortality.

If future mortality improvements are to continue at the current pace, there will likely need to be increases to NHS spending which are significantly above inflation. This will be particularly challenging in the current high inflation environment, where there are significant pressures on many public sector budgets and increases to taxation are politically challenging.

Tailwinds – Technology, improved diagnostics and anti-ageing drugs

Technology has the potential to improve life expectancy by creating efficiencies in the health care sector where budgets and personnel are stretched. For example, Artificial Intelligence can be used to read diagnostic information efficiently, accurately and in some cases detect diseases earlier than if human radiologists were being used.

One key application is for cancer, which remains one of the major causes of death in the UK. Despite significant advancements in treatment, such as surgery and chemotherapy, there is still a lot of room for improvement. The deadliest form of cancer in the UK is lung cancer with an average of 35,000 deaths per year and where the average stage of diagnosis is stage 3. There is currently no nationwide screening program in place for lung cancer.

In 2019, the "NHS Targeted Lung Health Checks" lung cancer screening pilot was launched, which uses low dose CT scanning in conjunction with AI, made available to current and ex-smokers aged between 55 and 75. Results of the pilot were very positive with 77% of patients being diagnosed with lung cancer at Stages 1 or 2. This compares with 33% of lung cancer cases being diagnosed at these stages in 2018. As a result, in October 2022 the NHS began the roll out of this program nationwide.

If the average stage of lung cancer diagnosis was reduced from stage 3 to stage 2 over the next 5 years, we estimate that this could increase period life expectancy for a 60-year-old by 1 month. In context of overall aggregate best estimate improvements anticipated over the next 5 years, this would broadly reflect 25% of the net increases expected.

In addition to improvements in diagnostics, there is a pipeline of drugs which can help treat age-related diseases such as cancer and heart disease. In addition to targeting these specific diseases, some researchers are currently looking at drugs which could slow down the rate at which we age, treating ageing as the disease. In some cases, these drugs are currently being used for other purposes. The most promising is a drug called Metformin, which has been used for many years as a treatment for diabetes.

> "In addition to improvements in diagnostics, there is a pipeline of drugs which can help treat age-related diseases such as cancer and heart disease."

Results of an observational study published in 2014 found that a group of diabetics taking Metformin survived 15% longer than healthy matched controls. A 15% increase to life expectancy is 3-4 years for an individual age 60 and is highly material. This is equivalent to the life expectancy growth many firms from our benchmarking survey are expecting over the next 40 years.

However, the benefits of the drug have not yet been tested within clinical trials. The "Targeting Ageing with Metformin" trial ("TAME"), is aiming to do this. The trial is currently raising funds and recruiting 3,000 people aged between 65-79 to take Metformin, with a similar number taking a placebo, over a 6-year period.

Like most drugs, TAME faces challenges in relation to funding, adoption and regulatory approval. Despite these uncertainties, Metformin is just one of many anti-ageing drugs being considered. This should therefore be an area that we monitor over the coming years as a potential material driver of increases to life expectancy.

Benefits of a Driver Based Approach

We have considered a few examples of both positive and negative future drivers of life expectancy and considered the potential impact these could have. A driver-based approach can be beneficial and compliments the use of the CMI model but is not a replacement for it. There are many potential applications for this type of approach.

Firstly, when considering best estimate assumptions, it is useful to compare a CMI projection to a breakdown of improvements by cause of death. This shows that there needs to be a strong flow of improvements for cardiovascular disease and cancer in order to sustain improvements at the levels we have seen. If we are pessimistic about the prospects in these areas, we will expect improvements to slow down.

Allowances for COVID-19 can also be derived using a driver-based approach. This would include estimating the impact of COVID-19 becoming endemic and of the additional impact of long COVID for example, along with other important factors.

> "A driver-based approach can be beneficial and compliments the use of the CMI model but is not a replacement for it."

Considering trend assumptions from a driver-based perspective leads to a wider range than is reflected in the industry's CMI models, which arguably show some herding. For example, if you are sceptical about progress in Alzheimer's and Dementia, you may feel that improvements at old ages in the core model are too high.

Finally, a driver-based approach is more common when considering stressed assumptions. A breakthrough in medicine such as an anti-aging drug would be a typical event risk scenario in the internal model.

November 2022 Poll Results

Do You Think Institutional Investors Will Pull Back on Their Alternative Credit Allocations in the Next 12–24 Months?

