

# Latest Secondary Market Data Provides More Ammunition for Life Settlement Bulls



**Life Risk News**  
**ISSN 2753-7374**  
**Volume 2, Issue 5**  
**May 2023**

**Publisher**  
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# Editor's Letter

## Volume 2, Issue 5, May 2023

It's Life Risk News' first anniversary, and it's also the first anniversary of trade body the Life Insurance Settlement Association's (LISA) annual member transaction data report. *Greg Winterton* spoke to **Sherry Duarte**, Chair at **LISA**, **John Welcom**, Founder & CEO at **Welcome Funds**, **Reid Buerger**, CEO at **Coventry**, and **Bryan Nicholson**, Executive Director at **LISA**, to get their thoughts on the latest data in *Latest Secondary Market Data Provides More Ammunition for Life Settlement Bulls*.

The latest Cost of Insurance-related litigation case in the US was settled out of court in March. *Jeffrey Davis* spoke to **Khai LeQuang**, Partner at **Orrick** in Los Angeles, to get his thoughts on the potential impact of this settlement in *Latest Cost of Insurance Litigation Provides Little in the Way of Certainty*.

This month's Roundtable sees **Chris Anderson**, Head of Bulk Purchase Annuity Consulting at **EY**, **Shelly Beard**, Managing Director at **WTW**, and **James Mullins**, Partner, Head of Risk Transfer Solutions at **Hymans Robertson**, offer their thoughts on the outlook – and some of the potential challenges - for the UK Pension Risk Transfer market.

Our first commentary piece this month comes courtesy of **Charlotte Gerken**, Executive Director, Insurance Supervision at the **Bank of England**. Gerken recently gave a speech at the 20th Conference on Bulk Annuities in London and this article is an abridged version of said speech, *Moderation in All Things*.

Last month's Poll asked Life Risk News readers, *Do You Think There Were More Secondary Market Life Settlement Policies Purchased in 2022 Compared to 2021?* The consensus was strong.

Our second commentary piece this month comes courtesy of **S. Jay Olshansky**, Founder and Chief Scientist at **Lapetus Solutions**. *"Bet The Under": Hedge Fund Manager Makes Costly Mistake* tells a cautionary tale about the effect of using outdated mortality tables.

Our Q&A this month features **Thomas Deinet**, Executive Director at the **Standards Board for Alternative Investments**. Deinet discusses the SBAI's work in insurance-linked securities, ESG and alternative credit.

Life settlements advisory firm **AA-Partners** held a webinar recently, during which it highlighted some of the trends in the life settlement secondary and tertiary markets. *Greg Winterton* spoke to **Beat Hess**, Managing Partner at AA-Partners, about some of the trends that investors should focus on in *Life Settlement Market Trends Solid But Investors Should Look Below The Headline Numbers*.

I hope you enjoy the latest issue of Life Risk News!

**Chris Wells**  
Managing Editor  
Life Risk News

# Latest Secondary Market Data Provides More Ammunition for Life Settlement Bulls

Author:  
**Greg Winterton**  
Senior  
Contributing Editor  
**Life Risk News**

The Life Insurance Settlement Association (LISA), a Washington, DC-based trade association, unveiled its annual transaction data at its investor conference this past May 1st. Each spring, LISA surveys its life settlements provider members about the secondary market transactions that they participated in during the previous year; the members provide this data anonymously through a secure portal, which LISA then aggregates and publishes.

This is the second year LISA has collated market data to identify trends and benchmark market growth. And the headline is encouraging for the industry: some \$789.6m was paid to consumers by LISA provider members (which LISA claims represent approximately 95% of the entire market) in 2022, an almost \$40mn increase on the previous year.

**“The life settlement industry’s mission is to help educate consumers and advisors that just like any personal property, a life insurance policy is an asset that can be sold.”**

“We’re delighted to see an increase in the dollar amount that our life settlement provider members paid to American seniors last year,” said Sherry Duarte, Chair at LISA. “The life settlement industry’s mission is to help educate consumers and advisors that just like any personal property, a life insurance policy is an asset that can be sold. The nearly \$800m paid to consumers last year was spread across the United States, helping policy sellers pay down debt, go on vacation, help in their community, etc.”

The genesis of LISA’s efforts in this space was to highlight what it says are the benefits of the life settlement industry to consumers. Many in the life settlement market believe that too high of a percentage of the senior population in the United States are unaware that the option to sell their life insurance coverage for a lump sum cash payment even exists, and John Welcom, CEO at Welcome Funds, and the previous Chair at LISA who spearheaded this initiative, points to one of the data points to support LISA’s view.

“We still see far too many people either surrendering their policy back to the carrier for the surrender value, or worse, letting their policies lapse and getting nothing for them,” he said. “LISA’s provider members averaged a 5.2 multiple on the price they paid to consumers versus what would have been received from the life insurance company directly if they were to surrender their policy. That’s a significant financial benefit that our industry offers to seniors.”

There were 3,079 transactions completed by the 20 LISA provider members that contributed data to the report in 2022, a slight increase on the 2,998 recorded in 2021 when 23 providers participated in the project. A recent Life Risk News roundtable suggests numerous reasons for the apparent uptick in secondary market activity last year, including the relaxing of lockdown rules that enabled seniors to meet with their advisors, and a less risk-averse approach on the part of the insured. But the pickup in deal activity in 2022 may be less of a rebound and more of a sustainable medium-term trend. Reid Buerger, CEO at life settlements provider Coventry, said,

“The educational initiatives that our industry uses, including various forms of advertising, continue to prove effective. We’re seeing more and more submissions from consumers and financial intermediaries alike, eager to learn about their policies and understand their options and expect this trend to continue for the foreseeable future.”

The life settlement industry has historically been one of the opaquer asset classes within the wider alternative investment space. Indeed, the only other public source of secondary market transaction data is that provided by industry trade magazine The Life Settlement Report, part of The Deal, which collects data directly from insurance regulators at the state level; there is no publicly available data at all for the industry’s tertiary market. But Bryan Nicholson, Executive Director at LISA, says that initiatives like this will help the industry in terms of communicating both awareness and benefits.

“Any increase in the number of secondary market transactions means that the size of our market increases, and consequently, the aggregate dollar value paid to American seniors increases,” he said.

