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Prudent Portfolio Construction Methods Insulates Life ILS Sector from Lapse Rate Risk

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Editor's Letter
Volume 2 Issue 1 January 2023

Chris Wells
Managing Editor
Life Risk News

Happy New Year!

The cost-of-living challenges currently being experienced in many countries in the west represents a challenge for the life insurance industry in terms of increasing lapse rate risk. **Greg Winterton** spoke to **Adam Robinson**, Head of Life and CUO at London-based **Securis Investment Partners**, to learn more about the nuances of this risk and how to mitigate it for our cover story this month, *Prudent Portfolio Construction Methods Insulates Life ILS Sector from Lapse Rate Risk.*

The global insurtech market has been hot for years, with increasing amounts of deals and money going into the space. But 2022 provided challenges for venture capital investors as private market valuations became harder to accurately model. **Greg Winterton** spoke to **Michael Konialian**, CEO and Co-Founder at venture capital-backed insurtech **Modern Life**, to learn more about the outlook for life insurance-based insurtech in *Life Insurance-Based Insurtech Set for Challenging 2023 but Fundamentals Remain Strong.*

The life settlement market is no stranger to litigation and the past few years have seen some interesting cases come before the courts which have an impact on the space. **Jeffrey Davis** hosted a roundtable with **Laura Metzger**, Partner at **Orrick**, **Jim Maxson**, Partner at **EM3 Law**, **Brian Casey**, Partner at **Locke Lorde**, and **Jule Rousseau**, Partner at **ArentFox Schiff**, to learn more about the legal and regulatory outlook for the space in 2023.

Our first commentary piece this month stays on the life settlement theme, but addresses the market more broadly. **Cory Zass**, Founder of **Actuarial Risk Management**, offers his views in *What's In Store for Life Settlement Funds in 2023?*

The U.K. Pension Risk Transfer market received a boost at the end of 2022 when the U.K. Government announced reforms to the Solvency II regulation, with plenty of potential for fuelling growth. We asked *Life Risk News* readers, *Will Solvency II Reform Drive Increased Pension Risk Transfer Activity in the U.K. In 2023?* Unsurprisingly for a regulatory themed question, LRN readers are unsure about whether we'll see increased activity as early as this year.

Finance types love an acronym or buzzword, and insurtech is certainly one of those. But **Rob Norris**, Principal Analyst at **Celent**, dislikes the term. He explains why in our second commentary article this month, *The Engine of Insurtech: The Cloud.*

Our first *Q&A* of 2023 features **Scott Willkomm**, CEO of life settlement provider **Life Equity** and Chair of **ELSA**. **Greg Winterton** spoke to Willkomm to get this thoughts on both the life settlement market in general and ELSA's activities in 2022 and looking ahead to 2023.

Life Risk News' welcomes you back to the Life ILS Conference on Tuesday, May 23rd in London, U.K. Life ILS Conference 2023 will bring together investors, asset managers, policy makers and service providers to discuss the opportunities and challenges in the life ILS market; **Greg Winterton** spoke to yours truly to learn more about what we have in store for the event in Life ILS Market Opportunities and Challenges To Be Addressed at Life ILS Conference 2023.

Prudent Portfolio Construction Methods Insulates Life ILS Sector from Lapse Rate Risk

Author:
Greg Winterton
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In difficult times, consumers reduce or eliminate expenses that are considered non-essential. Streaming subscriptions in the U.K., for example, saw 1.66 million Subscription Video on Demand (SVoD) services cancelled in the second quarter of 2022, according to market research firm Kantar, as the effects of higher inflation began to be felt in the country as households reallocated wages to fund ever higher utility bills and food costs.

Unlike parts of its property and casualty insurance cousin, and like SVoD services, life insurance is not always a need to have. And the current cost of living crisis could see a rise in lapse rates as those with life and health cover decide that they can't justify the premiums in the current economic environment.

On the surface, an increase in lapse rates spells challenges for the life ILS sector. Portfolios in this space are heavily built on value-in-force (VIF) transactions, where the life ILS manager lends to an insurance company or agent based on the value of a block of existing life-related insurance policies and receives payments in return from the profit stream of those policies; rising lapse rates means that there are less policies in the portfolio to return capital, leading to write-downs.

The first line of defence against this potential risk is an obvious one.

> **"On the surface, an increase in lapse rates spells challenges for the life ILS sector"**

"Obviously we bake in some wiggle room for potential risks, like lapse rate risk. Making transactions at less than a 100% loan to value ratio is clearly the first step. Essentially, this buffer should absorb that first deviation of risk in a life ILS portfolio," said Adam Robinson, Head of Life at investment manager Securis in London.

The current macroeconomic challenge is pronounced in the United Kingdom. The country's inflation rate is over 10%, and industrial action is taking place on an almost unprecedented scale as workers in industries ranging from healthcare to railways demand pay increases to cope with the additional costs.

It's not quite as pronounced in North America, however. The inflation rate in the U.S. was 7.1% as at the end of November 2022 and 6.8% in Canada for the same period, and, whilst that's higher than in recent years, it's also better than in the U.K. This dispersion – at least, in developed economies, where life ILS managers do almost all their deals – provides diversification of risk in the space.

"It can be tempting for investors to look at situations like what's happening in the U.K. and think that's the case for other markets," said Robinson. "But a good asset manager will be diversified by geography as well as product type. Whilst the U.K. market is arguably at higher risk of rising lapse rates right now, it's not neccessarily the same case in North America."

