The Merlin Stone Report

The market for traded life policies

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MPG

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Foreword

When economic historians look back at the financial crisis of 2007-2009 they will see all the main asset classes - equities, bonds, property and even cash in the form of funds - nose-diving together, undermining the long-held mantra that diversification is a form of risk control.

They may also see it as the catalyst for the emergence of a new uncorrelated asset class. For during those turbulent two years, one class of asset that offered the potential to deliver steady, predictable returns was traded life policies (TLPs), also known as life settlements.

When the first Merlin Stone Report was published in 2007, the credit crunch was already beginning to take hold and financial markets were in turmoil. That report highlighted TLPs as a relatively new asset class that offered investors a safer haven for their money in the terrible market conditions that were ensuing. One might have thought such an option would have been seen as a godsend at the time. There was hardly a stampede from mass market investors but the message was not lost on certain sophisticated investors and especially institutions that did - and continue - to see the potential in TLPs. TLPs were, and still are, an unknown quantity among many investors but that situation is certainly changing, albeit slowly.

In this, the third Merlin Stone Report, I have attempted to take a more holistic view of the TLP market. The market is notoriously difficult to quantify, with no central exchange platform, but I have taken a look at latest estimates of the size of the market in the US. I have pinpointed countries that are seeing a greater focus on TLPs and also examined some of the product developments. On this latter point, fears raised in 2008's report about the growing use of securitisations have in fact been echoed in newspaper articles in recent months. I have included updates in regular sections of the report and there is also some fresh research, including a survey among life settlement brokers in the US to get a feel for what is happening at the coalface as well as updates on research among retail investors and financial advisers in the UK.

So for those who are unfamiliar with TLPs, what exactly are they? They are whole of life insurance policies issued in the United States and which are sold by the original policyholders so that they can enjoy some of the benefits during their own lifetimes. The new owners will continue to pay premiums on the policies until they mature i.e. when the lives assured end, and they receive the payouts. This concept of a secondary market for life insurance policies is far from new. Markets for second hand life policies have existed for many years in the UK, where traded endowment policies (TEPs) are the norm, and in Germany, where whole of life policies are prevalent. These markets exist because policyholders can get a better price for their policies on the open market than by surrendering them to the insurance companies that issued them. Even so, investors can still buy them at deep discounts from their known or expected maturity values. So much so, they have become a niche asset class for both institutions and private investors to the extent that there are even mutual funds that invest in them.

With regards to the UK's TEPs, however, there is a problem in that the market has a limited shelf-life. The problems surrounding them have been extensively recorded, namely issues over their failure to pay off mortgages, low early surrender values, mis-selling etc. As a result, new with-profit endowments are sold in much lower volumes than they once were, so there will come a time when the second hand market for them will no longer be viable.

The same cannot be said of TLPs because life insurance continues to be sold in the United States at very high volumes without the controversy that bedevilled endowments. People in the US continue to buy life insurance, while it is also frequently provided in employee benefit packages. Credit Suisse estimated that $23 trillion of death benefit existed in the US in 2006, making it the largest life insurance market in the world.

A major difference between endowments and TLPs is that while the former have limited terms, usually between ten and 25 years,

with payouts made to the lives assured who survive, in the US the most common form of insurance is whole-of-life, paying out only on the death of the life assured. From an investment point of view, TEPs do provide some certainty in that the investor knows there will be a payout at the maturity date, if not before. What is not known is what the maturity payout will be, given uncertainty over the levels of annual and terminal bonuses. With TLPs, the reverse is true. The final payout is known, but it is not known when the policies will mature.

The transaction by which an existing life insurance policy is sold to third parties is known as a life, or traded, settlement. The life settlement market is generally regarded as having started in the US around 1990, when around $50m worth of policies were traded, according to Bernstein Research. The life settlements market started to grow rapidly as a result of the AIDS epidemic in the 1980s. A large number of people needed cash to pay for their care and a substantial market developed to meet those needs. Policies sold on lives assured that have been designated as having a terminal illness or to be in terminal decline, with a perceived life expectancy of less than three years, are known as viatical settlements. These were the main type of policies traded in the initial stages of the market. Brokers would offer policyholders prices and find buyers, or 'funders'. These funders were primarily private individuals, aligned with finance companies.

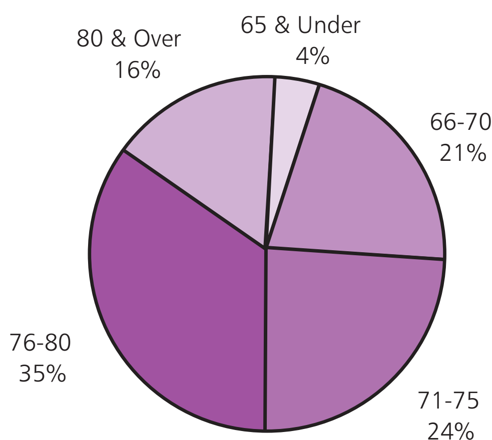
Many AIDS-related policies turned out to be a bad investment, as life expectancy estimates were notoriously unreliable, due to the advent of new drugs that extended life expectancy. 'Viaticals' are still perceived as risky investments, so the market has gravitated towards senior life policies (over-65s), where life expectancy opinions are much more accurate. Figure 1 shows a comparison of the features typical of both types of policies, illustrating how life settlements tend to be of higher value with older lives assured and longer life expectancies, while Figure 2 gives a breakdown of life settlement clients.

Fig 1: Viaticals vs Life Settlements

Viaticals versus Life Settlements		
	Viaticals	Life Settlements
Policy size	< $100,000 and usually between $25,000 - $50,000	> $100,000 and usually over $250,000
Policy holder	AIDS patients in the 25-44 age band	Senior citizens over age 65
Life expectancies	< 2 years and usually 12 months or less	> 2 years and as high as 12-15 years

Source: The Life Settlements Market (Deloitte Consulting, 2005)

Fig 2: Age Distribution of Life Settlement Clients



Source: National underwriter/Bernstein Research, March 4, 2005

Holders of life policies might wish to sell before maturity for a number of reasons. They might no longer wish to pay the premiums, or they might need the cash for purposes such as paying for care or charitable purposes. These reasons are analysed in more detail below, but essentially, selling policies on the open market means policyholders can reap the benefits from policies they have paid for.

Of course, there are ethical issues around what have come to be known in some quarters as 'death bonds' or 'death futures'. These issues are discussed in more detail later in this paper. Suffice to say that, from the point of view of investors, TLP fund performances have spoken for themselves. Some funds have produced double digit annual returns throughout the credit crunch, which could be seen as miraculous, given the massive falls seen in many other asset classes. As we went to press, financial markets had been recovering for some months, suggesting that investors' outlooks were moving back to what might be regarded as more normal. No doubt this will mean equities especially will be returning to favour, but what cannot be denied is that TLPs have at least established their credentials in the credit crunch. This year's report will try to map out developments in the market and lay out the potential for this exciting asset class to evolve, with some views on what will need to be in place for it to do so.

View from the coalface

Even though life settlements as an asset class are uncorrelated to other assets, the market has not existed in a bubble, immune from the turmoil seen in the rest of the world.

To gauge the impact of the credit crunch on the TLP market, Life Settlement Leads (LSL), a US-based intermediary firm between buyers and sellers of TLPs, carried out a survey of its 30 top brokers especially for this report, to get a snapshot view 'from the coalface', both in terms of what has happened and where the market is seen to be going.

While many observers of the life settlement market predict significant growth, this does depend ultimately on individuals actually selling their policies. In the long term, the number of policies coming to market is expected to increase as higher levels of policies are issued, the population gets older and policyholders become more aware that they can sell them on the secondary market rather than just let them lapse or surrender them back to insurers.

Given the economic downturn of the last two years, it might have been reasonable to assume that more policies would come onto the market as more people suffered financial difficulties and sought cash. Nearly two out of five brokers (37%) said they had seen up to 20% more life settlements being sold by clients (see Figure 3). Somewhat surprisingly, 60% of the brokers were seeing fewer policies coming through their books. Just 3% said the volume of policies coming through was about the same.

The brokers also gave the reasons they had seen for why clients sell policies (see Figure 4). The most commonly cited primary reason was an inability to pay premiums (27%). This was followed in importance by a need for cash to pay for major expenses (23%) and no longer needing life cover (17%). The findings reflect the reasons outlined in more depth later in this report.

The market has clearly been adversely affected by a downturn in policies coming to market over the last year or so, looking forwards. However, growth predictions were striking: seven out of ten brokers (69%) predicted that clients would be selling more policies in five years time (see Figure 5). This includes nearly half of the brokers (43%), who predicted that growth in the market would increase by up to 20% more, one in five (20%) who predicted the growth would be up to 40% more, 3% who thought the growth would be 60% more and another 3% who even thought the market would double.

The brokers were also very positive about the outlook for life settlements as an investment (see Figure 6). Seven out of ten (70%) were favourable about prospective returns over the next five years from funds that invest in life settlements, including 30% that were very favourable. Only 13% were negative about the returns.

Overall, this research points to a difficult period in the life settlement market over the last couple of years, demonstrating there was some fallout from the credit crunch. However, there is a high degree of confidence in market growth and especially in the returns that can be made from the asset by investing in them through funds. Interestingly, although the life settlement market has seen lower volumes during the credit crunch, the main driver of this is lower demand. This resulted in discount rates rising. Those investors that continued to buy policies more recently will achieve higher returns as a result of paying less for policies.

Fig 3: Sales dynamics of Life Settlements

Were more or less of your clients offering their life policies for sale in the first six months of this year compared with the same period last year?	Percentage
Less	60%
The same	3%
Up to 20% more	37%
Up to 40% more	0%

Source: LSL

Fig 4: Reasons for selling policies

What were the reasons for your clients wishing to sell policies?	Primary reason	Secondary reason
Unable to pay premiums	27%	20%
Need cash for major expenses	23%	3%
No longer need life cover	17%	7%
Need different type of cover	3%	7%
Change in beneficiaries (eg divorce, death of beneficiaries)	0%	0%
All of the above	13%	0%
Other	17%	10%

Source: LSL

Fig 5: Expectations for sales of TLPs

Do you expect more, fewer or the same number of clients to sell their policies in five years time?	
Double or more than double	3%
Up to 60% more	3%
Up to 40% more	20%
Up to 20% more	43%
About the same	13%
Less	17%

Source: LSL

Fig 6: Favourability towards TLP funds

How favourable are you about the prospective returns on funds that invest in life settlements over the next five years?	
Very favourable	40%
Favourable	30%
Neutral	17%
Negative	13%
Very negative	0%

Source: LSL

Changing sentiment in the UK

One of the more active markets for investment in life settlement funds is the UK. The market is still in its early stages but it is sufficiently active for research in it to be meaningful. The research shows growing awareness and favourability towards the asset class among both retail investors and the country's highly influential independent financial adviser community.

The UK situation is particularly interesting, given its long history of with-profits products, a form of investment that shares many characteristics with life settlement funds. For many decades, with-profits investments promised steady, predictable returns. In fact, for a long time they did deliver. However, a few years ago, there was mismanagement by actuaries, who were overly generous with bonuses to investors, while adverse market conditions hit the performance of the underlying funds. The most common form of with-profits investing was endowments, which were typically used to repay mortgages. Lately, these failed to fulfil their promise of repaying mortgages, resulting in much bad publicity. As a result, with-profits is now in significant - some would say terminal - decline.

This decline in sentiment towards with-profits in the UK has been tracked for the last three years by research commissioned by MPL for the Merlin Stone Report[1]. In April 2007, 57% of with-profits investors, some 5.5 million people, said that they were unhappy with their performance and 21% of these said that they were not planning to continue to invest in them. In 2008 the results showed aversion to with-profits had grown, no doubt closely linked to the powerful negative sentiment in the middle of the financial crisis, when confidence in investing generally was very low. The research showed 64% of with-profits investors said they were unhappy with their performance and the proportion saying they were not planning to continue investing in them was 25%. In 2009 the research showed even more with-profits investors were unhappy with their investment, with 70% saying that they were unhappy, including 32% who were very unhappy.

Adversity to with-profits has also been mirrored in research over the last three years among IFAs[2] (ironically, one of the main channels through which with-profits endowments were sold). In July 2009, (see Figure 7), 57% of IFAs said they viewed with-profits negatively, including 17% who said they viewed it very negatively. This compares with 63% of IFAs in 2008 who said they viewed with-profits-based investments negatively, including 25% who said very negatively, and 67% in 2007, including 32% who said very negatively. While a clear downtrend is not shown by these three sets of data points, it is clear that a substantial majority of IFAs are negative towards with-profits. The practical result of this sentiment is shown by other figures in the research that shows that in both 2009 and 2008, 78% of IFAs said that they were not recommending clients to invest in with-profits-based investments.

