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Insurance Linked Strategies:
Life Settlements

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Consulting. Outsourcing. Investments.

Insurance Linked Strategies: Life Settlements

by Ryan Bisch, Senior Associate and member of Mercer's Alternative Boutique

Executive summary

One of the fallouts of the global financial crisis was the realisation that many of the more traditional alternative, such as hedge fund of funds, asset classes failed to provide adequate strategy diversification. Mercer believes investors should continue to investigate the use of longevity-linked investments such as Life Settlements to gain exposure to real alternative risk premia.

Longevity-linked investments are increasingly becoming a larger part of the larger Insurance-Linked Strategies (ILS) asset class, an asset class where, until recently, the majority of the focus has been on investments linked to catastrophe reinsurance. However, increased volumes in the longevity-linked strategies, such as life settlements and longevity hedging instruments, signals a wider acceptance for these types of risks by capital markets investors.

We believe the Life Settlements asset class has potential to offer an attractive return stream uncorrelated to capital markets. Investors can capture an underlying risk premia, longevity risk, which is effectively an arbitrage against the insurance company. Understanding the intricacies of managing exposure to longevity risk is critical to a successful investment in this asset class. This asset class is potentially worth consideration only by investors who have an appreciation of its risks and complexity.

The underlying risk premium investors capturing with an investment in Life Settlements can be best described in as an exposure to:

- a structural pricing inefficiency and
- a liquidity premium

We believe this risk premium should remain over the medium term, however short term imbalances could cause fluctuations in the level of the returns available to investors.

The Life Settlements asset class is new and relatively untested from a mainstream institutional investor context. While data and asset class history continue to accrue, the risks are perceived to be high. Investors need to be comfortable that the returns available are sufficient compensation for the risk involved in being an early adopter / investor in Life Settlements.

Asset class introduction

Life Settlements, in general terms, represents a secondary market for life insurance contracts. The owner of the life insurance policy sells it to a third party investor for a cash payment. This transaction occurs in place of allowing the contract to lapse or surrendering the policy to the insurance company for its cash value. Investors in Life Settlements become the insurance policy owner and beneficiary and gains longevity exposure, by paying outstanding premiums and then collecting the death benefit of the insured.

Life Settlements typically involve the sale of policies insuring the lives of the elderly (normally the insureds are 65 years and older; average age at sale is approximately 80 years) via the Life Settlements market to an investor.

The seller of the policy receives a one-off cash payment from the investor. This one-off payment is typically substantially higher than the surrender value of the policy offered by the insurance company. The investor continues to service the policy (i.e. continues to pay insurance premiums) and in exchange receives the insurance benefits (face value of the policy) upon death.

Relatively few countries have a secondary market for life insurance policies and while there have been examples of "life settlement" transactions in Australia, UK, Japan and various other regions, the US market is by far the most developed. The key characteristics of the US life settlement market which make it a suitable secondary market for life insurance policies are the size of the market and the type of policies typically purchased in the US market (specifically a significant market for whole / universal life insurance policies).

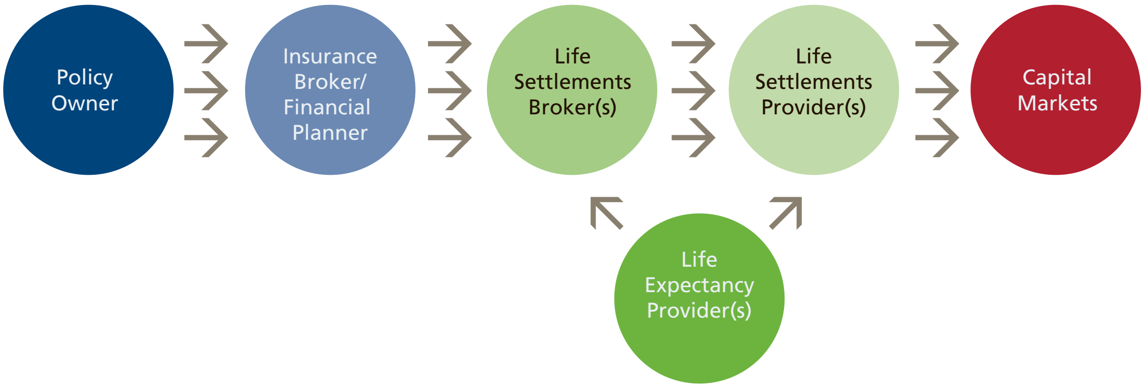
For investors outside of the United States the structure and complexities of whole / universal life insurance policies may be foreign as much of the insurance purchased nowadays in geographies such as Australia is term insurance. Universal life insurance policies represent the bulk of policies transacted in the life settlements market (estimated between 85% and 95% of market); these are a form of permanent life insurance.

