Choose life

The US life settlements sector is marketing itself to pension funds and European insurers as an easy way to add diversification to a portfolio. But how are the risks modelled and how can the banks and hedge funds that are brokering the transactions accurately measure longevity risk, a speciality of the ceding insurer?

WILLIAM RHODE REPORTS

THE US LIFE SETTLEMENTS market has been in the mainstream press for all the wrong reasons lately, with a series of sensational articles peppered with catchphrases such as Wall Street fat cats, death bonds, Aids viaticals and ghoulish investment schemes.

The reason for the sudden witch-hunt, it seems, is that life settlements are on the brink of securitisation, with an announcement by little-known Canadian rating agency DBRS that it may be close to rating a debt issue backed by a pool of life settlements.

In some ways, the development could not have come at a worse time. The mortgage-backed securitisation market debacle is painfully fresh in everyone's minds and there is an overwhelming legacy of negative sentiment that has little to do with the dynamics driving a life settlements securitisation market.

Jonathan Ross, a securitisation and funds lawyer at Dorsey and Whitney in New York says: "Securitisation is still a dirty word by association. Clearly, abuses at all levels need to be addressed and lessons learnt. But there is no getting away from a monetisation theory of a reliable asset pool, and that is why the market has turned to life settlements."

Massive potential

Life settlement volume growth has been spectacular in recent years. According to a report by Hartford, Connecticut-based Conning Research in October 2008, roughly $12 billion worth of life settlements changed hands in 2007, up from $6.12 billion in the previous year. Volumes are seen doubling to $24 billion in 2010 and could be as high as $114 billion within just a few years. And with more than $26 trillion of life insurance policies in force in the US, according to the American Council of Life Insurers, there is the sense that these figures are just the tip of the iceberg for the life settlements market.

"There comes a time in the life cycle of any financial instrument when there is enough critical mass for investors and market-makers alike to recognise true value," says Jim Aspinwall, adjunct professor of mathematics at Florida Southern University. "Life settlements are just now reaching a point where securitisation is inevitable. It is a market that can offer double-digit returns with little or no risk. I firmly believe this will be the next great asset class for investment and trading."

Industry sources say investment banks are chomping at the bit to securitise life settlements. A number of banks have been earning themselves licences to buy up and originate life insurance policies in the hope that they might later be able to securitise them.

According to a press release from October 2008, Credit Suisse is one such firm, earning itself a licence to purchase life insurance policies from policyholders in 45 jurisdictions in the US. The bank did not respond to repeated requests for comment.

On a panel at a November conference of the Life Insurance Settlement Association (LISA) in Washington, DC, Forrest Gilman, the former global head of longevity derivatives at Deutsche Bank in New York,

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touted life settlement securitisation as the way forward. Gilman has since left the firm to set up an asset management company, Last Wave Capital, and could not be reached for comment. Deutsche Bank declined a request for interview.

Dirty history

Meanwhile, the life settlements sector has its own dirty history to live down. During the late 1980s, people with Aids were pressurised by unscrupulous brokers into selling their life settlement policies at excessively low rates to pay for expensive medical care, only for investors to subsequently lose out on their purchases as medical breakthroughs extended the lives of patients and so, too, the premium payments on the policies (see box, page 30).

But since the turn of the century, the life settlements sector has reorganised itself, with a new emphasis on policies sold by 'seniors' (the over-65s), who are broadly expected to live between three and 15 more years. Under the terms, the original policyholder receives a payment lower than the full value of the policy in return for receiving capital upfront. The new policy owner then continues to pay the premiums and collects the full payout at maturity.

For those with portfolio diversification needs, life settlements offer an investment that is seemingly uncorrelated with the equity, fixed-income and commodity markets. And they deliver attractive returns. According to a report in 2005 entitled 'Perspectives on the Life-Settlement Market', published by Sanford C Bernstein, the estimated return on a life policy held for seven or eight years is likely to be in the region of 9–13%.

"Apart from the home market in the US, this new asset class has attracted the attention of a wide range of institutional investors around the world, including investment banks, insurance companies, hedge funds and pension funds, as well as wealthy private investors," says Martin Buck, head of sales and marketing at Surrenda-link, a UK-based investment manager dealing in life settlements and trade endowments policies.

"Life settlements offer an attractive risk premium and, in theory, have no correlation with the equity or credit markets," says Gerda Smits, a spokesperson at Dutch pension fund PME, which invested $550 million (£338 million), or 2% of its total assets, in US life settlements in 2006.

