Life Settlements and Longevity Swaps

Opportunities for investors, individuals, insurers and pension funds

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Trillions of dollars of unfunded (and under-funded) social security and pension liabilities, combined with the demographic time-bomb of aging populations, creates a daunting challenge in terms of covering the costs of retirees' costs of living, care and healthcare – before even considering their desire to bequeath wealth (and lifetime gifts can be more tax efficient than bequests).

Many older people may not realise that they do have assets, besides their home, that can be monetised – and life assurance policies can be amongst the most valuable financial instruments they may own. While it is commonplace for people to release equity from their homes, far fewer take advantage of the opportunity to sell a life assurance policy. "There are always some people negative on life settlements but the industry provides a vital source of revenues for our senior population," says Schulte Roth & Zabel (SRZ) partner Thomas R. Weinberger.

The United States is among those countries that do permit transfers of ownership for life insurance policies, which can change hands more than once.

Vibrant tertiary market

In fact "the tertiary market is more active than the secondary market," explains Boris Ziser, SRZ partner and co-head of the firm's Structured Finance & Derivatives Group, who, along with Weinberger, serves as outside general counsel to the Institutional Longevity Markets Association (ILMA).

He explains how the initial sale from the policy holder is 'secondary' and all subsequent transfers are 'tertiary'. The secondary market is not that active, because "consumers may not be aware of the value of their life policies or the existence of the life settlement market; and the investors may not have the ability to deploy capital over the lengthy time period that might be required to aggregate a large portfolio," surmises Ziser.

But once initial transfers of ownership have taken place, the tertiary market – which involves investors selling to other investors – is very active, and highly heterogeneous. "It might involve one, five or hundreds of policies. Face values of policies are mainly within a $500,000 to $10 million range, with the average between $1 million and $5 million," Weinberger observes.

Additionally, the leverage, or premium finance, market is active and SRZ represents a number of lenders who make loans to investors to pay premiums on policies. "It can be cheaper to borrow to pay premiums than to use equity capital to do so," argues Weinberger, but leverage is not present in all vehicles. According to Ziser, "Investment vehicles can be funds or other aggregation structures and will vary for tax and other reasons."

Investors into longevity risk include some of the world's largest pension funds, endowments and foundations; smaller allocators can also access the asset class, sometimes through funds. Investors are targeting high yields in the mid-to-high teens that are seen as compensation for a number of risk factors. The most obvious risk is when longevity exceeds estimates, which may also increase premium costs. Rising longevity is one reason why cash inflows from mortalities could fall short of the outflows needed to pay premiums; increases in premiums, where permitted, are another. Foreclosure risk can apply where any lenders have recourse. There are also legal risks around contestability of policies.

Assessing risks

Weinberger, who lectures on longevity and mortality, acknowledges that in the early 2000s, some funds made what turned out to be aggressive assumptions that have left some allocators 'once bitten, twice shy'. In particular, longevity estimates (which naturally require confidential access to medical records to protect individual privacy) were far too low. Explains Weinberger: "Assessing life expectancy reports is all part of the process, and investors have developed proprietary evaluation mechanisms to arrive at a value for policies that takes longevity risks into account."

This is where the diversification benefits of a portfolio of policies come into play, he goes on. "If you buy a portfolio that has enough diversity, then if some people live longer and others shorter, the portfolio can withstand the impact of fluctuations."

There are several ways to address the unpredictability of cash-flows, which has historically resulted in some funds falling prey to unintended debt-for-equity swaps. Some structures may involve a private equity structure whereby committed capital is drawn down as, and when, required. "Other models can use already invested equity capital. If a fund is set-up and not all of the capital raised is spent on acquiring policies, a reserve can be set aside," Ziser adds.

The reserve is sized based on assumptions about premiums for the pool of policies. Or there may be a leverage facility that is paid down as, and when, mortalities occur. Nonetheless, the risk of asynchronous cash flows resulting in policies lapsing, or leverage being required, is disclosed and can be seen as a type of contingent liability.

Contestability risk diminishing

Investors are cognisant of the legal risks, too. The secondary market for life insurance policies only exists after policies have passed the two-year threshold for contestability. However, there is also some risk of insurance companies challenging policies after this two-year period. Here, it seems the 'devil is in the details' and thorough legal due diligence is recommended. Notes Weinberger "the insurers have not generally been successful at challenging policies but have had success in certain states. The risk of litigation and loss must be analysed state by state."

Each US state has its own insurance regulator, and insurance companies' legal challenges are usually brought in the state where policies are issued, and vary in nature. Ziser enumerates insurers' typical arguments as being "that the insured never paid premiums; did not disclose financing; could not afford the policy; or a third party funder did not have insurable interest, and so the policy is void or voidable."

Precedents set are again state-specific. "Some states have more case law than others and some have none at all, partly because they usually settle rather than proceed to trial," Ziser observes. The good news for investors is that "insurers have lost more often than they have won, so we have seen a very marked decrease in litigation," he says.

Aligning interests

Sophistication in assessing all of these risks, and in particular, longevity and mortality risk, has grown greatly, and investment vehicle structures have become more appropriately tailored to the risk factors. Structures are also aligning interests between investors and managers more effectively. Some investors may have memories of pre-crisis fund structures that allowed managers to receive (or sometimes accrue as a liability) carry based on unrealised theoretical valuations that turned out to be too high, because longevity estimates were too low. Now structures will typically involve realisation-driven carry, reflecting investor expectations for less liquid investment strategies.

Longevity swaps, pension funds and insurance companies

Life settlements are an example of 'micro' longevity risk while longevity swaps are an example of 'macro' longevity risk. "Life settlements tend to involve smaller pools of lives whereas longevity swaps can involve tens of thousands of lives or be based on a population-wide index depending on how they are structured," explains Weinberger.

SRZ has also worked on macro longevity swaps, which can include insurers buying or selling pools of annuities, pension funds performing buyouts, and other transfers of risk between various players. These deals have generally been bilateral, bypassing capital markets, though "there are potential opportunities for intermediaries to bridge investors with sellers of longevity risk," foresees Ziser.

So far, SRZ has mainly dealt with European insurers in the space as the market for European longevity swaps has been stronger for two key reasons. Weinberger explains that "regulators in the UK and the Netherlands are focused more on longevity risk; and pension funds in Europe often offer escalating payments that exacerbate the longevity risk."

In contrast, US pension funds have emphasised LDI (Liability Driven Investment) and cash-flow matching. However, SRZ thinks the United States is poised to catch up with Europe in macro longevity: "We have seen deals done and expect to see more," says Weinberger. **THFJ**