Universal life insurance policies cover the duration of the life of the insured; if the policy is kept in force, payout is assured at maturity of the policy. Policies typically accrue a cash value as premiums are paid. Hence if insurance is cancelled prior to maturity of the policy the policy owner is typically entitled a payment from the insurance company representing the surrender value of the policy.

Origination process

The origination process has evolved over time as licensing and disclosure requirements have increased. Life Settlements providers are increasingly internalising the origination process—i.e. interacting directly with the policy owner/financial advisor and bypassing the Life Settlements brokers. This reduces overall cost of the origination process and provides greater control to the Life Settlements providers over how policies are sourced.

The purchase process for a life settlement typically involves a number of parties:



Life Settlements brokers

Life Settlements brokers are intermediaries who represent the policy owner looking to sell their policy. The Life Settlements broker typically transacts with a Life Settlements provider.

Life Settlements providers

Life Settlements providers typically serve as the purchaser in a life settlement transaction. Providers perform analysis and apply various valuation techniques to calculate the value of the policy and place a bid for purchase of the policy.

Life Expectancy providers

Life Expectancy providers issue life expectancy reports that provide an estimate of the insured's life expectancy. This estimate is based on the insured's medical records/history.

Longevity Risk

One of the key risks in Life Settlements is longevity, the risk that life expectancy improves more than is actuarially anticipated. In practice, the exposure to longevity risk represented by how accurately Life Expectancy providers can predict the life expectancy of an individual /cohort of lives.

At a macro level, the role of the Life Expectancy providers is the same as that of the equivalent actuarial /underwriting function at any insurance or reinsurance company—pricing of an insurance policy depends on life expectancy/mortality. However, the ability to create mortality tables specifically tailored for the Life Settlements market is constrained by the amount "experience data" available. Historically, the Life Settlements industry have not access to nearly as much relevant data as that of the wider insurance industry —given the primary focus of the asset class is a small subset of the overall population (i.e. elderly impaired insured lives). However, it is worth noting that Life Expectancy providers have been able compiled more data in recent years than what was previously available —the data used to project life expectancy for elderly impaired lives is only starting to approach statistically reliable levels.

Investment case: Why invest?

The underlying risk premium which investors in the Life Settlements asset class are aiming to capture can be described in separate components:

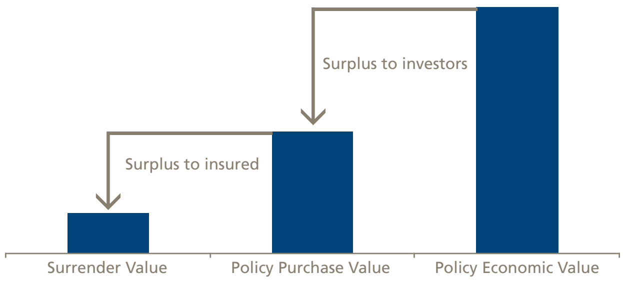
- Structural Pricing Inefficiency
- Liquidity Premium

Structural pricing inefficiency

The structural pricing inefficiency originates from the pricing approaches adopted by the life insurance industry. Generally, insurance companies typically manage policy profitability by either charging lower premiums or offering higher surrender values. In order to increase the uptake of life insurance, the industry (including regulators) supports a practice of charging lower premiums. This means that overall, the insurance industry will either generate less profit or a larger proportion of the profit needs to be sourced from policy lapses.

This structural pricing inefficiency is further exploited as individual insurance policies can not be re-priced once issued, even in the case where the insurance company is aware of new information, such as a new medical impairment of the insured, which would impact the value of the policy.

Investors in the Life Settlements market should be able to benefit from this structural pricing inefficiency by purchasing policies with low surrender values from individuals with impaired mortality profiles and then holding the policy to maturity.



Liquidity premium

Life insurance contracts are an illiquid asset in the hands of the policy owner. Historically, if a policy owner wanted to liquidate this asset the only option was to surrender the policy back to the insurance company and receive the surrender value; which is a payout equal to the accumulated cash value in the policy less the, often large, surrender charge.

The Life Settlements market exists to provide liquidity to the policy owner, similar to the secondary market for private equity. Motivations for selling a life insurance policy will vary; however, reasons will typically relate to a change in financial/personal situation rendering the policy unnecessary. The change in situation may often be related to financial and/or medical distress.

Policies will typically be offered to the secondary market at a discount to the asset's economic value. This discount should compensate for the transfer of illiquidity and address the information asymmetry (the policy owner will likely have more information about the health status of the insured than the potential acquirer will).

These risk premia should remain over the medium term—however short term imbalances in supply and demand could cause significant fluctuations in the level of the risk premium available to investor.