But there is a question mark over the issue of non-correlation. According to Smits, as well as taking a hit on its fixed-income and equity investments in the financial maelstrom, PME has also seen its life settlement investments suffer.

"Due to the extreme situation on the financial markets, the non-correlation with equity didn't work as expected," she says. "When the markets normalise we expect the non-correlation to do its work again."

At the time of going to press, Smits did not respond to a request to elaborate.

But Eamonn Ling, head of investment at Catalyst Investment Group, a London-based firm that specialises in senior life settlement investments, rebuts the suggestion.

"Life settlements are truly non-correlated to the traditional instruments that pension schemes invest in and, when properly used, non-correlated assets will produce higher returns for the same risk, or the same returns for lower risk," he says. "Given the recent volatility of traditional market-related investments, non-correlation is a highly sought-after characteristic."

Pension funds in Germany and the Netherlands have traditionally found appeal in life settlements, but there are indications that the net

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is widening. Ling says there is currently one large, blue-chip asset manager that has a mandate from a variety of pension and endowment investors to put money to work in the life settlements arena, but he did not disclose the name.

The California Public Employees Retirement System has made life settlement investments. So, too, has BlueCrest Capital Management,

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a London-based hedge fund with $15 billion (£9 billion) in assets under management, some of which is gleaned from pension funds.

In response to growing demand for life settlement investments in the UK, Integrity, a TEP firm, plans in October to launch a Dublin-based life settlements fund targeting the institutional capital markets. In preparation for the launch, the firm has also written a risk assessment and mitigation methodology for life settlement funds that will be released at the end of October.

Calculating the risk

But how are the risks modelled and how can banks and hedge funds, which are brokering these transactions, accurately measure longevity risk, a risk that is widely seen as the speciality of the ceding insurer?

"Determining the life expectancy (LE) of the life assured is probably the single most important factor in a life settlement investment and is fundamental in accurately assessing the price for each policy acquired," says Surrenda-link's Buck. "Actuarially robust policy pricing and portfolio valuation methodologies are vital to successful investment performance."

LE estimates, which are based on the policyholder's medical and family history and a wide range of other factors, are typically provided by a number of third-party medical underwriters in the industry.

"The trouble is when you try to evaluate the LE on a policy, the range in estimates from the different underwriters can be as high as 40%," says David Rawson-Mackenzie, managing director of Centurion Fund Managers, an alternative investment house specialising in longevity and life settlements. "When the premiums are adjusted to account for the longer life expectancy estimated, you find that you've gone from a positive to a negative yield."

Fund managers have to rely on their own expertise to assess LE, a process that typically requires time-consuming analysis. But some high-profile problems at banks with life settlement portfolios have demonstrated that it is due diligence that cannot be skipped.

"Banks have tended to acquire large pre-existing books of policies

Aids viaticals

The roots of the life settlement market lie in the late 1980s and early 1990s, when Aids victims with an estimated life expectancy of less than two years sold – or were persuaded to sell, an important difference – their life insurance policies in order to have access to the capital to fund expensive medical care.

Investments based on these 'viatical' settlements – the term used for the secondary market where insureds have a life expectancy of less than two years – were not generally successful due to overly aggressive sales practices, inaccuracies in estimating policyholder life times, and unanticipated medical advances that prolonged the lives of Aids patients.

Jim Aspinwall, adjunct professor of mathematics at Florida Southern University says: "It is important not to confuse the existing life settlements market for seniors with the Aids viaticals market. Aids sufferers were estimated to live for two years or less but then medical breakthroughs extended their lives so investors had to pay premiums for much longer. Medical breakthroughs broke the back of that market. It was a disaster."

The early victims of Aids in the US were largely gay men, many of whom were not particularly old. They often had no wives or children (the traditional dependants in a life insurance policy), but they had life insurance policies through employment or due to other investment activity. Viatical settlements offered a way to extract value from the policy while the policyholder was still alive.

At the time, the Aids mortality rate was very high, and life expectancy after diagnosis was typically short. Investors were reasonably sure they would collect the full value of the insurance policy in a relatively short time. This combination of events caused a surge in viatical settlements as both investors and viators saw an opportunity for mutual benefit.