With-profits investments were not alone in incurring the wrath of investors. In the financial crisis of the last two years, all the main asset classes, including equities, bonds, property and even cash in the form of cash funds, have suffered. As a result, many forms of investment vehicles have delivered negative returns to investors. With-profits did have unique problems over the last few years, however. Even when markets picked up after 2003, the bonuses paid out on with-profits were very small as the funds sought to make up the losses of the last bear market between 2000 and 2003. Many with-profits funds that were financially weak had also switched to bonds before markets recovered from 2003 in an attempt to de-risk and match future liabilities, thereby missing the rally. The market downturns seen over the last two years will only serve to hit such funds hard again.

Investors are very disillusioned with their investments generally over the last few years. However, investors in endowments have been warned to expect shortfalls and unsurprisingly, many are looking to exit. What is sometimes misunderstood about with-profits however, as many IFAs would tell you, is that investors never really fell out of love with what with-profits promised, namely steady, predictable returns. It was just that with-profits failed to deliver on that promise. The problem for investors is finding an alternative

[1]MPL commissioned the research company YouGov to interview 2,438 people between 26th and 30th April 2007; 2,115 people between 21st and 22nd April 2008; and 2,017 people between 27th and 29th May 2009. The research was conducted online. The samples were based on nationally representative samples of GB adults aged 18 and over. Results were weighted in order to be nationally representative.

[2]MPL commissioned the research company George Street Research to interview 202 IFAs throughout the UK between 9th and 16th June 2009; 201 IFAs between 9-16 June 2008; and 207 IFAs in May 2007.

to the steady, locked-in returns that made with-profits so attractive in the past. Exit penalties may also prevent them switching. The MPL research[2] shows a majority of IFAs are aware of this. In 2009, 55% of IFAs said they were actively seeking an alternative investment class for their clients with many of the characteristics of with-profits based investments.

TLPs do offer the prospect of steady, predictable returns. The problem for TLPs is that they are not well known, they are not generally accepted, either officially or unofficially as a separate asset class and their performance track record has yet to be fully established, although some funds have existed for five years or more, with very positive results.

If TLPs are to become a serious choice for IFAs then their profile in the industry needs to be higher than it is. MPL's research[2] (see Figure 8) shows that IFAs have become more familiar and positive towards TLPs insofar as 78% were familiar with them to a little or great extent in 2009, with 74% saying so in 2008 and 70% in 2007. As much as this is positive, the number of IFAs who are very familiar with TLPs stays at around one in five. It is probable that the publicity generated around TLPs delivering steady returns over the last two years despite the extreme adversity seen on financial markets will have been a factor in making IFAs curious about TLPs. I would also like to think that publication of the Merlin Stone Report has also helped to highlight the benefits of TLPs!

More encouraging is the fact that the percentage of IFAs who were favourable to TLPs has risen from 15% in 2007 (with 1% very favourable and 14% favourable) to 20% in 2009, with 5% very favourable and 15% quite favourable.

The ways in which IFAs use TLP funds in practice is covered in a later section of this report. What the above research does show is that recognition of TLPs has risen at a time when the market's recent problems has made it even more imperative for IFAs and investors to find alternatives to what they have previously chosen. However, it is also clear that there is still some way to go for IFAs to recognise the potential for TLP funds, whether as a close substitute for with-profits or as part of an investment portfolio. Recognition does seem to be moving in the right direction, perhaps helped by the credit crunch. A solid minority in the IFA community accept the benefits of TLPs.

Fig 7: IFA views on with-profits-based investments[2]

View of with-profits based investments	Percentage of IFAs in 2009 that share this view on with-profits based investments 2008 figures in [] brackets and 2007 in ()
Very positive	2% [1%] (1%)
Positive	16% [12%] (6%)
Neither	21% [20%] (20%)
Quite negative	40% [38%] (35%)
Very negative	17% [25%] (32%)
Do not know	4% [3%] (5%)

Source: MPL[2]

Fig 8: IFAs' views on traded life policies[2]

Familiarity with TLPs as an investment product	Percentage in 2009 2008 figures in [] brackets and 2007 in ()	Favourability towards TLPs	Percentage in 2009 2008 figures in [] brackets and 2007 in ()
To a great extent	19% [18%] (22%)	Very favourable	5% [3%] (1%)
To a little extent	59% [56%] (48%)	Quite favourable	15% [20%] (14%)
Know the name	14% [19%] (13%)	Neither favourable nor unfavourable	49% [32%] (41%)
Never heard of them	6% [5%] (12%)	Quite unfavourable	19% [27%] (23%)
Do not know	2% [1%] (5%)	Very unfavourable	10% [8%] (10%)
		Do not know	3% [10%] (11%)

Source: MPL[2]

[2]MPL commissioned the research company George Street Research to interview 202 IFAs throughout the UK between 9th and 16th June 2009; 201 IFAs between 9-16 June 2008; and 207 IFAs in May 2007.

How do financial advisers use TLPs?

The research outlined above shows that IFAs' favourability towards TLPs is improving, although IFAs still have some way to go in understanding them and how they can be used. Many IFAs, however, are using TLPs to great effect.

A leading example of how IFAs are finding a place for TLPs in their clients' portfolios is Argent Personal Finance Managers, a discretionary private client and advisory firm based in the City of London. It has been using TLPs for five years and regards them as an 'anchor' asset class, providing reliable returns that stabilise portfolios. In a similar vein, Argent employs market neutral 'fund of hedge funds' for much the same purpose.

Argent manages five 'growth portfolios' in which clients can invest their pension, ISA or general wealth assets. These are called Absolute Return, Cautious, Balanced, Balanced-Plus and High Octane. Approximately 80% of Argent's assets under management comprise pension accumulation funds and, to that end, the average client has a long term horizon. This is ideal for TLPs which trade monthly and do not immediately lend themselves to the provision of immediate income in the way a fixed interest gilt or corporate bond fund does. The Absolute Return portfolio currently holds 15% in TLPs while the Cautious and Balanced hold 10% each. The higher risk portfolios have higher exposure to equities.

The portfolio asset allocations are reviewed on a regular basis. Argent originally used the model asset allocations provided by the Association of Private Client Investment Managers and Stockbrokers but quickly decided that the level of equity exposure in the APCIMS portfolios was higher, on average, than that with which it felt comfortable. Argent's definition of 'Balanced' is 50% equity and 50% non-equity as opposed to the definition suggested by the trade body the Association of Private Client Investment Managers and Stockbrokers, which has equity somewhere between 60% and 70%. The proportion of equity and non-equity does not change in Argent's portfolios, but within the equity exposure the weightings have changed and become increasingly less 'UK-orientated' over the last three years. In the fixed interest area, the distribution between investment grade and high yield changes, but TLP exposure has remained fairly static.

When Argent assesses a TLP fund, one of the first things it looks at is the number of policies held in the fund. What Argent refers to as 'critical mass' involves the fund holding enough policies at outset to verify the actuarial statistics. In other words, the greater the number of policies, the more accurate the margin assumptions are likely to prove as policies move towards maturity. Similarly, Argent likes to see diversity in the same way that a diversity of holdings may exist in any other investment fund. It then asks questions about the quality of the life policies the fund is buying, as determined by the credit rating of the issuing life assurance companies. Argent likes to see policies held with insurance companies that have a minimum credit rating of AA. The importance of financial strength has been underlined (and in some cases undermined!) by the credit crunch, which claimed several top names in the finance industry. AIG was a big name insurer with a large question mark about its creditworthiness, but those fears dissipated after the Federal Reserve's $85 billion rescue package. However, this shows the importance of diversity in a TLP fund - minimising the impact of an insurance company defaulting on an insurance payout.

It should be borne in mind, however, that it was the AIG holding company rather than any of its insurance subsidiaries that experienced the credit risk issues. If an insurance company were to become insolvent then in addition to the protection provided by compulsory reinsurance rules and State Guarantees, its insurance book can also be sold as an ongoing concern to another insurance company. As such, the credit rating of an insurance company is of less importance to policyholders.

The consistency of returns reflected in the monthly net asset value of a TLP fund is another key issue. Argent looks closely at the process used by fund managers when valuing a fund each month. In the first instance, it is important to establish that there is, indeed, a process of revaluation taking place based upon maturities and new additions to the fund, as opposed to a 'finger in the wind' approach based upon anticipated margins over time.

Nigel Newlyn, Director at Argent, commented: “It is hard to do thorough due diligence because of the very nature of the product and the variables associated with each policy in the fund. This is why the size of the fund and a feel for the regularity of the valuation processes involved are key indicators as to the likelihood of consistent returns being realised.”

As a reasonably recent phenomenon, TLP funds are difficult to research. Data is not easily available and 'research' can amount to spending a day with a fund's management reviewing first-hand the monthly evaluation process. The lack of a recognised investment sector or any central database covering TLPs makes it harder to monitor performance. In fact, most research depends on information provided by the fund providers.

Newlyn says that the attractiveness of TLPs has become more apparent over the last 18 months as clients' portfolios have been eroded by poorly-performing markets. A “healthy chunk” in an asset class delivering 8% plus, irrespective of what the markets are doing, provides great support for a portfolio.

He said: “As an asset class we are totally in favour of TLPs. It serves our purpose to have a percentage of our portfolios invested in assets which are solid and chug along no matter whatever markets do. It is bit like the Holy Grail of investment and I hope I am not tempting fate by saying that! I get the impression that TLPs are not widely used by IFAs, although I am sure they will be soon. We only stumbled across them because of our constant search for assets which are uncorrelated to equities. It is not that there is resistance to TLPs, it is just a question of more marketing being needed. I am sure that if the Investment Management Association saw fit to recognise TLPs as an asset class by including them in a new sector then you would find IFAs would use them much more.”

The international expansion of TLPs

Without a doubt the financial crisis has been a major help in highlighting the benefits of TLPs. Investors all around the world have been hit hard by across-the-board falls in the mainstream asset classes.

In such a sombre environment, the steady, incremental returns offered by portfolios of TLPs when they are managed in a robust way can look somewhat enlightening to those who are made aware of them.

The most interesting market developments are being seen at present in Asia. Apart from Japan, Australia and Hong Kong, the region has some way to go before it reaches the sophistication of investor markets in the West, although it is developing fast and the regulatory environment is improving rapidly.

Across Asia there is some sensitivity to the death aspect of life settlements. This creates some moral issues in the retail market, which tend to access TLPs by investing in funds via offshore bond wrappers such as those offered by Hansard and Skandia.

Institutional investors are much more open to life settlements as an asset class, finding funds offering double-digit internal rates of return of up to 12% highly attractive. Managing Partners Limited was the first life settlement company to establish an office in Asia, having opened in Hong Kong earlier this year. Other such companies do operate in the region but on a short-term fly in, fly out basis. MPL has received substantial interest from institutional investors, most notably in Japan, where it has signed a deal with fund management company United Investments, with Nomura Trust Bank acting as trustees. United has created an onshore fund in Japan that will feed into MPL's Traded Policies Fund. It will be offered to Japanese pension funds and represents a landmark deal in Japan.

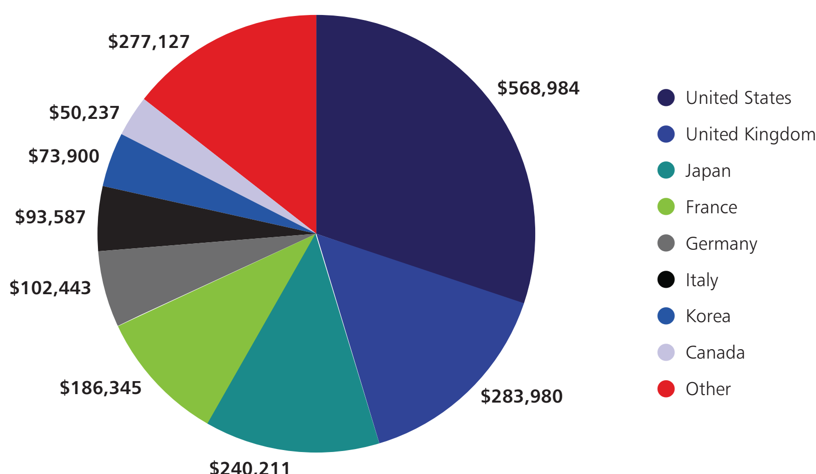
Harvey Athwal, Sales Director at Managing Partners (Asia) Limited, commented: "We will be offering potential returns of 7-8% when anything around 6% is huge in Japan. Japanese pension funds conduct major reallocations of capital in July, September and February. Three years ago a return of 10% was impossible to sell when equities were promising so much more. Now, everyone wants consistent returns. Institutions were already thinking of investing in with-profits so we have been very timely in establishing ourselves in Asia. Investment banks will be the first to pick up TLPs and run with them."

With a base in Hong Kong, MPL fully anticipates receiving interest from China as a whole. Taiwan also has great potential, with awareness quite high about life settlements because of investor exposure to them in recent years.

