

Liquidity Management in a Life Settlement Portfolio

Background

A Life Settlement (LS) is an asset resulting from the sale of an existing life insurance policy to a third-party as an investment. The third-party is then responsible for the payment of ongoing premiums (to the life company that issued the policy) and receives the claim payout following the death of the insured life.

The majority of the LS market comprises policies whereby the investor has flexibility regarding the premium payments that are made to the life company. Assuming that the relevant criteria are met (e.g. maintaining a positive account value), owners are able to optimise premium streams to ensure that the amount of cash within the policy is reduced and cash outflows for a portfolio are minimised. As cost of insurance within policies (in general) trends upwards over time, so will the expected stream of premium payments for a single policy (and hence portfolio).

LS are purchased with an inherent mortality profile and expectation of the future premiums that will be required. Liquidity problems can arise when mortality assumptions are overstated. This can prove to be a double-edged sword as a delay in receipt of the expected death benefits reduces the cash inflow (which may be assumed to be used for premium commitments) and also increases the outflow (as premium commitments continue longer than expected).

Additionally, with regards a LS portfolio cash flows, the receipt of death benefit payments is prone to be irregular (i.e. months of zero inflow followed by a large receipt) whereas the payment of premiums is very likely to be smooth and increasing over time. This natural feature of the asset class and resulting mismatch in cash flows can also create liquidity strains for a LS portfolio.

Should these liquidity issues fail to be identified and addressed then this has the potential to result in distressed sales (both of individual policies and entire portfolios), or in extreme cases could jeopardise the ongoing solvency of the fund. Even if these liquidity pressures are able to be absorbed by the fund, the overall return to investors will be reduced markedly.

LS portfolio managers will typically produce modelling forecasts of expected future premium commitments allowing for expected death benefit receipts. These forecasts will aid in the determination of cash reserving levels (i.e. the amount of cash held to support premium and expense outflows) chosen at outset and at periodic review points. Often this level can be chosen as a multiple of future premiums commitments (e.g. 12 months) or as a monetary amount (e.g. \$2m or 2% of NAV).

There are a number of options available to LS portfolio managers, with the aim of mitigating the potential occurrence of (and consequential effects of) liquidity risk:

Increased Cash Reserve Levels

The previous section alludes to a level of cash reserving set and maintained by the LS portfolio managers. As the level at which cash reserving is set increases, there is a subsequent reduction in the liquidity risk in the portfolio.

The major disadvantage with maintaining a high level of cash within the portfolio is the resultant impact on the investor returns achieved. If a higher proportion is held as low-yielding cash (and/or short-term money market assets) then a lower proportion will be invested into high-yielding LS assets. As a result the overall performance will be dragged down by the investment held in cash; an effect that can be very significant.

In general, a cash reserve level of up to 24 months of future premium and expense commitments is targeted by many portfolios. Levels above this are considered to be poor use of investible capital.

Credit Facility

A LS portfolio could agree a line of credit with an appropriate institution such as a bank. The usual features of a credit facility apply, whereby the portfolio will abide by defined rules regarding when and how cash can be drawn and the maximum value of the facility.

An advantage of this option could be that the line of credit is only drawn upon as and when it is required. Additionally, any previously used portion of the facility can be repaid upon receipt of death benefits. This allows for a dynamic approach to liquidity management whereby the facility is in place to allow for the natural mismatch between the smooth expected premium payments and irregular death benefit receipts.

The drawback and usual deal breaker (particularly over recent times) has been the cost associated with such a credit facility. There is a cost associated with the monies actually drawn down by the portfolio (usually a set level above a LIBOR benchmark) but also a non-utilisation fee on the remaining balance of the facility. Such costs are typically only available at levels which are severely detrimental to the potential investor returns.

Moreover, determining the size of the facility required is a complex process and the decision made will affect the potential reductions in both liquidity risk and investor returns. The larger the facility, the lower the liquidity risk but also the greater the reduction in potential returns.

Credit facilities would be suited to those investors that are able to organise them at a non-prohibitive cost. For example, if provided by another entity within the same organisational structure and costs are charged at a minimum.

Sales

A tertiary market exists within the LS industry whereby a portfolio is able to trade policies that have previously been purchased. As a consequence, portfolios are able to sell policies to other market entities in order to generate cash when required.

The usual process for sale will require up to date medical records/life expectancy reports, offering policies to market, negotiation regarding price and eventually sale/transfer of ownership. On average, a typical sale may take three months from the point of decision to sell up to receipt of monies. As a result, decisions regarding sales for liquidity purposes should be started no later than 6 months prior to the defined pinch point (i.e. cash projected to run out). Portfolios can decide to put individual cases, small batches or the entire stock to the market.

The main advantage is that it can be argued that the existence of the tertiary market and known broad timelines for sales allows for additional liquidity to be generated as and when required. A lower level of cash reserve can be maintained with sales used simply to top up the cash when it drops below the lower limit (e.g. 6 months of future premiums).

Furthermore, by putting multiple policies to the market the portfolio may receive bids that are in excess of the current valuation placed on the LS (or above cost basis). This may allow the fund to achieve uplift on the sale of the policy, meaning that the necessary sale has actually enhanced performance.