“Our goal was to produce accurate market information that our industry could highlight in order to educate both advisors and consumers on the benefits of the life settlement option. We think LISA’s work here does that and we look forward to continuing this in the coming years.”

**“Our goal was to produce accurate market information that our industry could highlight in order to educate both advisors and consumers on the benefits of the life settlement option. We think LISA’s work here does that and we look forward to continuing this in the coming years.”**





# Latest Cost of Insurance Litigation Provides Little in the Way of Certainty

Author:  
**Jeffrey Davis**  
Contributing Editor  
Life Risk News

Skellig ICAV, a collective investment vehicle from Ireland, along with Gannet Funds and its securities intermediary, Wilmington Trust, have reached a settlement with John Hancock Life Insurance Company of New York in a lawsuit accusing the insurer of unlawfully increasing the cost of insurance on a targeted group of universal life insurance policies.

The plaintiffs had filed the lawsuit in the U.S. District Court for the Southern District of New York in Manhattan, citing “sudden and massive COI increases” and seeking compensatory and punitive damages, equitable relief, and attorneys’ fees.

Details of the settlement were not released. The suit was filed in September of 2022.

According to the filing from March 2022, “the parties hereby stipulate to dismiss this action in its entirety with prejudice, with each Party to bear its own attorney’s fees and costs.” The reference to “with prejudice” means that the plaintiff will not be allowed to bring the same claim to the court again.

**“I think insurance companies will have to consider that not all policy owners will be satisfied with the economics of class action settlements, and that is a good thing.”**

“The settlement terms are confidential, but we’re pleased with the outcome,” plaintiff attorney Khai LeQuang, a partner in the Orange County of law firm Orrick, told Life Risk News.

Asked if the settlement might influence other existing COI litigation, LeQuang said that would be “unlikely because these agreements tend to be confidential.”

“I think insurance companies will have to consider that not all policy owners will be satisfied with the economics of class action settlements, and that is a good thing,” he said in response to a question from Life Risk News about a possible broader impact on the life settlement market.

Representatives from John Hancock were contacted for this story and responded that they “will be in touch if we have a comment.”

According to the lawsuit, John Hancock increased the cost of insurance on a specific group of its life insurance policies, including policies owned by the plaintiffs.

Skellig runs a fund that owns a Performance UL policy with a \$15m death benefit and argued that John Hancock increased cost-of-insurance rates for that policy and 1,500 others in 2018 but without giving a clear explanation.

While John Hancock had not disclosed the criteria used to define the targeted group subject to the rate increase, the plaintiffs said it seems to consist of disproportionate numbers of investor-owned policies. By raising the cost of insurance rates without proper justification and only on this targeted group, John Hancock has breached the terms of the plaintiffs’ policies, according to the lawsuit.

“Notably, in recent years, a handful of life insurance companies have increased cost of insurance rates despite consistent improvements in U.S. mortality over the past several decades,” the lawsuit stated. “These rate increases have prompted numerous lawsuits, all of which, to Plaintiffs’ knowledge, have resulted in the insurance companies paying out millions of dollars in settlements or verdicts. John Hancock itself recently settled a lawsuit concerning its failure to lower cost of insurance rates—despite improved mortality — for over \$91 million.”

The most important factor in life insurance is mortality, and it is widely known in the industry that mortality has improved since John Hancock began issuing Performance UL policies in 2003, the lawsuit states. In fact, new mortality tables would support a decrease in COI rates, but John Hancock increased rates on the plaintiffs’ policies anyway, which goes against the express and implied terms and conditions of the policies.

The lawsuit noted that industry analysts confirm that mortality has continued to improve. For instance, a report published by Towers Watson in 2016 recommends that life insurance companies assume positive improvements in mortality for every age over 55.

Similarly, the lawsuit states, statistics from the Human Mortality Database show increased life expectancy and lower mortality rates for older

individuals in the United States between 2010 and 2015, while a Society of Actuaries report on historical population mortality rates indicates continuing improvements in mortality rates every five years from 2000 to 2014.

Also from the lawsuit: "According to a 2010 report by the Government Accountability Office (GAO), life settlements can be a beneficial option for policyholders with unneeded life insurance, as they can receive more by selling the policy to a third-party investor than surrendering it to the insurer for its cash value. Insurance companies, such as John Hancock, have embraced the life settlement market to sell more insurance, with consumers buying insurance with the comfort of knowing they could sell their policies for fair market value later.

insureds, who stand to lose significant value from any obstacles to selling their policies. Reports indicate that a significant number of senior citizens let their policies lapse or surrender them, with many of them indicating they would have considered selling their policies in the life settlement market had they known about it. Therefore, insurance companies like John Hancock that raise COI rates in contravention of contractual terms are not only hurting policyholders but also the entire life settlement market, including hundreds of thousands of senior consumers."

**"According to a 2010 report by the Government Accountability Office (GAO), life settlements can be a beneficial option for policyholders with unneeded life insurance, as they can receive more by selling the policy to a third-party investor than surrendering it to the insurer for its cash value."**

"However, John Hancock has targeted many of these policies for cost of insurance (COI) increases, forcing policyholders and investors to either pay exorbitant rates to keep their policies or lapse/surrender them, thereby destroying the economic benefit of the policies. A weakened life settlement market would be of particular concern to senior

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# Roundtable

## UK Pension Risk Transfer Consultants



**Chris Anderson**  
Head of Bulk Purchase  
Annuity Consulting  
EY



**Shelly Beard**  
Managing Director  
WTW



**James Mullins**  
Partner & Head of Risk  
Transfer Solutions  
Hymans Robertson

The Pension Risk Transfer (PRT) space in the United Kingdom has been on a growth trajectory for much of the past decade. Life Risk News' Greg Winterton spoke to Chris Anderson, Head of Bulk Purchase Annuity Consulting at EY; Shelly Beard, Managing Director at WTW; and James Mullins, Partner, Head of Risk Transfer Solutions at Hymans Robertson, to get their thoughts on the outlook – and some of the potential challenges – for the world's largest PRT market.