Author:
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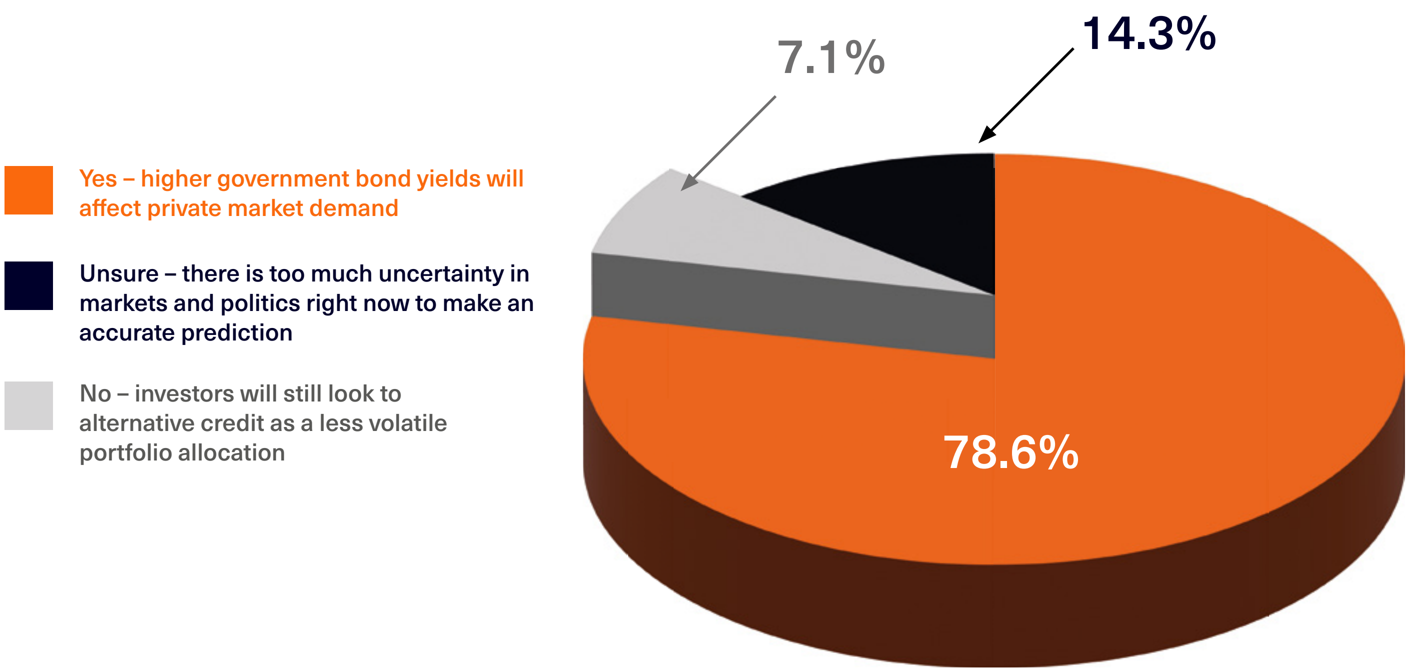
Life Risk News

Recent interest rate rises on both sides of the Atlantic and general political and economic uncertainty could see investors rebalance portfolios towards government bonds.

So, for this month's poll on Life Risk News, we asked our readers what they thought the impact of recent increases in interest rates would have on the alternative credit market generally.

The feedback was convincing. 78.6% of Life Risk News readers think that investors will pull back on their alternative credit allocations due to higher government bond yields making private market debt strategies relatively less attractive; 14.3% think there's too much uncertainty to make a definite call; and only 7.1% think that investor appetite for alternative credit products will not reduce as a consequence of the current higher interest rate environment.

Alternative credit asset flows data for 2023 won't be available until mid-2024. However, it'll be interesting to follow the anecdotal evidence to see whether investors do indeed rebalance in 2023 in favour of more liquid debt exposures.



Life Settlements Portfolio Construction – Art or Science?

Author:
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CEO
Gabriel Maeder
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> **"The dimensions of life settlements – life expectancy, age of insured, gender, projected premium streams - are unlike any other asset, so constructing a life settlement portfolio comes with a different set of challenges"**

The concept of a life settlement investment is quite simple: the collected death benefits must exceed the cost (premium payments, fees, etc.). A positive balance pays back to investors their initial investment and delivers a positive return once the initial investment has been paid off.