The market knowledge/data received during the sales process allows for analysis of the remaining portfolio. For example, it can provide useful insight into whether market pricing is low or high (whether it

is good to buy/sell), the areas which are generating higher offers (which policies may achieve better sale prices or which policies may offer increased returns if investment was extended further)

The major drawback of using sales as a form of liquidity within a LS portfolio is mainly due to the timing at which they occur. If sales are chosen as the mitigation option, then once the portfolio reaches the trigger point required for sales (e.g. cash less than 6 months future premiums), there is no option but to sell policies. This means that there is potential for forced sales at depressed prices if the market at that time is less than buoyant. In the worst case, there may not be market entities willing to bid on enough policies to generate sufficient monies. This may be a consequence of the market being depressed and/or the policies themselves being outside the target range of the LS market.

Sales of LS from a portfolio at a price lower than that at which it is valued will inevitably result in a significant overall reduction of investor returns. As there are then fewer policies in the portfolio, the volatility of cash flows will also increase which could also feed into increased chances of future liquidity issues due to mismatch of inflows and outflows.

The process of using sales as a form of liquidity management is employed by a large proportion of the LS industry due mainly to the downsides of the other options rather than necessarily the advantages of this method.

Stop-Loss Reinsurance

If observed on individual LS, Stop-Loss Reinsurance is designed to pay out a preset proportion of the death benefit proceeds if the insured life survives to a pre-determined point in time. For example, a fee can be paid upfront in order for \$1.2m to be paid out after 10 years for a policy with total death benefit of \$2.0m and a life expectancy (LE) of 8 years.

The major advantage of this option pertains to increased certainty regarding future premium commitments and death benefit receipts, and hence management of such cash flows is easier. Premiums have a defined future point at which no further payments will be required and a significant portion of the death benefit will be received at a defined point (or the full amount at an earlier point in time).

Consequently, the use of stop-loss reinsurance would work towards providing a guaranteed minimum investor return due to a known cut-off date for premiums and receipt date for the (proportional) death benefit.

As with the use of a credit facility, the major disadvantage of the use of stop-loss reinsurance is the prohibitive costs involved. This is likely due to the highly concentrated risk of the individual asset underwritten by the reinsurer when calculating a price, and the scarcity of institutions willing to offer such a service.

A perceived important feature of investment in an LS portfolio is the potential for double digit investor returns. Although the incorporation of a stop-loss reinsurance element allows for a guaranteed minimum, it is likely to be in the low single digits. Investors are likely to view this negatively given they may find low single digit returns elsewhere with comparable or lower perceived risk.

Due to costs and availability this method of liquidity risk mitigation is rarely used at present.

Complementary Assets

The basis behind this option is the use of alternative assets to supplement the portfolio and provide income to cover future premium commitments. A good example of assets in this context are Structured

Settlements (SS) and Life-Contingent Structured Settlements (LCSS). SS and LCSS are essentially annuities awarded to individuals as a result of personal injury or wrongful death lawsuits that have been sold onto a secondary market. The difference between SS and LCSS is that the payments received under the latter depend (in some capacity) on the survival of the underlying annuitant.

Theoretically, the main advantage of the use of LCSS is the potential for counteracting one of the major LS risks; namely longevity. As previously discussed, individuals living longer may cause liquidity issues whereas with LCSS, individuals living longer means that the cash inflows are received for longer, to the benefit of the portfolio. If the portfolio were to purchase a mix of SS and LCSS, the former provides an element of guaranteed payments (regardless of annuitant survival) and the latter provides mortality dependent elements.

In theory, as these assets are income-generating a lower initial cash reserve can be set (as there are known future cash inflows) and more investible capital can be deployed in the higher-yielding LS assets.

SS and LCSS with deferred payments can also be utilised to match anticipated LS premium liabilities in such a way to provide assistance at a certain point in time (e.g. LE plus 2 years).

SS and LCSS can provide a higher yield than cash (or other short-term money market instruments) and as such should cause lower cash drag on the overall investor returns.

Although the mortality/longevity risks are theoretically opposite, this assertion depends fundamentally on the assumption that the underlying population cohorts are the same. This is unlikely to be true in reality and as such there is a compound risk whereby the annuitants experience higher mortality (reducing cash inflows) and the LS population survives longer (increasing cash outflows). This would actually result in more severe liquidity issues for the portfolio rather than providing mitigation.

Another drawback of this mitigation option concerns the uncertainty over the availability of SS/LCSS at the required volumes and with the correct specific characteristics. If the portfolio cannot source enough assets that provide an adequate match to the expected premium commitment profile, then the mitigating effect will be greatly reduced.

The option also assumes that a portfolio has the correct documentation regarding investment guidelines that would allow for such assets to be acquired. Moreover, there may also be regulatory constraints pertaining to the assets that restrict access due to the investor's and/or portfolio's country of domicile. Even if the previous two points are satisfied, the investor/portfolio may not have access to the framework/market required to acquire such assets.

Conclusion

In reality, the choice between the options above is not a simple one and will depend on a number of factors. Investor preference, market conditions (LS, global and SS/LCSS), portfolio composition, population mortality, and availability and cost of options will all play a part in the final decision.

In the current climate, the most likely option would be to use a combination of varying the cash reserve levels (based on periodic projection modelling) and tertiary sales as and when required.

Over time, credit facilities may become less cost-prohibitive as the global market continues to recover and the reinsurance and use of complementary asset options becomes more prevalent as availability and understanding increase within the industry.