**GW: What are some of the main drivers underpinning the UK PRT market's current growth spurt?**

**CA:** On the demand side, the rise in interest rates that began in the second half of 2022 is the primary driver of increased activity in the pension risk transfer space, as it had the effect of improving the funding positions of many schemes. Schemes that were four, five, six years away from coming to market this time last year are now in a position to do so and are actively looking for quotes from insurers.

On the supply side, there is a lot of capital that's looking to enter the market. There are firms looking to set up new bulk annuity providers, and firms that are looking to participate by offering funded reinsurance services.

**SB:** The improvement in funding levels due to interest rate rises is the main one but another item driving this is the changes in life expectancy data since the onset of Covid. A few years ago, some schemes thought that they would be looking at a buyout in eight to ten years, but now they might be looking at being ready in the next two to three years, depending on their hedging strategy. And that's not a complete outlier – many schemes will have seen their plans brought forward by five years.

**JM:** I agree. And what I'd add is that the pension scheme trustees are keen to engage in this process. They've had this good fortune in terms of a vastly improved funding level, and it's natural for them to want to insure their scheme as soon as they can.

And we're not just talking about pensioner buy-ins here – activity for full scheme buy-ins/buy-outs has materially increased as well and these are now the most common transactions in the market.

**GW: What is one of the under-covered (i.e., the trade media doesn't write or talk about it much) trends in the UK PRT market and why do you think this are important to highlight?**

**SB:** Most of the coverage is of the bigger deals, the billion, or hundreds of millions of pounds deals. But so many UK defined benefit pension plans are small and its key that the market continues to serve those schemes too. It's important to highlight this because members of these smaller schemes still deserve protection, and successfully insuring their scheme means that they can get access to better security and administrative support than small schemes can on their own.

**JM:** There are a few things in my opinion. I think the market underestimates how much work needs to be done on data after transactions are signed. Often people think that's 'job done' but the work after that to tidy the data up and get it perfect so that it's ready for buy-out is significant and detailed and involves a lot of people hours.

I also think the member experience is something else that's important to mention. When a scheme does a buy-in, the member won't notice anything different because the administration remains with the scheme. But when they move to buy-out, it's a massive change – previously, the member had a relationship with their pension scheme and employer they might have worked for and now they have a contract with an insurance company. Member journey and communication is an under talked area.

Lastly, ESG does actually get good coverage, but I think it should get even more. Insurers are investing billions of pounds every year. It might well be over £50bn that flows through insurance companies during 2023.



That could do an enormous amount of good if it's invested in the right way. I'd like to see even more focus on the ESG side.

**CA:** I think the volume of companies trying to enter the UK's bulk annuity market is a trend to watch, as a number of firms now have the approvals and the teams in place and are ready to start writing business. It's not just existing insurers trying to enter, however. There's a much wider range of interested parties including asset managers and sovereign wealth funds, as there aren't many investments that can make a good internal rate of return over 30 years. This will be a big trend that will define the market in the next few years. But will the new providers be able to compete on price, and do they have something new to offer?

**GW: Liquidating assets so a scheme can access capital to enter into a buyout or buy-in is a complicated challenge for trustees and the scheme advisors. What are some of the current challenges and solutions here?**

**CA:** The main challenge for schemes is deciding from the myriad of options that are available to them. Some insurers may be willing to take the assets as part of the premiums, or the scheme could arrange for a deferral of premium or obtain a loan from the sponsor or a third party, or they could try to sell the assets themselves before coming to market. Any decision will depend on the assets in question.

**SB:** The biggest challenge for schemes is dealing with their less liquid holdings. This is a challenge for both schemes who are looking to proceed to a short-term buyout and those looking to manage liquidity more generally. That said, there are lots of options out there and the first step is to undertake a feasibility study to understand the best strategic approach depending on the asset type. Understanding the full breadth of options – for example using deferred premiums, secondary market sales, inspecie transferring to the insurer – as well as the potential for future market innovations – is absolutely key for schemes to get the best result.

**JM:** It's possible to negotiate a tailored price lock with your chosen insurance company. This means that the insurer agrees that their buy-in premium will move in a very similar way to your pension scheme's assets. This ensures that, in the final stages of the buy-in process when contracts are being agreed, the risk of the buy-in premium moving in a different way to your scheme's assets is materially reduced. This gives much-needed security, and transaction confidence, for trustees and pension scheme sponsors. It's also possible to ensure that your chosen insurer takes on all of the 'out of market risk' whilst scheme assets are being disinvested into cash and transitioned across to the insurer to pay the buy-in premium.

**GW: What are some of the pros and cons of DBPP's rushing to get a deal done now (because they are suddenly well funded) versus waiting?**

**JM:** There have been eight insurance companies in the UK for seven years now, but we expect some new entrants into the market this year and in 2024, so some schemes might take the view that more competition might lead to better pricing. But it just makes sense to move quickly if you can. To my mind, the market is only going one way, so I'd say that assuming that a scheme is well prepared, there's not a good enough reason to wait. I don't believe that essentially trying to time the market is the best idea here.

**CA:** The challenge is that a scheme might miss out on better terms down the road. New entrants might offer better pricing and solutions that others can't yet offer. We're currently seeing schemes that can afford insurance now going ahead.

**SB:** The main pro for the scheme is the certainty of pricing. What I'd add on the downside is the uncertainty around whether you have got the best possible price. For example, pricing is partially driven by life expectancy, which is currently more uncertain than it's been for a long time. That could be a reason why a scheme might look back and say they overpaid.

**GW: What are some of the barriers to growth that the UK PRT market faces? Are any of these barriers quick(ish) fixes – e.g., less than 12 months – or are they more medium-long term, structural, and what can be done about it?**

**CA:** The pension risk transfer space is resource intensive and requires specific skills, and finding this talent is a significant challenge. There is enough capital, assets and schemes, but there is only a small pool of people that understand how this all works, and all firms are going after the same targets. This is not only an insurance problem – for example, it's also a challenge for employee benefit consultants that work for the pension schemes.