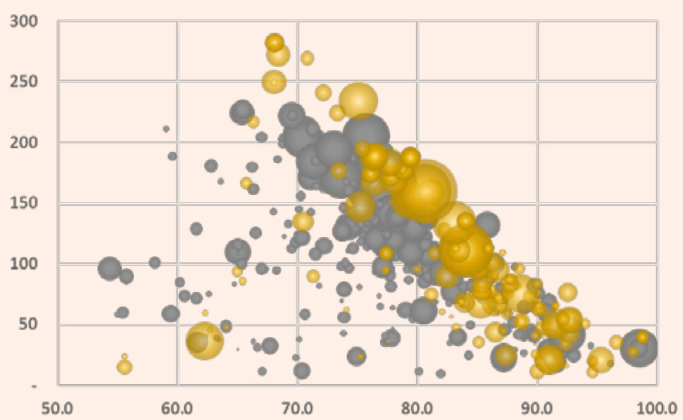
The dimensions of life settlements – life expectancy, age of insured, gender, projected premium streams - are unlike any other asset, so constructing a life settlement portfolio comes with a different set of challenges than other asset classes.

Figure 1 below shows a section of life settlement deal flow. The age of the insured persons [years, x-axis] is as low as 50 and goes up to close to 100 years. The life expectancy estimates [months, y-axis] reflect age, gender, and health of the insured persons. The size of the policies relates to the size of the dots. Policies referring to male insureds have grey dots, policies referring to female insureds have yellow dots.

- Gender: roughly two thirds of the policies in the chart refer to male insureds, roughly one third to females. In addition, there are joint policies.
- Life expectancies ('LE'): the range of life expectancies in the market is large. The shortest life expectancies are a few months and the longest can be more than 240 months.
- Size of policies: the range is exceptionally large. There are small policies with a face value of just $50,000 and larger policies with face amounts in excess of $25million.
- Other criteria which need to be considered are the policy types, the premium finance status, the smoker status of the insured persons, the quality of the documentation, and so forth.

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

Figure. 1: Offered policies, July to November 2020



> "The main issue in life settlement investing is that the accuracy of the life expectancy estimates is uncertain. The face amounts do not necessarily come due when they should (according to the obtained life expectancies). Consequently, the future cashflows are uncertain"

The accuracy of used life expectancies

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

The accuracy of the life expectancies is linked to other issues. There is still no requirement and/or standard for the medical underwriters to disclose the accuracy of their life expectancy estimates. Furthermore, the information for a transaction is provided by the sell side. The interest of the sell side is to achieve the highest possible price for a given policy, which depends ultimately on the life expectancy of the individual – the shorter the life expectancy, the higher the achievable price. The non-alignment of interest in combination with the information asymmetry between the sell side and the buy side overlays every engagement. This challenge needs to be carefully considered and dealt with by investors.

The key to success

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

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

How to choose an asset manager?

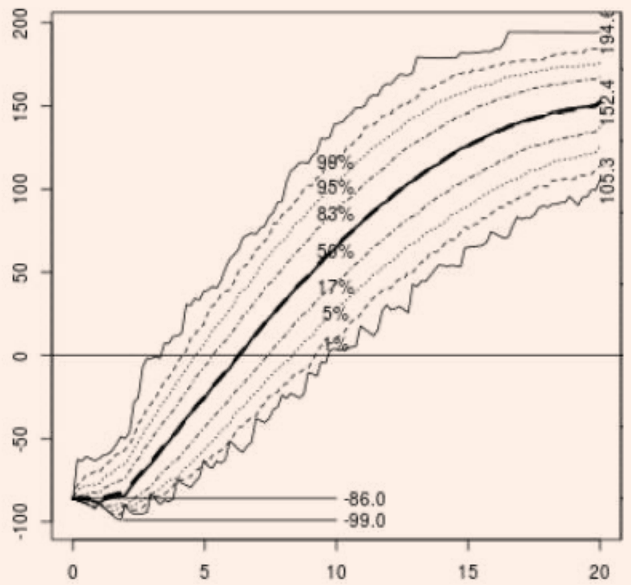
The assessment of an asset manager is key before any investment since a wrong investment decision can have significant negative consequences.

