

INVESTING IN LIFE SETTLEMENTS

As we begin to see a higher degree of transparency and convergence in life expectancy estimates, David Rawson-Mackenzie of Centurion Fund Managers shows how life settlement funds can tailor their needs by using synthetics structured either as longevity or mortality notes



DAVID RAWSON-MACKENZIE set up Centurion Fund Managers in 1999. He was instrumental in the research and subsequent launch of a series of longevity funds as a new asset class which included structuring one of the first longevity swaps in the industry with a major investment bank.

Life settlements, as a relatively new asset class, have seen considerable evolution in both physical policies and synthetic products in the past six to eight years. Today, it is possible to source both products from a number of major investment banks, although these may take many different forms depending upon the institution.

In the physical market, whilst the origination side has seen increasing statutory and self regulation, there still exists today a certain amount of origination risk, particularly in the premium finance area. Historically, longevity risk has been difficult to quantify due to lack of actual-to-expected

mortality experience. In recent years, as more entrants enter this market, we are beginning to see a higher degree of transparency and convergence in the longevity estimates. The financial risks are linked to the credit risk and liquidity of the insurance carriers.

The synthetic products available range from customised swaps to longevity and mortality notes. Whilst similar to the physical market, the synthetic one avoids the structural risk, namely the necessity for a correct tax structure without which death benefits would be subject to US withholding tax.

From a fund manager's perspective, we have seen very little in the way of pertinent investor information aimed at informed investors. In order to determine the liquidity risk of a fund, investors and their advisors need to have access to information such as valuation methodology, distribution of policy IRR in a portfolio, lapsed time between policy issue and acquisition dates and sensitivity analysis in order to evaluate how the policies will be priced in the open market.

Currently few managers are active in the synthetic longevity market where synthetics are used principally to

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DAVID RAWSON-MACKENZIE, CENTURION FUND MANAGERS

Type of risk	Physical vs Synthetic	
Origination risk	Yes	No
Tax risk	Yes	No
Credit risk	Small, due to individual state regulation of each carrier	Increases as the trade may reference the parents of the insurance carrier
Liquidity risk	Lower in synthetics but depends on counterparty and terms of contract	Lower in synthetics but depends on counterparty and terms of contract
Longevity risk	Yes	Can be reduced by either "standardising each life" or merging with physical portfolio
Currency risk	Yes	No



mitigate origination and tax risks, though their value may evolve as we start to see carriers challenging premium-financed policies or the IRS start to challenge tax structures.

If asked today for my recommendations to institutional investors wishing to invest in this asset class, I would start by saying: don't limit yourselves to life settlements if looking for micro-longevity exposure – both reverse mortgages and life tenancies have their own advantages and disadvantages. That said, for life settlements, physical paper requires an abundant amount of in-house knowledge – one needs to understand the different policy riders, premium financing risk, tax structuring, policy maintenance, down to the mundane task of policy servicing and premium optimisation. Actuarially, one needs to understand the methodology used by each underwriter in determining mortality factors and life expectancies so as to gain insights into the differences in longevity estimates which dictate both value and return.

Technical knowledge can be acquired and many in the US have five or more years' experience, though few have experience in both physical policies and fund management. The table on the left summarises the different risks associated with physical policies and synthetic products.

Whilst no in-depth industry knowledge is required for synthetics, there are idiosyncrasies here as well. Synthetics introduce credit risk into the valuation which is seldom priced into the physical market and usually come with a degree of leveraging which adds to extended longevity sensitivity. These two factors alone could have a significant negative impact on the portfolio value. Customised synthetics are best used to complement a physical portfolio but the parameters and criteria used for valuation need to be clear from the start. Today, opportunities exist not only with the established players but also with those whose portfolios may need liquidity. For a fraction of the cost, a new market entrant can tailor his longevity needs by using synthetics structured either as longevity or mortality notes whilst leaving the origination risk with the portfolio owner. As these longevity structures become more innovative, this can only be good for the asset class. ■

Q&A



MICHAEL CRANE is managing director, International Distribution for Coventry. Based in London, he plays a senior role in the global expansion of Coventry's industry-leading longevity distribution platform.

HFMWeek: What are the benefits of investing in traded life policies?

Michael Crane (MC): One of the primary benefits investors have seen is the lack of correlation in traded life policies, particularly the US life policies known as the life settlement market. An investment in a diversified pool of life settlements provides exposure that is not linked to share prices, credit spreads or other traditional capital markets risks. The primary risk is the longevity of a group of older age persons (typically aged 70+), but this can be managed by having a suitably diversified pool of policies. In addition, a well-originated, serviced and diversified portfolio of life settlement policies can provide attractive returns.

HFMWeek: What impact has the global economic downturn had on the traded life policy market?

MC: The primary impact was a lower amount of capital being deployed to buy policies coming to market. In recent months we have seen capital returning to the market to take advantage of the buying opportunities that currently exist.

HFMWeek: What key factors are contributing to the current growth of the traded life policy market?

MC: Following the global financial crisis, more investors are looking for asset classes with lower or no correlation to stock and bond markets. In addition, investors want investments that are simple and transparent. Since life settlements are 'physical' assets and the basic transaction is simple and straightforward, the life settlement market appeals to a broad range of investors. As a result, we have seen investment capital coming from hedge funds, pension funds and insurance companies, as well as from private banks and family offices.

HFMWeek: What effect has the development of synthetic products had on the market?

MC: The synthetic markets (swaps or notes linked to policies or lives) have provided investors with increased ability to customise exposure and transactions, with different risk features or return packages.

HFMWeek: In terms of service provision, what can you offer hedge funds interested in investing in traded life policies?

MC: Coventry is the largest specialist firm in the US life settlement market. Our fully integrated platform can source attractively priced life settlements in large volumes using strong quality control processes. In addition, we provide administration services for life policy assets (servicing and life tracking), and we have administered more than \$40bn in face amount of policies.

HFMWeek: What are the implications of the additional levels of service provision (for example, medical underwriters) often required by traded life policies?

MC: The additional services provided by third parties such as the independent medical underwriters, trustees and custodians are important services to help assess the value of policies and to ensure proper security and custody arrangements since policies are not traded on exchanges. A strong servicer/asset administrator is also very important.

HFMWeek: What impact will the future prospect of increased regulatory oversight have on the market?

MC: The US market is already well regulated with 37 states currently regulating life settlements. The presence of more regulation that protects the interests of the consumer will benefit all parties involved in the life settlement market.

HFMWeek: What challenges and opportunities do you expect to see going forward?

MC: Given the scale of the \$22tn US life insurance market, the opportunity for investors is tremendous. As with any growing asset class, there are a range of participants entering the market. One of the key challenges is to thoroughly due diligence business partners to ensure one deals with firms that have a strong history and a record of completing successful transactions for their counterparties. In addition, because the market involves unconventional types of risk (longevity and insurance), there is a need for professional asset managers for the asset class who can bring the institutional standards and practices historically applied to other asset categories to life settlement investing. ■