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Personnel Battle Heating Up As Constituents Change in Booming UK Pension Risk Transfer Market

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Editor's Letter, Volume 3, Issue 03, March 2024

Chris Wells
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Life Risk News

The first two weeks of March have provided new constituent developments in the UK's pension risk transfer market as industry players compete for talent. *Greg Winterton* spoke to **TC Jefferson**, Managing Partner at executive search firm **The Plenum Group** and to learn more, with additional commentary from **James Mullins**, Head of Risk Transfer at consulting firm **Hymans Robertson** in *Personnel Battle Heating Up As Constituents Change in Booming UK Pension Risk Transfer Market*.

The **European Life Settlement Association** (ELSA, publisher of Life Risk News) has recently published Selling a Life Insurance Policy: Why and How, a 'fact sheet' that the organisation says is designed to help investors less familiar with life settlements understand why insureds sell their policy in the first place. *Greg Winterton* spoke to **Rob Haynie**, Managing Director at life settlement broker **Life Insurance Settlements** and **Bryan Nicholson**, Executive Director at US trade group the **Life Insurance Settlement Association** to get their views on this topic more broadly in *Drivers of Policy Sales Persistent but Bigger Picture More Interesting to Investors*.

Obesity is a factor in all of the four main non-Covid causes of deaths in the UK in 2022, but evidence has emerged that certain cohorts may in fact benefit from a certain amount of extra weight. *Aaron Woolner* spoke to **Rahul Nawander**, Medical Director at life expectancy underwriters **Fasano Associates** and **Nicola Oliver**, Director of Life and Health at longevity specialists **Medical Intelligence**, to learn more in *Solving The Obesity Paradox, When Being Fat Is Good For You*.

Roger Lawrence, Managing Director at **WL Consulting**, returns with his third and final analysis piece based on the 2023 edition of the **ACLI**'s Life Insurance Fact Book. This time, some interesting observations specific to the life settlement industry, in *Decline in US Life Insurance Policy Numbers Offset by Rising Aggregate Face Amount*.

Valuing a life settlement is a complicated process with different approaches. **Beat Hess**, Partner at **AA-Partners**, offers his thoughts on what investors should be cognisant of when discussing valuation and NAV curves with asset managers in the space in *NAV Performance and Valuation Reporting Considerations in Life Settlements*, a guest article.

Our *Q&A* this month features **Anna Bailey**, Managing Partner at life settlement investor, **Chestnut Capital Management**. Bailey offers her views on smaller face value policies, investor awareness and more.

The insurtech market is in the midst of something of a maturation, but there is one corner of the space that is yet to be disrupted. *Greg Winterton* spoke to **Brian Casey**, Partner at **Locke Lord** to get his thoughts on the space, with commentary from **Robert Le**, Senior Analyst, Emerging Technology at **PitchBook** in *Annuities Could Provide Bright Spot for Struggling Life Insurance Insurtech Market*.

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

Personnel Battle Heating Up As Constituents Change in Booming UK Pension Risk Transfer Market

Author:
Greg Winterton
Contributing Editor
Life Risk News

Last September, the UK pension risk transfer (PRT) market received a new entrant in the form of M&G, the ninth insurer to enter the market; its inaugural transactions were with its own pension fund, and an unnamed external scheme.

On 8th March, the market officially welcomed its tenth. Royal London announced its 2023 results in a press release, and one specific bullet point in the release had many in the PRT market talking.

"[We] Extended our annuity capabilities in advance of an intended participation in the bulk purchase annuities market, focused on providing a competitive solution to the trustees of defined benefit pension schemes," said Royal London in the release.

That there should be two new players in the market should come as no surprise. The UK PRT space has seen significant growth in the past few years; consulting firm Hymans Robertson published a press release on 12 March which stated that 'total pension scheme buy-in and buy-out volumes for 2023 reached an all-time high with both the number and value of transactions secured the highest ever recorded'.

> **"We also continue to see a healthy and competitive market for smaller schemes that want to transfer risk. For instance, all our buy-ins transactions under £30m received quotations from multiple insurers in 2023"**
> **- James Mullins, Hymans Robertson**

Data collected by Hymans Robertson shows the extent of the increase in deal activity. The firm published Risk Transfer Report 2024 on 1 February, its annual deep dive into the bulk annuities market in the UK. The appendix to the report contains a timeline of aggregated values of longevity swaps, buy-out and buy-in transactions since 2009.

Notably, until last year, the highest aggregate value of buy-in and buy-out transactions took place in 2019 and 2020, at £43.6bn and £31.3bn, respectively, before interest rates began to rise in the UK. But there were clearly some very large transactions that skewed the numbers; data provided by Hymans Robertson to Life Risk News suggests that a total of 153 buy-in and buy-out deals were completed in 2019, and 141 in total in 2020, compared with at least 254 (Hymans Robertson has still to finalise its 2023 data collection effort) in 2023, where £48.2bn worth of deals have so far been completed.

Many in the industry have wondered whether the market would end up being dominated by activity in the mid-larger end. The time commitment to analyse and price a £1bn deal is generally not ten times the effort it takes to do so for a £100mn transaction; larger mandates make more money, which lead to some speculating whether smaller schemes might get pushed to the back of the queue. Fortunately, for trustees of smaller schemes that are looking at a bulk annuity solution, James Mullins, Head of Risk Transfer at Hymans Robertson, says in the press release that concern didn't come to fruition in 2023.

"We also continue to see a healthy and competitive market for smaller schemes that want to transfer risk. For instance, all our buy-ins transactions under £30m received quotations from multiple insurers in 2023," Mullins says.

Hymans Robertson also expects the UK PRT market to sustain the activity levels of last year into this – and beyond. Mullins says in the press release that "there are over 15 buy-in transactions due to come to market over the next few months that are each between £1bn and £2bn. This group of large transactions alone add up to around £30bn and that's before we take into account the material flow of buy-ins that are less than £1bn, along with mega transactions that are several £billion in size."

Many tailwinds exist to support Hymans Robertson's view. That there are soon to be ten insurers active in the UK PRT is an obvious one; there is simply more capacity to complete bulk annuity deals now. Also, the UK government has begun to implement changes to the Solvency II regulatory regime; a key change is a reduction in the risk margin that insurers need to hold, which should free up capital, allowing them to take on more bulk annuity business without exceeding solvency requirements. Additionally, wider investment options will exist, allowing insurers to invest in a broader range of assets, which could improve their ability to match the long-term liabilities of bulk annuities.

