



# Russell Research

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## Life Settlements Investments

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Synopsis: Life settlements is becoming an increasingly popular asset class, offering good returns that are largely unaffected by financial crises and market downturns like those of 2000 and 2008. What are they, what benefits can they offer as a new asset class for your portfolio, and what are the downside risks? We discuss these questions, and outline the features of different vehicles for life settlements investments.

# Life Settlements Investments

By

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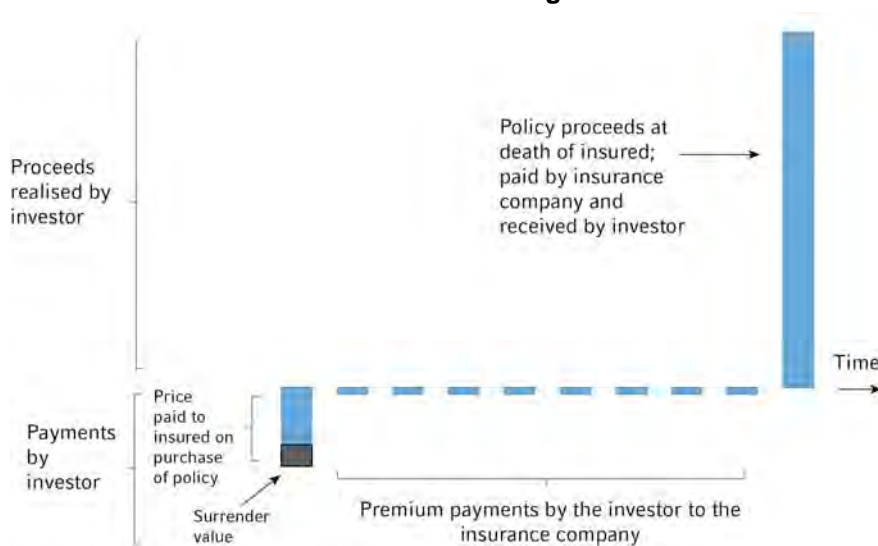
## WHAT ARE LIFE SETTLEMENTS?

A life settlement is a financial transaction in which a life insurance policy holder sells a no longer wanted policy to an investor for more than the cash surrender value offered by the life insurance company. The investor pays all subsequent premium payments to the life insurance company and receives the sum insured on death. Exhibit 1 displays the cash flows associated with an insurance policy on and after settlement.

For the policyholder, life settlements opens up a secondary market providing enhanced market values for his or her policy, rather than the lower cash surrender value offered by the life insurance company.

For the investor, a portfolio of life settlements offers a comparatively low risk-return trade-off compared with equities. Further, life settlements diversify overall investment risk because mortality rates are not correlated with other asset class returns. Institutional investors in life settlements include investment banks, insurance companies, private banks, hedge funds, pension funds and wealthy private investors.

**Exhibit 1: Cash Flows Surrounding a Life Settlement**



To reduce the term of investment and to minimise service costs, portfolio managers generally limit their purchases to larger policies on older lives. The market is primarily in United States policies and investors look at policies with face values upwards of US\$750,000 on lives 65 years or older, and issued by a life insurance company with an 'A' rating or higher.

## WHY INVEST IN LIFE SETTLEMENTS?

### EXPECTED RETURNS ARE GOOD

Life settlements are usually priced to yield an expected rate of return of 11% or 12% p.a. Pricing is based on standard actuarial methodology using estimates of mortality provided by medical underwriters who carry out comprehensive reviews of the insureds' medical records. There are five leading medical underwriters who specialise in providing life expectancies for life settlement transactions. Getting the mortality assessments right is the critical issue when assessing the value of a life settlement.

## DIVERSIFICATION BENEFITS

Life settlements returns are almost uncorrelated with returns on other investments because their returns are tied to mortality risks, not market risks. Diversification into life settlements is thus very effective in reducing portfolio risk.