**SB:** I agree but I also think that there is the potential for capacity constraints in the medium term. Global reinsurers like longevity risk because it diversifies their mortality risk. But once reinsurers have enough longevity risk for maximum diversification, they might become less keen on some deals. And that ties into the human capital element. Insurers need people to do the work, win the business, price it, implement all the transactions and there is only a certain number of them that can do that. We're at a point now where we're seeing the insurers being pickier than ever when they decide whether to quote on a case. The power in this market used to be with the schemes, but currently it's more with the insurers.

**JM:** Agreed on people power. These transactions require specialist skills, and the market seeing the shift in demand that it has in the past few years means that insurers become more constrained. They can only quote on so much business. Yes, they can improve technology and processes, and that helps. But I think we'll see some transactions take longer in the next couple of years because of the challenges insurance companies face in people resources.

**GW: What's your bottom-line message to a DBPP scheme that, so far, has not taken its first steps on a PRT journey? What's the one or two key questions they need to ask of themselves before taking that first step?**

**SB:** Preparation is the main thing that comes to my mind. Schemes need to get the right advisor, get their data in order, and their governance structure. This isn't something that should be rushed just because a scheme now finds itself in a much better funding place than expected.

**JM:** Preparation is the key. A scheme needs to understand where they are today and what preparation needs to be done and follow through on that – it could be data-related, it could be asset related – and then take steps to make sure they are addressing any gaps. And while they're doing that, they need to figure out the best way to approach the market. Insurers are people constrained, and they won't want to quote on everything. One way to address that is to commit to working with only one insurer. This approach materially moves them up the priority list and, with an experienced consultant, can be the best way to deliver excellent value. They might pick just two or three and have a process with a single round. All schemes use a consultant during this process – picking the right one goes a long way to ensuring the scheme is best placed to achieve a strong outcome.

**CA:** For schemes that haven't taken any steps so far, it's crucial to have data and benefits in order. Insurers want schemes to come to them with clean data so that they can understand what members they have, what they are entitled to, and when. Data-related issues are often what holds transactions back, so having clean, structured data is key.

This is also important for smaller schemes. When the market gets crowded, and resource constrained – like it is now – smaller schemes can lose out because it's more beneficial for insurers to work with larger schemes. This means that smaller schemes need to make it as easy as possible for an insurer to do business with them, and clean data is the way to do that.

# Moderation in all things - speech by Charlotte Gerken



Author:

**Charlotte Gerken**

Executive Director of  
Insurance Supervision  
Bank of England

**“This heightened demand from pension schemes might lead you to think that there is enough new business for all insurers to get their fill, leading to competitive pressures easing up. In practice, given the lumpiness and finite nature of this market, I see strong incentives for insurers to stretch their supply capabilities in the short term.”**

*This article is an abridged version of the original, which can be found at <https://www.bankofengland.co.uk/speech/2023/april/charlotte-gerken-speech-bulk-annuities-conference>*

A lot is happening in the Bulk Purchase Annuities (BPA) market: pension scheme funding levels have greatly benefited from the rise in interest rates<sup>1</sup>, and the UK insurance industry is preparing itself for record levels of bulk purchase annuity transfers<sup>2</sup>.

De-risking corporates of their legacy defined benefit schemes brings substantial benefits to UK plc, and the additional capital insurers inject contributes to the security of pension scheme members. This structural shift in the provision of retirement income also gives insurers an increasingly important role as long term investors in the UK real economy. Insurers therefore need to balance the short term financial and reputational incentives to grow rapidly, with long term and enduring financial strength, to meet the long term needs of policyholders and the economy.

## Market developments - Accelerated growth

From historic lows of 0.1% in December 2021, the UK Bank rate rose to 4.25% in March 2023. While it could hardly be described as plain sailing for pension schemes or their sponsors, the rise in interest rates has generally reduced the value of their liabilities and boosted funding ratios (see chart 1). This has greatly improved the affordability of buy-outs for many pension schemes.

At the same time, trustees of pension schemes are reported to be increasingly viewing buy-outs as a long-term target<sup>3</sup>. Increased affordability and a decreased appetite to retain this risk have led to a growing appetite for schemes to transact in one go, rather than perform staged buy-ins spread over several years<sup>4</sup>. So called ‘jumbo’ schemes may also present exciting opportunities for the insurers. This all points to a material increase in pension schemes’ demand for BPA in 2023. But I’d note that this is an acceleration of the existing demand for BPA in a large but finite market in run-off (see chart 2 and 3).

This heightened demand from pension schemes might lead you to think that there is enough new business for all insurers to get their fill, leading to competitive pressures easing up. In practice, given the lumpiness and finite nature of this market, I see strong incentives for insurers to stretch their supply capabilities in the short term, to capture as much of the new business while they can, before leaner years arrive. So, let us move to the main course, and examine three areas where we see this stretch arising in practice.

## An expansion of risk appetites

As deals become larger and increasingly focussed on buy-outs of complete schemes, we observe BPA writers expanding their risk appetite, sometimes outside their current core expertise. Firstly, our supervisory work suggests there is an increased appetite to insure deferred pension scheme members: the younger, not yet retired individuals. They bring several additional risks for insurers including much greater uncertainty in the longevity risk, as assumptions have to be made over a much longer period of time, together with risks stemming from policyholder options, such as cash commutation, flexibility on retirement age and transfers outs<sup>5</sup>. This appetite is supported by reinsurers, who provide both pricing expertise and capital.

**“The PRA welcomes innovations in this market as insurers seek to better support their clients. At the same time, we want insurers to understand the additional risks and uncertainties when accepting premium that includes such assets.”**

Secondly, the disruption in the UK gilt market last autumn resulted in some pension schemes being overweight in illiquid assets<sup>6</sup> as gilt values fell significantly, and schemes sought to reduce their leverage under liability driven investment strategies<sup>7</sup>. We see insurers increasingly developing solutions to accept illiquid assets as part of the BPA premium, as pension schemes may be reluctant to dispose of these assets in the open market, potentially at a large discount. This requires significant due diligence, and we are seeing insurers seeking more advice from third party specialists such as property valuation experts both for illiquid asset valuation and to calibrate adequate market value haircuts. Alternatively, we have seen deferrals of premiums incorporated in deals giving pension schemes time to dispose of such assets in an orderly fashion<sup>8</sup>. These premium arrangements can be complex and potentially capital intensive due to the increased uncertainty they can create. The PRA welcomes innovations in this market as insurers seek to better support their clients. At the same time, we want insurers to understand the additional risks and uncertainties when accepting premium that includes such assets. Even if firms use external expertise to price or manage these deals, Boards remain accountable for the decisions taken. They need to understand the basis for advice from third parties and to challenge the advice robustly. Straightforward questions need good answers: are these risks within appetite? have the bespoke features of the deal been considered over the full lifetime? how has the inherent uncertainty present been captured within the decision-making process? As noted in our 2023 Supervision Priorities letter<sup>9</sup>, we are carrying out a thematic review to assess whether BPA writers' risk management processes are keeping pace with their growth ambitions and expanding risk appetites.