But one challenge that may serve to put the brakes on the PRT freight train is that of just how many people are available to do the work. TC Jefferson, Managing Partner at executive search firm The Plenum Group, says that activity at present is at an all-time high.

> **“£50bn a year will be the new normal for buy-in volumes, with the market expected to be at least that level every year for the remainder of the decade”**
> **- James Mullins, Hymans Robertson**

“Demand for pension risk transfer professionals is greater than ever,” he says. “There is significant competition for people with deal experience from both insurance companies and the specialist consulting teams. The demand is across the board, and we are increasingly fielding mandates for operation roles as well as pricing and consulting positions.”

The activity is so intense that the market is behaving almost like the tech industry of the late 2010s, and the banking industry pre-global financial crisis.

“We’ve seen more counter-offers in the last twelve months than at any time in the last 15 years combined,” says Jefferson. “And even firms that don’t have an active mandate are receptive to reviewing the details of someone who might be able to bring pension risk transfer expertise.”

The runway for the PRT market in the UK is long. Consulting firm WTW says that there are approximately £1.3trn of defined benefit liabilities in the UK, with only 15% of those having been insured via a bulk annuity deal. The extent to which human capital constraints impact the growth of the market remain to be seen, and the same can be said for the country’s regulatory changes. But for now, Mullins says that the recent past should be something of a ‘new normal’.

“£50bn a year will be the new normal for buy-in volumes, with the market expected to be at least that level every year for the remainder of the decade.”

Drivers of Policy Sales Persistent but Bigger Picture More Interesting to Investors

Author:
Greg Winterton
Contributing Editor
Life Risk News

Despite their industry now being two decades old (in its current form), life settlement asset managers still, occasionally, have to undertake the role of educator when discussing the asset class with a potential new investor.

One question that is known, anecdotally, to come up is: 'Why would anyone want to sell their life insurance policy?'

After all, in many countries in Europe, the Middle East and Asia, you can't sell it, so those less familiar with the nuances of Grigsby vs Russell – and the multi-billion-dollar industry that the case created (albeit approximately 90 years later) – will not know this option even exists in the US.

So, trade group the European Life Settlement Association (ELSA, publisher of Life Risk News) has recently published 'Selling a Life Insurance Policy: Why and How', a 'fact sheet' that the organisation says is designed to help investors less familiar with life settlements understand exactly that.

> "Mid-sixties is an approximate age where activity in the market starts to pick up because many of these polices on younger seniors are cheaper, so that's the attraction for buyers at the younger end of the market"
> - Rob Haynie, Life Insurance Settlements

The rationale behind highlighting the reasons why a policyholder sells a life insurance policy is twofold; the first one is of reassurance, as end investors less familiar with the life settlement market want to know that their underlying asset managers have the ability to execute their strategy in the medium to long term; life settlements are illiquid assets, and many of the funds in the market are closed-ended, private equity-style vehicles with a long duration. Asset managers are not paid to sit on cash, so investors want their money deployed.

Fortunately – for the life settlement industry – demographics are on its side. Every year, millions of Americans turn 65; a recent article in Axios says 4.1 million will do so in 2024, a record.

"It's not that life settlement investors won't look at a policy on a 64-year-old, for example," says Rob Haynie, Managing Director at life settlement broker Life Insurance Settlements. "But mid-sixties is an approximate age where activity in the market starts to pick up because many of these polices on younger seniors are cheaper, so that's the attraction for buyers at the younger end of the market."

Regardless of age, Selling a Life Insurance Policy: Why and How cites four main reasons that account for deal flow in the industry's secondary market: affordability, financial reasons, health reasons, and lack of need.

Health and financial reasons are the two reasons most often cited as providing a societal benefit, the other side of ELSA's rationale for producing its latest fact sheet.

"Selling a life insurance policy can unlock capital to fund a wide range of spending. This includes healthcare, which provides a better qualify of life for seniors. But it also includes paying down any debt or providing a deposit for a house for someone's children or dependents. All of these are benefits to society more broadly," said Bryan Nicholson, Executive Director at US trade group the Life Insurance Settlement Association (LISA).

The biggest of the four reasons cited by ELSA in its fact sheet in terms of driving supply is lack of need, according to Haynie. However, he adds that there is a bigger picture to any conversation around the drivers of supply that a potential investor should be cognisant of.

"All these reasons are drivers of activity in our space, but lack of need is probably the biggest. But it's also important to say that many seniors don't even know about it. Think of a bridge – for every one person who crosses to the other side where the payout is, there are 6,000 that don't even know the bridge exists," he says.

Haynie's comment segues into the ever-present challenge – and opportunity – that those in the life settlement space say is in front of them.

Every year, approximately 3,000 life settlement transactions are completed in the secondary market. Many in the industry express frustration that the number isn't significantly higher; another 'fact sheet' published by ELSA in December 2023 claims that the value of all of the life settlement transactions by dollars was, at $4bn, just 0.64% of the value of all lapsed and surrendered policies in 2022 and that, "if the percentage value of all in-force life insurance in the United States that would qualify for the life settlement option were just 2%, then the life settlement secondary market could potentially be three times its current size in any given year".

> **"The challenge our industry faces is not one of viability, it's an awareness issue. We want and need that 3,000 number to increase – that's the rising tide that will lift all boats"**
> **- Rob Haynie, Life Insurance Settlements**

Efforts are underway to move the needle, both at the individual firm level and the industry level, mostly through trade associations like LISA in the US and ELSA in the UK. But for Haynie, the reasons why policyholders sell, and the persistence of those reasons, means that the runway for the industry remains long.

"The challenge our industry faces is not one of viability in the medium to long term. The reasons why an insured sells their policy have always been there and will always be there," Haynie said.

"It's an awareness issue. We want and need that 3,000 number to increase – that's the rising tide that will lift all boats and the potential for that to increase significantly is the biggest reason why investors should be excited about this market."

Solving The Obesity Paradox, When Being Fat Is Good For You

Author:
Aaron Woolner
Contributing Editor
Life Risk News

Obesity is a killer, but nobody dies directly from being overweight. Instead, excess pounds are linked to a higher risk of getting type II diabetes, developing fatty liver, and having a stroke, while research links obesity to up to 8% of all cancer cases.

Obesity is a factor in all of the four main non-Covid causes of deaths in the UK in 2022, while diabetes itself is a risk factor for heart disease, the leading cause of mortality worldwide.