Return profile

The cash flow profile of a Life Settlements transaction involves an initial cash payment, followed by a series of premium payments, and finally receipt of a lump sum once the policy matures (i.e. insured life dies).

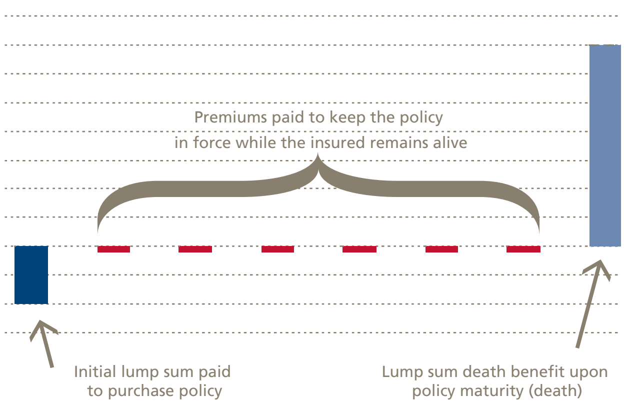
Premium payments are required for as long as the insured life is alive to keep the policy in-force.

Under the universal life policy premiums can be reduced to the minimum cost of insurance—premium amount is normally optimised to maximise the Internal Rate of Return (IRR) and minimise the amount of cash built up in the policy.

The IRR is impacted by:

1. Amount of initial purchase price
2. Size and number of ongoing premiums
3. Timing and size of death benefit

Typical Cash flow profile for a Life Settlements transaction



Risks

The risks involved with this Life Settlements asset class are summarised below.

Longevity Risk: the risk that life expectancy improves more than actuarially anticipated. This risk can be separated into two components:

- **Systemic risk:** this risk arises from the potential for sudden/significant mortality improvement due to medical progress.
- **Specific/idiosyncratic risk:** the risk that an individual insured lives longer than what was reasonably predicted by life expectancy providers.

Ethical/moral considerations: adopting a view on the ethics of the mortality/longevity markets is typically one of the first steps involved when considering an investment in this asset class.

Headline risk: the possibility of a negative reaction to investing in this asset class. Given the ethical/moral considerations discussed above there is a risk that investments in this asset class could result in negative press or scrutiny by peers.

Counterparty/credit risk: Life Settlements exposure to counterparty risk depends on the structure of the investment.

- Physical policy investments: are exposed to carrier counterparty risk (i.e. credit of the insurance company) in similar fashion as the original policy owner.
- Synthetic transactions: are exposed to credit risk via the counterparty to the synthetic transaction (typically an investment bank).

Portfolio concentration: limited diversification at the portfolio level as a result of too few policies, concentration in specific diseases or policies with large face amounts can lead to increased risk of exposure to the volatility of individual policies.

Tax risk: tax implications will depend on the jurisdiction of the investor and should not be ignored.

Liquidity: Life Settlements is an illiquid asset class.

Regulatory risk: the Life Settlements industry is largely unregulated compared to other more developed asset classes such as equities and bonds.

Origination risk: this covers a number of topics in the process of identifying and purchasing policies.

Legal risk: refers to issues surrounding insurable interest and non-contestability features.

As the market is relatively new and continuing to develop as an asset class—which means risks continue to evolve—investors need to remain aware of the changing industry dynamics. Investment strategies should be flexible enough to be adapted as the market evolves over time and continues to mature and develop as an asset class.

Conclusions

The Life Settlements asset class is new and relatively untested from a mainstream institutional investor context. While data and asset class history continues to accrue, the perceived risks are high. Investors need to be comfortable that the returns available are sufficient compensation for the risk involved in being an early adopter / investor in Life Settlements.

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Investors need to be cognisant that with this type of strategy they are bearing longevity risk—the potential that people will live longer than expected. Understanding the intricacies of this risk is critical, and for many institutional investors already exposed to the risk of mortality improvement, such as defined benefit pension schemes, Life Settlements may not in fact be appropriate.

Mercer believes there are close parallels between a life settlement investment strategy and successful implementation strategies for other areas of alternative investments such as private equity or hedge funds. As always, for example, well considered implementation is critical, access to high quality managers and careful due diligence is of paramount importance.

Ryan Bisch

Senior Associate

Ryan is a Senior Associate in Mercer's Alternatives Boutique, a unit within the Investment Consulting business. In this role, he is primarily responsible for generating intellectual capital and providing advice to institutional investors on the use of alternative assets. Additionally, Ryan is responsible for manager research coverage of insurance linked strategies.

Ryan joined Mercer in September 2002 as an actuarial consultant. He is based in Melbourne, Australia.

He holds a Bachelor of Science majoring in actuarial science and with a minor in business from the University of Alberta, Canada. Ryan is a CAIA charterholder and an affiliate member of the CFA Institute.

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