Recent events in financial markets have demonstrated that, despite being diversified, many portfolios were composed of asset classes that were more correlated with each other than was anticipated. Life settlements is an asset class that should be uncorrelated with traditional asset class returns even in times of financial crisis.

## HOW BIG IS THE MARKET?

The life settlements market grew from almost nothing in the late 1990s to US\$12 billion of life insurance face values settled in 2008. Sanford Bernstein (2005) expects the market of in-force policies to expand to an estimated US\$160 billion “over the next several years”<sup>1</sup>. Growth is expected to occur in two ways:

- *Supply side*: Policyholders are becoming more aware of the options available and are increasingly opting to sell their policies in the secondary market created by the life settlements industry rather than surrendering them or letting them lapse.
- *Demand side*: Investors are looking at life settlements as an asset class with a good risk/return trade-off and excellent diversification characteristics.

## REGULATORY BACKGROUND

There are some common features of United States insurance law which create a sound foundation on which the secondary market for United States life insurance policies is able to grow. These common features explain why the origination platform for life settlements is located primarily in the United States.

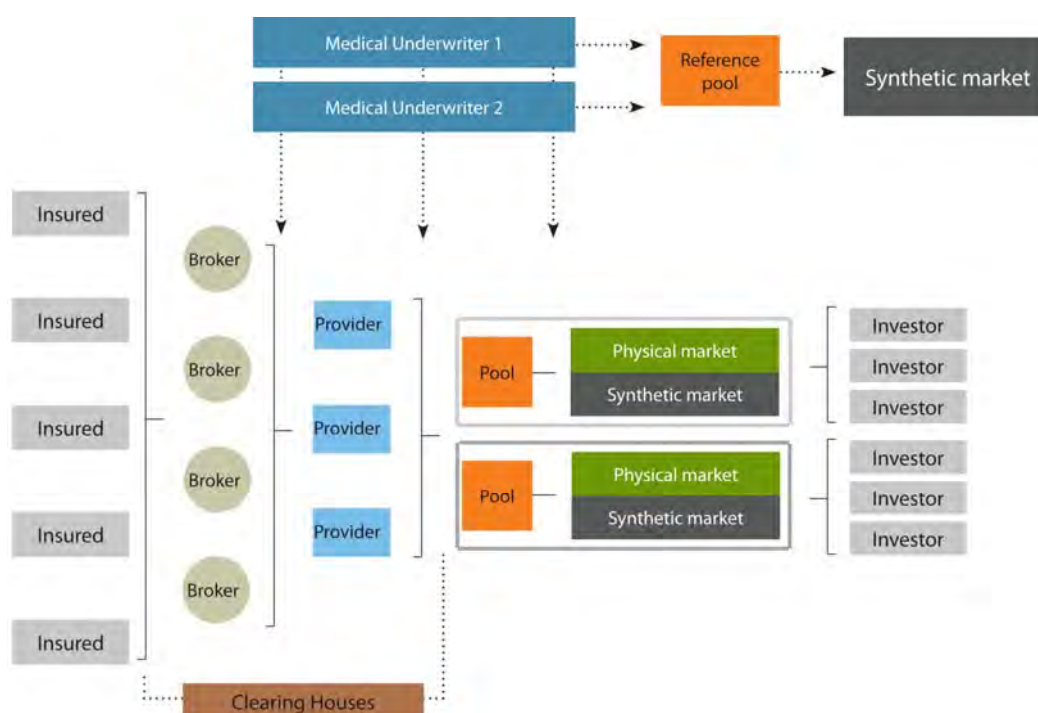
- *Non-contestability*. The existence of a ‘non-contestability clause’ in United States insurance policies means a third party can purchase a two-year old (or older) life insurance policy secure in the knowledge that there is little chance it will not be honoured.
- *Insurable interest*. An insured can transfer a policy to any other party after it is issued provided that at the time the policy was written a valid insurable interest existed.
- *Regulatory developments*. Many states in the United States have introduced regulations leading investors to view life settlements with greater confidence.