The number of overweight people is so high globally that the World Health Organisation has dubbed it an, 'obesity epidemic'.

> **"There's over a billion obese people globally and we know without any debate that being overweight increases your risk of chronic diseases"**
> **- Nicola Oliver, Medical Intelligence**

"There's over a billion obese people globally and we know without any debate that being overweight increases your risk of chronic diseases such as diabetes, heart disease, cancer, and musculoskeletal disease," says Nicola Oliver, Director of Life and Health at longevity specialists Medical Intelligence.

Being overweight may be a proxy for a number of leading causes of mortality but Rahul Nawander, Ontario-based Medical Director at life, health, and life settlement firm Fasano Associates, says that thinking over the dangers posed by obesity has changed over the last ten to 15 years.

Evidence has emerged that certain cohorts may in fact benefit from a certain amount of extra weight.

The Body Mass Index (BMI) has been the main indicator of the extent of someone's obesity (or not). It is calculated by dividing a person's body mass by the square of their height; a BMI over 25 means a person is considered overweight, more than 30 and they are considered obese.

Oliver says there is a fundamental problem with the use of BMI and that its relatively blunt approach can classify otherwise healthy people as obese.

"BMI may not be the best measure of obesity. Take the example of a professional rugby player or a bodybuilder, these people are by definition very fit but because of their muscle bulk they would be classified as overweight or possibly even obese. However, BMI remains a good proxy for measuring bodyweight" she says.

But Nawander says questions are also being raised over whether a high BMI is always negative for health. He says that, while traditionally, obesity has been considered as being bad and that people should look to lose weight if they were classified as obese, research has emerged which challenges this thinking - for some cohorts, at least.

"Several studies have found obesity is an independent predictor of mortality. Interestingly this research also found that when you look at people older than 65 there is a term known as the 'obesity paradox'.

"What this means is that people in this age group who are obese tend to have a slightly better life expectancy compared to people who have a BMI of around 25 or even less. The hypothesis is that frailty becomes an issue after the age of 65 and a certain amount of extra weight can be helpful," says Nawander.

The additional weight can be positive in the case of hospitalisation as overweight patients have fat reserves to help deal with the well-documented issue of poor food in medical facilities.

Nawander says that the obesity paradox is only apparent among older people who are mildly overweight and that in severely obese people, other mortality risk factors supersede its impact.

"Not that every overweight person benefits from the obesity paradox. Once a person's BMI goes over 36 or 37 then the other ill-effects from being obese will determine the mortality outcome. There's a small window where being overweight is good," says Nawander.

According to Nawander, knowledge of the obesity paradox is filtering through to pricing life settlements contracts. Whereas the traditional approach would be to apply a certain amount of debits to a policy holder whose BMI was higher than the average for their cohort, now, firms are acting differently.

"If a person's BMI was between 30 to 35, previously we would assume they had a lower life expectancy. But now we look at this differently and say that additional fat could be helpful from a life expectancy perspective," he says.

Nawander is bullish that obesity's risk to health can be tamed by the latest generation of medication, of which some has garnered much attention on social media from Tik Tok and Instagram influencers for their apparent weight-loss capabilities.

> **"A future trend could emerge over the next 10 to 12 years where you start to see people who in general are close to their optimal weight. Perhaps the current obesity epidemic will be contained to an extent"**
> **- Rahul Nawander, Fasano Associates**

While these intravenous medications are designed for treating diabetes, their role in controlling the production of glucagon - a hormone produced by the pancreas to help regulate blood glucose levels - has produced positive results in relation to weight loss.

Nawander said that life settlement providers are now encountering applicants which don't have diabetes but are using glucagon control medication to regulate their body weight.

"A future trend could emerge over the next 10 to 12 years where you start to see people who in general are close to their optimal weight. Perhaps the current obesity epidemic will be contained to an extent," he says.

Oliver says that the impact of the current generation of weight loss medication is limited because in theory they are only available to diabetes patients and a very specific subset of the overweight population.

But she points to the large rewards available to the pharmaceutical firm which manufactures the first mass-market obesity medication and says that currently there are 600 obesity treatments which are in phase three trials.

"There's not a shortage of appetite amongst pharmaceutical companies to develop a successful medication. Phase three trials are at the advanced assessment stage and firms are usually pretty confident at this point, given the requirements of the first two phases which are rigorous and involve spending a substantial amount of money, that they will achieve success," she says.

"There is a big pipeline of potentially important treatments coming onto the market, some are medications, others focus on lifestyle and possibly some surgical treatment," Oliver adds.

Nawander is positive that an effective and low-cost obesity treatment would have multiple positive health implications for life expectancy.

"Mortality improvements won't come from across the board as diseases will be affected differently by a reduction in obesity. I'm also not saying that someone who we are quoting to live 90 years today will live to 100 in five years' time. But maybe it could shift from 90 to 93 over a relatively short period. It will be a step-by-step process," he says.

Decline in US Life Insurance Policy Numbers Offset by Rising Aggregate Face Amount

Author:
Roger Lawrence
Managing Partner
WL Consulting

The third of our reviews of the ACLI digest of US Life Insurance statistics focusses on how factors affecting the life settlement market are developing. Key amongst these are the surrender volumes, which help indicate the volumes of policies that could be available to trade, and the rate of new business.

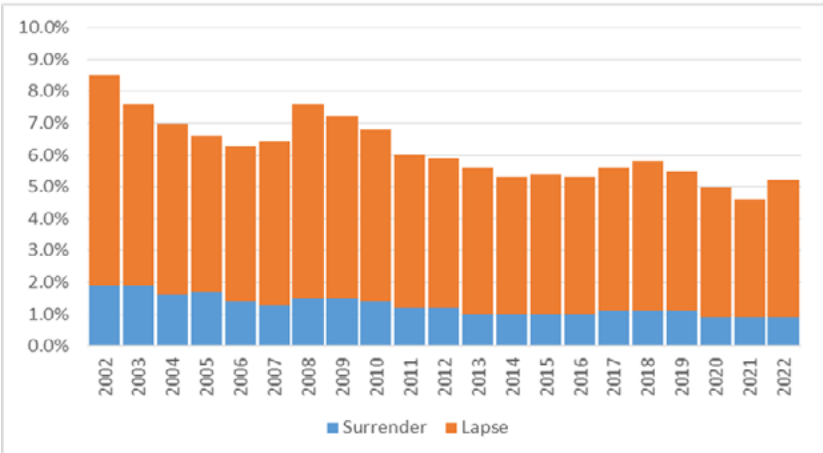
The ACLI data are all retrospective, and the latest set refers to the year 2022 which, by now, is already just over a year old compared to market participants' current experience; it is also information of a low granularity, so one needs to be aware that there are some generalisations being used to imply trends. The types of policy most commonly traded in the secondary market are only a sub-set of the whole range of life insurance products issued, so a trend in total business may not perfectly reflect the trend in tradeable products alone.