Viatical settlements eventually developed a bad reputation in the investing community. The companies that purchased them from policyholders typically resold them to individual investors. Salespeople were paid large commissions to push the settlements, which were not conventional investments and which were widely misunderstood by many investors. The government regulatory agencies had little experience and few regulations dealing with viatical settlements, leading to unscrupulous industry practices.

One of the most infamous viaticals cases involved the Mutual Benefits company in Florida, headed by Peter Lombardi, which had 28,000 investors in Aids viaticals. In 2003, the Securities and Exchange Commission closed the firm saying it was involved in a $1 billion Ponzi scheme. Lombardi is currently serving a 20-year prison sentence.

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in blocks, where it isn't possible to drill down into the quality of individual policies," says Catalyst's Ling.

Historical mortality data can be used to create what is effectively a mortality curve. Somewhat oddly, historical data for life expectancy can also be gleaned from the credit derivatives market.

According to Aspinwall, a key issue for those involved in the early stages of development for credit derivatives instruments, was trying to figure out when a bond might redeem or go into default. Experts turned to actuarial science for the answer, to figure out the likelihood of the bond 'dying'. Today, the historical data that has built up in the credit derivatives market can now be used to assess longevity risk in the life settlements market.

Stress testing, both of the LE projections and the mortality curve, can help fund managers establish conservative valuations on specific policies.

Variety is the spice of life

Another way to mitigate longevity risk is to include a wide variety of life settlements as well as life expectancy quotes for each life in a portfolio. This can either help the fund manager understand the internal rate of return sensitivity upfront and so determine a suitable safety margin for the portfolio at the start of the transaction, or fine-tune the portfolio to provide exactly the risk/return characteristics they desire.

"Portfolio diversification helps in managing the risks, such that the expected standard deviation of early policy maturities versus later policy maturities differs," says Ling.

And, with the right analysis available, a fund manager can skew the portfolio to his advantage, making sure it includes people most likely to die.

"You don't want to get the health addict who lives on apples and runs five miles a day, far better to go for the couch potato who likes junk food," says Aspinwall. "That's the best way to mitigate longevity risk."

Longevity swaps, a swap based on a particular list of lives and whose payout depends on the survival of those lives, can also be entered into to mitigate longevity risk.

In 2008, Credit Suisse entered a longevity swap with Centurion, whereby the group acquired a portfolio of synthetic, or simulated, life policies, based on a longevity index built by the investment bank.

"With synthetic trades, as with physical trades, we require a minimum of two life expectancy reports from providers that both the counterparty (that is, the bank) and ourselves approve," says Centurion's Rawson-Mackenzie.

"We then use the mean of the two life expectancies, subject to it being less than our maximum limit. Where it is above our limit, we solicit an additional life expectancy report from another provider until we have two evaluations meeting our requirements. We then evaluate the sensitivity to extended longevity by analysing when the yield goes negative."

For physical policies, investors tend to look at the policy issue date and the acquisition date and apply a coefficient to take into account negative selection by the life assured. But this is not required in a synthetic trade where there is a history of life expectancy evaluations. Investing in a synthetic portfolio also has the advantage of being more flexible, since the assets can be more easily sold on. It also smoothes out the fund's returns, because the cashflows in a synthetic contract are known and set out in advance.

Regulation

Regulation is also a problem for the life settlements market since it is governed at the state rather than federal level.

Rawson-Mackenzie says: "The regulatory landscape is constantly shifting, which makes it difficult to keep on top of developments. Managers of life settlements portfolios must be aware of changes and their implications on an ongoing basis, which adds to the complexity of the role."

Experts say transparency and standardisation are paramount for the life settlements sector to develop and thrive, something that trade associations are well placed to promote.

Says Aspinwall: "The life settlements industry needs an International Swaps and Derivatives Association."

A number of trade associations have sprung up in the last year, such as the European Life Settlements Association and the International Society of Life Settlement Professionals (ISLSP), a trade association based in Italy that is actively involved in promoting US life settlements to institutional investors in Europe.

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Andreas Hauss, founder of ISLSP says: "We started ISLSP because we saw a need for the life settlements sector to be promoted and made more transparent. The lack of knowledge and consequently the misplaced fear is outstanding. Securitisation in the sector would create a new and exciting investment opportunity, increase liquidity in life settlements and drive down policy premiums in the primary market, a real win-win situation for all."

But it is a fear that will need to be overcome if Wall Street is to get its way. People are all too aware that greed is not a good enough reason to start a market – no matter how big the returns may at first appear. L&P