#### **A reliance on third-party capacity**

The second area is the use of third-party capital and asset origination capacity, known as funded reinsurance, to support these large new business transactions that are both capital-intensive and put a strain on in house asset origination capabilities. In principle, attracting new capital to support BPA liabilities is positive – so long as the capital is aligned with the long-term risks it is intended to support.

Our work so far has focussed on the evolving contract and collateral structuring, the counterparty risk management frameworks, internal model approaches and firms' stress and scenario testing. We are exploring these aspects carefully and are increasingly focussed on four key elements:

1. Recapture events: We have looked at the circumstances under which the risks that insurers have ceded might end up back on their own balance sheets. Default of the reinsurer is only one of them. Voluntary and automatic contractual termination triggers linked to solvency coverage ratios, credit ratings, or legal and regulatory environments bring material uncertainty to the recapture triggers.
2. Wrong way risk: We have observed the emergence of reinsurers with newer business models narrowly focused on credit markets where diversification benefits might be less evident<sup>10</sup>. This introduces a wrong way risk as the quality of the collateral portfolio is likely to deteriorate as the financial condition of the reinsurer falls.
3. Collateral management: The latter two risks are magnified by the increasing use of less liquid assets in collateral portfolios such as structured products, commercial mortgages and private credit. Here, credit rating, valuation and matching adjustment (MA) eligibility uncertainty might exist which may not be adequately mitigated by valuation haircuts and margining practices.
4. Management actions: On recapture, insurers have to estimate the cost and mitigating effect of the management actions potentially available to them. This might include the cost of entering replacement contracts, asset portfolio rebalancing with potentially high transaction costs, unpredictable prices as market liquidity dries up, and unwinding or replacing large crosscurrency

**“In line with the Government’s objectives for Solvency II reform, insurers’ investment strategies have an important role in supporting sectors that require certainty of funding over the long term, including education, social housing and infrastructure.”**

hedging exposures. These bring material uncertainty, as estimates of the costs and benefits in stressed conditions are inherently difficult to predict accurately.

Taken together, these four elements are significant and should factor into the industry’s risk appetite for using third party capital and their asset origination capabilities. Senior managers therefore need to reflect on these inherent uncertainties when making business decisions. They need to approach these arrangements with caution and consider carefully whether their risk management processes are able to deal with these risks adequately. With responsibilities for pension payments for millions of policyholders for decades into the future, insurers need to demonstrate they can execute these transactions prudently and manage their risks over the whole life of the contracts.

More broadly, the long-term implications for the UK economy of these arrangements bear examination. Within the objectives of the Solvency II reforms, it is not clear that the incentives of third-party capital providers are aligned with UK insurers’ role in making investments in UK based long-term infrastructure and productive assets. Both the PRA and insurers need to think about the opportunity cost of funded reinsurance – in terms of UK direct investments foregone – as well as the benefits and risks.

#### **Greater interconnectivity with wider financial markets**

Related to that point, the third area I would like to touch on is a key aspect of the changing pensions and insurance landscape. One industry estimate, suggests that the UK life insurance industry could onboard more than £500bn of pension liabilities – and associated assets – over the coming decade<sup>11 12</sup>. This is a big structural change in the control of long-term investments in the UK, and the decisions that insurers make now will have long term consequences for the performance and development of the broader economy.

In line with the Government’s objectives for Solvency II reform, insurers’ investment strategies have an important role in supporting sectors that require certainty of funding over the long term, including education, social housing and infrastructure, and where financing the transition to net zero such as via renewable energy infrastructure and technologies requires patient and deliberate commitment. Making such investments can also generate a competitive advantage in a market where ESG credentials are increasingly valued by trustees<sup>13</sup>.

This could generate material benefits to society – and to insurers – provided they maintain discipline in their leverage, that is, the extent to which they deploy debt capital and use reinsurance to back their promises to policyholders. Taking on new BPA business in volume, over a relatively short period, will also involve significant hedging programmes via interest rate, cross currency and inflation swaps, more complex investment arrangements, and will increase interconnectivity with the wider financial market. Insurers therefore need to understand, as they take on these vast sums of assets and liabilities, how they may become greater sources or amplifiers of liquidity risk.

In this context, insurers need to focus on the feasibility of their own management actions under stress. Our 2022 Life Insurance Stress Test feedback<sup>14</sup> noted that concurrent reactions in stress can reduce the effectiveness of any assumed management actions. Better and more frequent information, improved modelling capabilities and enhanced liquidity management will inform this, but firms cannot fully resolve these uncertainties via these methods. Senior management therefore need to limit their need to rely on trading and rebalancing in stress, as such activities may destabilise financial markets further, which would be to their own detriment.



### Conclusion – Desired outcomes

The BPA market is in a period of accelerated growth and yes, while we are pleased with the opportunities this brings, insurers should approach this with moderation. A healthy and sustainable life insurance market is a long-term value creator for the whole economy. It is in everybody's interests to work together to ensure a dynamic vibrant industry for years to come. One that serves the needs of, and provides protection for, customers, and makes the strongest contribution it possibly can to investment in the wider UK economy.