Geographical diversification isn't the only free lunch in the life ILS space. Product diversification becomes more of a consideration for portfolio construction in times of heightened risk; some life-related products are more resistant to lapse rate risk than others, and the nuances of these products come to the fore. Additionally, life ILS managers can further diversify portfolios by investing in a mix of lapse and non-lapse risk products.

"If you look at funeral plans, these tend to be purchased by lower income groups because it's a comparatively high cost. At first glance, one might think that these are at higher risk, but they have historically had stable lapse rates," said Robinson. "And in other products, policies sometimes offer premium holidays and/or a reduction in benefits, which again means lapse rates, insofar as full termination of the product, don't increase to the extent and offers some level of portfolio protection."

There's a flip side to portfolio exposure lapse rate risk. Whilst existing deals might be at higher risk of rising lapse rates, pricing for new deals adjusts to compensate; consequently, those added to a life ILS portfolio in 2023 improve the overall portfolio's risk/return profile.

"If we think that a particular country, like the U.K., is at higher risk of rising lapse rates, we'll price that in through higher interest rates or lower LTVs [loan to value] – i.e., effectively a higher price for the insurance company. And we are seeing higher pricing right now, across the board.

But it comes down to risk and return, and demand from insurance companies for capital. Sometimes, seemingly unattractive markets can become attractive," said Robinson.

> **"Lapse rate data is usually published with a lag. Premiums can be yearly or quarterly, as opposed to monthly, which means that an insurance company, let alone a life ILS manager, has a more limited view into whether that policy will lapse or not"**

Lapse rate data is usually published with a lag. Premiums can be yearly or quarterly, as opposed to monthly, which means that an insurance company, let alone a life ILS manager, has a more limited view into whether that policy will lapse or not. Also, grace periods mean that a policy that lapses in December, for example, might not be recorded as a lapse until March.

It's the same with aggregated data, which life ILS managers use to take the temperature of their market. The American Council of Life Insurers, for example, publishes an annual fact book, which contains life insurance lapse rate data, but the most recent version of the report, published in November last year, contains data through the end of 2021, when macroeconomic volatility was more benign (the Association of British Insurers didn't respond to a request from Life Risk News asking if it maintained this data for U.K. insurance companies in time for publication).

All this means that it is currently unclear what the exact lapse rates were for full year 2022. But for Robinson, regardless of what they were, he's confident that life ILS best practice should insulate the industry to a high degree.

"We take a similar approach to constructing our portfolios as a diversified public equity manager might," he said. "There's a significant amount of actuarial modelling and analysis in our space to ensure that we're mitigating risk, whether that's lapse rates or something else. So yes, the cost-of-living crisis in the U.K. might seem to represent a headline risk for the life ILS space, but prudent risk management techniques, like geographical and product diversification, means that investors should feel better about the industry than it seems."

Life Insurance-Based Insurtech Set for Challenging 2023 but Fundamentals Remain Strong

Author:
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The life insurance segment of the insurtech sector continues to see less activity than its non-life cousin. Private markets analytics firm Pitchbook's Q3 2022 Insurtech Report, published just before Christmas, says that $306.5mn of deals were completed in the first three quarters of 2022 in its health and life segment; property and casualty ($518mn) and Commercial ($503mn) represents the two largest segments by dollar amount through Q3 last year.

It's not surprising. Life insurance-based insurtech has lagged its non-life counterpart since the dawn of the market in the early 2010's; a combination of demand-driven factors such as certain segments of property and casualty (P&C) insurance being mandatory, and the comparatively straightforward nature of underwriting these products when compared to life insurance, has meant that more investment dollars have flowed into P&C start-ups.

> "Life insurance-based insurtech has lagged its non-life counterpart since the dawn of the market in the early 2010's"

The gap might be about to narrow, however. Michael Konialian, CEO and Co-Founder at New York-based insurtech Modern Life, says that the wins in the P&C segment have opened some eyes in the life-based sector.

"We're now in the early innings of a wave of substantial investment and digital transformation in the life insurance space," he said. "The innovation in P&C and success stories there have also helped shift the mindset at carriers that the innovation in the life space is something to embrace today rather than wait for the future."

For venture capital funds and their investors, there's hardly a shortage of opportunity. In the United States alone, LIMRA's 2022 Insurance Barometer, published in April last year, suggests that more than 100 million Americans are either underinsured or uninsured when it comes to life insurance; add to that the Covid-19 pandemic, which, according to the barometer, drove 31% of Americans to say they would be more likely to consider buying life insurance in 2022.

Whatever percentage of that opportunity turns into an increase in the number of insured, most of that business will go through an advisor, like an insurance agent, and Konialian says that the insurtech market can support life insurance advisors, which in turn will improve outcomes for their customers.

"More than 90% of life insurance purchased today is still facilitated by a financial or life insurance advisor. However, very little innovation has focused on enhancing the advisor experience," he said. "The first wave of insuretech innovation focused on simpler, easier to underwrite, term products sold directly to consumers, but we think the advisor community is the next frontier for innovation in our space; technology which will handle not just simple term life policies but also permanent life and other more complex products that need to be tailored for a client's specific needs."

The insurtech market generally slowed down in 2022, in keeping with most of the sub-sectors in the private markets as valuations fluctuated in line with those in the public markets, and investors like venture capital and private equity funds chose to watch the game from the side lines rather than play in it. Pitchbook's report says that 461 insurtech deals – across all sub-sectors - worth a total of $7.9bn were completed through the first three quarters of last year, pacing well behind the banner year of 2021, where 736 deals were completed at an aggregate value of $14.3bn.