## MARKET PARTICIPANTS

Exhibit 2 shows the many parties involved in the life settlements market. These are:

- *Insured*: The individual covered by the policy.
- *Broker*: Helps the policy owner sell the policy.
- *Medical Underwriters*: Make individual life expectancy estimates based on reviews of medical records. The accuracy of their estimates is fundamental to achieving good returns.
- *Provider*: A licensed entity that purchases life insurance policies from individuals or their brokers. They are responsible for making sure that documentation conforms to applicable statutes relating to consumer protection and insurance and life settlement practices and procedures.
- *Clearing Houses*: A number of trading platforms have arisen so that investors can bid for policies directly from the insureds, eliminating the need for intermediaries.
- *Investor*: Typically an institution, e.g. pension fund, hedge fund, investment bank.

<sup>1</sup> Sanford Bernstein (2005). Life insurance: Long view – Life settlements need not be unsettling. March.

**Exhibit 2: Structure of Life Settlements Market**

The synthetic market, referred to in Exhibit 2, operates alongside the physical market. This market is discussed below.

## METHODS FOR INVESTING IN LIFE SETTLEMENTS

### DIRECT INVESTMENT

It is possible to invest by purchasing life settlements directly, but this is complicated. First, a portfolio should hold at least 300 policies to control risk, and the policies should be reasonably similar in size. There are also a number of risks associated with tax liability, premium payment regimes, legal contestability issues, life insurer creditworthiness, and regulatory requirements that are beyond the resources of most investors to manage directly.

There are two avenues open to investors who might wish to access the physical market, both employing a “pass-through” structure. One is through an open-ended pool, and the other is through a closed-ended pool. Each has specific additional risks that an investor should understand.

### OPEN-ENDED POOL

Open-ended pools, usually structured as unit trusts, buy life settlements whenever cash is made available from investors. They operate on a “pass-through” basis and returns come from policies which have matured. While the pool handles most of the origination risks and management problems associated with direct investment, they create some risks of their own:

- Whenever a new investment is made, the pool must be revalued to maintain equity between new and existing investors.
- Returns may suffer if a large number of investors wish to liquidate their holdings at the same time, because the underlying life settlements are not very liquid. Alternatively, some funds retain the right to restrict liquidations.

### CLOSED-ENDED POOL

A pool is created with at least 200 policies and investors purchase a share of the pool. Once established, the pool is closed to new investment. Pools operate for a specified time period after which policies remaining in the pool are sold in the secondary market.

The advantages of a closed-ended over an open-ended pool include the transparency and control over the investment process, and the elimination of problems associated with investors coming and going from the pool. However, there is still a risk associated with the price at which policies remaining on maturity of the pool can be realised. How liquid will the secondary market be at this time and will the policies be able to be sold at “fair” values?

### SYNTHETIC LONGEVITY MARKET

Investment banks have created synthetic instruments where the bank is the counterparty, assuming origination risks and allowing investors access to the market without the investor physically holding insurance policies. The synthetic market insulates investors from most of the origination risks found in the physical market.

Synthetic instruments make payoffs to investors linked to the survival of a pool of reference lives, usually upwards of 300 lives. The payoffs to investors therefore reference ‘lives’ rather than ‘policies’, and it is more accurate to call them *longevity*, rather than life settlements, investments.

There are two main methods that banks use to hedge their exposure.

#### *Method 1: Warehoused Risk*

The bank can ‘warehouse’ risk by physically purchasing policies on which the reference lives are based, thereby hedging risk associated with the synthetic products it writes. However, these synthetic instruments have a finite term. It is important that investors understand the issues around the valuation of any remaining policies once the defined term of the synthetic instrument passes.