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## May 2023 Poll Results

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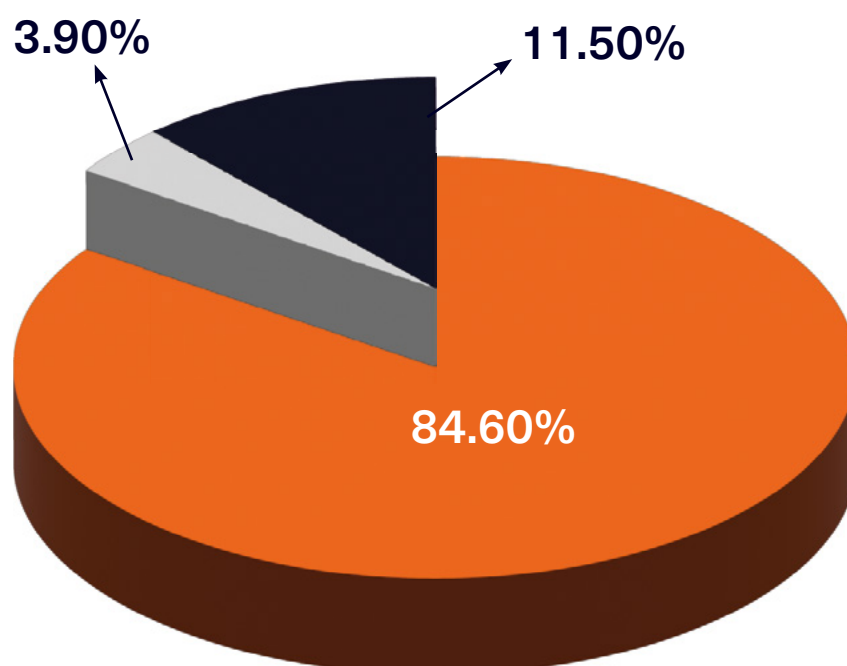
# Do You Think There Were More Secondary Market Life Settlement Policies Purchased in 2022 Compared to 2021?

Talk to almost any life settlement broker and they'll tell you that they saw an uptick in activity in the industry's secondary market in 2022 when compared to the prior year. Corroborating those views, however, isn't possible until the end of the Spring and early Summer each year, when trade body the Life Insurance Settlement Association and industry trade magazine The Life Settlement Report, part of The Deal, publish their own data which cover transactions in the secondary market.

So, ahead of these data releases, Life Risk News asked our readers, Do You Think There Were More Secondary Market Life Settlement Policies Purchased in 2022 Compared to 2021?

The response was overwhelmingly in the affirmative. 84.6% of survey respondents said that they thought that there were more secondary purchases last year when compared to 2021. 11.5% were unsure, and only 3.9% said no.

The next couple of months will tell the market whether the bulls or the bears were right.



# “Bet The Under”: Hedge Fund Manager Makes Costly Mistake



Author:

**S. Jay Olshansky**

Founder

**Lapetus Solutions**

**“The tables were not just mildly out of date, they were based on data that was more than a decade old. Since we knew that death rates for the U.S. population declined rapidly in that decade, that meant the bank was overestimating mortality and underestimating survival by a lot.”**

In 2009 my colleague and I were contacted by a hedge fund manager in New York City that was interested in investing in life settlements. He is well known, but I'll protect his identity to save him the embarrassment about to be revealed. We were flown out to NYC and visited his lavish board room where there were a half dozen people in the room accompanying the hedge fund manager.

They were considering an investment in a large portfolio of lives offered by a bank and wanted to know if we had insights on how long these people were likely to live. The investment was an over/under “bet” – they needed to decide whether there would be fewer or more deaths per month than predicted by the bank offering the investment.

A 3-page brief describing the specifics of the investment was placed before us, including most importantly the assumptions used by the bank to generate the monthly survival estimates.

Normally it might have taken some time to draw a conclusion about such a request, but in this case, my colleague and I looked up after just a few minutes reading the brief and we both said simultaneously – “bet the under”.

Shocked at how quickly we arrived at our conclusion, the hedge fund manager said, “how do you know this?” Simple, I said, “the folks at the bank used life tables that were out-of-date – this is a slam dunk”.

The tables were not just mildly out of date, they were based on data that was more than a decade old. Since we knew that death rates for the U.S. population declined rapidly in that decade, that meant the bank was overestimating mortality and underestimating survival by a lot. More people would survive each month relative to the prediction made by the bank. The speed and confidence we exuded in our answer unnerved the folks in the room more than just a little.

The skeptical hedge fund manager blurted out “what if some of these folks live forever?” They won't, we said, they'll all die. “What if some live to 120 or 130?” “It's highly unlikely”, we said, “the timing of death in humans is highly predictable and only one person in history lived past 120”. The hedge fund manager then went through a litany of medical breakthroughs that he believed were forthcoming, suggesting that there is great uncertainty in survival. It's worth emphasizing that survival analysis was not his area of expertise; it is ours.

Our response was “sure, these advances might happen, but even if they do, unless we find a way to modify the biological aging of our bodies, all the people in this investment pool will die out in a highly predictable way”. The folks in the room obviously had not read any of our published papers on the biological forces that govern human longevity and survival.

I then asked the hedge fund manager two questions that really threw him and the other people in the room for a loop.

The first was whether he could begin and end the investment whenever they wanted in a calendar year? The answer was yes, but he wanted to know why. I said, “If you bet the over, start the investment in November and end it in the month of February of some future year; if you bet the under, start the investment in March or April and end it in a future October. “Why” he asked. “Because of the seasonality of influenza deaths – which kill anywhere from 30,000 to 70,000 people every year in the U.S. (notwithstanding COVID-19). In this way you can juice up the return on your investment by using nothing more than timing.”

**“The hedge fund manager didn’t believe us, so they didn’t make the investment. We were able to track the survival trajectory of the investment cohort for the next year, and sure enough, there were many fewer deaths each month than predicted by the bank. This was a classic case of “adverse selection” where we had information on survival that the bank apparently either didn’t have or didn’t pay attention to.”**

They had no clue!

The second question was whether the bank reported on the chronological age of the individuals, or did they have dates of birth. “Why” he asked. “If you bet the over, cherry pick the cohort for people born in the same year, to include people born earlier in the year like January through March; if you bet the under, cherry pick the cohort to include people born later in the year like October through December.” The reason should be obvious – people born earlier in the year are older than people born later in the same calendar year.

At older ages, this can make a notable difference in survival. For an investment cohort of this size, using this information had the potential to juice returns even further. Jaws were dropping right and left at this suggestion. Again, they had no clue!

What happened after we left?