- Ask for a few examples of life settlement funds which reached the end of their investment period.
- Ask for the investment results of all investments/ funds from the asset manager which reached maturity.
- Ask for the contact details of the largest investors/ the most prestigious investors in previous funds or running funds and speak with them about their experiences.
- Ask for the 'cash-on-cash' balance of running investments i.e., how much death benefit is collected versus expenses per time period.

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

> **"It is not a challenge to buy policies - the markets are there, and investors can help themselves. The challenge is to buy policies which ultimately allow the investor to collect more cash from death benefits than they pay in premiums and fees. This is the art of life settlement investing."**

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



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

It is not a challenge to buy policies - the markets are there, and investors can help themselves. The challenge is to buy policies which ultimately allow the investor to collect more cash from death benefits than they pay in premiums and fees. This is the art of life settlement investing.

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Q&A

Ashu Bhargava

Chief Origination Officer, Clara Pensions

Clara Pensions, the British pension superfund, celebrated its first anniversary of completing the assessment process for defined benefit consolidators in the U.K. by the country's Pensions Regulator. Life Risk News' Greg Winterton spoke to Ashu Bhargava, Chief Origination Officer at Clara Pensions, to discuss the organisation's first year since completing assessment, the outlook for 2023 and the broader pension risk transfer market.

LRN: Ashu, first of all, happy anniversary. Tell us about Clara Pensions' first year post-regulatory sign-off: what have been some of the things that went smoothly, and some of the things that perhaps didn't go as smoothly as you had hoped?

AB: 2022 has been a significant year for Clara. Following our first important milestone of completing the rigorous TPR assessment process at the end of last year, we have been focused on transactions. It's really important that we're turning the potential provided to us by assessment into delivering for members and we're excited to be progressing steadily with our first transactions.

We have spent the year working with a range of potential transactions at different stages and we've also continued to build the team to make sure we're ready to take on our first members.

However, 2022 hasn't been without its challenges. The volatile economic environment has impacted the whole market and has meant that we've seen some potential transactions fall away, but we have a very strong pipeline and look forward to completing our first transaction soon.

LRN: Back in May, Clara Pensions committed to ensuring its investment portfolio delivering net zero emissions by 2050. Why was this important to Clara to do now, when arguably you're still at the starting blocks stage of your journey?

AB: Clara is all about delivering long term commitments, an approach which stems from our commitment to being 'member-first'. As a new business without existing assets and liabilities, we have been able to start from a blank sheet of paper as an asset owner. This means we've had a real opportunity to set our direction from Day 1 in a way that best meets the needs and expectations of our future members. Our environmental commitments are a clear part of this, and it was right to make the first Net Zero commitment at the beginning of our journey.

LRN: A rising interest rate environment – like the one we're in now – means that the general funding levels of defined benefit pension schemes is improved. Have you seen an increase in DBPs coming to Clara to discuss consolidation in recent months because of the macroeconomic environment and if so, are these conversations exploratory or are the pension plan sponsors pretty clued up and are looking to accelerate their timelines?

AB: Ultimately, improved scheme funding is good news for members and sponsors. As a result of rising interest rates, we are seeing a range of different changes in funding – for example, some schemes which removed hedges during September now have worse funding, while those who retained hedges haven't seen their funding levels move, and many others have experienced improved funding.

Improved funding often brings an opportunity to look at a pension scheme and the right endgame for it, and we're having lots of conversations with schemes, including those that are exploratory and those that are more developed. However, it's not just about scheme funding. The worsening economic outlook for sponsors is driving trustees to think about their current pension position and whether a transfer to a superfund would be the right solution, to ensure security for members whilst also freeing up the sponsor company to focus on running their business.

LRN: The U.K. Government recently published its response to its consultation on Solvency II reform. Whilst there's still much more to come in terms of legislation and the PRA getting involved, what's your view on the impact of the potential SII reform on the PRT market more broadly and Clara's activities in the space?

AB: Clara has a bridge to buyout model so naturally we are interested in seeing how Solvency II evolves. It is currently unclear what these changes mean for insurer pricing as against capital requirements, but the bulk purchase annuity market is already a very successful one as it gives space for both insurers and consolidators to offer different options to sponsors and trustees to improve member security. We are therefore confident that while the potential Solvency II reform may alter the type of schemes we are talking to, it will not impact the need for consolidation and an alternative to an insured buyout.