Despite the pull back, deal activity in 2022 through the first three quarters is still high enough to deliver the insurtech market's second-best year on record. And unlike some sub-sectors of venture capital, there's an in-built resilience to the life insurance market that makes it an appealing risk counterparty for early-stage investing.

"The U.S. life insurance industry is over 150 years old and is a $150bn market. It is a core financial planning product that hundreds of millions of people have a need for, and has shown a lot of stability across market cycles," said Konialian.

Despite the opportunities in the life insurance-based insuretech market, 2023 is set to be a challenging one for the sector.

"We believe the market outlook for insurtech companies remains challenged—including higher competition and unsustainable business models—despite early progress, and that venture funding will slow for the foreseeable future," wrote Robert Le, Senior Analyst, Emerging Technology at Pitchbook and author of the Q3 report. "Insurtech companies have been viewed as overpriced in the private markets—as was reflected in our index of recently listed public insurtech companies, which was down more than 75.0% over the last 12 months ending September 30, 2022."

> **"Structural tailwinds, such as the acceleration of the use of digital technology in consumer's daily lives, brought on by the Covid-19 pandemic, a tech-savvy population purchasing pretty much anything via their phone or laptop, and advances in healthcare all point to a strong opportunity set in life insurance insurtech"**

Whether 2023 is the year that life insurance insurtech begins to close the funding and activity gap on its non-life peers remains to be seen. Given the macroeconomic headwinds facing all private markets strategies, perhaps it's unlikely, and given the size of the non-life insurance market and the necessity of purchasing that insurance, perhaps it never will.

But structural tailwinds, such as the acceleration of the use of digital technology in consumer's daily lives, brought on by the Covid-19 pandemic, a tech-savvy population purchasing pretty much anything via their phone or laptop, and advances in healthcare all point to a strong opportunity set in life insurance insurtech in the medium to long term.

"Many consumers haven't gotten the life insurance coverage that they need because of logistical challenges, such as waiting months for an application to be approved or jumping through hurdles like a medical exam. We believe that shortening that timeline from months to weeks - or even minutes - can help a number of those people get covered," said Konialian. "Demand by consumers and advisors is also driving life insurance innovation. Having been exposed to simpler, integrated workflows in other domains, many advisors are not only open to what's possible, but are actively seeking out new technology for more complex life insurance cases.

There's an incredible amount of opportunity for future innovation and investment in the life insurance space, given the scale of the opportunity and the potential impact for technology to dramatically transform it."

Roundtable
Life Settlements Legal & Regulatory

Brian T. Casey
Partner, Co-Chair, Insurance Regulatory and Transactional Practice Group
Locke Lord

James W. Maxson
Partner
EM3 Law

Laura Metzger
Partner
Orrick

Jule Rousseau
Partner
ArentFox Schiff

Understanding litigation risk is part and parcel of a life settlement investor's day to day, and Life Risk News' Jeffrey Davis spoke to life settlement attorneys Brian T. Casey, Partner, Co-Chair, Insurance Regulatory and Transactional Practice Group, Locke Lord; James W. Maxson, Partner, EM3 Law; Laura Metzger, Partner, Orrick; and Jule Rousseau, Partner, ArentFox Schiff to get their views on the current state of litigation in the life settlements industry and what to look for in the coming year.

JD: Are there any cases in litigation today that the industry should be paying close attention to and what might we learn from them?

JR: We had some important Delaware decisions that have been well discussed and digested. There's the Berland decision in the Delaware Supreme Court, and the Malkin decision. They really set some new parameters in Delaware law for litigation both by insurance companies and by estates of deceased insureds. And those decisions have now led to two trial court decisions that are even more important than the Delaware Supreme Court decisions.

Berland basically handed everything - silver spoon included - to the estate, but it's going before the Third Circuit. But the trial judge was a Third Circuit judge and we're not optimistic that the Third Circuit's going to reverse a decision by one of their brethren. If that case gets locked in federal court, decisions in Delaware and state cases could all go badly for the industry.

Then we have a second case that's in Delaware State Court where the state court judge did the same thing that the federal judge did in Berland. That case we might get to take to the Delaware Supreme Court - we're waiting for the client to give us the go ahead - so there's likely going to be a fourth Delaware Supreme Court decision that hopefully will limit the way the courts have treated these estate cases in Delaware.

But if they don't, it's just an open door for litigation firms. They seem to be bringing these cases that file a lawsuit and say, "pay us money, you have no defense in the state of Delaware".

If you do get sued, in the context of the overall industry, it's a minor blip, but nobody wants to lose a $5mn or $10mn collection that they've already collected and booked into their profits for the year.

The second decision, which was a carrier case, is also a major decision, and there'll be more to come in that case as carrier cases now apply the rules from Seck. So those, those are all three important things to follow and we're all following them.

JM: There have been knock-on effects from these cases impacting the industry as well. In particular, Wells Fargo and Wilmington Trust, which act as securities intermediaries, are requiring that fund managers effectively leave funds in the securities intermediary account to cover tail risks in litigation cases.

JR: There's a case in California where they're also seeking to get Wells Fargo dismissed as merely being a pass-through for the money. If we can get a couple of decisions like that, that's going to give Computer Share and Wells Fargo a little bit more comfort that they're not going to be on the hook. Right now, they're looking at the fact that they could be found liable to an estate as well, particularly when their customer is an offshore fund that can't be sued in the United States. So, that is a crucial legal issue that we're pushing, and others representing Wells Fargo are pushing litigation too. Are the securities intermediaries going to be deemed not at risk in a state litigation?

JD: There's a continued regulatory clamp down on so-called enhanced cash surrender value transactions. What should the life settlement industry be watching for in that area?