The hedge fund manager didn’t believe us, so they didn’t make the investment. We were able to track the survival trajectory of the investment cohort for the next year, and sure enough, there were many fewer deaths each month than predicted by the bank. This was a classic case of “adverse selection” where we had information on survival that the bank apparently either didn’t have or didn’t pay attention to.

The hedge fund manager and his associates were extremely cautious, and we got that, but we handed them a golden goose of adverse selection on a silver platter and their arrogance and misinformation led them astray. They could have made a killing on that investment if you’ll excuse the play on words. My colleague and I would have bet our retirement funds on the under.



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# Q&A

**Thomas Deinet**

Executive Director, Standards Board for Alternative Investments (SBAI)



Alternative investments industry body the Standards Board for Alternative Investments (SBAI) sets industry standards and maintains several asset-class specific 'toolboxes', designed to provide asset managers and investors active in those markets with guidance documents specific to their needs. Greg Winterton spoke to Thomas Deinet, Executive Director at the SBAI, to learn more about their work in the insurance-linked space, ESG, and alternative credit more broadly.

**GW: Thomas, the SBAI's work in the insurance linked strategy space focuses primarily on the catastrophe risk investing market. What originally drove the decision to create standards specifically for this segment of the alternative credit market?**

**TD:** The SBAI's Alternative Investment Standards apply to a wide range of alternative investment strategies, including ILS fund managers. But specific practices in areas such as valuations are different in insurance linked strategies compared to other alternative asset classes, such as long short equity, macro strategies, CTAs, credit, etc. With our community of ILS managers and institutional investors, we have identified areas where more clarity and consistency of practices was needed, and then set out to develop industry guidance on these topics which is available in the SBAI Toolbox. Our ILS Working Group brings together institutional investors and asset managers to discuss relevant industry issues and produce practical guidance.

In addition to the SBAI's ILS Toolbox, the Insurance Open Protocol Risk Reporting Template allows for standardised risk reporting to investors.

**GW: The first resource the SBAI published in this area was focused on valuation. That's something that is critically important in the life settlement market as well. What are the main points to note in the insurance linked strategy space in this regard?**

**TD:** ILS funds typically invest in a spectrum of assets that may range from catastrophe bonds to private collateralised reinsurance structures. Large catastrophic events are often complex, and the ultimate insurance related losses may not be known for a considerable period after such an event, potentially resulting in material valuation uncertainty over an extended period. The valuation required is a single number, but this number is often the summary of a wide range of potential outcomes.

As there is no secondary market in most types of insurance exposures written by ILS funds, managers are required to derive their own valuations, although third-party valuation firms may be utilised to various degrees in the valuation process. One exception is the catastrophe bond market, for which a secondary market does exist, and third-party pricing indications are available at most times from brokers, although in times of stress the bid/ask spread may be very wide.

While it is clearly desirable to have "accurate" valuations quickly after a loss event, actual loss information will materialise over time as insurance claims are reported, adjusted and settled.

The SBAI ILS Valuation memo addresses this by setting out the key features of a robust valuation framework for ILS managers, including governance and disclosure, valuation policies, and covers ILS specific valuation issues including dispersion of loss estimates, differences in valuation approaches, and side pocket.

**GW: The SBAI has done extensive work in the area of responsible investing. How does the SBAI see this in relation to the insurance-linked space?**

**TD:** ILS is an asset class that provides value for society, and therefore can be seen to have inherently positive responsible investment (RI) characteristics.

Instruments such as catastrophe, reinsurance or publicly traded bonds provide the means to recover from disasters, helping governments, companies and individuals to rebuild. Dedicated RI approaches within ILS, however, are in their infancy and often do not fit neatly into regulatory or industry-based reporting frameworks. As with many other alternative investment strategies, both the practicality and the effectiveness of RI integration and dedicated RI approaches can vary, and application of these strategies requires careful thought and discussions between asset managers and allocators.

As the focus on RI related risks has increased, these risks have begun to feature more prominently in the investment process. In the SBAI Policy Framework, we highlighted the importance of a flexible and well understood process to ensure that time and resources are spent on the risks that are financially material to the strategy.

Insurance by its nature has long considered environmental risk factors within its investment process, particularly in the case of insurance against natural catastrophes. Social risk factors are also considered by many ILS managers in underwriting decisions looking at items such as claims behaviour and assignment of benefits and others – albeit less explicitly.

Whilst there are issues with transparency of RI data, it is still possible to create internal frameworks to include the assessment of RI related risk factors in the investment process. Asset managers can establish processes to identify and assess RI-related risks and/or opportunities that are inherent in the portfolio. A framework of this sort would integrate RI-related risks and opportunities into the risk management and underwriting process.

**GW: Many firms in the longevity and mortality risk space see their industry as being closest to the alternative credit space, and the SBAI has done plenty of work here, too. What are the main similarities or differences in valuation between your ILS and alternative credit toolboxes?**

**TD:** For any type of fund, valuation is the process of determining the fair value of the assets and liabilities that underlie the calculation of the fund's Net Asset Value at a given time. Valuation can be straight forward for funds that trade in liquid markets, where for example closing prices of securities are readily available, but it gets more difficult when assets or liabilities are less liquid or not traded at all, as it is the case in private credit or private collateralised reinsurance structures.

Robust valuations frameworks for such illiquid assets are important, since they address conflicts of interest between different investors in the same fund where investors can subscribe or redeem from the fund, they address conflicts of interest between the manager and the investors since valuations affect the compensation of the manager, and they facilitate performance assessment and comparison.

The SBAI's work on Alternative Credit Valuation, available in the SBAI's Toolbox, focusses on the fair value process of loans, including Enterprise Value Estimations and Financial Instrument specific valuation approaches. In contrast, for ILS funds, valuation requires the capture of information about material loss events to which the investments may be exposed, to assess the fair value impact of these events.

Irrespective of a fund's strategy, our Standards and Toolbox materials related to valuations focus on a foundation of strong governance with appropriate oversight, checks and balances. Sourcing and managing accurate data and valuation inputs is also important. We believe strongly in avoiding conflicts of interest and where they do exist in the valuation process, they should be appropriately documented and communicated in a transparent manner to investors.