LRN: Finally, Ashu, what can you share with us about Clara's plans for 2023? Any specific goals or targets in mind?

AB: We are making great progress on our first transactions, and we remain on track to deliver £5 billion in transactions by 2025. We will continue to be led by trustee and sponsor needs and look forward to welcoming our first members.

Ashu Bhargava
CEO
Clara Pensions

German Secondary Life Market Robust Amidst Cost-of-Living Challenges

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Reasons abound as to why an American would sell their life insurance policy to a third-party investor, including paying off a mortgage, funding a divorce settlement, or paying medical bills; it's something of a safety net in times of financial need.

Many other countries don't have a similar safety net available to their citizens. The U.K. has a traded endowment policy market, but that's now largely defunct. Enter Germany, which does, and one consequence of the prevailing macroeconomic environment, where residents of most countries in Europe are experiencing cost of living challenges, is that more people with a life insurance policy in Europe's largest economy are looking into selling it on the secondary market.

"The size and volume of trades on the German secondary market depend on the existing economic situation," said Christian Seidl, Executive Board Member at Bundesverband Vermoegensanlagen im Zweitmarkt Lebensversicherungen (BVZL), a trade association in Germany that represents investors in the secondary life market in the country. "In the first half of the year, we saw an increasing number of people coming to us and asking questions about selling their policy because of all this uncertainty, increasing inflation, interest rates, etc. People feel a need to liquidate their assets."

> **"A life insurance policy in Germany is as much a part of a retirement plan as it is a worst-case scenario plan."**

A life insurance policy in Germany is as much a part of a retirement plan as it is a worst-case-scenario plan; it's a sort of savings account, because if the policy holder is not deceased at age 65, the policy pays out anyway, giving the recipient a lump sum to do with what they choose.

The supply side of the German secondary life market is robust. Many Germans have life insurance and citizens have access to information through organisations like the BVZL to help them make informed decisions regarding whether selling their policy is the right decision for them. Contrast that with the United States, where fund managers and brokers often comment that awareness amongst policyholders – or, rather, a lack of it - is a significant supply barrier.

That contrasts with the buyer side. In the U.S., talk to any life settlement fund manager and they will tell you that access to capital to buy policies is not a roadblock on the route to success. Capital is aplenty, demand is high, driving up prices – and therefore, driving down returns.

In Germany, investors face a different dilemma. The German secondary market is, from an investor's perspective, largely an interest rate arbitrage. Life insurance policies contain both a guaranteed interest rate for the life of the policy, and an annual surplus which is based on the profitability of the life insurance company itself. Policies issued in the 1980's or 1990's were highly attractive for investors because they came with comparably high guaranteed interest and at the same time, refinancing costs were low in a low interest environment.

Newer life insurance products, however, come with no, or only very low, guaranteed interest. This doesn't make much difference in a low interest environment but today, in an environment of increasing interest rates and refinancing costs, it becomes less attractive to purchasers. According to Seidl, there are already signs of a bump in the road.

"We're definitely seeing a slowing down at the moment. Just in the last few weeks we've seen a decrease in the number of trades because of rising interest rates. For the purchaser, buying policies becomes less attractive. They're currently purchasing very selectively," he said.

Getting an accurate measure of the in-force size of the U.S. life settlement market is difficult; a recent reader poll conducted by *Life Risk News* showed that the industry itself doesn't really know. The German secondary market is much, much smaller – BVZL estimates that it's a few hundred million Euros – and the short-term outlook remains unclear because it depends heavily on the long-term expectations of insurance companies and policy purchasers regarding interest rates and refinancing costs, which are uncertain at the moment. But it remains robust and enjoys a lack of controversy that isn't always the case with the life settlement market.

"We don't have the 'profiting from death' discussion that the life settlement market does because our market is just an interest rate arbitrage market.

The policies pay out even if the insured person doesn't die," said Seidl. "We [BVZL] have a good relationship with the consumer agencies and they understand that the policy holders just want to liquidate an asset for whatever reason. The regulatory environment doesn't have a lot of activity, and so the outlook for the industry is really just closely tied to the interest rate environment."

> **"The regulatory environment doesn't have a lot of activity, and so the outlook for the industry is really just closely tied to the interest rate environment."**

Life Risk News

Life Risk News
ISSN 2753-7374
Volume 1, Issue 8
December 2022

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