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Success of US traded life policy market depends on the development of a robust regulatory framework, says Pensions Institute

Today, the Pensions Institute at Cass Business School in London publishes a new report, 'And death shall have no dominion: Life settlements and the ethics of profiting from mortality', which assesses the regulatory and ethical concerns for investors in US traded life policies (TLPs).

The multi-billion dollar market in TLPs, also known as life settlements, claims to offer institutional and retail investors an attractive and comparatively low risk alternative asset class that can play an important role in diversification, as mortality experience is not correlated with equity and bond markets. However, since the asset class emerged in the mid-1990s, regulation – which is at US state rather than federal level – has not kept pace with the growth in the size and the complexity of the market. Inconsistencies in regulation currently affect the reputation of the market and raise questions over the ethics of 'profiting from mortality'.

The market in TLPs – worth in excess of $13bn and expected to grow to $160bn over the next few years – has attracted interest from major investment banks, insurance companies, asset managers, hedge funds, and pension funds. In addition to the direct market in policies, financial institutions have also established a synthetic life settlement market, which offers institutional investors products that replicate the investment in a portfolio of life settlements. Separately, retail funds are emerging in the 10 largest OECD countries.

Key findings of the report:

- The move to more consistent and rigorous regulation across US states should enhance policyholder protection, improve market transparency and reputation, and provide better data on market size and potential growth.
- The report concludes that there would appear to be no particular ethical issues associated with investing in this asset class that distinguish it from well-established pensions and life market investments that are also based on mortality projections, provided that products and processes are fully transparent to all parties, including the original policyholder and the end investor, and provided that the privacy of the policyholder is safeguarded. With full transparency, private investors can choose whether or not to invest in life settlements in accordance with their personal views and beliefs, while institutional investors can consider the ethics of the asset class in relation to any socially responsible investment strategy that is in place.
- The 'cash-based' longevity risk instruments that currently predominate (i.e. life settlements) might be expanded over time by the trading of exposure to pools of similarly medically underwritten older-age persons, without direct reference to policies. This trend will accelerate if major investors become more discriminating about the non-longevity risks of policies (or policy-linked exposures).

The market for TLPs is based predominantly on US 'whole life' policies sold by 'seniors' aged 65 and over, who have a medical condition that reduces their life expectancy, typically to between three and 15 years. Unlike term assurance, which runs for a fixed period, whole life policies last a lifetime and in most cases are assignable, which means that a third party can buy the policy, maintain the premiums, and receive the benefits on the original policyholder's death.

The report says that the benefits of the market include:

- Additional liquidity for policyholders, who no longer need the life insurance and who might get a higher cash sum in the secondary market than the surrender value offered by the issuing insurance company.
- It makes available to institutional and private investors an alternative asset class, based on portfolios of life settlements or of longevity risk linked to groups of older-age individuals (whether owned directly or via pooled funds), that claims to offer an attractive and comparatively low risk-return trade-off compared with equities, and which also provides diversification of investment risk, since life expectancy is not correlated with returns in equity and bond markets.
- Institutional investors might also benefit from the growing interest in synthetic structures that replicate direct investment in life settlement portfolios, since synthetic transactions appear to remove some of the risks and concerns related to cash policies.

However, the report also raises concerns about the market as it operates at present:

- Data protection is not guaranteed: personal details, including the policyholder's medical condition and the contact details of the policyholder and beneficiaries might be passed on to intermediaries and investors.
- Regulation is inconsistent. The market is regulated at US state rather than federal level (as is the case with the US insurance industry as a whole) and is undergoing review and reform in many cases. However, not all states regulate the market and those that do tend not to adopt common rules.
- If overly optimistic mortality assumptions are used to price policies, this will inflate the cash sums paid to policyholders (and also the intermediaries' sales commission) and reduce the potential return on life settlement portfolios and funds.
- There is the potential for market distortions associated with 'stranger-originated life insurance' (STOLI) practices, where seniors are persuaded to take out insurance through a 'premium financing' arrangement, whereby an investor provides a loan or pays cash to cover the cost of premiums, with the intention of buying the policy in due course. US life insurers are concerned that such practices could distort the primary purpose of life insurance, which is based on an insurable interest between an insurer, a policyholder, and a beneficiary, and is not intended for speculative investment purposes. Moreover, STOLI cases could be contested in the courts and the benefits paid to the family rather than the investor.
- Some investors with specific ethical concerns about mortality-related products might inadvertently invest in life settlements due to lack of transparency, for example, in the case of hedge funds. This issue might also arise where individuals are beneficiaries of institutional funds, or funds of funds, that use life settlements to diversify risk, for example, pension funds and charities.
- The secondary market could reduce the percentage of policies that lapse and therefore affect insurers' profits. This might have the knock-on effect of increasing life insurance premiums for older ages.

David Blake, Director of the Pensions Institute and co-author of the report, says: 'Policyholders who sell into the secondary market must understand that a third party will profit from their death, while investors must appreciate that their return is based on the successful prediction of the date of death of the original insureds whose policies are held in the fund or portfolio. However, provided appropriate safeguards are in place, life settlements should not raise ethical issues that are not present in other mortality-linked investments, such as pensions, annuities or reverse mortgages'.

Debbie Harrison, a Senior Visiting Fellow of the Pensions Institute and co-author of the report, says: 'The emergence of synthetic structures that replicate an investment in life settlement portfolios could be of considerable interest to institutional investors seeking exposure to older-age US longevity risk. Such structures could eliminate exposure to policy-related risks, such as reputational risks in relation to how policies are sourced, and cross-border tax risks'

David Blake and Debbie Harrison, 'And death shall have no dominion: Life settlements and the ethics of profiting from mortality, Pensions Institute, July 2008, www.pensions-institute.org.

For more information contact:

Caleb Hulme-Moir, Press Officer, Cass Business School
020 7040 5147; 07866 707262; c.hulme-moir@city.ac.uk

Debbie Harrison, Senior Visiting Fellow of the Pensions Institute,
01992577420 / 07742 552807; debbie.harrison@virgin.net

David Blake, Director of the Pensions Institute, d.blake@city.ac.uk

About the Pensions Institute

The Pensions Institute at Cass Business School was founded by Professor David Blake in 1996. As the first and only UK academic research centre focused entirely on pensions, the Institute brings together a broad range of disciplines from economics, finance, insurance, and actuarial science through to accounting, corporate governance, law, and regulation. The objectives of the Pensions Institute are to undertake high quality research in all fields related to pensions, to communicate the results of that research to the academic and practitioner community, and to employers and trustees.