Interest in TLPs exists mainly in countries that have had active markets in life policies, such as the UK, Germany and the US. However, even in such advanced markets it is still hard to establish how large the market is for investments and to what extent it is growing.

Nevertheless, it is worth reviewing where the largest life insurance markets currently exist as an indicator of which countries will be most amenable to investing in TLPs. Figure 9 gives a breakdown of the sizes of life insurance markets. Unsurprisingly this puts the US and UK top of the list. Germany and Italy, where investors have flirted with life settlements, are in fifth and sixth places respectively. Japan has just started to look at life settlements. Of these biggest life insurance markets, only France seems to have an aversion to investing in life settlements.

Fig 9: The global life insurance market (US $m)



Source: Wharton, Life settlements: Signposts to a Principal Asset Class, 2009

Rients Aapkes is a director and shareholder at LifeCap Brokerage SA, which distributes TLP funds in Belgium, Germany and Central Europe. He says interest in TLPs has increased because of the steady, uncorrelated returns they offer but there is still a lot of distrust among investors for all asset classes. He said: “People are looking for alternatives to cash because interest rates are so low but they just do not trust anything. Investors would rather have a safe product and little or no return than something they are not entirely sure about. TLPs are an asset class that do and will have a place in investors' portfolios, it is just a matter of educating people about them.”

In Germany, investors have been buying them for some years, either within funds or, interestingly, the policies themselves. This latter method has created a small market and creates risks from lack of diversification. As it is such a small market, it has avoided being regulated, so brokers are free to sell the policies themselves without any regulatory issues.

The fund route also has its problems in Germany. The funds are closed-ended because of preferential tax treatment, and have fixed terms of up to ten or 15 years. Difficulties arise from this inflexibility. Only a set number of policies are bought at the inception of the fund and once policies mature the proceeds are held as cash. If at the end of the term the policies have still not matured then these have to be sold, quite possibly at a deep discount to their true worth. The portfolios left at the end of the term can sometimes be quite substantial, making the problem of selling them all the more serious. Investors have had little or no return, in some cases with vehicles set up purely for tax purposes. As a result, the German market has been looking more towards open-ended structures within which to manage life settlement portfolios. One solution developed by Berlin Atlantic has been to set up closed-ended funds as feeders into an underlying open-ended portfolio.

Aapkes still believes the German market still has some way to go before its financial advisers fully use life settlement funds within a full asset allocation framework similar to that used by many IFAs and wealth managers in the UK, although recognition of life settlements as an asset class is growing.

He believes that apart from educating investors, more robust retail investment vehicles need to come on to the market for investors. He believes many product providers have much to learn about how to manage risk. For example, he believes it has been a common mistake among fund providers to buy higher value policies from wealthy but healthy sellers who tend to live longer than general mortality statistics suggest. He said: “The TLP market will grow. It is just a matter of getting to the point where the products are built properly and have demonstrably good performance uncorrelated to other asset classes. It is a market where you have to prove you can do it right and then you can promote yourself.”

One indicator of the increasing acceptance of TLPs as an asset class is the AAP Life Settlement Index. This tracks the performance of funds implementing an investment strategy in the US life insurance sector and serves as a benchmark for investors in traded US life insurances. It uses the net asset values of open-ended funds from around the world, except for those domiciled in the US. It tracked 12 funds at its launch in December 2006. The number has grown to 17 now. Its rarity value - it is the only broad market index covering publicly available and open-ended life settlements funds - means there have been many requests from institutions to benchmark it for their own investment products, including structured vehicles.

One frustration that AA Partners has had in managing the index is a lack of openness by some product providers with regards to their funds - so much so that the company is considering whether to launch a transparency index.

Beat Hess at AA Partners believes that life settlements have a future as an established and recognised asset class, largely because investors need diversification. He said: “It will be a slow development though. There is still not a massive rush from institutional investors into the asset class. The market and the asset class is still very non-transparent and very complex. Eventually the product range will be as broad as other asset classes. Most types of products are already available, including swaps, securitisations, open-ended and closed-ended funds, wraps, etc, These are just not as broadly available as other asset classes. We shall see more and different strategies, more hedge fund-like strategies for arbitrage business because the market is not efficient yet. That will attract new money in and give support to the asset class. Crucially though, development will depend on the transparency of the industry.”

In general, one of the main drivers of the TLP market internationally is the fact that institutions are now taking TLPs much more seriously. Whereas until two years ago the asset class was seen as an unknown quantity, now that its returns are looking more attractive versus other asset classes several institutions are devoting resources to understand its technical nature. There are now some very significant names involved in the market, including Goldman Sachs, Commerzbank, Citibank, Credit Suisse, Nomura and Barclays. Various articles on the involvement of Wall Street financiers attest to this, but the involvement of institutions goes much further. They are taking the lead on TLPs and as history shows, they are usually followed by other investors.

Institutional developments

One of the most significant observations in 2008's Merlin Stone Report regarded the increasing use of TLPs in securitised instruments.

The report noted that several major institutions on both sides of the Atlantic were offering notes backed by portfolios of TLPs and that there were several reasons to be concerned about this. These concerns were subsequently aired in the media at the time but have been widely echoed in recent months, not least in the New York Times (Wall Street pursues profit in bundles of life insurance, 5 September 2009). The Times observed that despite the failure of sub-prime mortgage securitisations during the financial crisis, Wall Street bankers were now focusing on TLPs, packaging hundreds or thousands of policies into bonds that could be resold to investors, picking up huge commission fees in the process. Some have been dismayed that this signified a return by Wall Street to the bad old ways of chasing profits with complicated new products. Risks listed by the Times included fraud, with life settlement brokers coercing the ill and elderly to take out policies with the sole purpose of selling them back to the brokers (stranger-owned life insurance), and of the lives insured surviving much longer than anticipated, quite possibly through advances in medical science.

The issue has also been raised at a high political level. At a US congressional hearing on life settlement securitisations, Democratic congressman Paul Kanjorski said: “The securitisation of complex financial instruments that few people understood helped lead to the current economic crisis. It therefore astounds me that financiers are eager to return to the casino culture before they have even settled up the bad debts they made on sub-prime mortgage-backed securities,” (Whose life is it anyway? Financial Times, 25 September 2009).

The concerns expressed in my report in 2008 focused less on TLPs as an asset class per se and more on the quality of TLPs being used and the limitations of using closed-ended vehicles such as securitisations. To offer securitisations, institutions set up a separate legal entity, commonly known as a special purpose vehicle (SPV). There are several advantages in doing this for the originator of a securitisation. The main one is transfer of the risks of holding certain assets to a separate legal entity, which can sometimes borrow money at better rates and be “off-balance sheet”, so that the originator does not have to include the entity in its annual report as a liability. Often the SPV will buy a portfolio of TLPs from the originator. The SPV then sells bonds backed by the portfolio to the wider market, offering a coupon of perhaps 8% per annum and return of capital after a set term.

This is a debt instrument rather than a fund. As such it is a closed-ended vehicle, so the investor cannot exit it during the term, while the administrator has to manage an unwieldy portfolio of TLPs for a fixed period. The portfolio cannot be traded once it is securitised, so the manager cannot add new policies when some have matured, meaning payouts have to be held as cash. A decision must also be made as to what to do with un-matured policies once the term is up. Should they be sold at a discount in a fire sale, or should investors be told they cannot have their capital back because not every policy matured?

From the point of view of investors, there is a strong argument in favour of investing in a TLP fund instead of a securitisation. This would achieve at least the same returns, if not better, as it avoids the added costs of running a securitisation, but it also provides much more liquidity. This is because it is much easier to withdraw assets at any time in a fund, whereas exits are usually restricted throughout the term of a security.

Another problem is that the securitisations are linked to the performances of the underlying assets, which may not necessarily deliver expected returns. In fact, there is a good chance they will not. For example, an originator might have bought 6,000 policies that once represented a fair cross-section of life expectancies of the sample population, of which 1,500 might mature over a number of years. The best returns will have been made from these early maturities. Those left are 'survivors', who statistics show to be likely to live disproportionately longer than average life expectancies. These residual portfolios often find their way into securitisations and their future returns are likely to be below par going forwards. The only way to adjust the portfolio to be a fair reflection of average life expectancies and secure the 8-10% returns investors should expect would be to use the mortality experience of the portfolio to date rather than use general population tables and to make allowance for that in setting the price that the SPV pays for the portfolio of policies. Otherwise, the growing use of securitisation instruments with TLPs is fraught with risks for unwitting institutional investors.

TLPs' potential for predictable, steady returns means that they are also a useful tool in the growing practice of liability-driven investment (LDI) - the process by which institutions seek to manage their investments and risks with a strong focus on the future pension payouts they need to make to scheme members. Pension funds were hit both by the equity bear market of 2000-03 and the current one. The depletion in the value of their assets means that their ability to meet their liabilities, in terms of both present and future pension payments, has fallen.

LDI strategy became a major industry issue because of the losses made in 2000-03. Defined benefit pension schemes, which pay out proportions of final salaries to scheme members, now want to match those liabilities with a higher degree of certainty, or less risk. As a result, some schemes have switched investments from equities to the less volatile bonds. However, the predictability and smoothness of TLP returns make them ideal for this purpose. As an alternative to bonds, they also offer diversification. Indeed, institutional investors placing a greater focus on LDI strategies are now more attracted to the greater predictability of TLP-based funds, which has certainly been MPL's experience in the market.

The potential use of TLP funds for LDI was highlighted in a report in 2008 by the Pensions Institute at Cass Business School, entitled 'And Death Shall Have No Dominion: Life settlements and the ethics of profiting from mortality'. The report pointed out that UK defined benefit pension schemes might consider life settlements as an alternative asset class to aid diversification and form part of an LDI strategy. It pointed out that in the Netherlands, some of the large pension funds were now investing in TLPs, while Germany was one of the first investment markets to be attracted to them.

Size and growth of the TLP market

Rising interest in TLPs, combined with a general lack of knowledge about them, has prompted many questions about just how substantial the market for them actually is and how fast it is growing. The truth is that there are no firm figures.

No central trading exchange or platform exists for them in the US so trading volumes cannot be measured in the same way as equities, for example. Nor is there an independent or official third party to which life settlement players must report the volume of policies traded.

Some of the best estimates of the size of the TLP market have been made by Conning Research & Consulting. Conning's latest estimate for the market was in a study published in October 2009 entitled 'A Buyers' market for Now', which said the volume of life settlement transactions in 2008 was $11.77bn, or slightly down from the $12.20bn it estimated for 2007. It estimated that this meant there was, in terms of face value, $31bn of US life settlements in force at the end of 2008.

Conning estimated the volume of trade to be $2.00bn in 2002, $2.62bn in 2003, $3.25bn in 2004, $5.50bn in 2005 and $6.12bn in 2006. So 2008 represented something of a pause in an upward trend. Conning attributed this pause to the economic crisis, which saw credit lines dry up, making it extremely difficult for life settlement buyers to finance premium payments on policies. Changes to life expectancy tables also threw underwriters calculations into disarray, raising uncertainty around predicted returns, Conning said. However, 2008's strong growth marked a significant milestone in the development of the life settlement market, the report said: "It represents a shift from a sellers' market, where increasing capital chased policies and sellers could ask for, and receive higher prices, to a buyers' market, where scarce capital and an over-abundance of policies meant buyers could offer lower prices to sellers." Conning anticipated the fallout from 2008's financial crisis to abate however and a relatively quick shift in power from buyers back to sellers.

Conning anticipated more growth in the market and certainly at least until the end of 2011. Factors supporting growth include educational campaigns by the life settlement industry to both brokers and policyholders, which should increase awareness of the secondary market option. Recent economic conditions have also led to increased media coverage on this option for those strapped for cash, while higher levels of consumer awareness generally should lead to more policyholders being willing to settle their policies. As baby-boomers exit the workforce from 2011, there is more chance of life settlements being used to help fund retirement. However, life settlements are a maturing market that should eventually reach saturation point, Conning said.

Some historical estimates of the market are even higher than Conning's. The US' Life Insurance Settlement Association (LISA), a trade body, estimates the face value of settlements traded in 2006 was $12.5 billion. In its 2008 pamphlet 'The Basics of Life Settlement - A Guide for Consumers', LISA estimated the face value of life settlements would reach $16bn in 2008. Credit Suisse has been even more optimistic, estimating the market had grown to $20bn in 2006.

Growth in the TLP market depends on the right balance between supply and demand. The market must have a critical mass to attract continued demand at attractive prices for investors. Domination by a few players would be bad for the market. However, the market is showing signs of maturity as a major investment class because large financial institutions have developed a clear appetite for market share. The introduction of adequate regulatory codes covering the TLP market in an increasing number of US states is also likely to contribute to that growth potential, by providing an environment in which the market can flourish.