"The types of policy most commonly traded in the secondary market are only a sub-set of the whole range of life insurance products issued, so a trend in total business may not perfectly reflect the trend in tradeable products alone"

Policy Cancellations

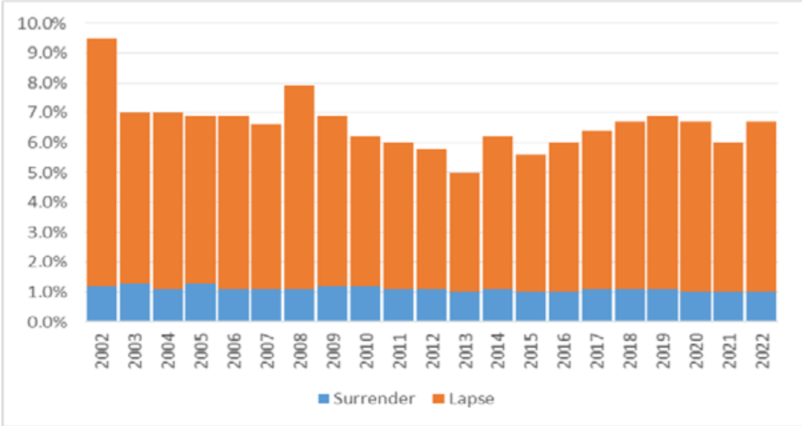
Policy exits will come about as death or maturity claims and, possibly most commonly, through lapse (with no value) or surrender (if there is an intrinsic value), although the two may be aggregated in some statistics. The ACLI provide cancellation rates split by surrender and lapse and split the figures between individual and group policies. We will focus on individual policies, as shown in Figures 1 and 2 below, but there is no further granularity between product types.

Figure 1: Individual Policy Cancellations by Face Amount



Source: ACLI Life Insurers Fact Book, 2023 Edition

Figure 2: Individual Policy Cancellations by Number



Source: ACLI Life Insurers Fact Book, 2023 Edition

Over the twenty years from 2002-22, cancellation rates have been slowly reducing; that applies to surrender rates as well as lapse rates, and by both policy numbers and by face amount. Periods of financial stress, notably 2008 and 2009, affected cancellation rates as one would intuitively expect. 2022 saw an uptick in total cancellations from 2021 as higher interest rates and inflationary effects on consumer budgets started to bite; it's not unlikely that this may have continued into 2023 and 2024.

Lapse rates will include all term policy cancellations and a proportion of universal Whole of Life (WOL) policies that have been allowed to lapse after draining any built-up policy value. Surrenders will primarily be WOL and Endowment policies that are simply cancelled on the spot whilst the policy still has a positive value, probably because there is no longer a need for life cover, settling a divorce, or for capital raising reasons, rather than allowing the policy to dwindle away by running down policy value.

The 2022 total cancellation rate was 6.7% (lapse 5.7%; surrender 1.0%) by policy number but only 5.2% (lapse 4.3%: surrender 0.9%) by face amount. That pattern applies to all historic years and again is to be expected as it tells us that on the whole it is the small face policies that are most frequently cancelled early, and it is likely that these are held by people more susceptible to a personal financial shock.

> “Whilst the absolute values for cancellation rates of WOL policies are important to the life settlement secondary market, so too are the relative patterns on a year-by-year basis”

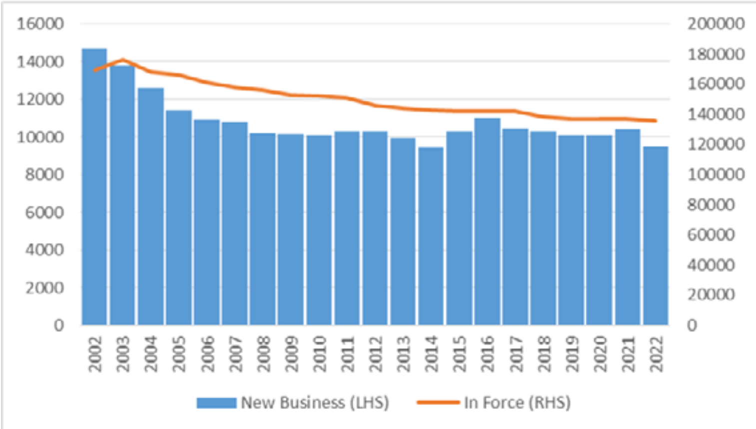
From all of these values, the most interesting ones for the life settlement market are the rates of cancellation of WOL policies, although some other policy types are traded. Unfortunately, there are no more granular figures available to specifically extract such values. We can fairly reasonably assume the vast bulk of the surrenders relate to WOL policies and together with a smaller proportion of the lapses. The surrender rates themselves are an aggregate figure for all policy types, so the rate that applies to just a population of WOL policies in force will be greater. By how much is not possible to tell, but it is at least twice the stated rate for surrenders judging by the relative levels of new policy sales between the two product groupings (reviewed below).

Whilst the absolute values for cancellation rates of WOL policies are important to the life settlement secondary market, so too are the relative patterns on a year- by- year basis. This is remaining stable, albeit with the emergence of a slight bulge in 2022, and one would expect this to continue whilst higher interest rate conditions prevail. Regulatory pressure on insurers to increase persistency, and to reduce potentially unwanted product sales, will be forces pushing back against the life settlement market, but there is a limit to how far this can go as there will always be a need for some policyholders to cancel early.

New Policy Sales and In Force Life Insurance

These values are of interest to the life settlement investor because they represent the reservoir of future tradeable product and the rate at which the stock is being built up or replenished as other policies drop away as lapses, surrenders, or claims. Both Numbers and Aggregate Face Amounts are provided in Figures 3 and 4 below. In our analysis, we have concentrated on individual policies, although there is also a substantial number of group certificates as well; these, however, are typically much smaller in value and have been excluded.