BC: You want to be on the lookout for maneuvers by the life insurance companies to come up with a different way of doing the same thing. They have smart lawyers and product development people, so they may come at it from a different angle but try to achieve the same goal.

There are still some life insurance policies that have onerous anti-assignment clauses designed to thwart life settlements that some of the carriers were able to get away with and filed and approved by some state insurance departments. I had one that came in recently and it might be a nice follow-on opportunity for the folks that are working with the state legislators and regulators on this enhanced cash surrender value issue to go ahead and start addressing these anti-assignment clauses that are out there while they're up.

JD: What's the current lay of the land regarding whether life settlements are securities?

BC: I have a new article coming out which examines the question of whether, under state blue sky securities laws, a plain vanilla tertiary life settlement trade could be a securities transaction, and the answer is it can be, in some states. Some states have exemptions, but when you weave your way through it, some states don't.

JM: Most states have adopted that view. For instance, several years Georgia ago adopted the uniform securities act. And it just flat out says life settlements are securities, no exceptions, no exemptions, nothing. And it is pretty much universally ignored.

BC: For big life settlement investment funds, it's not a practical issue if you're an offshore fund and you're selling in a tertiary transaction. However, if you were selling to a buyer that has its principal place of business in one of these 'bad' states, then it could be a securities transaction. But by and large the funds aren't principally located in these states, thankfully.

LM: Right. And you would also have to look at the characteristics of the buyer to see if you can fall into exemptions there as well.

JD: Let's talk about things that arguably could do with being undone. For example, in some states a policy owner cannot sell a policy for five years after issuance. This disadvantages policy owners in those states that don't permit them to sell an asset that they lawfully are entitled to monetize. What are your thoughts here? And is there anything else that you'd like to flag here?

BC: Well, let's clarify that. I mean there are exceptions of course like in any area of law. So yes, there's a presumptive five-year ban, but then you have to look at the exemptions. There's one for changed circumstances, becoming terminally ill, divorced, that kind of thing. And then if it's not non-recourse, premium financed, you can do it after two years, so it's not necessarily a flat-out five-year ban.

JM: And there's really only a handful of states that have the five-year. Florida has the one that Brian just discussed that you can sell after two years if you can prove the policy was originated via a non-recourse premium finance program.

Something that I still encounter that is occasionally problematic are the minimum pricing rules. Those tend to be in the regulations rather than the statutes. But I still have clients call regularly and say, "hey, this person has a 30-month LE, and it says we have to give them 80% of face, do we have to give them 80% of face?" And the answer is, "yes, that's what the regulation says". And that sometimes results in the consumer being unable to monetize their asset because practically speaking, the policy's not worth anything close to 80% of face. And I've advised clients to tell the sellers, "Call the department of insurance and see if they're willing to tell you it's okay since we can't tell you it's okay." I'd love to see those rules revoked, but I don't know if there's much appetite by state regulators to revoke these regulations.

BC: If we had our druthers, there's all kinds of other stuff that I would clean up in the model life settlement laws, particularly in the NAIC model act. For example, there's all this securities law and investment side-isms in there because at the time the insurance regulators developed the model act, the securities regulators were really just getting up to speed on the life settlements industry.

JM: A situation happened recently where the provider sent a client a viatical settlement investment disclosure required by NAIC model act, and they were like, "what the heck is this?" And I told them to not worry about it. These aren't burning issues, but they add to the overall friction of the industry in terms of everyone complaining about how long it takes to close deals. A big part of the problem is that the statutes are so byzantine, and they vary so much from state to state. It would be great to see more uniformity but that just isn't going to happen.

BC: One other friction area I see fairly frequently is that state insurance regulators oftentimes don't understand the difference between Gramm-Leach-Bliley privacy and HIPAA privacy. They're taking the position that a HIPAA authorization has to terminate in two years. That's just not the law.

The provision in the settlement law says when you get an authorization to get information, not from a physician, but from the insurance carrier, it terminates and you have to renew it every two years or so. This creates these friction areas because either they don't understand the law or they're misapplying it.

JD: What are you seeing in the area of increased data privacy and security compliance obligations?

BC: Lots. You've got the CCPA (California Consumer Privacy Act), and acts in some follow-on states that may or may not apply to the life settlement industry depending on what data is being collected. The NAIC is revamping its Gramm-Leach-Bliley Act data privacy and security regulations, which were passed in 2000 to become more CCPA-like to give more data rights to consumers. And then you also have a species of new regulations and laws addressing artificial intelligence and machine learning, all of which ties back into to the privacy issue.

LM: I think the biggest risk to this industry right now is in these data protection acts because data is ultimately how you value the policies and restrictions on your ability to share or use that data, or requirements that make it more onerous to obtain that data, are just really bad for this industry. And I agree that it's probably an open question as to whether or not the California law might apply to some people and it might not apply to others but at the same time, I look at this as if data is managed within these laws in the right way, it potentially is their most valuable asset. And finding a way within all this regulation to monetize that data could give a completely new life to the industry because then you're not only relying on the underlying value of the actual asset, you're using data in a completely different way.

BC: I agree. The reality is that the investment funds really are in the regulatory gap on privacy laws. I think they'd like to stay that way, but it may change.

JM: One of the things that I've always thought was interesting is a lot of these life settlement laws have explicit provisions that allow you to share information in connection with the resale of a policy. But at the same time, a lot of them have provisions that say something to the effect of 'just because this law says you can do it doesn't mean there's not another law that says you can't.' This is just another example of how confusing and conflicting the life settlement laws can be.