While the declining interest in with-profits investments in the UK points to a finite life for the traded endowment policy market, the fact that whole-of-life policies continue to be sold in the United States, combined with an aging population, indicates a continued and thriving TLP market that will continue to expand for many years. Thus, Conning estimated that between 2007 and 2016, the average size of the US' life settlement market could be between $90 billion and $140 billion per year.

Fig 10: Estimated Life Settlement Trading and Cumulative Volume ($ in billions)

Year	2002	2003	2004	2005	2006	2007	2008
Annual volume:	$2.00	$2.63	$3.25	$5.50	$6.12	$12.20	$11.77
Cumulative volume:	$1.90	$4.20	$6.72	$9.98	$13.50	$22.58	$30.68

Source: Conning Research & Consulting, 2009

Fig 11: The size and growth of Life Settlement business

	Transactions (Face Value)		Annual Growth		
	Amount of life cover sold ($Trillion)	Life settlements ($Billion)	Life Settlements	Cash Value Life	Settlements as a % of Life Sale $Billion
1998	1.1	0.2			0.0%
1999	1.1	1.0	400.0%	3.1%	0.1%
2000	1.2	1.1	10.0%	11.0%	0.1%
2001	1.3	1.3	18.2%	3.0%	0.1%
2002	1.4	1.4	7.7%	8.1%	0.1%
2003	1.4	2.5	78.6%	-0.2%	0.2%
2004	1.5	5.0	100.0%	6.6%	0.3%
2000-04 Average			42.9%	5.7%	0.2%

Source: ACLI/Bernstein Research, March 2005

One of the reasons there is so much room for expansion is that the life policies traded constitute a small proportion of the policies surrendered each year. This suggests lack of awareness by policyholders of the secondary market open to them by surrendering policies. Figure 11 shows the exponential growth in the value of life settlement transactions in recent years, averaging 42.9% over the five years from 2000 to 2004. However, their value as a percentage of sales of life policies is still quite small (0.2% on average over the period).

The factors are all in place for a much larger secondary market. As life expectancy in the US rises over time, the chances are higher that people will outlive the usefulness of their life policies, especially with regards to income protection for dependents, who are more likely to become independent as the subject of the life policy ages. Awareness of the life settlement industry will increase, as people realise they can get more for their policies than if they were to surrender them back to the insurance companies.

Figure 12 shows how Suneet Kamath, writing in the 'Bernstein Research Call' in March 2005, estimated the TLP market could grow from $13bn in 2005 to $161bn by 2030. His calculation was based on a rise in the US population aged over 65 to 72m by 2030. Kamath calculated that around 3% of all life policies owned by the over-65s had been surrendered. This 'penetration rate' would imply an increase in market size of $12bn, due solely to the increase in the over-65s population. However, Kamath estimated that the surrender rate could reach 20%. This could add another $137bn to the life settlement market.

Figure 12: Potential size of the Life Settlement market in 2030

Source: US Census Bureau and Bernstein estimates/Bernstein Research Call, March 2005 (please note that there has been some rounding of figures)

Risk considerations

TLPs are not riskless. One can know from day one what a policy will be worth at maturity; one cannot know exactly when it will mature and how many premiums must be paid before then.

So, buying just one or a few TLPs would be speculative - it could pay huge dividends if the policies pay out quickly, but might backfire if it took longer until the policies mature. However, one can address each of these risk factors and reduce their impact by smart investment management, to create very smooth, predictable returns. Risk factors and the methods used to address them are listed below:

Inaccurate Life Expectancy estimates (LEs) – If the average life assured lives longer than predicted, then the return on that policy will be lower. This risk is mitigated by purchasing a large number of policies so that the risk of inaccuracy is balanced by spread. The claims experience is then factored into the actuarial model monthly to ensure that any adjustments are made smoothly, rather than the portfolio experiencing dramatic spikes in value. Each month the LEs should be extended towards population mortality as the likelihood of increased mortality rises each month that a death does not occur.

A fund should obtain at least two LEs on larger policies that it acquires and to reject a policy where there is too much disparity in LE opinions. MPL addresses this problem by only acquiring policies where life expectancy can be accurately assessed. Typically, MPL focuses on elderly lives (over 65 years), where population mortality tables provide a good basis for estimating life expectancy. It then applies adjustments, after specifically considering an individual's state of health. It should also be remembered that insurance companies' life expectancy tables are highly accurate.

However, mortality rates do change, as people's life expectancies generally rise over time. The model must therefore be updated regularly, using new tables. The actual survival and deaths of the lives assured under policies in a portfolio must also be factored in to the expected returns. Interestingly, the closer lives assured get to their expected date of death, their very survival means that their life expectancy must be adjusted to beyond that death. MPL adjusts its projected returns on a monthly basis.

Premium liability – If average life expectancy turns out to be inaccurate, this also means that premiums must be paid for longer than expected. This creates an additional expense for a fund, reducing its net value. If a fund does not calculate future premium liabilities when acquiring policies, this risk is increased. It must also recalculate the increase in premium liability monthly in line with the extension of LEs towards population mortality. MPL also includes a sensitivity factor in its actuarial valuation model that effectively extends LE monthly, to account for the effects of improved mortality and its consequent additional premium liability..

Currency risk – TLPs are US dollar-denominated assets. However, any fund with non-US dollar share classes can be hedged to reduce currency risk. Currency hedging is a complex exercise and carries risks that individual investors may find hard to understand or quantify. When considering a non USD TLP fund one should therefore assess a fund manager's experience in currency hedging by reviewing their past performance and asking them to articulate how they hedge the currency risk.

Liquidity – The TLP market is similar to most other financial markets in that assets are freely traded. However, the timing needed to settle a trade is longer than in many markets, due to the specialized nature of this asset class. For this reason, liquidity risk may arise if the sale of one or more policies takes longer to complete. It is important for investors to understand that whilst investment returns are quite smooth and predictable, that TLP funds are not as liquid as some other asset classes and such an investment must have a medium term investment horizon.

Counter-party risk – The insurance company that issued a policy that a fund has bought may default on its obligations to pay out on maturity. This risk is reduced by policy spread or by diversifying across a range of insurance companies' policies and also by the fact that each US State operates a compensation scheme that indemnifies policyholders against insolvency of the issuer. Any fund manager has to demonstrate a spread of assets In the case of TLPs; this means a spread of insurance companies, taking into account their different credit ratings.

Contestability law – In the US, contestability law prohibits an insurer from repudiating a claim on any grounds once a policy has been in force for at least two years. This risk can be avoided by not buying contestable policies. However, there is a risk that the two-year period may be extended to five years.

Keeping track of policyholders and their state of health might also be considered a risk. In practice, this is easily achieved by writing into the purchase contract for a TLP that anyone who is caring for the policyholder must provide information on them. In the US, public death records can easily be checked on the Internet - the information is publicly available within two weeks of death. Several firms specialise in policy tracking in the USA, so most mutual fund managers outsource this work.

When investors assess the various TLP funds, they should understand that those fund managers who significantly outperform their peers may be taking unwarranted risks. The actuarial models used to value policies held within a fund vary among fund managers. If a manager values policies too aggressively in the early years of holding them and factors these high values into a fund's returns, this can lead to volatility and underperformance in later years if the policies fail to deliver the expected performance. So, funds with performance fees attached can be open to abuse by unscrupulous managers. It is much more accurate and fairer to all investors over time if managers factor in smoother returns from policies when valuing their funds' unit prices.

Evaluating fund performance

Portfolios of TLPs can provide smooth, steady returns when they are managed in a prudent, professional manner. The foundation of such a prudent investment process is applying correct actuarial analysis of Life Expectancy (LE) tables to the lives assured in order to value a portfolio.

The standard reference used by underwriters to gauge LEs is the USA's Valuation Basic Tables (VBT). They use this data together with information on medical conditions to estimate LEs on individuals. Updated every seven years, the VBT runs out to age 121 and represents the USA population mortality data broken down by gender, smoker/non smoker, ethnicity and other important factors.

The latest version of the tables was published in 2008. It extended LEs in line with the well-known long term trend for increasing longevity. As a result of the new tables, 21st Services, one of the big LE estimators in the US, adjusted its medical underwriting criteria, which in some cases meant LEs were very much extended.

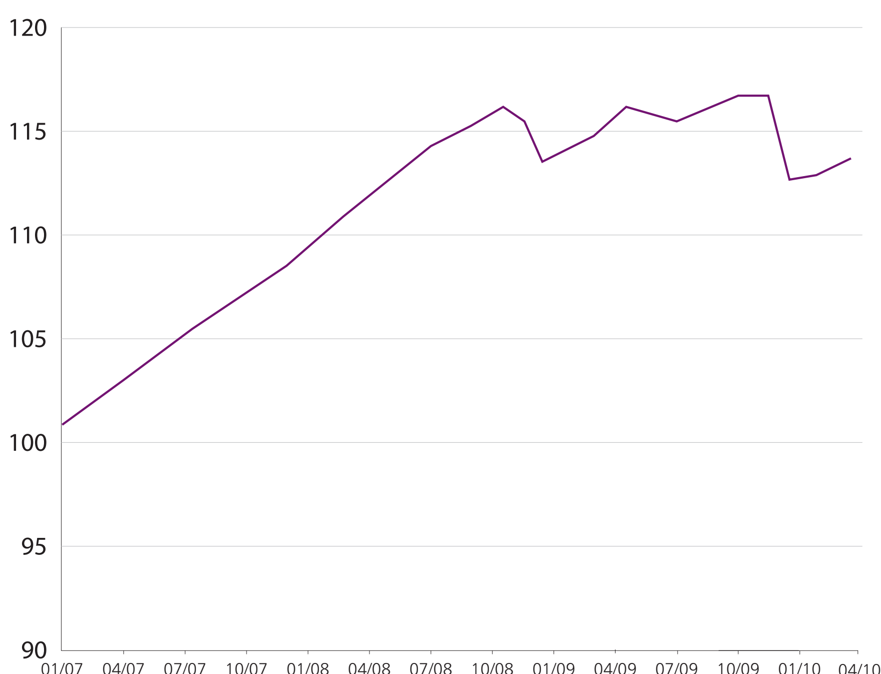
The 'shock' of this adjustment had the effect of reducing the anticipated returns of portfolios that had valued policies based on expected maturities sourced from the 2001 VBT. Portfolios of policies subsequently traded at depressed values.

This impact is illustrated in Figure 13. The diagram shows the performance of the AAP Life Settlement Index, which tracks the performance of 17 funds that invest in TLPs. A downturn occurred from October 2008 after the publication of the VBT tables. Longer LEs required a revaluation of life settlements that depressed the Net Asset Values (NAVs) of several funds.

There need not have been a shock, however. The idea of "improving mortality" is hardly new. More sophisticated actuarial valuation models would already have taken account of gradual improvements in LEs. MPL, for example, has a valuation model that takes into account many factors that will affect the portfolio over time, not least of which is the expected improvement in mortality. MPL's provision for improved mortality had already "smoothed in" the impact of the new LE data outlined in the 2008 VBT, and will continue to do so.

The margin of error will still widen, the longer the life expectancy of a policy. This is true even for more sophisticated valuation models. This is why MPL maintains an average LE on the policies in its portfolios of around six years. Some funds in the market have extended this to 10

Fig 13: Performance of the AAP Life Settlement Index, December 2006 to March 2010



Source: AAP

years. This is far too long - it implies that some of the policies are not expected to mature for nearly two decades.

Valuation processes continue to improve over time, as more information about mortality experience becomes available. A spokesperson for a leading actuarial firm warned that information levels are still imperfect: "One advantage of recognising new experience over time is that it gives you the chance to recognise better information in an orderly way as opposed to abruptly. We have more information over time about what is really happening in the market and the way it will develop in the future. But they are indications, not fact. We shall not know the full facts until all policies have ended in claims. Trying to anticipate the future is a gradual integration of this new information. It is certainly more prudent to steer a portfolio gradually than to have the valuation leaping around.

"The longer one tries to predict mortality or longevity for one individual, the more inherent error there will be. Over long life expectancies there is a greater likelihood that small improvements in health treatment and disease management or some revolutionary improvement in healthcare will affect a person's lifetime. The TLP market is also still relatively young, having been around for just a few years. So if you look at a policy with a 15-year LE, the chances are that for half of such a term you probably do not have any real experience to relate to. The fact is that trying to estimate long LEs will put you further into the unknown."

It is important to note that AAP also attributed the downturn and levelling off in performance illustrated in Figure 13 to factors other than adjustments to the VBT. These reasons included losses incurred as a result of policies being sold in distressed market conditions and fund managers having to pay higher rates of interest on borrowed assets used to pay premiums on life policies (The impacts of mortality tables and the financial crisis on open-ended funds, the International Life Settlements Conference, Las Vegas, September 2009).

