Life Settlements: The Opportunity Continues to Grow

Like many asset classes, Life Settlements faced challenging times in 2011. But looking forward, SL sees a growing opportunity for investors seeking stable returns.

2011: A Challenging Year

The ongoing global financial crisis led to a shortage of capital for potential investors and several high profile fund failures continued to be attributed to the nature of Life Settlements as an investment, rather than other factors not exclusive to the asset class.

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Furthermore, the supply to the secondary market remained relatively low compared to historic levels. This was directly attributable to the lower prices available in the market, as fewer policies could be sold to investors at a premium to the cash surrender values offered by insurers. However, this was good news for those Life Settlement investors who have had cash to spend as it has reduced competition for policies and enabled buyers to be more selective with their purchasing criteria whilst still achieving high returns.

The Legal Landscape: A Strengthening Foundation

In the US at the end of 2010 there was a significant victory for the Life Settlement industry in the Kramer Vs. Phoenix case. The New York state Court of Appeals ruled that a person can take out a policy on his or her own life and immediately transfer it to whomever the person wanted, even if it was never intended to provide insurance protection for someone with an 'insurable interest' in the insured's life.

There have been around 200 cases heard in the US courts over the last few years that have revolved around insurable interest issues or Stranger Owned Life Insurance (STOLI). These have had varying outcomes but the prevailing message is that it is vital to carry out stringent due diligence on all polices purchased to reduce the risk that they may be the subject of litigation at a future point.

Looking Forward

Improved regulation for investors and policy sellers

On 25th April, the FSA made the announcement that they would hold an extended period of consultation regarding the promotion of Traded Life Policy Investments (TLPIs). SL sees this as important evolution of the asset class, with market regulation playing a key role in ensuring a consistent level of standardisation across the industry for policyholders, advisers and investors. SL has always supported the view that whilst a number of Traded Life Policy Investment (TLPI) products are unsuitable for the mass sale to retail investors in the UK, we consider that a 'blanket ban' could be regarded as overkill and as such would be disproportionate to the particular risks associated with the asset class.

It is encouraging to see that the FSA has decided to expand the breadth of its knowledge before making any final decisions as to the future rules for promotion of TLPIs to retail investors. We are also gratified to note that the FSA has heeded feedback from the industry that TLPIs need to be considered in the wider context of alternative investments. SL will continue to work closely with the FSA and support them in their decision making process.

In particular, we are of the view that the important role that the financial advisor has in relation to such transactions cannot be under-estimated. Advisors have a duty to ensure that they properly understand the nature of the product, explain the relative risks/rewards to their clients and that such investments are a suitable investment given the clients particular needs, risk appetite and current portfolio of investments.

From the very outset of the debate, SL has maintained a view that at this stage in the asset class's evolution, Life Settlement investments should only be marketed to sophisticated investors. This is due to the necessary resource to understand both the potential risks and benefits of the asset and the products which invest in it.

The Life Settlement industry has not escaped the high profile fund failures, which have cast a shadow across the whole of the financial services industry. As it applies to Life Settlements the debate seems to have lost sight of the fact that most failings were due to other factors and not the assets themselves.

The main issue lies in the way in which some funds have been structured or marketed. A complex investment proposition has, in some cases, been over simplified with potentially complicated structures where the risks need to be carefully understood.

SL has long advised that potential investors need full disclosure of the risks involved, coupled with the utmost transparency. Life Settlement funds require liquidity to meet premiums and expenses. Liquidity comes from cash reserves maintained by the fund, borrowings, new investors or from early policy maturities. Failure to maintain sufficient cash reserves to pay on-going policy premiums can result in a loss of value because policies will lapse, jeopardising the long term health of the fund. This is the issue that lies at the heart of the fund failures and the reason why investors need to be comprehensive in their due diligence and fact finding to ensure they understand the funds liquidity strategy as well as its investment strategy.

As Life Settlements require ongoing premium payments in order to keep them in force, meeting these and other expenses should remain a high priority for Life Settlement funds.

SL is of the view that a blanket retail ban is not the only way forward. Indeed, in its consultation submission to the FSA, we put forward the case that advisors play a vital role in the transaction of Life Settlements and within the context of RDR, intermediaries should be given the opportunity to offer their clients a degree of choice, providing that they fully understand the nature of the product and can explain the relative risks/rewards to their clients. Additionally, intermediaries should ensure that such investments are suitable given the client's particular needs, risk appetite and current portfolio of investments.