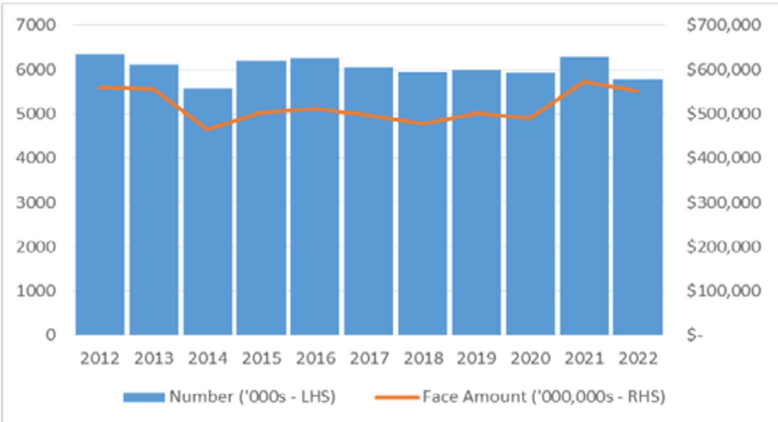
Figure 3: Individual Life Insurance Policies, New Business and In Force, by Number



Source: ACLI Life Insurers Fact Book, 2023 Edition

> “Measured by face amount, new business levels are broadly flat throughout the period. This contrasts with a decline by numbers, suggesting that larger policy sizes are compensating for reducing volumes”

Figure 4: Life insurance Policies, New Business and In Force, in Aggregate

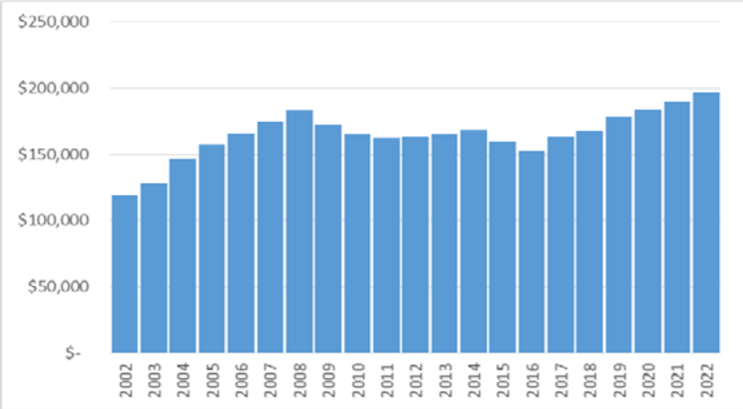


Source: ACLI Life Insurers Fact Book, 2023 Edition

The aggregate in force face amount has steadily increased and is now $14.02 trn. The rise in this value represents an annual growth rate of 2.1%pa which, when compared to the growth rate of US GDP over the period of 4.3%pa, represents a slow decline in value in real terms.

By policy number, the trend has been for slowly reducing volumes of sales although the rate of decline has reduced in recent years. Measured by face amount, new business levels are broadly flat throughout the period. This contrasts with a decline by numbers, suggesting that larger policy sizes are compensating for reducing volumes as can be seen in Figure 5 below.

Figure 5: US Life Insurance New Business, 2002 – 2022, Annually by Average Face Amount

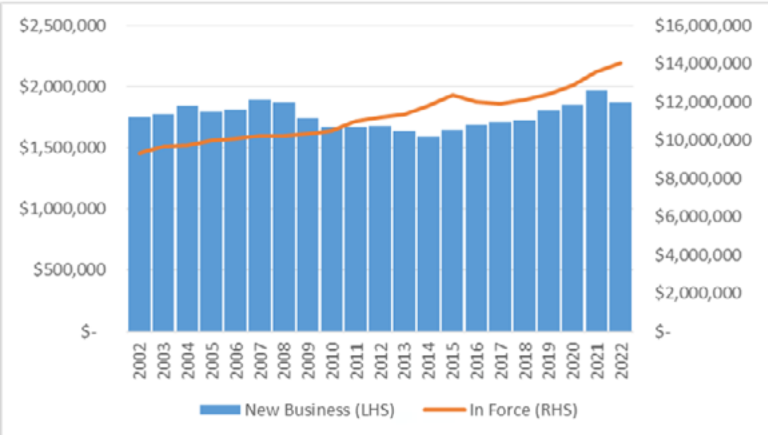


Source: ACLI Life Insurers Fact Book, 2023

Edition Whole of Life and Endowments Specifically

The aggregates for individual policies refer to all business, including term policies of differing types. These polices make up roughly half of the total new business and typically carry larger face amounts than whole of life or endowment policies. The data available aggregates WOL and Endowment although sales of the latter are a relatively small proportion.

Figure 6: US Life Insurance, Individual WOL and Endowment New Business, 2012 - 2022



Source: ACLI Life Insurers Fact Book, 2023 Edition

“New business remains buoyant which bodes well for the near- and medium-term future, but replacement rate both in terms of numbers and policy size (in real terms) is still in a phase of slow decline”

A historic dataset is not available so we can only show data back a decade, but the pattern is one that is fairly stable both in number and size. For policy traders, that is superficially good news, but the picture is slightly coloured by the fact that whilst nominal aggregate face amounts have remained stable, in real terms they will have been declining.

Summary

Policy cancellation rates are currently being driven by economic conditions, but the broad trend is one of slowly reducing rates of policy lapse or surrender. By and large, however, they remain stable.

New business remains buoyant which bodes well for the medium-term future, but replacement rate both in terms of numbers and policy size (in real terms) is still in a phase of slow decline. This may be due to a general trend towards a reducing household savings ratio across the US rather than any fiscal or regulatory changes that make products relatively unappealing compared to alternatives. At the present rate of decline, one would conclude that there remains plenty of longevity in the secondary policy market yet.

NAV Performance and Valuation Reporting Problems in Life Settlements[1]

Author:
Beat Hess
Managing Partner
AA-Partners

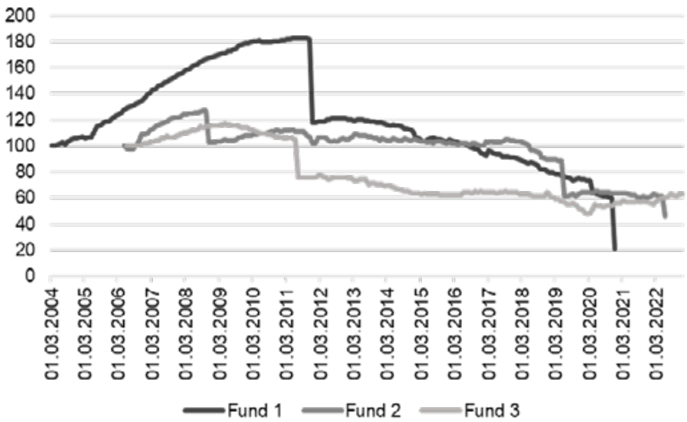
> **"Each of the three funds in Figure 1 display an appealing NAV curve, albeit of differing durations. In each case, a steep depreciation and downwards or sidewards movements occur, interrupted sometimes by further, sudden depreciations"**

The return of life settlements stems ultimately from income exceeding expenses. The investment needs to be profitable, so it should be judged by its 'cash-on-cash performance'. The net asset value ('NAV') performance, however, is different to the cash-on-cash performance, as various appreciations and depreciations of the portfolio are included in the NAV as well as the changing value of the cash account.