The implications of this for evaluating funds' NAVs and their subsequent performances are pivotal. It raises a crucial debate on whether TLP funds should use a 'mark-to-market' or a 'mark-to-model' basis. Under the former basis, NAVs will reflect the current prices of policies, so if market prices fall then so do NAVs, and vice versa. Under the latter basis, NAVs are calculated using a theoretical model that assesses the 'fundamental' value of an asset.

Some would argue that mark-to-market is a fairer reflection of NAV. After all, if investors divest from a fund then the NAV they cash in would be a function of the current market value. In normal market conditions the NAVs under both models should converge. But if NAVs measured under the mark-to-market basis suffer when conditions are difficult, as happened during the financial crisis when lower demand from investors drove down the market prices of life settlements, then this calls into question the capacity for TLP funds to deliver steady, incremental returns uncorrelated with other asset classes.

Under a mark-to-model basis, it is assumed that policies will always be held to maturity, and NAVs are calculated accordingly, making it unnecessary to incorporate current market prices in NAVs. After all, the maturity values of policies will remain the same irrespective of market conditions. The only unknown is expected time to maturity, which is also unaffected by market sentiment, which can drive asset prices both above and below their 'fundamental' value.

The downturns and flat performance of the AAP Index from the end of 2009 reflects its heavy weighting to funds using a mark to market basis to calculate NAVs. Some funds have experienced dips because of their need to sell policies to create liquidity, which effectively means marking-to-market. However, this highlights the importance of maintaining sufficient liquidity in the fund, which would allow a fund to use a mark-to-model basis. Such funds have been notably more successful in maintaining steady, incremental returns.

The necessity for prudent management to avoid liquidity issues is explained in the following section.

The science - and art - of valuing life policies

This section has been written, at the invitation of the author, by Muzaffar Soomro and Eugene Le Roux, of BDO, a Cayman Islands partnership.

Undoubtedly, investment and interest in the life settlement industry has increased substantially over the last few years by both individual and institutional investors. One of the attractive points of this asset class is the lack of correlation to the stock markets. Even in the recent financial crisis that saw stock markets tumbling, life settlement funds were mostly giving their investors positive returns. The calculation of return and the valuation of life policies by life settlement funds are the focus of this article.

It would be very easy and straightforward if an investor in life settlement funds purchased a policy and patiently waited until it matured without ever wondering how much the policy is worth in the interim. It would also be short-sighted of them to do this. Fortunately, most, if not all investors want to know both how their investment is performing and what is its value on a regular basis. Additionally, life settlement funds have subscriptions and redemptions which are based on the fair value of the policies it holds.

The best fair values are valuations based on quoted prices in active markets for identical assets or liabilities. As traded life policies are not frequently traded or quoted on a stock exchange, it is extremely difficult to obtain or place a "fair value" on this asset which a potential buyer is willing to pay. Thus the question arises, "How are life settlement policies valued?"

Life settlement investments are similar to a zero coupon bond, in that an investor purchases such a bond at a discount and at the maturity date they receive the face value of the bond. Similarly, an investor of a life settlement policy buys a policy at a discount and upon maturity receives the face value of the life insurance policy. Unlike the zero coupon bond, the maturity date of a life settlement policy is variable. The maturity date of the policy is the date of death of the insured. The issue is that the price paid for the policy is based on an estimated life expectancy (LE) that can be (and usually is) incorrect in that nobody dies exactly when expected. The LE is usually calculated by using the Society of Actuaries' (SOA) Valuation Basic Tables (VBT) for standard mortality along with an underwriter's assessment of how the individual's mortality compares to standard, based on current information on medical conditions.

The most common method used for valuation is the use of a discounted cash flow method which is based on a defined discount rate allocated to the investment. A Probabilistic Approach is typically employed which is actuarially based in its roots. It fits the policies' expected cash flows (life insurance premium payments and death benefits) to a monthly mortality scale as generated by the specific LE of each insured. This mathematical approach is the same that actuaries have been using for years in the pricing of life insurance and annuities. It is the best fit to reflect the law of large numbers, which may or may not be applicable to a given life policy. The LEs provided on the policies are most commonly based on an actuarial method or commonly referred to as a "Mean" measure. This implies that the mean or average life of the population with the same characteristics will have terminated by the end of the provided LE month. The LEs must be provided by LE providers, which are widely recognized and reputable companies specializing in this particular industry.

As these valuation methods and LE calculations are complicated, it is advisable to employ an actuarial firm with expertise in the valuation of life policies, and an LE provider that firmly understands the calculation/estimation of LEs and the use of the VBT enhanced with specific medical and other factors of the insured.

However, there are a number of problems that occur when trying to utilize this methodology. According to Corwin Zass of Actuarial Risk Management, the first issue is that two LE providers may produce very divergent LEs even if they are looking at the same underwriting information. That leads to differing estimates of the value of a life settlement at a given point in time. A second issue arises when attempting to value life settlements at a later point in time. For example, if an LE provider were to establish an LE of 38 months in February 2009, what would be the appropriate LE if we want to establish a value as of February 2010? Some logic would lead us to the conclusion of 26 months (assuming the person was still alive) but that would be incorrect. Since the LE was established based on a mean, and some of the lives in a large group would have died, the current LE for surviving lives should actually exceed 26 months. But then we hit another roadblock. What if this life has had a significant medical event since February 2009? In that case, the LE should be adjusted downward, but without a new underwriting review by an LE provider, there is no way to even know about the medical change or establish a revised LE. Finally, it may be assumed that actuaries have a precise understanding of mortality, but that is not always the case, especially with respect to older lives where medical advancements may have large-scale impacts. Surprisingly enough, many of the LE providers had to adjust their estimates upwards in early 2009 solely because the Society of Actuaries released a revised VBT table.

There are other uncommon techniques not mentioned in this article which may better suit valuation requirements. With all valuation techniques, there are strengths and weakness. It is vital that the fund decide on a valuation technique that is consistent year after year to ensure performance and other aspects are comparable and that comparative numbers are reasonable. The decision of which methodology to use is not an easy one, but crucial to the ongoing success of a life settlement fund.

About BDO

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How changes to life expectancy underwriting impact the life settlement market

This section has been written, at the invitation of the author, by Dr Jianjun Hao, PhD, Head of Underwriting, and Dr Glen Chapman, MD, Medical Director, at MidWest Medical Review, an independent medical underwriter.

Mortality studies with specific risks have been conducted by life insurance companies for over a century, initiated by the Specialized Mortality Investigation, published by the Actuarial Society of America in 1903. Such studies, often made on a cooperative intercompany basis, have been carried out for the purpose of aiding the underwriting selection process. This selection process means to determine which risks can be included in the limits of mortality for standard insurance, which risks are insurable with an extra premium, and which are uninsurable because the excess mortality is too large. As valuable as they are, insurance studies have never been adequate to meet all the needs of medical underwriters as well as lay underwriters responsible for risk selection process, which is to mean they have always been limited in providing little or no experience as a guide in disease risk of applicant, for example, as a history of Coronary Artery Disease following By-pass Surgery or Percutaneous Intervention, or a history of Alzheimer's disease with progression, or Breast Cancer after apparently successful therapy.

Life settlements are now one of the fastest growing segments of the life insurance marketplace. The life settlement process allows a subject to tap the value of assets previously unavailable or undervalued. At the same time, it provides investors a way to offset market fluctuations and the potential to earn attractive return. Life settlement-backed instruments offer an effective, uncorrelated hedge against the economic cycles of other markets.

Life settlements typically involve the sale of life insurance policies by owners whereby the insured (greater than 65 years of age) or persons having some medical history which may result in a shortened life expectancy. The life settlement per se becomes a cash payment to the owner of a life insurance policy for an amount greater than the cash surrender value, but less than the death benefit in exchange for the policy ownership. With the change in ownership, the life settlement company (investor), takes ownership becoming the beneficiary of the policy, and is responsible for the payment of all future premiums to keep the policy in effect. Upon the death of the insured, the death benefit is paid to the investor(s).

The settlement amount is determined after calculating the present value of future benefits from the proceeds of the policy minus the present value of future expense of the purchaser. Since the purchaser is required to pay the policy's premiums until maturity, it can be seen how critical the life expectancy estimate becomes. If a life expectancy determination turns out to be too long, then that owner of the policy receives a diminished return on investment. However, if the subject exceeds the life expectancy given too much, it will be paid with reduced return.

Investors in the secondary market rely on life expectancy calculation submitted by life expectancy providers. The accuracy of a life expectancy calculation is necessary for the long-term success of all secondary insurance transactions. The question of how accuracy can be achieved in the life expectancies is of ongoing concern. Certain underwriters prior to 2008 provided very long life expectancy estimates when compared to other providers. This lengthening of an underwriters' mortality expectations resulted in dysphagia throughout the life settlement industry. In 2008, the adoption of the VBT Mortality Table reduced their calculations 12 to 24 months over prior calculations. While this revision has resulted in a short-term upheaval, some predict it will help in the long run.

The Achilles Heel to underwriting life settlements is the subject's medical record submitted for review. The questions to be asked are: “Has all relevant information been submitted? Has the record been 'cherry picked' to provide a worse case scenario”? The true approach to underwriting such cases requires the expertise of medical-scientific-actuarial analysis. This process must be independent of all submitting entities: the provider, seller, broker, or investor. The independent assessment relies on the actuarial analysis using the most recent data available such as the 2008 VBT, as well as its own research to develop in-house base tables and underwriting manual. Underwriting and modelling require an extensive knowledge of clinical trials, as well as the subject's demographics for the determination of a life expectancy. At Midwest Medical Review the present adopted mathematical model includes 50 listed medical conditions, along with therapy available. In an analysis of the VBT table alone for the calculation of a life expectancy, it was determined that the 2008 VBT table had shorter life expectancies for less than 45 years of age and longer for greater than 65 years of age, when compared to 2001 CSO and 2001 VBT with variation between 45-65 years of age. Thus, the 2008 VBT is excellent for pricing and valuation for life settlement policies, and it is not perfect for life expectancy estimates. Market participants are stressing the need for standardization along with a measurement of actual to expected results. In the life settlement market, the life expectancy calculated for an individual based on this mortality table should reflect current and past medical conditions, future therapy/risks, and applied risk factor characteristics of the subject. Only by providing unbiased information in support of decision about a life settlement transaction can the best result be achieved.

- JH, GC

Prudent management needed for TLP funds to avoid liquidity issues

This section has been written at the invitation of the author by Jeremy Leach, Managing Director of Managing Partners Limited, which sponsored this report.

In today's economic climate the difficulties associated with making the right investment decisions can be overwhelming as the enormous number of possibilities can turn the variety of choice into a problem rather than a benefit. Most investors seek to create a balanced spread of assets within their investment portfolios with the aim of capitalising on the growth potential that asset-backed securities can yield over deposit based savings. In recent years, however, we have seen unprecedented market volatility and extended periods of negative sentiment which, coupled with extraordinarily low rates of interest have made these objectives harder to achieve than ever before.

With the advent of the global credit crisis, investment professionals have been motivated to spend more time and energy on understanding and assessing the benefits of alternative, non-correlated asset classes. As a result of this research the investment community has gained greater appetite for Traded Life Policies or TLPs (also referred to as Senior Life Settlements in America), because of their unique potential to deliver smooth, predictable investment returns irrespective of market conditions.

It is no surprise that with key global currency interest rates at less than 1% per annum a significant proportion of institutional investment houses are now active participants in the TLP market and the key drivers for wanting to participate in TLPs are as follows:

- TLP funds are defined as a non-correlated asset class
- TLPs offer an absolute return
- TLPs are unaffected by market turbulence
- TLPs are able to deliver steady, incremental returns of up to 10% per annum year-in, year-out

Liquidity risk

As with any asset backed investment there must be a consideration that whilst investing in a TLP fund could potentially generate significantly greater returns than depositing money in the bank, there are two key considerations to analyse, these being liquidity and risk.

Many investors consider risk and liquidity to be closely related but with TLP funds the two factors have less correlation than one would ordinarily expect. A prime example of why there would typically be a risk/liquidity link can be seen from the recent fortunes of the UK property market, where in 2007 property values start to weaken and continued to do so for more than 12 months, culminating in a considerable price correction.

As result, many property funds experienced significant reductions in value and fund managers were unable to sell property readily because of the market decline. Understandably, investors wanted to head to safety by redeeming their property fund investments but were unable to do so as there was insufficient liquidity in many funds to permit redemptions to take place. As a result, shareholders could not liquidate their property investments and simply had to sit and watch their capital value erode.

The inability to surrender an investment clearly impacts on the risk profile of an asset class. In the case of TLP funds, however, the investment returns are not necessarily compromised during periods of low liquidity as the gains achieved in TLP funds are based on fixed maturity values that deliver an absolute return.