#### *Method 2: Reference Lives*

A synthetic index is formed from a representative sample of insureds over the age of 65 that has been assessed by a medical underwriter. The lives in the index are independently tracked, providing real-time mortality information. Synthetic instruments are structured on the index thereby eliminating the risks of the physical market. Indices are determined by the reference lives in the pool that underlie it and the value will move up or down based on investors’ changing views on the longevity and mortality in the pool. Note, however, that these synthetic instruments are not backed by any physical life settlements.

Typically longevity notes (notes with payoffs linked to the index) or swaps are issued on the index. However, it is necessary to find a third party to take the position, which in a physical market or the market for synthetic pools is taken by the insurance company.

## RISKS AND RETURNS

### LONGEVITY RISK

Longevity investments are usually priced to yield an expected rate of return of 11% to 12%, based on estimates of mortality provided by medical underwriters. The key factors affecting actual returns on longevity investments are:

- the accuracy of expected mortality estimates provided by underwriters;
- the level of mortality improvement in excess of that allowed for by the underwriters and in subsequent security pricing; and
- for closed-ended life settlements portfolios, the recovery rate on liquidation of policies remaining at the end of the term.

If insured lives survive longer than expected then the rate of return will be lower than expected because:

- investors must make premium payments for a longer period; and
- it will be longer before the death benefit will be received.



Life expectancy depends on underlying mortality rates, i.e. the probabilities of death within a given year. Mortality rates increase with age, and the underwriter's task is to produce a table of mortality rates for each insured life giving the probability of death in each future year. This is usually done by adjustments to a set of tables produced by the Society of Actuaries; the latest version is called VBT 2008.

The sensitivity of returns to mortality estimates was seen in 2008 when a number of life expectancy underwriters disclosed that they had been systematically underestimating both mortality levels and the rate of improvement. Consequently, the valuation of many life settlements portfolios was revised downward resulting in periods of negative returns towards the end of 2008. This period of poor returns coincided with poor returns in financial markets, but they arose from completely different sources.

### SENSITIVITY OF RETURNS

The sensitivity of returns depends on:

- the level of leverage in the contract; and
- whether a cash inflow is ultimately obtained for each life in the pool.

Swaps are highly leveraged, making them sensitive to estimation errors. The leverage can be removed by collateralisation, where a cash pool is established to pay the fixed side of the swap, but the resulting expected returns are much lower.

Moreover, swaps, collateralised or not, pay out only on deaths within the term of the contract. If mortality is overestimated, fewer deaths than expected occur within the term, and returns drop sharply. This problem can only be reduced or eliminated by committing to a long-term contract (20 or 30 years).

A closed-ended life settlements pool has low leverage, and a payment is received on every life, either a death claim or recovery of policy value on liquidation at the end of the term. Thus the sensitivity to mortality underestimation is greatly reduced. However, returns are reduced if recoveries on remaining policies are less than their actuarial values. Moreover, there are additional institutional, counterparty and regulatory risks.

An open-ended life settlements fund avoids both kinds of problems, but now there are problems of liquidity and transparency, plus additional institutional, counterparty and regulatory risks.

### CONCLUSION

Life settlements or derivative longevity instruments offer good returns that are virtually uncorrelated with other asset class returns, making them a potentially valuable addition to most balanced portfolios. As with other alternative asset classes, we would recommend an initial portfolio allocation be limited to 5%.

However, there are a number of issues that have to be taken into account.

- Direct investment would require resources not available to many New Zealand investors.
- Open-ended pools introduce problems of liquidity, transparency and institutional risk.
- Closed-ended pools avoid most of these problems, but the returns are sensitive to the liquidation of policies remaining at termination. A long duration mitigates this problem.
- Swaps and other derivative securities are sensitive to mortality estimation error. This can be reduced by collateralisation, but at the cost of reduced return, or by opting for an extended term. Some banks also offer redemption options that mitigate risk.

These issues mean that longevity investments will probably be attractive only to funds with a long investment horizon, but for such funds, the good risk/return trade-off and diversification benefits make them worthy of serious consideration.



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