**GW: Lastly, Thomas, the failure of Silicon Valley Bank (SVB) is a stark reminder that banks are vulnerable. What is the key message to institutional investors when assessing counterparty risk?**

**TD:** The failure of Silicon Valley Bank (SVB) is indeed a stark reminder that banks are fragile, and we just published a brief paper on this. For institutional investors, the SVB failure provides food for thought as to how their investment managers and fund vehicles engage with banks and counterparties (such as prime brokers, OTC relationships, etc.) more broadly, as well as the extent to which concentration risk and overreliance can become entrenched.

The fallout of this event continues and there have been a number of subsequent failures. Stress in the US and European banking system is still present. The SVB failure reminds institutional investors that:

- i) The financial health and stability of any institution cannot be taken for granted, and
- ii) Events in the financial services industry can develop at a rapid pace.

To address some of the concerns raised by the SVB, we have promoted the utilisation of the standardised Administrator Transparency Report (ATR) Template (<https://www.sbai.org/toolbox/administrator-transparency-reporting-atr.html>), which helps investors identify and track exposure to counterparty risk (including cash deposits) within comingled investment funds through periodic reports. Investors can then aggregate risk exposure across funds to obtain an overall risk perspective. This facilitates ongoing monitoring and informs

risk management decisions. It is worthwhile noting that ATRs are common among hedge funds but are not used in venture capital or private equity, where most exposure to SVB resided.

Similarly, Open Protocol risk reporting can be applied to the ILS space and our Toolbox provides guidance on how to do this.

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# Life Settlement Market Trends Solid But Investors Should Look Below The Headline Numbers

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Life Risk News

If you ask a life settlement broker if they think that secondary market activity was higher in 2022 than in 2021, you'll likely receive an enthusiastic 'yes'. Industry body the Life Insurance Settlement Association has published their annual data now, and trade magazine The Life Settlement Report, part of The Deal, also collects its own data direct from the states, so shortly, empirical evidence will be available to either support or contradict those views.

Transaction data in the tertiary market isn't as straightforward to come by, but Zurich, Switzerland-based investment advisor AA-Partners (AAP) collects some of this data, and 2022 provided a welcome rebound in activity in the life settlement industry's most opaque space.

"In the tertiary market, the number of single transactions bounced back last year. While activity was still slightly short of the 2020 level, it was up substantially on 2021," says Beat Hess, Managing Partner at AAP.

AAP data suggests that the average face value of single transactions decreased from \$4m to \$2.4m last year, the average age of insureds decreased to 80.6 years of age (down from 84.7 years in 2021) and the average life expectancy of the insureds increased to 70 months, up from 62 months the previous year.

**"In the tertiary market, the number of single transactions bounced back last year. While activity was still slightly short of the 2020 level, it was up substantially on 2021."**

Unlike the life settlement industry's secondary market, however, inferring trends from tertiary market data isn't as straightforward, and Hess cautions newer investors that are looking at the space to take it with a pinch of salt.

"70% of the reported activity in our life settlement transaction data collection is transacted in the tertiary market, so more than twice the secondary market," he says.

"But tertiary market deals are to a significant part driven by supply. The data is much less homogenous than in the secondary market – it's very dependent on who comes to market, and with what."

Of course, that's not to say that the data is irrelevant. Investors, whether they be new or familiar with the space, can make good use of tertiary market information.

"The primary way that investors should use tertiary market data is as a check and a balance on valuations. Policies are only worth what another buyer is willing to pay. Therefore, tertiary market transactions are the correct reference point for the valuation of life settlement portfolios," says Hess.

In the industry's secondary market, activity level information does provide investors with a solid pulse on the overall direction of the market. The life settlement market needs a constant supply of 'new blood' in order to be sustainable in the medium to long term, so any growth in these numbers would be welcome to investors, managers, and service providers alike.

But even in a growing secondary market, Hess urges investors to drill down into the life expectancies (LE) that managers are using. Data collected by AAP shows that the average LE used for closing in the secondary market was similar in 2022 to those used in 2021 or 2020 – however, these are considerably longer than they were in 2018 and 2019. Furthermore, the number of LEs per transaction has decreased from approximately 1.8 in 2014 to 1.14 last year. The trend in the decrease of the number of LEs used per transaction was overlapped by a significant switch from the firms that were the dominant medical underwriters until about 2018 to newer, and previously less often used, medical underwriters.

"The LEs are provided by the sell side, which has an interest in short LEs since the transaction price becomes higher with shorter LEs," says Hess. "But starting back in fall 2018, a significant lengthening of LEs occurred and consequently, the market for LEs started to shift. The use of the two main medical underwriter firms dropped off and they were replaced by historically less often used medical underwriters or even new medical underwriters with a short track record."

The average medical underwriting is significantly longer today than in the years up to 2018, and this is a good thing. This does not mean that the LEs are overall correct today, but the LEs are overall longer than in the past which improves the situation for today's investors overall."

**"It's wrong to use discount factors from actual transactions and actual medical underwriting and to apply it to policies purchased in 2018/19 because by doing that, you're inflating the value of your assets. If the assets are priced higher, the regressions should be distinct. The valuation has not substantially changed."**

"Therefore, it's wrong to use discount factors from actual transactions and actual medical underwriting and to apply it to policies purchased in 2018/19 because by doing that, you're inflating the value of your assets. If the assets are priced higher, the regressions should be distinct. The valuation has not substantially changed," says Hess.

Still, positive trends in the life settlement market, like in other asset classes, are to be cautiously welcomed.

"Some of the trends that we have observed, both in the past year or so and in the more medium term, should provide encouragement to investors," says Hess. "But there are still a lot of blind spots that investors need to try and be aware of."

The impact of longer LEs on the life settlement market is that projected IRRs have fallen. AAP also collects valuation data, and a regression analysis conducted by the firm shows that valuations haven't changed materially in the past five years. Lower projected IRRs in today's market environment therefore don't reflect higher prices. The relative prices today are largely in line with 2018/2019, the lower projected IRR therefore don't result from higher prices but from longer LEs.

## Secondary Life Markets Conference 2023

**Date:** September 12<sup>th</sup> 2023

**Location:** EY, Canary Wharf, London, UK