LM: There are older policies in the market that get traded that could be impacted by these provisions and the restrictions on sale that don't have the documentation necessary to permit the sales with some level of comfort around this issue. I think that's a significant concern. I'd also be concerned if I'm trading in some of these states because if you are covered by these laws and these transactions, then when you're doing portfolio sales or policy sales, what liability do you still have? We started being much more thoughtful about this issue several years ago, specifically with confidentiality agreements and adding provisions, especially when you're dealing in Europe.

But I think that's going to become the norm now in the US and it might become more difficult to transact with certain counterparties that aren't going to be complying at the level that some firms are going to need them to.

JD: Let's talk about best interest fiduciary duty and pushing on life insurance agents to include the life settlement option to a life insurance policy, surrender or lapse. What are your thoughts here?

BC: I think it would be great for consumer policyholders and probably for our industry if there was a best-interest duty. But if the agent is not initiating a potential life settlement transaction, I don't think that an agent who represents a carrier - and is not the agent of the customer in the legal sense - would normally have a duty to the policyholder because their duties run to the carrier, not to the client. On the other, most life insurance customers perceive "their agent" as being their advisor, and oftentimes, life insurance agents can be dual agents for both a life insurer and the life insurance customer.

JM: I agree with Brian. There was a case going back maybe 15 years out of California, where a family did sue an agent because he failed to tell them about the life settlement option, and their policy lapsed, and the parties just ended up settling. The significant thing from that case was the cause of action, which withstood a motion to dismiss by the agent, created the possibility that there could be a viable claim - that if an agent fails to disclose the life settlement option, they have been negligent, if nothing else.

JD: Finally, what is the most important thing from a regulatory perspective as we head into 2023 that you think is likely to have the biggest impact on the life settlement industry?

LM: This isn't necessarily a regulatory issue, but I think one of the biggest issues is that life insurance policy inventory is low, and it is becoming more difficult to transact. Over the last year or two, there haven't been as many massive transactions as there used to be. If managers want to try to acquire some of these larger portfolios, it seems that they have to be more creative and be willing to engage in lengthier and more cumbersome ways of obtaining the underlying policies, as you saw in the battle over financing the GWG portfolio. That's a very different transaction from what we used to see two years ago, when there were 100 or 200 policies for sale, and you could buy and close them within two months. In my mind, that is both a business and legal issue for 2023. In addition, I think the GWG scenario and the allegations currently pending there does a disservice to how much the industry has cleaned up. But as a result, you might see some of the institutional investors more cautiously consider future investment.

BC: Given that the life settlements industry has been heavily regulated in about 46 states for many years, I don't expect much new legislative or regulatory activity directly aimed at this industry. But 2023 should see more regulatory action regarding enhanced cash surrender transactions and in the data privacy and security area.

JR: I think that state regulators exercising their power over providers could become a big problem, as we saw from Florida at year end 2022. As licensees, providers must respond to market conduct and investigative inquiries and if states want to make their lives hard, they have the statutory power to require a lot of meaningless information that could create headaches and expense for providers, most of whom live on tight budgets.

JM: I tend to agree that, with the possible exception of Florida, we are not likely to see a great deal of regulatory activity in 2023. I caveat that by noting if Florida does engage in a more aggressive posture, other states might also pile on. That scenario aside, I am more concerned about the state of the economy and the impact a recession would have on the life settlements industry. In 2008-2009, in conjunction with the "Great Recession" the industry saw a significant contraction from which it has only arguably recovered in the last year or so. Having another recession knock the industry back on its heels again would be disappointing when it has provided some much-needed financial help for U.S. seniors.

What's In Store for Life Settlement Funds in 2023?

Author:
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Founder & Principal
Actuarial Risk Management

When discussing what's in store for life settlements funds, it's important to consider what's come before. In 2022, public equity and bond markets both suffered double-digit losses as investors reacted to a triple-whammy of the Russian invasion of Ukraine, higher inflation in part driven by higher commodity prices, and a rising interest rate environment designed to rein in price rise pressures.

Selling pressures in the public / liquid markets translated to the private markets. Private equity and venture capital funds had to endure valuation write-downs in line with their public market equivalents. Alternative credit investments like private debt also started raising red flags as portfolio companies began to feel the strain of consumers tightening their belts.

Life settlements fit into the alternative credit bucket. But we didn't see plummeting values in life insurance policies owned by life settlement investment funds because that's not how these instruments work; we didn't see life settlement funds deviating too much from the typical discount rates they use to bid for policies; and we didn't see many forced sellers in the tertiary market. Indeed, the underlying drivers of return in the space and the lack of correlation to both public and private markets are exactly what attracts investors to them in the first place.

> “We didn't see plummeting values in life insurance policies owned by life settlement investment funds because that's not how these instruments work; we didn't see life settlement funds deviating too much from the typical discount rates they use to bid for policies; and we didn't see many forced sellers in the tertiary market”

The impact of macroeconomic events and trends in the life settlement market comes in the form of the risk/return trade-off versus other options. Demand for life settlement policies has been increasing in recent years as more investors realise the benefits of adding exposure to this asset class to a diversified portfolio; this has had the effect of dampening the discount rate at which life settlements are purchased, a classic case of increasing demand causing price pressures on the existing supply. If interest rates keep rising, and demand continues to increase, a cross-over point could be reached where the life settlement asset class offers very little risk premium over risk-free returns despite the lack of reduction of the longevity risk exposure inherent to these products.

What's different here is that investors are re-evaluating whether the classic 60/40 stock/bond portfolio is right for them. They're increasingly looking to alternative credit solutions to replace some of their government bond exposure so they can access less volatile, longer term return streams. We've seen some investors look to the life settlement market in 2022 for this exact reason and we'd expect that to continue in 2023, provided that the discount rate gap doesn't close too much.