The NAV curve of a fund serves various purposes. While its primary objective should be the reflection of the true and fair value of the assets, it's also used as a marketing tool; the attraction of new capital is often driven (to a significant extent) by the shape of the achieved NAV curve.

Many life settlement funds show, at least for some time, a smooth, upward sloped NAV curve, as can be seen in Figure 1 below. It is clear how this could be used as a marketing tool to attract new capital. Furthermore, the NAV curves give the impression of a low-risk investment, at least initially.

Figure 1 – NAV Curve of Three Life Settlement Funds



Source: AA-Partners. (All three NAV curves are extrapolated from actual open-ended life settlement funds. The NAV curves therefore reflect the value of the life settlement portfolios including the cash portion on the balance sheet. Funds 1 and 2 were liquidated, Fund 3 is still running.)

Each of the three funds in Figure 1 above display an appealing NAV curve, albeit of differing durations. In each case, a steep depreciation and downwards or sidewards movements occur, interrupted sometimes by further, sudden depreciations.

The NAV curves raise questions as to where the claimed NAV performance is coming from and about the reliability of a life settlement NAV for investment decisions.

Valuation Is Key to Understanding NAV Performance

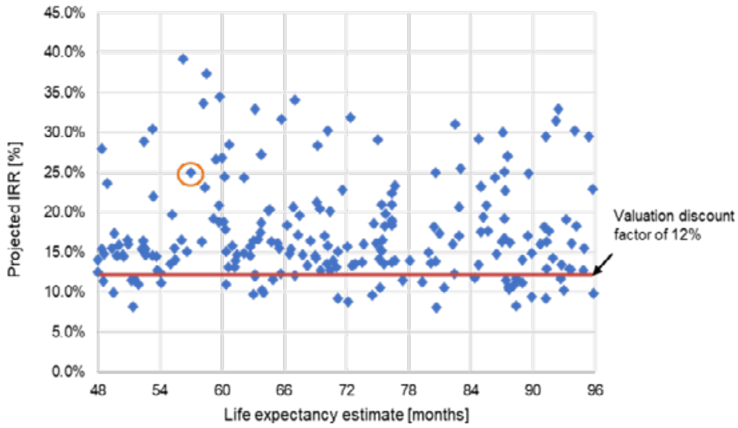
Life settlement asset managers need to determine the discount factors ('IRR') that they use for the valuation of the life settlements in a portfolio. To achieve a valuation in line with market prices the discount factors used need to be in line with the prevailing discount factor of a similar life settlement in the life settlement tertiary market where policies are traded between professional investors.

Life settlements are a non-standardized asset, i.e., every life settlement is different and comes with specific features, risks, deficiencies, and issues. It is therefore common sense that each life settlement transaction results in

> **"The vast distribution of projected IRRs illustrates that discount factors per single life settlement need to be used to achieve a valuation in line with market prices"**

a different discount factor. Figure 2 below shows the distribution of IRR of recently closed life settlement transactions The discount factors vary widely. They account for the peculiarities that are connected to a particular policy etc.

Figure 2: Snapshot of Projected IRR of Recently Closed Life Settlement Transactions



Source: AA-Partners. (The IRRs of closed transactions in Figure 2 above are widely distributed. The distribution reflects the unique features and peculiarities of individual life settlements. For instance, the transaction in the red circle (aged life expectancy of 57 months at the transaction date, projected IRR of 25%) refers to a policy with life expectancies from 2012 and no actual medical information available, so the shortcomings of the asset led to the high projected IRR.)

The vast distribution of projected IRRs illustrates that discount factors per single life settlement need to be used to achieve a valuation in line with market prices. However, using just one discount factor[2] for the valuation of all of the life settlements in a portfolio, compare for instance the 12% line in Figure 2, could lead to an inappropriate performance presentation.

- The use of a single discount factor can lead to undue appreciations of newly acquired inventory if the discount factor used for the valuation is lower than the appropriate market IRR. This can create an upward sloped NAV curve that does not reflect the true value of the portfolio. The upward sloped NAV curve can be used as a marketing tool to attract new investors, which allows the fund to acquire new inventory which can be appreciated, and so forth.
- This holds for open-ended as well as for closed-ended funds during the rump-up phase. The NAV performance of funds using non-fitting discount factors changes when no additional inventory can be acquired due to a lack of new subscriptions or depleted cash accounts. The NAV curve is then determined by other factors, for instance, the contribution of 'aging' to the portfolio, the cash-on-cash performance, and so forth.

The importance of this source of NAV performance is high. The upward sloped NAV curve, that results from applying a single discount factor to newly acquired inventory, can give the impression of a seemingly, low risk investment with high return[3]. But the NAV performance is not 'real' because the gains are not realized. The life settlements can't be sold for the value on the books since the applied discount factor for the valuation does not reflect the peculiarities and the features of the individual policies.

Furthermore, the appealing shape of the NAV curve, that results from the use of a single valuation discount factor and respective appreciations, can 'mask' the true performance. A life settlement portfolio needs to be profitable, the collected proceeds from life insurance policies need to exceed the expenses (i.e., premium payments and fees). A portfolio that uses a single valuation discount factor may show a great NAV performance but might have never been profitable. And the investors may therefore not ask for the relevant information (i.e. actual to expected ratio, cash-on-cash performance) since the NAV curve looks so compelling[4].