From a risk management perspective it is equally important that a fund manager is able to sustain sufficient liquidity to pay future premiums and to hedge currency risk. As long as these objectives are achieved then the correlation between risk and liquidity is quite low and investors would not naturally expect to lose money by being locked into an investment for longer than a cash alternative. The potential return that can be achieved from TLPs are vastly superior to cash deposits. Therefore an investor's decision should really be based on an ideal investment horizon for no cash holding that falls in line with the liquidity of the asset class in question.

It is not true to say that TLPs are illiquid, however. In fact the 2008 Merlin Stone Report estimated $12 Billion of TLPs were bought and sold in 2007, suggesting that there is a particularly buoyant market for TLPs if sold at the right price and it should also be remembered that TLPs do not ultimately need to be sold as they naturally return to cash at maturity.

One of the greatest threats to the liquidity of any fund is its largest investor. With open ended investments where shares are redeemable on a periodic basis then the liquidity needs to be managed very efficiently. On one hand the investment manager needs to keep a fund as fully invested as practical in order to maximise investment returns, yet sustain a liquidity level to service any expenses that the fund endures and to meet redemptions from those investors that wish to redeem. Whilst it is important to emphasise to investors that there needs to be a medium term investment horizon (ideally similar to the average term that each policy is likely to remain within the portfolio before maturing), there are many reasons why an investor may need to redeem prematurely. In the case of larger institutional investors this may be because they have categorised a TLP fund incorrectly as part of their own cash portfolio or that they have liquidity issues of their own.

It is critical that the provisions within an offering memorandum empower the directors of a fund to manage larger redemptions in a way that protects the best interest of all investors and it would not be reasonable for one large investor to force the sale of assets at a deep discount (so that they could take their money at short notice) if by doing so it

adversely impacts on the investment value or liquidity of the remaining investors. Therefore it is common sense to have a provision whereby if a large investor or a significant number of investors wish to redeem at short notice then they should bear the financial loss that would be incurred by the premature sale of assets themselves rather than other shareholders.

If these terms were applied then it puts the responsibility back on the institutional investor to communicate their intentions with reasonable notice and to agree with the manager a workable redemption strategy that will not impact on investment values for anyone, nor threaten the liquidity of the fund.

Currency risk

We have seen a significant level of volatility between primary currencies over the past two and a half years, causing problems for any asset class that aims to deliver very smooth, predictable investment returns in the base currency of the investor. For this to happen, the manager needs to hedge the currency risk as efficiently as possible between the USD (being the currency in which TLPs are purchased and valued), and the base currency of the investor.

The most cost-effective way to hedge currency risk is by purchasing forward foreign exchange transactions (or Forwards). But a Forward either creates cash or consumes cash, depending on whether the dollar strengthens or weakens. If a currency pair, such as dollar-sterling or dollar-euro, moves significantly in an adverse way then that creates an enormous liquidity burden on a fund by eating away at the cash reserves.

When currency pairs are as unpredictable as they are now, with the stability of sterling threatened by the potential ineffectiveness of a hung parliament and the euro undermined by the Greek, Spanish and Portuguese credit risks, then a blend of options and forwards are needed, especially when the volatility has been ongoing for so long.

Forwards are a type of derivative that lock in the price at which two parties are obligated to buy and sell a specified amount of currency on a particular date and at a set exchange rate. When purchased in the correct ratio to a currency pair such as Pounds and Dollars, they offset any positive or negative currency trend. Forwards are comparatively cheap to buy because they cover both sides of the trade and so they have nominal impact on net asset values.

Options work in a different way in that they only cover one side of the trade. They tend to be more expensive because of this but as their name suggests, they are an option to buy or sell a currency at a set price in the future and only need to be exercised to offset the loss that may be incurred if a currency pair creates negative value. So if the dollar were to strengthen, for example, the option would not be exercised and the fund would still gain from the increase in dollar value against sterling.

Conclusion

Whilst TLPs are an inherently complex asset class, there are number of asset managers that have delivered extremely attractive investment solutions to the market. The past two and half years have been an extremely testing period for all asset managers and there has been arguably no better time period in which to assess how well they have dealt with the key management challenges associated with TLPs funds, which are Liquidity and Currency Risk.

One should remember that TLP funds are typically valued on a mark to model basis and therefore superior performance is not necessarily a guide to the long term future performance of a fund. Ultimately, all fund managers purchase policies in a competitive market place where the regulatory framework requires market makers to obtain fair value for both buyers and sellers of policies and there is no magical method of buying policies at a substantial discount to the market. The only way to deliver Alpha (i.e. superior investment performance), is therefore to keep management charges as reasonable as possible and at all times avoid TLP funds with performance fees, not only because of the moral hazard of incentivising the manager to deliver higher returns when using a valuation model, but equally because TLPs have a finite upside potential and 'hedge fund style' charges simply cannot be justified or afforded with an upside potential of 8% to 10% per annum.

The credit crunch has also been a period of time in which TLPs can adequately demonstrate that their returns are not correlated towards the core assets classes and whilst investors should only consider using TLP funds if they feel sufficiently knowledgeable to do so, when used correctly in a balanced portfolio, TLPs have the potential to balance the volatility of a portfolio with their smooth, predictable investment returns.

The risk issues with TLPs cannot be underestimated nor simplified and it is the joint responsibility of Fund Manager and Financial Adviser alike to understand and artic_late the risk considerations to an investor to enable them to assess the asset class for suitability. It is all too easy for an uneducated investor to believe they are purchasing an extremely low risk alternative to cash but this is not the case; TLPs are an inherently complicated asset class to manage and there are many reasons why a fund may not deliver upon its intended objectives. One should therefore examine the past performance of a fund to assess its merits and equally understand the liquidity and risk considerations that relate to the asset class.

Ethical issues in the TLP market

The TLP market raises some emotive issues. Firstly, policies are linked to deaths of individuals. Secondly, individuals are selling at a deep discount assets that they could otherwise pass on to inheritors.

However, while the macabre element is often a knee-jerk reaction, there seems to be increasingly more acceptance of TLPs as a rational, un-emotive financial strategy. For example, David Blake, author of the Pensions Institute at Cass Business School's report on TLPs, said: "Provided appropriate safeguards are in place, life settlements should not raise ethical issues that are not present in other mortality-linked investments, such as pensions, annuities or reverse mortgages," (IPE.com, 8 July 2008).

The TLP market allows policyholders to benefit from policies they create themselves, rather than having to pass those benefits on to someone else. The creation of a 'secondary' or second-hand market means policyholders can get a higher price for their policies than if they surrendered their policies to the insurance companies.

It can be hard to quantify this benefit, but a paper in 2002 by Neil A Doherty and Hal J Singer entitled 'The Benefits of a Secondary Market for Life Insurance Policies', gave one of the best estimates. They extrapolated data provided by the market leader in life settlements, Coventry First, which estimated it had around a third of the life settlement market. Figure 14 shows the results of their findings. The total surrender value offered to policyholders by insurance companies on policies was estimated to be $93.4m in 2002 but the total offered to policyholders on the secondary market was $336.3m, meaning that policyholders who sold their policies in the life settlement market benefited by an additional $242.9m in total.

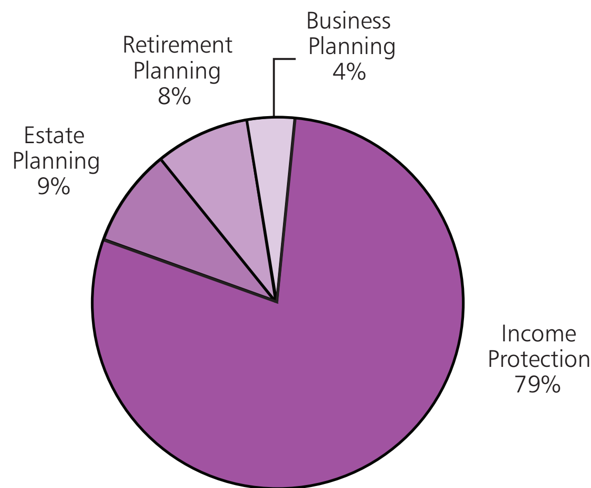
A study by Deloitte Consulting published in 2005 entitled 'The Life Settlements Market' gave an actuarial perspective on the market. It said that credit should be given to the life settlements industry for creating a secondary market. The study did, however, conclude that policyholders with impaired health could maximise their estates' values by selling other assets and maintaining their life assurance policies until death.

Fig 14: Annual consumer welfare gains from the use of Life Settlements (in millions of dollars)

	Coventry First		All Life Settlement Firms
	Jan - Aug 2002	2002 Projected Total	2002 Projected Total
Policies	352	528	$1,584
Total Surrender Value	$20.8	$31.1	$93.4
Total offer to Policyholders	$79.1	$118.6	$336.3
Total Policyholder Surplus	$58.3	$87.4	$242.9

Source: Coventry First internal customer data/The Benefits of a Secondary Market for Life Insurance Policies, by Neil A Doherty and Hal J Singer

Fig 15: Drivers Behind Life Insurance Purchases



Source: The Hartford (2003 Consumer Survey)/Bernstein Research, March 2005

While keeping policies may improve the value of policyholders' estates, this is not always a priority for those who want to sell. There are many reasons why someone may want to sell a policy, but it helps to understand the reasons why they are bought in the first place. Figure 15 lists the main reasons why people buy life insurance. It shows that the vast majority do so for income protection, but other important reasons include estate and retirement planning and business planning. There are several reasons why these motivations may become less important or irrelevant several years later. An article by Rick Gardner published in the 'Journal of Practical Estate Planning' in August/September 2005 listed the reasons for selling as:

1 **Changing life insurance needs:** People's insurance needs often change as their lifecycles unfold. For example, a young couple might take out insurance to cover against premature death or to pay for college fees, or they might divorce. Premiums can be a burden or an unnecessary expense, and they may even outlive their beneficiaries. By selling their policies, holders receive cash for what have become other priorities in their lives.

2 **Business succession:** Companies sometimes insure their staff. Over time, the insured staff members may leave the company, the company may become unable to pay the premiums, or a new owner may take over and change staff benefits. Key-man insurance taken out on a member of staff who subsequently leaves is regarded as a classic opportunity for a life settlement.

3 **Need for Long Term Care:** The TLP market took off with the AIDS epidemic when policyholders needed ready cash to pay for medical treatment and care. This need exists for many other cases unrelated to AIDS. If a person does not have long term care (LTC) insurance, a life settlement can provide the assets to buy policies or care. Indeed, the US government's Medicare website points out that a life settlement can achieve this. A common myth is that wealthy clients do not need LTC insurance because they have other assets to fund LTC. In practice, the high costs of LTC insurance means that selling a policy can be more cost-effective in protecting other assets for inheritors.

4 **Giving to charity:** Some wealthy people give their policies to charities on the understanding that the beneficiaries will maintain the premiums. Unfortunately, some charities let policies lapse because they cannot keep up the premiums or maintain administration of policies. There has been some ignorance about the secondary market among charities. Charities have therefore missed the chance to generate immediate revenue. So it might be better for policyholders to sell policies on behalf of the charities and give them higher donations, without asking them to maintain premiums.

The market for funds

There is already a range of funds available to both retail and institutional investors in the UK, with minimum investments for the former starting from £25,000, or £5,000 if an investment is made via a wrap such as a SIPP, portfolio bond, trust or fund platform.

When deciding on a fund, investors should examine the profiles of the fund managers, including their credibility, reputation, experience, regulation and how long they have been in business.

Most TLP funds deliver growth. There are some income funds, with yields generally in the 5-6% per annum range, but as an asset class, TLPs do not lend themselves easily to being an 'income' investment because they do not generate incomes. They must be combined with other assets that do, such as bonds or property.

As in other asset classes, TLP retail funds generally tend to carry higher levels of charges than institutional funds. There are economies of scale in servicing institutional clients, while higher percentage fees are needed in retail funds to contribute towards the higher proportionate workload of servicing a larger number of shareholders with smaller-scale investments, such as delivering evaluations and producing marketing literature, and to generate commission for intermediaries to cover their marketing efforts.

However, the average TLP retail fund would have lower charges than a hedged fund or long equity fund but higher charges than a currency or bond fund. TLP retail funds tend to have around a 5% initial charge and a 1% annual management fee. Liquidity can be a challenge with TLP funds, but shares (in open ended investment companies or “OEICs”) are redeemable upon demand, though investors often have to give a month's notice or pay redemption penalties of 5-10% if they want an immediate withdrawal.

Institutional funds are charged more competitively, given their economies of scale. Annual management fees can be low double-digit basis points with no initial charges and no performance fees. These structures are lower than the average bond fund and only marginally higher than a cash fund (typically 0.5%). Individual investors are increasingly attracted to the fact that many TLP-based funds have low charges.