Another factor that affects the life settlement market is the activities of life insurance companies themselves. It's important to remember that the life settlement market is a negative contributor to life insurance company performance because what the insurance company pays out to life settlement investors is higher than the surrender value they would pay to the original policyholder.

The post-Global Financial Crisis ZIRP era impacted life insurance companies' profits because they were unable to access yield from government bond investments whilst simultaneously being on the hook for higher interest rate promises to policyholders who took out coverage well before the GFC. Raising the Cost of Insurance component of a life insurance policy was one action taken by some carriers to increase revenues to address the shortfall.

> “A rising interest rate environment might be beneficial to the life settlement industry, however, because life insurance companies can access higher yielding investments which might mitigate the need for additional COI increases”

Another issue is that of ‘carrier encroachment’ – where life insurance companies buy the policies back from the insured themselves at higher values than the surrender value (but lower than what the policy holder would get from the life settlement market).

A rising interest rate environment might be beneficial to the life settlement industry, however, because life insurance companies can access higher yielding investments which might mitigate the need for additional COI increases. Additionally, the National Council of Insurance Legislators (NCOIL) passed a resolution last year which, in theory, should negate the carrier encroachment issue.

Other things to look out for in 2023 – and beyond – include the widening of the net used to model life expectancy. The industry has traditionally relied on medical reports, which vary wildly in comprehensiveness and consistency, to support their decision to purchase a life settlement. We’re seeing developments in the underwriting process ranging all the way from life insurance based insurtech to the hiring of internal life expectancy underwriters to either replace external providers or provide a second opinion to them. The other main topic that we feel is one to watch in 2023 is one of the levels of deal flow in the secondary market. Life settlement funds say there isn’t enough supply in the market but what’s also true is that the market isn’t set up to absorb a significant increase in the supply of policies in the secondary market due to operational challenges and the cumbersome nature of the bidding process.

Like many sub-sectors of the alternative credit industry, the life settlement market is set for an interesting 2023, but for different reasons. Where private debt investors see concern about inflation causing consumers to tighten their belts, thus affecting their portfolio companies, life settlement investors see concern from potential further interest rate rises eating into the risk premium that life settlements offer and dampening demand, for example. But life settlements have proven their ability to adapt in the past two decades and the industry is arguably in ruder health than ever before. It’s going to be interesting to see how life settlements performs from an absolute and relative perspective in 2023.

December 2022 Poll Results

Poll: Will Solvency II Reform Drive Increased Pension Risk Transfer Activity in the U.K. In 2023?

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The U.K. Government's recent publishing of its response to its own Solvency II consultation provided encouragement for the country's pension risk transfer market. Looser capital constraints for insurance companies could see more money available for defined benefit pension plans looking to fully insure their plans via the buy-out option.

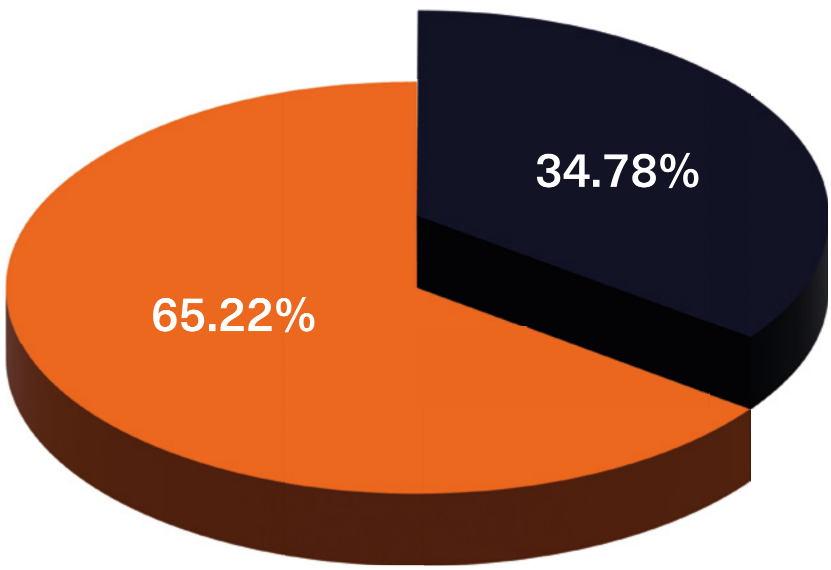
So, for this month's poll on Life Risk News, we asked our readers whether they think 2023 will deliver the first wave of increased deal flow in the sector. Approximately a third of respondents – 34.8% - think that the U.K.'s PRT market will see increased activity this year. None at all think that there are too many other headwinds, leaving nearly two-thirds – 65.2% - saying that it's too early to call one way or the other.

Perhaps 2023 is too early. But demand is at an all time high, so regardless of whether anything happens this year in terms of the British Government passing Solvency II reform, expect another busy year in the U.K. PRT market.

Yes
Less onerous capital requirements equals more bandwidth for insurance companies

Unsure
Much depends on what the actual legislation ends up being

No
Too many other headwinds exist to sustain recent activity levels



The Engine of Insurtech: The Cloud

Author:
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Celent

I need to get something off my chest. I am not a fan of the term insuretech. There, I said it. I can't help it—lexical pedantry runs in my family.

