Striving for a secure life

David Rawson-Mackenzie, founder and managing director of Centurion Group, comments on the progress to securitisation of life settlement policies

Each month we ask an industry expert to raise an issue of importance for the whole financial services sector

There has been renewed interest from the capital markets in the securitisation of life settlements policies which prompted condemnation from the American Council of Life Insurers followed by strong rebuttals from, among others, the Institution of Life Markets Association and the European Life Settlements Association.

To securitise life settlement assets investment banks amass large pools of life settlement policies which are then split into tranches based on their risk profiles and then sold as bonds to investors such as large pension funds. These investors will then receive the payouts upon the maturity of the policies.

Despite this surge of interest from the capital markets there has only been one successful life settlement securitisation, undertaken by Risk Finance – a unit of AIG. This securitisation in early 2009 was privately rated by AM Best and consisted of life settlement policies with total face value of $8.4bn. Until a number of key issues can be resolved, many believe a publicly rated life settlement securitisation is far from an imminent reality.

The first key issue centres on the ability to accumulate a sufficiently large and diverse pool of suitable policies – a successful securitisation would have to involve well over 1,000 policies to ensure an adequately stable cash flow. Another consideration is transparency. The supposition from the ACLI is that as securitisation requires a large number of policies, this could promote fraudulent life policy applications and can potentially exacerbate the Stranger Originated Life Insurance issue.

It is often difficult for investors investing in a securitisation to perform due diligence on the underlying assets and fully understand the risks involved. The final concern has to do with the lack of convergence or standard methodology in the life expectancy estimates which can lead to variance in the valuation of the underlying assets.

Centurion's David Rawson-Mackenzie

There is no doubt there are still hurdles to overcome before life settlements can be securitised in a standardised manner. Most would agree life settlement securitisation brings with it many advantages. For an illiquid asset class, securitisation is a means of providing and increasing liquidity in the life settlement market which will promote greater volume of trades thus potentially giving investors a wider choice. A more vibrant life settlement market should also lead to quicker convergence of higher standards, thus professionalising the asset management and servicing of the assets and greater disclosure including classification or evaluation of acceptable premium financing definitions. These steps should address concerns that the securitisation of life settlement policies will lead to fraudulent selling of life insurance.

For life settlement securitisation to gain traction, investors need to understand the implication of extended longevity risk in any life settlement securitisation, or in any life settlement investments for that matter. One factor which strongly influences sensitivity to extended longevity is the life expectancy estimates provided by the underwriters. Historically, longevity estimates from different underwriters could vary dramatically. As interest grows in this asset class, there is an increasing need for standardisation and convergence of underwriting methodologies.

This will lead to underwriters adjusting their longevity tables, hence estimates, which will have a negative impact on the return. It is important to understand the impact that such an extension could have on the sensitivity of the trade. If the securitisation is structured with a degree of leveraging any longevity extension will affect the performance of the trade.

Another potential risk investors in a life settlement securitisation face is origination risk with regards to the life settlement portfolio. The life settlement market views premium financed policies differently than non-premium financed ones and there are different quality premium financed programmes in the market. All these should dictate the policy's rate of return.

However, without transparency in the underlying assets, it would be difficult for investors to determine or understand the quality of the policy origination and hence the risk embedded in the underlying assets. Non-US investors have additional issues when considering investment in a life settlement securitisation. The IRS ruled in May 2009 that the death benefit received by an investor from a life policy issued by a US-domiciled insurance company is taxable as income. Non-US investors will need to determine whether they could benefit from a partial or full exemption from US withholding tax on receipt of the death benefits. Life settlement securitisation will provide liquidity to an asset that is semi-illiquid and with increased transparency and convergence of standards and methods in estimating longevity it is a question of time before we see the first publicly-rated life settlement securitisation.

Biography

David Rawson-Mackenzie is the founder and managing director of Centurion Group, a financial services company with over sixteen years' experience in providing investment and tax solutions to both institutional and high net worth clients. In 2000 he set up Centurion Fund Managers and started researching life settlement and longevity as a new asset class. He launched one of the market's first life settlement funds, Defined Return Fund, in 2002, targeted at high net worth clients. This was then followed by the launch of the Channel Islands-Stock Exchange listed Life Settlement Strategy Fund in 2006, developed to allow for synthetic life settlement transactions.

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