In terms of demand for TLP funds, Germany is the biggest investor market in Europe by far. There are primarily closed-ended investment vehicles in Germany because of specific local tax advantages. It is hard to accurately assess the size of the German market, but three fund managers, Berlin Capital, Dresdner Kleinwort and PMB, are estimated to raise more than $2bn each year between them. The German domestic market as a whole represents about $3bn. Offshore open-ended investment companies (OEICs) raise around $1bn a year.

In the future, larger institutions are likely to enter the TLP funds market, most likely by acquiring the longer running open-ended funds from boutique asset managers. A combination of the strength of brand and established track record will introduce a new level of credibility and appreciation for the asset class.

Changes in tax treatment of life settlements

In May 2009, the United States' Internal Revenue Service released its Ruling 2009-14, which sought to clarify its interpretation of the tax position relating to gains made on the maturity of life settlements.

In May last year the life settlement industry was given two landmark rulings by the US's Internal Revenue Service that went a long way towards clarifying the tax treatment of sales of policies. The rulings were welcomed by the industry for making the tax position a great deal clearer. For many it has prompted a review in the way that tax can be mitigated to optimise investment returns.

Essentially, the rulings stipulated that the profits made from sales and maturities of life settlements are to be treated as income rather than capital gains. Revenue Ruling 2009-13 was the more straightforward of the two and referred to the tax treatment of life insurance for policyholders. Ruling 2009-14 related to tax treatment of investors.

Ruling 2009-13 cited two main cases: one in which a policyholder surrenders a policy back to an insurer and another in which they sell a policy on the open market. In the former case, taxable income is calculated to be the amount for which the policy is surrendered minus the premiums paid. If a policy is sold on the open market, the taxable gain is generally higher because account is also taken of the amount used to pay for insurance cover over the term that the policy was held. As such, the calculation is:

Taxable income = The price paid for a policy less the (sum of all premiums paid on the policy less the portion of those premiums paid for provision of insurance while the contract was held)

Revenue Ruling 2009-14 referred to the tax treatment of investors. This stipulated that the net death benefit realised from a policy is to be taxed as ordinary income. The amount used for tax purposes is the benefit received less the cost of the investment, where cost is the price of the policy and the premiums paid on it plus any other considerations paid after the transfer of the beneficiary.

Given that the Ruling identifies that the profits made from the maturity of a TLP are to be treated as income, a foreign entity is liable to pay withholding tax on the gains which, unless it is domiciled in a jurisdiction that has a double tax treaty with the USA, means that entity's tax is payable at a rate of 30% of the net gain. If the entity is domiciled in a double tax treaty jurisdiction then withholding tax does not need to be applied as long as it can be demonstrated that tax will be paid there instead. Therefore whilst there may be complex ways to mitigate US witholding tax in jurisdictions such as Dublin and Luxembourg, simply setting up a fund there will not mitigate any tax, it merely moves the tax liability to a different jurisdiction.

There are ways to mitigate the tax for investors, however. Managing Partners Limited (MPL) addressed the issue of taxation with regards to its Traded Policies Fund some time ago. The Ruling merely confirmed for MPL what it had always thought the tax situation to be. MPL's conclusion was that it was highly unlikely that a solution could be found outside of the USA, whether it was through a double tax treaty jurisdiction or not. Its strategy has been therefore to deal with this objective in the USA by changing the nature of the asset before the proceeds are passed out of the jurisdiction to maximise the returns to the fund.

The Fund has been operating this system throughout much of its five-year history and it has had a positive effect on the reduction of taxation the Fund has paid. The returns have been net of these taxes and while MPL is seeking a review of its process to ensure it is not compromised by the new Ruling it has assured its investors that withholding tax is paid by the Fund and not by them and that the returns are quoted net of any tax that the Fund pays.

In a Client Memorandum dated May 2009, Clifford Chance, one of the world's leading law firms, welcomed the rulings and said that they provided important and critical guidance for the secondary market for life insurance policies. However, it did point out that there were three main questions unanswered. Firstly, given that buyers of second hand policies often borrow to finance the payment of premiums, how should the interest payments be treated in terms of tax? Secondly, how should a foreign person be taxed if they sell a policy rather than collect the death benefits? And thirdly, how are death benefits sourced if the life assured is an American but the insurance company is not based in the US? These unanswered questions illustrate that there is still some scope for the Inland Revenue Service to provide further guidance and bring more rigour and certainty to the life settlement market that could only help to make it a more mature, efficient and established entity.

Regulatory changes

This section has been written, at the invitation of this report's author, by Lindsay Held, a lawyer for Life Settlement Leads, Inc., a New Jersey-based firm that is an intermediary between buyers and sellers of TLPs.

Currently, there are no federal laws that specifically govern life settlement transactions. Regulations governing transactions and the licensure of life settlement brokers, which represent policy owners wishing to sell their policies, and life settlement providers, which purchase policies (usually on behalf of institutional or other purchasers), are the domain of each US state.

During 2008, several states, including Hawaii and West Virginia, have promulgated laws and regulation governing life settlements; as of October 2008, slightly more than half the states are "regulated." A licensed entity must undergo a vigorous license process, in connection with which the state insurance departments investigate whether the proposed licensee possesses the appropriate experience, character and competence to be licensed. Owners, directors and officers of the licensed entity typically undergo a background check, and the licensee must submit, among other things, an anti-fraud plan and gain approval of all contract forms to ensure that consumers receive adequate and appropriate disclosure of the transaction.

Several prominent states, including New York and California, have proposed life settlement legislation, and, subject to political conditions, such laws are expected to be enacted in 2009. The life settlement industry is typically extremely supportive of legislation that ensures that consumers receive appropriate disclosure and provides them with life settlement options, which, historically, life insurance carriers have not disclosed. Without life settlements as a viable option, the only choice an owner has is to surrender the policy to the carrier for the "surrender value," which is significantly less than a fair market price. A majority of the states have enacted the National Association of Insurance Commissioners (NAIC) Model Act. In addition, several states have promulgated or considering adopting the model act created by the National Conference of Insurance Legislators (NCOIL).

In addition, five states recently amended their statutes and regulations to follow an Amended NAIC Model Act, which prohibits selling a policy within five years from the issuance date (this is in contrast to the 2 year exclusion period of the NAIC Model Act and the NCOIL Act). This 5-year ban is an attempt to restrict the sale of "manufactured" policies (generally known as "Stranger-Originated Life Insurance Policies" (STOLI), whereby the policy owner never truly had an insurable interest in the insured under the policy because the premiums were not paid by the owner or there was a pre-arranged deal at the time of policy issuance to sell the policy at a later date to a third party.

The traditional life settlement industry vigorously opposes premium finance deals or other STOLI arrangements; however, the Amended NAIC Model Act is pro-insurance carrier and anti-consumer because it arbitrary lengthens the prohibition period to five years without focusing on the true issue of insurable interest.

MPL's view is that it supports all laws and regulations that seek to license providers and brokers and to provide full and fair disclosure to the consumer of all commissions earned by all intermediaries, as well a full disclosure of the benefits and consequences of a consumer selling a policy. Artificial prohibitions on selling a policy are an unfair restriction on alienation and hurt consumer choice and the economy as a whole. Similarly, insurance carriers should not be permitted to restrict their agents from communicating to consumers the various options to settle a policy.

Streamlining the whole transaction process would also facilitate better deals for the seller and end-buyer. At present, there are too many parties between the buyer and seller. Efforts by providers and other institutional purchasers to go direct to the consumer should be facilitated and not hindered by regulations, because consumers would likely earn more for a policy by selling directly to the purchaser.

Cantor Fitzgerald has established an online platform to bring institutional buyers and sellers together and provide transparency. However, the platform has not conducted a significant number of transactions and has been perceived by most in the industry as a failure to date because it has not reduced transaction time and has added another layer of transaction costs. In general, MPL favours the goal of adding transparency to the market but also supports lowering overall commissions paid to intermediaries.

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A response to the FSA's view on TLPs

The lack of understanding of TLPs is a global issue. Indeed, one of the main reasons for this report being commissioned was to try in some way to counter that education gap. What is sometimes surprising though is the quarters in which poor understanding of TLPs can be found.

Even sophisticated investors and financial advisers have shown lack of understanding. Research in this paper shows how low levels of knowledge have been amongst UK IFAs, albeit with some recent improvement. However, one of the more surprising examples of a failure to grasp the issues emerged in February this year when Peter Smith, Head of Investments Policy, Conduct Policy Division at UK regulator, the Financial Services Authority, addressed a conference held by the European Life Settlements Association. The fact that Mr Smith addressed the topic of TLPs was a step in the right direction towards acknowledgement of TLPs as an asset class. However, his words revealed some naivety about the subject.

Increased interest by the FSA in TLPs is no doubt a consequence of higher levels of investment into the asset class and incidents such as the Keydata scandal. Keydata, which was authorised by the FSA, seemed to display an extraordinary lack of understanding about the asset class and its risks. Around 5,500 clients invested more than £100m in Luxembourg-incorporated SLS Capital through Keydata's secure income bonds. Keydata was put into administration last June while the Luxembourg District Court has put SLS Capital into liquidation. Administrator PriceWaterhouseCoopers found information last year suggesting the investments had been liquidated and possibly misappropriated. Unfortunately, no amount of diligent risk controls can protect against outright fraud.

A main focus of Mr Smith's speech was product providers' marketing material, which he said failed to outline adequately the risks involved in TLPs. They were, he said, “woefully inadequate”. In particular, Mr Smith said there was a particular risk of unrealistic performance illustrations being provided as a result of fund managers manipulating valuations by using shorter life expectancy figures to calculate future payouts.

Mr Smith was quite right to point this out. In fact, all of these risks have been covered in depth in this edition of the Merlin Stone Report and its two predecessors. However, Mr Smith used the term “TLP Investments”, or TLPIs, to cover any products that invest in TLPs, senior life settlements or viatical settlements. This gives the impression that all TLP products carry the same risk. Grouping TLPs (also referred to as senior life settlements), life settlements, viatical settlements and indeed those that Mr Smith did not mention such as premium financed policies, contestibles and longevity derivatives together is like saying a penny share has the same risk as a FTSE 100 stock. The risk profiles are, quite simply, completely different.

While Mr Smith was correct to say that an accurate estimation of life expectancy is the single most important factor in assessing the price of policies held within a TLPI, he did not explain how these risks can be addressed. Mr Smith believed that it is very hard for life insurers to measure this risk, but that has not stopped them from turning a profit year in, year out. He did not acknowledge how far TLP fund managers target certain areas of the life insurance market to make returns. There is a big difference in the mortality profiles of a 35-year-old with a terminal illness and an 80-year-old with severe heart disease. The potential for error is far greater with a younger person than an octogenarian. As a result, fund managers tend to focus on the elderly end of the market.

The dangers of focusing on younger lives assured was illustrated in the 1980s when the viaticals market failed to give investors the returns they expected because medical advances meant that many HIV-positive sufferers who sold their policies lived beyond the expectations factored into the sale prices (see Foreword above). The reality is that many TLP funds now buy policies on more elderly lives assured and the greater certainty implied by such will significantly reduce mortality (or longevity) risk.

This report analyses risk controls and the importance of smoothing out returns (see Risk Considerations above). Essentially the manager of a TLP fund must produce a valuation basis that equitably unwinds an absolute return over a variable period, and plan for the future premiums that must be paid until a maturity occurs. While it is important not to under-rate longevity risk, it is not impossible to determine mortality.

Mr Smith outlined some other risks that were of concern to the FSA. He said there was a very real risk of products failing to invest in sufficiently diverse portfolios of policies; that despite the size of the TLP market, their specialised nature meant they were rather illiquid; and that, as with structured products, there was a counterparty risk if the insurance company were to become insolvent and unable to meet death benefit claims.

Investors should indeed look for sufficient diversification of policies with regards to the number of insurance companies issuing the underlying policies. There are also potential liquidity risks, but this is not unique to TLPs. Commercial property is a very 'lumpy' investment but that in itself is not a reason for avoiding property. Investors just need to assess how a fund manager manages this risk.

With regards to counterparty risk, it is worth noting that all US life assurance in issuance must be fully reinsured. This means both the underlying insurer and the re-insurer would need to go bust for a problem to exist, and even then State guarantee schemes provide added protection. Arguably, this means there is far more counterparty risk in structured products and, for that matter, bond funds. This risk can be managed by buying policies from a wide number of assurers with high credit ratings.

One point that Mr Smith did not identify, which is possibly the most significant risk factor of them all, is that TPLIs are United States issued life insurance policies and are therefore a dollar-based asset. This means that there is a currency exchange risk, which requires careful and expert hedging. Investors should always make sure that a product provider has a disciplined hedging strategy to deal with this.

