

Life, death and structures

Turning life insurance into an investment product is a risky endeavour with a shady past. Now a new consortium is trying to build the first large-scale business in this area. Navroz Patel takes a look at the shadowy world of life settlements

A disgruntled spouse bringing about the untimely demise of his or her other half in order to cash in on a life insurance policy is a scenario beloved by crime writers. But monetising life insurance doesn't have to be quite such a grisly affair. In the past few years, a niche secondary market for life insurance policies – albeit an extremely illiquid one – has emerged in the US, with a handful of licensed brokers now permitted to buy and sell policies.

The market for life settlements – the name given to the policies of senior citizens with somewhat impaired health, sold to third parties – is still relatively small. Analysts estimate the size of the market is somewhere around \$6 billion. Now a newly formed consortium, Lake Shore, is taking on the myriad risks associated with life settlements, and is attempting to create the first large-scale business selling structured notes based on the securitisation of portfolios of life settlements.

Lake Shore expects to close its first deal, with a notional of around \$250 million, by early October. "The problem with the life settlement industry, to date, is that it has been about one-off deals – that is not what we are about," says Philip Baker, a London-based managing partner of Lake Shore Asset Management – a member of the Lake Shore consortium.

"We are building a life settlements structured products machine here."

Although the new business operates under the Lake Shore brand, the enterprise is actually a strategic alliance between: Lake Shore Asset Management, an investment management firm based in London specialising in exchange-traded derivatives strategies; Risk Capital Partners, a New York-based boutique insurance consultancy and brokerage; a network of licensed life settlement brokers that procure policies; and an undisclosed US investment bank whose structured products team has put the deal together.

Lake Shore claims it already has around \$800 million worth of orders from banks and institutional investors wanting to sell on the product to their high-net-worth clients. "We can create a very attractive structured product. It is uncorrelated with the bond and stock markets," says Baker. Typical net yields could be 500–600 basis points, but Baker says each product is structured to suit the needs of the client. In broad terms, Lake Shore's clients will have the choice of either a note with a fixed coupon, or what the firm refers to as an opportunity basket. In the latter case, some of the client's potential return is redeployed to Lake Shore Asset Management, which puts the capital to work in one of its exchange-traded derivatives strategies.

Buyers of life settlements are taking

on longevity risk – that is, the risk that the insured senior citizen will live longer than actuarial tables imply, meaning the death benefit will not adequately compensate the buyer for the premiums it pays. However, the potential profits for those willing to take the longevity, regulatory and compliance risks associated with the product are substantial.

This explains why most of the major structured product groups on Wall Street are attempting to initiate or expand their life settlements business. Although Société Générale is not active in the US life settlements market, John Chauvel, a managing director in the French bank's securitisation group in New York, says his firm is seeing an increasing flow of potential deals. "Life settlements appears to be becoming a principal business, where banks buy portfolios of accumulated assets and either carry them on their book or warehouse the risk before exiting through the asset-backed securities market."

Wall Street structured products groups aren't exactly falling over themselves to publicise their growing interest and involvement in the US life settlements market. Alongside the significant capital and infrastructure required to build a sustained life settlements business, banks have to be prepared to take on significant reputational risk. "Despite the potentially large profitability of life settlement arbitrage, banks struggle with the tainted nature of the asset," says one East Coast insurance structured products specialist. "Whether you call it longevity risk or mortality risk, you are in essence pricing and profiting from someone's death."

However, Alice Yurke, a New York-based structured transactions attorney at law firm Morrison Foerster, believes attitudes are changing. "The negative cachet is fading. When it comes down to it, life settlements are simply about allowing the insured to monetise their policies," she says. "Given demographics, the market has huge potential, which is why investment banks are getting involved."

Life settlement specialists *Risk* spoke to say that among investment banks, Credit Suisse First Boston (CSFB) is the largest player in the life insurance structured transactions market. It acquired ING's US premium finance business in January 2005. The firm is a major player in the financing of high-net-worth individuals' life insurance premiums. In these transactions, CSFB creates a trust on behalf of an individual policyholder that borrows money from CSFB to finance the premiums of a newly initiated life insurance policy. The policy itself serves as part of the collateral for the loan made by CSFB.



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"Those firms that succeed in building a true life settlements business will be those able to devote capital and warehouse risks when required," says Jeremy Bennett, London-based global head of credit and insurance structuring at CSFB. "Volumes are insufficient to drive meaningful securitisation business currently, but it is possible to do transactions on an ad hoc, deal-by-deal basis."

But there has been one large non-private deal launched into the market. Last year, Merrill Lynch and Legacy Benefits, a New York-based life settlements specialist, offered a glimpse of what could become a vibrant part of the asset-backed securities market. The \$70.3 million Legacy Life Insurance Settlement 2004-1 deal closed in February 2004 and was the first rated life settlement securitisation. "By the time the deal had ramped up, the portfolio included several hundred underlying life insurance policies," says Morrison Foster's Yurke, who worked on the deal. "From a ratings perspective, it was important to reach this critical mass without concentration risk."

The Legacy Benefits deal was an important milestone for the life settlements industry, which is still struggling to shake off negative perceptions of the product. As one New York-based securitisation specialist puts it: "Some of the operators who have originated these assets have been involved in ethically and

sometimes legally dubious practices."

The life settlements industry has its modern day roots in the emergence of the Aids epidemic in the late 1980s. So-called viatical transactions allowed the terminally ill to monetise their life insurance policies and receive cash while they were still alive to pay for costly medical care. Some investors in viatical deals were the victims of fraud, as unscrupulous viatical settlement companies got healthy individuals to impersonate terminally ill Aids and cancer patients during medical examinations.

Twenty years later, Lake Shore's Baker says the advance orders from institutional investors for its new life settlement structured product deals demonstrate that sophisticated institutional investors are now comfortable with this asset type.

But beyond the operational and legal risks related to purchase of policies, Lake Shore has a tough risk management challenge in mitigating its mortality risk. Nemo Perera and Chris DeSilva – managing partners at Risk Capital Partners – are responsible for developing this aspect of the business. If the underlying insured's mortality does not follow the projected mortality curve – that is, they live longer than actuarial models suggest – Lake Shore has to pay more insurance premiums than it initially thought it would, and is also subject to liquidity risk due to the delay of payment of the death benefit.

To mitigate this risk, Lake Shore has

**Philip Baker,
Lake Shore**

negotiated bonding – effectively reinsurance that covers longevity risk – with property and casualty insurers. The risk model developed by Risk Capital Partners involves stress testing and use of Monte Carlo simulations to analyse how the profitability of a transaction is affected by changing life expectancies of the underlying insured. "So we calculate at what date in the future we are fairly certain that a given percentage of the underlying pool would pay off a death benefit," says DeSilva. "Then we put on insurance to cover the possibility that this mortality expectation is not reached." Of course, selection of the underlying policies before the deal is structured also plays a critical role in the success of putting a deal together and sourcing bonding. The typical individual whose policy is suitable for a life settlement transaction is 70 years of age or above, with slightly impaired health that doesn't compromise insurability.

It was originally envisaged that the bonding element of the transaction would be the trickiest aspect of the venture, says Lake Shore's Baker. "It's a complex area, but we believe we can source bonding in the market. And there seems to be great demand from investors across the globe," he says. "So it's actually the life settlement procurement process that is likely to determine the speed of growth of our business." ■