It's not that I am against the idea of putting technology to productive use in the insurance industry. Rather, it's because insuretech seems like nothing new. Insurance and technology form a mix that's over 70 years old. Insurance carriers were among the first companies to use computers when they became commercially available in the 1950s. For decades, insurers have been adopting technologies commonly associated with insuretech, including artificial intelligence, geospatial analytics, and telematics. Digital distribution of insurance has been around almost as long as the Web itself.

The etymology of insuretech was not originally about insurers using technology to improve their businesses. Rather, it was—and still is—the story of venture capitalists trying to put incumbent insurers out of business (or at least drink their milkshakes). Private equity firms have invested billions of dollars in startup insurers that promise transformative improvements in value delivery and efficiency through technology.

If there's a tech in insuretech to emphasize, it's probably cloud computing. Insuretech firms tend to be heavily reliant on the cloud. In many cases, their products would be impractical to deliver, and their value propositions would be irrelevant, without the cloud. This is true of insuretech insurers, distributors, and solution providers alike.

> **"The increasing ubiquity and maturity of cloud paradigms, platforms, and providers is, in my opinion, the real engine of insuretech. The cloud has magnified the value of a host of other technologies and created synergies among them"**

The increasing ubiquity and maturity of cloud paradigms, platforms, and providers is, in my opinion, the real engine of insuretech. The cloud has magnified the value of a host of other technologies and created synergies among them. The opportunity for startup insurers to disrupt incumbents is largely rooted in their willingness and ability to go "all in" on the cloud. It allows them to generate compelling advantages in scale, network effect, and process efficiency.

Carriers see the writing on the wall. They know they will eventually need to replace their old technology powerplants with cloud-based engines, but most are struggling to make progress. Some have barely started their journeys. With well-funded insuretech carriers trying to put them out of business, one would think that incumbent insurers would move faster, but there are major challenges.

Cost. The cloud is not always cheaper. In addition to implementation costs, carriers face potentially more expensive ongoing fee structures. Monthly service charges may seem like a raw deal compared to an upfront purchase price and modest monthly maintenance fees. Modeling the cloud's return on investment and building a credible business case for the CFO can be tricky.

Capacity. IT departments are overburdened with other projects. It is hard to find time for cloud migrations when everyone is already busy trying to replace legacy core systems, modernize customer experiences, and implement better analytics. Ironically, insurers would find themselves better equipped to chip away at the innovation backlog if they could accelerate their migration to the cloud.

Complexity. With numerous cloud vendors, the largest of which have scores of product offerings, it is difficult to select the right mix of platforms and providers. Insurers are taking their time to get it right. No one wants to build a technology house atop a shaky foundation.

> "The full potential of the cloud cannot be realized by simply migrating or replacing existing systems. Rather, it requires that insurance companies reimagine how they do business to leverage the inherent advantages of the cloud"

Capability. Fundamental differences in the cloud, compared to traditional technology architectures, require new processes for developing software, managing data, ensuring security, and more. New processes, in turn, require new roles, skillsets, and tools, as well as a greater reliance on vendor partnerships. These capabilities take time to develop.

Coherence. The full potential of the cloud cannot be realized by simply migrating or replacing existing systems. Rather, it requires that insurance companies reimagine how they do business to leverage the inherent advantages of the cloud. Coherence between business strategy and technology strategy can be difficult to achieve when for decades they have been developed separately.

Carriers that can overcome these challenges will be able to deliver better value to their customers while also realizing cost efficiencies. More importantly, these cloud-based carriers will improve their ability to adapt to changing conditions, making their competitive advantage more sustainable.

Perhaps one day, someone will invent a clever portmanteau for cloud-based insurers. (I'd suggest calling them insurecloud carriers, but a few solution providers have already adopted some variation of it for marketing purposes.) On second thought, why bother? Eventually, all insurers will be cloud insurers, eliminating the need for yet another term.


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Q&A

Scott Willkomm
CEO, Life Equity, & Chair, European Life Settlement Association

The European Life Settlement Association recently returned Life Equity CEO Scott Willkomm as Chair. Life Risk News' Greg Winterton spoke to Willkomm to find out his views on the life settlement market generally and what 2023 has in store for ELSA.

GW: Scott, let's start with ELSA. What were some of the highlights of 2022 for the association?

SW: I'd point to a couple of things. Firstly - and this isn't quite specific to 2022 - is that in the last few years we have significantly increased our membership and industry engagement. ELSA's membership has doubled since 2018; we're now at 34. We want to position ELSA as the forum of choice for institutional investors looking at life-based secondary market investments for inclusion in their broader portfolios. Developing the code of practice and the master agreement for tertiary transactions are two endeavours that were designed to support that goal. We're making good progress in involving institutions into the conversation now.

Secondly, I think we've done a good job of demonstrating resilience and adaptability during the Covid-19 pandemic. Like everyone else, we adjusted to virtual events and communication; this was important as the pandemic highlighted the importance of understanding life risk amongst capital market participants and ELSA was able to demonstrate its strengths as a thought leader as well as provide a platform for discussion on the pandemic's wider impact.

The conferences we produce have continued to be some of the most sought after and best attended forums for networking in the life settlement industry, but we've also been expanding the audience with the life ILS event. Both of our conferences reach a broader universe and the fact that appetite amongst our members to return to in-person events this year validates what we're trying to do in terms of both networking and education.

Also, it would be amiss to not mention the launch of the Life Risk News publication as a highlight. The initiative behind the magazine was that we wanted to create a public forum for information dissemination not only in our space but more broadly with regards to life-linked investing. The first six months have been encouraging, and the magazine is hitting its stride now. We're starting to do more in-depth discourse – topical discussions that are of interest to our membership and our readership.

GW: What about some of the frustrations?