In response to Mr Smith's speech, Managing Partners Limited issued a six-point check list for investors outlining what they should look out for in TLP products and providers. This list, outlined below, says investors should avoid:

1. Higher risk funds that invest in viaticals, contestables or other type of life settlement where longevity risk is much harder to manage
2. Funds with high charges because the only way to gain Alpha is by lower charges when there is a competitive market for the purchase price of policies
3. Funds that charge performance fees; not only because the higher the fees are, the lower the investment return will be but also because there is a significant moral hazard in financially incentivising a fund manager to achieve higher returns when it is using a valuation model to achieve them
4. Financial products offered by organisations that avoid seeking FSA regulation. The FSA has a strict code of practice that requires regulated parties to give a high level of disclosure and to accept responsibility for providing investment professionals with sufficient information to identify the risks associated with an investment opportunity and be equipped to assess its suitability for an investment client or portfolio
5. Funds that do not have critical mass or a reasonable track record that enables an investment professional to judge on its own merits
6. Funds that do not have a good track record in managing the currency risk

While Mr Smith's speech was a landmark, it was only the latest hurdle that TLPs must jump as they move closer to the mainstream. They are still a relatively new asset class and much has still to be understood about them. However, they are growing in popularity around the world as investors recognise the benefits they can bring when they are handled in the right way.

Conclusion

The credit crunch may eventually be seen as the best thing that ever happened to TLPs. Without it, TLPs would not have been able to prove their credentials.

Despite the horrendous turmoil seen on financial markets, several funds that invest in TLPs continued to deliver steady returns, sometimes in excess of 10%. A look at the AAP Life Settlement Index in Figure 13 shows that this kind of performance was by no means universal, most likely because of the mark-to-market methodology used by several funds to measure Net Asset Values (NAVs). But even the performances measured by this index were in a different league to the double digit losses recorded by equity, bond and property funds in the financial crisis. It should also be borne in mind that the NAVs measured by a mark-to-market model are a reflection of the returns being traded at that time, rather than - arguably - a reflection of the fundamental value of the underlying assets that will be realised by investors who stay in the fund for the long term.

As an asset class TLPs will never deliver the astronomical returns that have been seen in commodities or tech stocks, for example, but nor should they deliver the losses that those same assets have delivered to investors, provided that a TLP fund is managed prudently, with the right actuarial analysis and judicious diversification. Many investors are very happy with cash-plus 2% or 3% returns, year-in, year-out, combined with capital preservation. This is the Holy Grail for investors and it helps explain the attraction of hedge funds. It also explains the appeal of with-profits endowments in the UK, which eventually failed to deliver on the steady returns they once promised.

So if the benefits of TLPs as an asset class are so apparent then why are they not more popular? After all, many studies predict that the market is set for significant growth in coming years. However, there is still a long way to go in terms of educating investors about the benefits but the take up among institutions shows that the message is getting across. There was a time when TLPs were not taken seriously by institutions, but some very significant names are being linked to TLPs with increasing frequency, including Citibank, BNY Mellon, Credit Suisse, Commerzbank, Deutsche Bank, HSBC, Allied Irish Bank, Wells Fargo and Cantor Fitzgerald.

The message is also growing internationally. Countries with substantial life insurance markets, such as the UK, Germany and Italy already have growing exposure to TLP investments. However, Asia, with its fast-growing economies, culture of saving and an emerging generation of wealthy investors present perhaps the most interesting market. Several product providers are starting to secure some substantial deals in the region.

The growing popularity of TLPs does have its dangers. One of the signs of maturity in the sector is the growing range and sophistication of products that use TLPs as an underlying asset. These include the longevity derivatives linked to indexes based on portfolios of life policies but another, more notable example that has attracted a great deal of publicity - often adverse - is the securitisations. Unfortunately, TLPs are often still misunderstood, even by institutions. The growing use of securitisations is a concern because of the ways in which they are put together and the motivation for originators to offer them. It would be unfortunate if the originators have sensed a growing interest in TLPs and have worked out a way of offloading the portfolios of residual policies that they have built up. Investors must scrutinise these securitisations very closely. The horrific fallout from the securitisations of mortgages seen in the US is a clear warning of the risks. TLP securitisations could be dangerous and offer no advantages - and many disadvantages - compared with using TLP funds as investment vehicles.

TLPs certainly deserve a higher profile. If this is to happen, the actions listed below are needed. The list is aimed at regulators, politicians, product providers, investment advisers and other industry players:

- TLPs must be given recognition as an asset class in their own right. This would require regulators and trade associations in various countries to recognise and promote TLPs as such and create bespoke listings and performance tables. Investment advisers should also recognise the value of TLPs and incorporate them into their clients' investments where appropriate
- There must be greater transparency around the products on offer, including funds and securitisations. Fund providers need to be clearer about the processes they use to evaluate their portfolios, the holdings they have and net asset values
- There should be tax incentives to encourage trading of life policies and investment into them
- Banks should capitalise life settlement market makers to allow the market a much higher degree of liquidity. If market makers could accumulate stocks of policies rather than the current situation in which they buy policies to order, then the whole process of buying and selling policies would become much more efficient and pricing much more stable, leading to improved returns for investors
- More needs to be done to educate investors about the benefits and dangers of TLPs
- A concerted effort by players in the industry is needed to achieve all of the above. Trade bodies such as LISA and the recently-formed European Life Settlement Association are to be applauded but they deserve more support from across the industry

The mass of evidence points to substantial growth in the life settlement market over the next few years, led by institutional investors who clearly understand the benefits of TLPs. However, as investors' appetite for alternative asset classes develops and more attention is focused on those assets that offer more predictable returns, demand for TLP investment must surely come from a much wider base of investors from across the globe.

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Please note that this report and all the guest articles have been written in broad and general terms and should not be relied upon to cover specific situations. Nor should any individual act, or refrain from acting, upon the information contained in this report without obtaining specific advice.

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About Managing Partners Limited

Managing Partners Limited (MPL) is a multi-disciplined investment house that specialises in managing alternative assets classes. MPL is an experienced investment fund manager in the field of traded policy funds, in particular TLPs, an asset class that is renowned for its inherent guarantees and balanced growth characteristics. The boards of MPL and its subsidiaries have over 70 years' collective experience in asset and fund management. MPL is a member of The Alternative Investment Management Association Limited ("AIMA").

MPL is registered in the Cayman Islands, where it is recognised by the Cayman Islands Monetary Authority as a Fund Manager and where it manages a number of collective investment schemes and regulated mutual funds. MPL has offices in mainland Europe and Asia. MPL's subsidiary Managing Partners Capital Limited (MPC) is based in the UK*.

*MPC ceased to be an appointed representative of Sturgeon Ventures LLP on the 21st of April 2011.

About Professor Merlin Stone

Merlin is a well-known commentator on the financial services industry, particularly in relation to investment, pensions, life insurance, mortgages, savings and channels of distribution and has published many reports on these subjects.

He has a first class honours degree and doctorate in economics. In parallel to his business career, he has also pursued a full academic career. He has held senior academic posts at various universities and is now a Visiting Professor at Oxford Brookes, De Montfort and Portsmouth Universities and teaches economics part-time for the Open University.

He is author or co-author of many articles and thirty books on customer management including CRM in Financial Services and Key Account Management in Financial Services. The UK's Chartered Institute of Marketing listed him in 2003 as one of the world's top 50 marketing thinkers, he was nominated as one of the 20 most influential people in the direct marketing industry in a Precision Marketing readership poll in 2003, while NOP World nominated him in 2004 as one of 100 most influential individuals for their input and influence on the development and growth of e-commerce and the internet in the UK over the previous 10 years. He is a Fellow of the Chartered Institute of Marketing and an Honorary Life Fellow of the UK's Institute of Direct Marketing. He is also on the editorial advisory boards of several academic journals, including the Journal of Financial Services Marketing, and writes for several trade publications.

Glossary

Contestability law - A law that covers instances in which a life company can refuse payment on a life policy claim, usually because certain medical conditions were concealed when a policy was taken out. However, insurance companies can currently only refuse payment within the first two years, although there are moves to extend this to five years. After this period, insurance companies can only cancel policies if the premiums are not paid.

Counter-party risk - This is the risk for each party to a contract that one or other parties to the contract will not meet their contractual obligations. This can also be referred to as default risk.

Currency risk - This is the risk that adverse changes in foreign exchange rates can erode the returns on overseas investments denominated in a foreign currency.

Face value - The face value of a life insurance policy is the amount it will pay out upon the death of a life assured, or the death benefit.

Gearing - This is the process by which a party borrows money in order to invest. This is done in the expectation that the returns from the extra capital will outstrip the interest repayments. 'Gearing' is often used to describe the level of a company's debt, expressed as a percentage of its equity capital. However, it can also be used to describe the level of borrowing an investor might make to supplement their investment in the hope of boosting.

Hedging - The use of financial instruments also known as derivatives or futures to reduce the chance of investment losses or enhance returns. In the case of TLP funds, financial instruments are used to minimise the risk that adverse changes in the foreign exchange rate versus the dollar will reduce the returns from the policies.

Key-man insurance - This type of insurance enables companies to insure themselves against the death or disability of crucial members of staff.

Liability-driven investment (LDI) - The management of a pension fund in terms of risks and expected returns in order to meet future pension payments to pensioners - the liabilities - as they fall due.

Life expectancy tables - These are summaries that give a measure of the average mortality and survival experienced by people of different ages in a given population. The figures need to be regularly updated because over time people tend to live longer. However, they are useful tool in measuring average life expectancy and therefore expected payouts in relation to a portfolio of TLPs.

Mark-to-market basis - This is a method of measuring the Net Asset Value (NAV) of a fund by evaluating the underlying assets using their current market prices. Sentiment and the balance between supply and demand thus become key drivers of NAV.

Mark-to-model accounting - This is a method of measuring the NAV of a fund by evaluating the underlying assets using a model to estimate their fundamental value, irrespective of their current market value.

Policy spread - The process by which investments are made in a range of life policies in order to diversify risk. The range can be across different ages and life expectancies of lives assured, as well as different creditworthiness in the companies issuing the policies.

Secondary market - In its most general form, this is an exchange or place of sale for securities that have already been issued, such as equities or bonds. In the case of TLPs, a secondary market exists for the sale and purchase of policies between the time of their initial issuance and before they mature.

Senior life market - The sale of a life policy under which the life insured is aged 65 or over is said to take place in the senior life market. The transaction is called a 'senior settlement'.

Share classes - The share capital of a company may be divided into different 'classes' of share, each class having its own 'rights' attached (for example payment of dividends or voting rights). The 'rights' attached to each share are set down in the company's Articles of Association.

Stranger-originated life insurance (STOLI) policy - This is a policy that is initiated for speculative purposes by a party with no relationship to the life assured. For example, an investor might approach a wealthy individual in his 70s or 80s, either directly or through a third party, with an offer to set up a substantial insurance policy on his life with the premiums paid for via a loan for the first two years. The set period is two years because under US regulations this is the time after which payouts on a policy cannot be contested by an insurance company. If he should die during the first two years, his

beneficiaries stand to receive the benefit net of the loan interest and charges. After this period, the life assured has three options: he can take ownership of the policy by paying back the premiums plus interest and fees to the investor, he can give the policy to the lender in satisfaction of the loan or he can sell the policy to the investor for a percentage of the death benefit. This pay-off, plus any initial fee or payment in kind, provides the incentive for the life assured for the policy to be taken out. Essentially, investors will set up such policies because their expectation of the life of the assured is at odds with that of the life company selling the policy. While the STOLI market has been criticised, stronger regulations now exist to safeguard the participants.

Traded life policy (TLP): These are of two classes – viatical and senior life

- **Viatical settlement:** This is a transaction involving the sale of a life policy to another party when the life assured is said to have impaired life expectancy is of less than three years. Viatical settlements made in the wake of the AIDS epidemic were the catalyst for establishment of the traded life policy market.
- **Senior Life Settlement:** This is an insurance policy that has no set term and which pays out a fixed sum on the death of the person whose life is insured. A senior life settlement is a policy that is traded where the life assured is over the age of sixty five and the life expectancy medical underwriting can be completed on the basis of statistical mortality rather than on health alone. In the US, such policies have premiums that that escalate over time, of which a part is invested into a savings element that accumulates a cash value with deferral of tax.

Withholding tax (US) - Foreigners in the United States are generally subject to US tax on their US-sourced income. Most types of US sourced income received by foreigners are subject to a US tax rate of 30%. A reduced rate may apply if there is a tax treaty between the foreign person's country of residence and the US. The tax is generally deducted from the payment made to the foreign person.

With-profits fund - This is a pooled investment vehicle that theoretically enables investors to secure smooth returns by locking in annual gains as 'with-profit bonuses'. In years of good returns, bonuses are given below the returns, thus enabling bonuses to be made from reserves in years when returns are not so good. With-profits funds are usually run by insurance or mutual companies and usually offer some form of life cover. With-profits funds suffered from poor investment returns in the bear market of 2000-03 and excessive payouts prior to that. As a result, some have had to reduce the final payouts on policies and their outlook is for much lower returns than in the past.

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