We believe that many advisers are ready to step up to the plate, but are currently hampered by;

a) The lack of transparency in a number of Life Settlement structures
b) The lack of transparency around the potential risks
c) The use of differing valuation methods which can be misleading in relation to previous performance and providing a "mirage" of consistency which does not in fact exist

These points could be addressed by the introduction of FSA rules and guidelines that will require standard disclosures in relation to products intended for retail sale and does not require a blanket ban which was mooted at one stage by the FSA prior to their consultation.

Meanwhile, in the US, the SEC's ongoing investigation into the asset class will almost certainly lead to the introduction of new legislation that will be beneficial to both investors and policy sellers.

The Role for Experienced Asset Managers
Although like many asset classes, Life Settlements have seen a tough couple of years, the experienced asset managers have emerged as leaner and stronger organisations. The application of tried and tested business models and firm actuarial foundations has enabled SL to weather a turbulent market. We see the remainder of 2012 as presenting good opportunities to engage with new investors across the globe, who are seeking the stable returns that this asset class can deliver as the financial climate improves.

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SL's Approach

In support of our position as one of the longest established asset managers in Life Settlements, SL has invested time, expertise and technology to create points of difference in our approach and a key element of our approach is our policy acquisition due diligence process.

SL's policy acquisition process addresses 5 key areas: Valuation, Legal Title, Contestability Periods, Fraud and Insurable Interest

SL's Policy Acquisition Process and SL's 100+ Point Checklist Policy Acquisition and Due Diligence
Strong due diligence processes are vital for effective Life Settlement asset management. When buying a Life Settlement policy it is essential to ensure that each policy is purchased following due process procedures. SL has been buying US policies since 2004 and uses a 100+ point checklist that must be followed for each case.

Designed in conjunction with our US legal counsel and our own internal actuarial team, SL's due diligence process has evolved over many years and is reviewed at least annually to take account of any market or legal developments.

SL has now purchased in the region of 2000 US policies, representing $3.4bn of face value and spending $840m. As a result of the stringent due diligence procedures in place, we have never had a policy rescinded and we have successfully claimed full death benefits on all maturities.

The SL Policy Acquisition Checklist addresses 5 key areas:

1. Valuation Critical Information
   The initial pricing of a policy and the bidding and negotiation process is almost entirely based on the information provided by the seller or their representatives. Diligent processes that confirm the accuracy of this information are vital to inform the subsequent management of the policy.

2. Unencumbered Legal Title
   When buying a policy one of the most important issues is to ensure that there is no reason why the ownership of the policy and the entitlement to the death benefit could be disputed in the future. Robust checking of policy title delivers clarity of ownership.

3. Policy is out of the Suicide and Contestability Period and is in Force
   When a policy is issued, it will usually have a two-year period during which the issuing insurance company can contest the payment of any death benefit for almost any reason. After that period, there are only certain instances in which payment can be disputed in the event of death (fraud or lack of insurable interest are the most common but this varies by state).
   To avoid disputes that may arise within that contestability period SL does not buy policies that are under 2 years old. Also and routinely SL conducts robust policy documentation checks to validate policy details.

   In addition, it is vital that we confirm that sufficient premiums have been paid by the previous owner to ensure that the policy has not lapsed or entered its grace period. This is done with the insurance carrier providing further opportunity for checklist information such as cash balances being completed.

4. Fraud
   One of the key reasons why an insurance company would contest the payment of a death benefit or look to rescind a policy is where it suspects fraud. This would most often be fraud at the time the policy was issued when the insured deliberately provides false information about age, net wealth, or existing amount of in-force insurance. SL's due diligence checklist is designed to identify any suspicious items and ensure they are investigated thoroughly, thereby minimising the likelihood that the insurance carriers will contest any payment of the death benefit.

5. Insurable Interest
   The law in most US states requires that the owner of an insurance policy at issue must have an insurable interest in the continued life of the insured. This would normally mean that the owner would be a family member, close friend or business partner/employer. SL's policy acquisition team carry out thorough checks to ensure that the original owner had insurable interest.

   During the peak of the Life Settlement market, when demand was exceeding supply, many policies were 'manufactured' via premium finance and beneficial interest schemes. Elderly individuals were encouraged and incentivised to take out policies with the premiums being paid by financing entities that would ultimately take ownership of the policy and then dispose of the asset in the market. This process was known as 'stranger owned life insurance' (S.T.O.L.I). There have recently been a number of cases in the US courts where insurance carriers have disputed payment of a death benefit or sought to have the policies rescinded on insurable interest grounds. STOLI being a real but manageable risk, SL has designed its checklist so that any items which may suggest a lack of insurable interest are investigated thoroughly.

Important Information