SW: I'm not sure I'd use the word 'frustrations' but there are things where I'd like to see us get better. Historically, we haven't really done much in the way of academic research and in-depth analytical content. And that's important because not only can it provide additional insights to our members and the industry at large, but it adds credibility as well. So, what we're doing now is the groundwork to launch a Research Committee which will take the lead on engaging with academics and that wider world to produce more in-depth, analytical content that we think will enable life settlements and broader life-based strategies to get a more consistent seat at the institutional investor table.

In a similar vein - and again I wouldn't call this a frustration, it's simply another area where we want to improve - would be more discussion in Life Risk News about critical actions that are going on, and the real-world implications about valuing life risk. We're getting there, though – the first six months of Life Risk News has been largely about producing more foundational content to educate the audience on the basics and now we'll look to go to the next level in 2023.

GW: Moving onto the life settlement market more generally now. From your perspective as a provider, as CEO of Life Equity, what trends emerged or changed in the market in 2022 and what was the impact on firms like Life Equity?

SW: Something I've noticed this year is that while we've seen some new brokers enter the market, and some formerly active brokers re-engage with it, we haven't seen the type of investment in market expansion from the broker side that I would have liked to see. Supply issues do plague the secondary market in the life settlement industry and even though there has been an uptick in deal activity in 2022, I think some of that is catching up from Covid-19. The brokers in the space tend to focus on higher value policies, which is understandable to a point, but there are plenty of policies that could turn into a life settlement that we never see because of this. I'm hopeful that as we begin the new year that more brokers in the industry expand the range of policies that they would consider.

GW: In terms of 2023, will these trends continue, or were they short term aberrations, and what else is on your radar to keep an eye on more generally this year?

SW: Obviously, with regards to the broker point I made, time will tell. In terms of other things on my radar, there are real business issues we, the life settlement industry, should be talking about and engaging with relevant groups. There is a lot of disparity in our industry in terms of stakeholder focus – there isn't enough collaboration going on and all the constituent groups need to do better in terms of talking to each other and supporting each other to move our industry forward.

GW: Finally, Scott, back to ELSA. What are some of the association's goals for 2023? Is there anything new coming down the pipe?

SW: The Research Committee is the new initiative we have. It will be finalised shortly and will begin planning probably before the end of the first half of this year. As I've already mentioned, getting Life Risk News to cruising altitude is another goal. I would hope that by the end of 2023, after 18 months of publishing, we'll have gotten to that point where it's a go-to place for the industry.

One of the things about the life settlement industry is that it seems to struggle to find legitimacy or believe in its own legitimacy. It has a bit of an inferiority complex when compared to the reinsurance world, for example. The efforts on the Research Committee side and investing in and expanding Life Risk News will enable us to get a more permanent seat at the table. We have something to say, and not enough of the right people are hearing it at the moment; we're confident these initiatives, added to our growing conference franchises, will help to solve for that challenge.

Life ILS Market Opportunities and Challenges To Be Addressed at Life ILS Conference

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The life ILS market, despite its smaller size compared to other alternative credit strategies, is more than two decades old; indeed, it expanded in the ashes of the global financial crisis as life insurance companies and others looked to the capital markets to reduce their longevity and mortality exposure and look for alternative liquidity options.

Today, life risk is very much a discussion point for markets, investors and policymakers as the world learns not only to live with the Covid-19 pandemic but to attempt to understand the medium to long term impact of the virus on both the broader population and specific subsets of it.

> **"Life Risk News is bringing together investment managers, investors, mortality and longevity experts to discuss and debate the wider issues facing the life risk markets today, at the forefront of which will be the positive contribution capital market participants can have in the development of the Life Risk markets"**

Life Risk News is bringing together investment managers, investors, mortality and longevity experts to discuss and debate the wider issues facing the life risk markets today, at the forefront of which will be the positive contribution capital market participants can have in the development of the Life Risk markets to provide liquidity, which provides a significant societal benefit, and provide investors with access to return streams that aren't correlated to traditional financial markets, enabling additional diversification and volatility smoothing.

Chris Wells, Managing Editor at Life Risk News, says that the event has never been more topical.

"2022 was a case in point that traditional markets can all move in lockstep and that exposure to alternative return streams can provide not only portfolio defence but in many cases, true alpha returns as well. Geopolitical and market challenges remain as we enter 2023, and the life ILS market is one that stands ready to support investors."

Mortality and longevity risk are the primary risk exposures in the life ILS market, and life insurance companies are the most common counterparty. Technology innovation in the form of insurtech is driving significant change at life insurance companies in terms of both the underwriting and sales processes, which in turn provides benefits to consumers in terms of better choice, better pricing, and better coverage. This provides more opportunities for life insurance companies to work with the life ILS market to access capital at compelling prices, supporting them with transferring risk off their balance sheets.

"The symbiotic relationship between life companies and the life ILS market works well for both sides but innovation from both the technology side and the investment side is opening up more opportunities than ever for the life ILS space," said Wells.

That's not to say that the next 12-24 months will be plain sailing for the life ILS market. Alternative credit allocations like life ILS are under pressure from more liquid debt strategies that are now delivering a higher yield, and there is continued uncertainty around mortality trends; life expectancy in the United States decreased in 2021 for the second consecutive year; according to the country's Centers for Disease Control and Prevention, at birth, the average American is now forecast to live to 76.4 years old, down from 77 years old in 2020.

The challenges and opportunities in the life ILS market are numerous and nuanced, and the Life ILS Conference 2023 is set to provide investors, asset managers and service providers with informative discussions and networking as the life ILS market continues to make its case for a more permanent space in institutional investor portfolios.

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