> **"A life settlement portfolio needs to be profitable, the collected proceeds from life insurance policies need to exceed the expenses (i.e., premium payments and fees)"**

Last but not least, the use of a single valuation discount factor can lead to various false incentives:

- The greatest risk in life settlements investing is that the life expectancies[5] used by the buyer are too short on average. However, the use of a single discount factor for the valuation incentivizes the use of the shortest available life expectancies, even though they may be too short. The shorter the used life expectancies, the higher the projected IRR of a transaction on average. Accordingly, the use of short life expectancies offers higher appreciation potential. And the true performance can be hidden via the upward sloped NAV curve.
- The use of a single discount factor for the valuation incentivizes the purchase of policies with deficiencies (e.g., policies with missing medical information, incomplete documentation and so forth). Such policies trade at higher IRRs when compared to similar policies without deficiencies. A single valuation discount factor does not account properly for such shortcomings. The higher average IRR of such policies offers greater appreciation potential.
- The use of a single discount factor incentivizes the purchase of policies with potential legal issues such as premium financed policies. Premium financed policies trade on average at a higher IRR than similar policies without premium finance issues. Thus, such paper offers greater appreciation potential than similar policies without premium finance status, since a single valuation discount factor does not account properly for this fact.
- The use of a single valuation discount factor can offer incentives to source policies in a way which allows to get paper at high IRR, via incentives for sourcing channels or counterparties and the suppression of lawful auctions, via a right of first refusal and so forth. Thus, it can offer incentives to deprive sellers of a fair price for their policies.
- The appreciations, although not realized, are performance-relevant and lead to an increase in NAV. The asset manager will earn management and incentive fees on the appreciated assets.

Life settlements are a non-standardized asset. Each life settlement represents a unique combination of features, risks, and impairments, which, as a matter of course, lead to widely dispersed IRRs.

The use of a single discount factor for the valuation of life settlements, instead of different discount factors that reflect the non-standardized character of each policy, is a blueprint to generate great NAV performance via appreciations of newly acquired inventory. The upward sloped NAV curve can be achieved irrespective of the true performance of a portfolio and irrespective of whether an asset manager is sophisticated - it is enough to acquire life settlements for higher projected IRR than the applied discount factor for valuation. But the NAV curve is not 'real' since it is based on the inflation of the value of newly purchased policies. Thus, such a NAV curve is misleading and unsuitable as a basis for investment decisions.

Conclusions

The use of a single discount factor for the valuation of a non-standardized asset is improper. Furthermore, it opens the door for a wide range of skewed incentives and misconduct. Thus, it should be a matter of fact for asset managers to use tailored discount factors for single life settlements.

The life settlement industry still lacks a robust set of performance presentation standards. The absence of such standards facilitates inter alia the use of discount factors for the valuation of life settlements that do not accurately reflect their peculiarities, or may not provide crucial information about the true performance of the investments. Thus, progressive market participants could state voluntarily whether they use appropriate discount factors per individual

"The use of a single discount factor for the valuation of a non-standardized asset is improper. Furthermore, it opens the door for a wide range of skewed incentives and misconduct. Thus, it should be a matter of fact for asset managers to use tailored discount factors for single life settlements"

life settlement and whether they provide the actual to expected ratio analysis and the cash-on-cash performance data to their investors.

[1]The article is an extract from the white paper 'Sources of NAV Performance', compare www.aa-partners.ch/fileadmin/documents/White_Paper/Life_Settlements_-_Sources_of_NAV_Performance.pdf.

[2]It would be a precondition for the use of a single discount factor in the valuation of a non-standardised asset that the discount factors of closed transactions are relatively narrow and consistent. However, the IRR of life settlement transactions don't meet this basic requirement. Actually, the contrary is true — compare the IRR distribution in the chart. The IRRs differ widely, which makes sense based on the background of the various impairments, legal risks and shortcomings of this asset. Furthermore, there are other non-standardised asset classes such as real estate or private equity. It is generally accepted that each real estate or private equity transaction comes with a distinct discount factor which accounts for the peculiarities of a particular asset being transferred. And consequently, it is general practise, and it makes sense, to use different discount factors for different properties and different private equity holdings for valuation purposes.

[3]The shape of the NAV curve is sometimes taken as a proof of the uncorrelated character of life settlement. The argument is false given this source of the NAV performance

[4]It should be a matter of fact for life settlement asset managers to include the cash-on-cash performance, the actual to expected ratio and so forth in every information to existing or potential investors ('performance presentation standards').

[5]The life expectancies are determined based on the health and medical information of the insured person by specialized companies ('medical underwriters'). There is no standardized process for the estimation of life expectancies, every medical underwriter has a different approach. The life expectancies prepared by the various medical underwriters with respect to the same life settlement can, therefore, vary even though they all rely on the same medical information.

Q&A

Anna Bailey
Managing Partner, Chestnut Capital Managment

Like most asset classes in the alternative credit market, the life settlement industry has had an interesting few years as macroeconomic changes have impacted fundraising and deal flow. Greg Winterton spoke to Anna Bailey, Managing Partner at asset manager Chestnut Capital Management, to get her thoughts on the current state of the space.

GW: Anna, let's start with something general. What's your view of the impact of the macroeconomic environment of the past few years on the life settlement market – on both fundraising and deal flow?

AB: The market is still steadily growing - not quite the way I think most participants in the market had anticipated, but there is growth year over year. In terms of deal flow, the main observation is that it has become a buyers' market again and yields are going up because of the higher interest rate regime. Also, fund managers seem to be holding on to cash as the impact of rising rates makes it more difficult to get lending that makes sense - and they can still achieve the yields they have promised investors. With fundraising, I see more pension funds entering the market – despite the better yields on liquid credit, investors are increasingly interested in alternatives that provide higher yields.

GW: You penned a guest article for Life Risk News in June last year that discussed the rise in activity in smaller face value policies. Is that something that you're still seeing, and does it still represent a medium to long term opportunity?

AB: Yes, this is a trend we are still seeing and some fund managers who traditionally purchased only large face are widening their parameters and buying policies with less than $1m in net death benefit (NDB). But I don't know that the market will support any policies with an NDB of less than $100k though because the cost economics just don't work.

GW: Related to the previous question – what's your view on the increasing influence of the direct-to-consumer channel in the secondary market? Does where the policy comes from have much of an impact on your portfolio construction?

AB: I think the direct-to-consumer models are continuing to grow and I appreciate the education aspect of it. There are still many consumers who don't know that they can sell their life insurance policy. With regards to portfolio construction, it doesn't much matter whether the deal flow comes from the direct to consumer channel or the intermediated channel. What's most important is that the origination is done well, and that it's compliant - no cutting corners - and the insureds are cooperative.

GW: Many in the life settlement market comment on what they perceive as an awareness challenge among seniors. But from your perspective as an asset manager, what about the awareness at the end investor level? Is that improving – or not?

AB: I think investor awareness is growing. That's a combination of an increased appetite for alternatives generally, as I mentioned earlier, which has led investors to our space as one option that they might consider, but also a greater awareness of life settlements more generally. I definitely don't think that we are considered the 'Wild West' any longer but that doesn't mean that there aren't challenges that we face, but those challenges competition-based, as there are many different types of alternative investments available now. But I also think that speaks to the maturity of our industry; we're often a serious consideration for an allocation now and a mature asset class should expect competitive pressures.

GW: Lastly, Anna, assume that there are investors reading this that are less or unfamiliar with the life settlement asset class. What's your

number one recommendation when it comes to the due diligence that they conduct on asset managers?

AB: My main recommendation would be to take as much time as you can to understand the nuances of the underlying asset and the specific drivers of return of it because they're not the same as many other financial assets. For example, mortality, which is one of the fundamental pillars of our market doesn't shift daily – sometimes, it's not even yearly. Having a good grasp on that is key; success in our market is a marathon, not a sprint.

Annuities Could Provide Bright Spot for Struggling Life Insurance InsurTech Market

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Greg Winterton
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Life Risk News

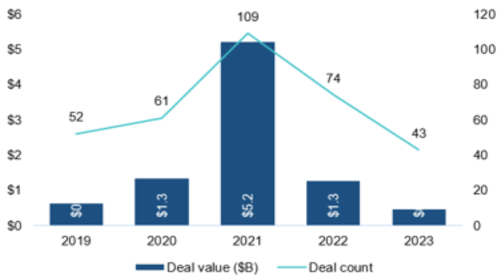
Data and analytics firm Pitchbook published its full year 2023 report on the insurtech industry in early March, showing that activity from the venture capital funds in the space delivered a six-year low in both the number of deals completed (486) and the aggregate value of deals ($5.6bn).

The data wasn't surprising to many industry observers: the private markets experienced fundraising and dealmaking challenges last year as macroeconomic (rising interest rates) and microeconomic (the fallout from the collapse of Silicon Valley Bank in March) forces conspired to put the brakes on the extraordinary recent growth rate in the space.

> **"Over the past couple of years, private market valuations for insurtech companies were considered overpriced, but public valuations may have begun to bottom out in late 2022"**
> **- Robert Le, PitchBook**

The overall trend is mirrored in the life and health segment of the insurtech market that PitchBook tracks. As can be seen from Figure 1 below, activity in the segment fell by approximately one half based on deal count, and a third ($0.5bn) based on aggregate deal value.

Figure 1: Global VC Deal Activity in The InsurTech Health & Life Segment



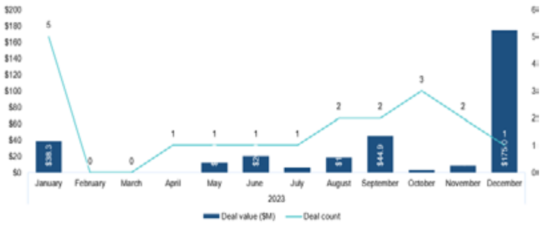
Source: PitchBook Data, Inc

The apparent precipitous decline in activity in the market from the halcyon days of 2021, however, shouldn't be cause for concern.

"Over the past couple of years, private market valuations for insurtech companies were considered overpriced, but public valuations may have begun to bottom out in late 2022, as reflected in the HSCM Public InsurTech Index. The index declined by over 70% as of year-end 2022 from a high in early 2021. However, the index has partially recovered and was up 32.6% in 2023," says Robert Le, Senior Analyst, Emerging Technology at PitchBook, in the report.

Perhaps unsurprisingly, activity in the life and health segment of the insurtech market is more robust in North America than in Europe or Asia. In 2023, 19 deals were completed worth $326.5m, with just one of these, Devoted Health's Series E round, accounting for $175mn of that in December.

Figure 2: North America VC Deal Activity in the InsurTech Health & Life Segment



Source: PitchBook Data, Inc

That compares handsomely with Europe ($28.4m across 11 deals) and Asia ($98.4mn across six deals). The reasons for the difference are not so much idiosyncratic to the insurance space as they are a mirror of the venture capital market more broadly.

"The insurance market in the US may be regulated at the state level, but it's still much more homogenised than it is in Europe, where you have different languages, cultures, and just as importantly for the insurance market, significant divergence in the regulatory landscape. Most insurtech innovation to date has been in the US," says Brian Casey, Partner and Co-Leader of the Regulatory and Transactional Insurance Practice Group at Locke Lord.

One point of note for life risk investors – both public ones that access life insurance companies through the public equity or liquid debt capital markets, and private ones that own or have an equity stake in life insurers – is that the PitchBook report contains a mention of the annuities market. According to the report, it's one that is ripe for disruption.

"Although the annuities industry is one area that has seen little insurtech innovation, that is beginning to change... large insurers face mounting challenges, including legacy processes for distributing annuity products and managing the relationship between policyholders and insurers," says Le in the report.

"The insurance market in the US may be regulated at the state level, but it's still much more homogenised than it is in Europe, where you have different languages, cultures, and just as importantly for the insurance market, significant divergence in the regulatory landscape"
- Brian Casey, Locke Lord

At the end of January, a press release from the Life Insurance Marketing and Research Association (LIMRA) says that annuities sales increased for the second consecutive year, to a record $385bn. Not all of those will be lifetime annuities (the type of annuity which contains longevity risk) but still, the growth of the overall market in the US shows the opportunity for insurtechs looking to disrupt the space.

The outlook for the insurtech market generally going forward remains uncertain. At a general level, PitchBook's report refers to the impact of climate change on the industry in terms of insurers withdrawing from certain regions, insurance premiums increasing, and a hardening reinsurance market.

More specifically for the life insurance space, there is increasing uncertainty around mortality data; life expectancy at birth in the US decreased in 2021 for the second consecutive year, for example.

How this translates to venture capital funds putting dollars into insurtechs remains to be seen. Many factors that aren't directly related to the insurance sector influence the flow of capital, ranging from macroeconomic to a generally tighter approach to investing across the entire VC industry. For Casey, however, there is room for optimism.

"The insurtech market is moving through its natural lifecycle as we have seen more M&A transactions involving insurtechs as well as right-sizing for those that have not yet been able to achieve expected performance. If the public insurtechs can start delivering better financial results, then VC capital will take notice of that,." said Casey.

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