

Life Settlements

Life Settlement Securitizations Offer Hedge Funds Efficient Access to an Inefficient Market

By Jennifer Banzaca

As discussed in previous issues of The Hedge Fund Law Report, hedge funds have discovered in life settlements the potential for absolute, uncorrelated returns – a particularly attractive investment proposition on the heels of an era in which assets heretofore considered uncorrelated actually rose and fell (mostly fell) as a group. Specifically, in our October 1 issue, we provided a detailed overview of the primary legal and business considerations applicable to hedge funds when investing in life settlements. See “Hedge Funds Turning to Life Settlements for Absolute, Uncorrelated Returns,” The Hedge Fund Law Report, Vol. 2, No. 39 (Oct. 1, 2009). Then in our October 7 issue, we focused on the most salient tax considerations for hedge funds investing in life settlements, including discussions of income versus capital gain considerations, offshore versus onshore issues, implications of treaties for structuring and related issues. See “Key Tax Considerations for Hedge Funds When Investing in Life Settlements,” The Hedge Fund Law Report, Vol. 2, No. 40 (Oct. 7, 2009).

This article – the third in the three-part series – focuses on the ability of hedge funds to invest in life settlements via securitizations, rather than directly. The goal of the article is to help hedge fund managers that seek to access the life settlements market determine the most efficient way to do so. To effectuate that goal, this article discusses: the mechanics of life settlements and life settlement securitizations; ways in which the risk profile of life settlement securitizations differs from the risk profile of other, more typical types of

securitizations, such as those involving mortgages; real world examples of life settlement securitizations; reasons why life settlement securitizations are relatively infrequent; testimony at securitization hearings held on September 24, 2009 before the Capital Markets Subcommittee of the House Financial Services Committee; the financial, operational and regulatory benefits of life settlement securitizations; the various downsides of life settlement securitizations; salient points raised during the recent “Life Settlements and Longevity Summit” sponsored by the International Quality and Productivity Center; anticipated regulatory developments at the federal and state levels; and life settlement swaps.

Life Settlement Securitization

As described in the previous articles in this series, a life settlement is the process whereby an investor (often a hedge fund) purchases a life insurance policy from the “insured,” the person who originally purchased the policy. The hedge fund or other investor pays the insured an amount greater than the cash surrender value of the policy – in effect, the trade-in value of the policy as determined by the originating insurance company – but less than the death benefit, in exchange for the right to collect the death benefit. After purchasing the policy, the hedge fund or other investor assumes the obligation to continue paying premiums until the maturation of the policy (that is, until the death of the insured). Life settlement investors can monitor the timing of the death of the insured through so-called tracking agents.

According to Boris Ziser, a Partner with Stroock & Stroock & Lavan LLP, the process of securitizing life settlements is similar to the process of securitizing other assets. “In terms of structure,” he said, “it’s very similar to any other asset-backed structure. You would aggregate a pool of life insurance policies and you would transfer them to a bankruptcy-remote special purpose vehicle which would issue securities that are backed by the cash flows that will be received from the policies that are in the pool.” Rachel Coan, a Partner with Katten Muchin Rosenman LLP, noted that most of the life settlement securitizations that have been consummated have been structured as Rule 144A, Regulation S or other private placement transactions.

Different Risk Profile Vis-à-Vis Mortgage Backed Securities

Ziser pointed out a key difference in the risk of securitized life insurance policies versus another commonly securitized asset: mortgages. In the case of mortgages, especially those made to lower credit quality borrowers, buyers of the securitized cash flows – that is, of notes that represent a claim on such cash flows – are exposed to the credit of underlying borrowers, or more specifically, the average credit of the mortgagors in the pool. In the case of securitized life insurance policies, on the other hand, the buyer is exposed to the credit of the original insurance company because the ultimate “principal” payment on the note will come from the death benefit payable by the insurance company.

But there is another key distinguishing feature between life settlement securitizations and more typical securitizations, such as those involving mortgages. Coan, of Katten, noted that in life settlement securitizations, the timing of cash flows are difficult to predict because the individual insureds

in a pool may live longer than expected – this is the so-called “longevity risk” inherent in life settlement investing. Similarly, there may be fewer deaths than expected in the years immediately following a securitization, which from the investor perspective results in an effective outflow of cash for premiums (either a discounted amount at the inception of the securitization or periodic amounts, depending on the structure) with no offsetting inflow.

Coan described the manner in which life settlement securitization sponsors (typically investment banks or life settlement providers) address this timing of cash flows issue. “In a typical securitization, the issuer would sell notes with a 10 or 15 year maturity,” she stated. “To get over the lumpiness or potential unevenness of the cash flows over the term of the notes, you may need to build into the structure certain types of credit enhancement, such as a liquidity facility that the issuer can draw on or a reserve account, in the event cash flows are insufficient to pay premiums and other expenses, as well as current interest. Another idea involves notes that have interest that’s not payable for a period of time. Some people have also discussed combining a pool of life settlements with a pool of structured settlements – i.e., annuities that are obtained to settle class action lawsuits in tort claims – so that there is a countervailing set of cash flows that may be more steady over the course of the notes.”

Examples of Life Settlement Securitizations

To date, life settlement securitizations have been frequently discussed, but infrequently executed. The most recent life settlement securitization took place in January 2009 when Risk Finance, a unit of AIG, led a securitization of more than 2,000 life insurance policies with a face value of approximately \$8.4 billion. The Risk Finance securitization was structured as a private placement.

Another securitization occurred in March 2004. In that case, life settlement provider Legacy Benefits Corporation concluded a rated securitization of a pool consisting primarily of life policies, but also including annuities. The transaction was underwritten by Merrill Lynch and rated by Moody's.

In other cases where life insurance policies have been securitized, the policies have often been pooled with other insurance-linked assets (as was the case in the Legacy Benefits transaction), such as catastrophe bonds, annuities, structured settlements and reinsurance recoverables. Thus a pure life insurance securitization is relatively rare. On catastrophe bonds, see "The Hedge Fund Transparency Act and its Unintended Consequences for Cat Bonds," *The Hedge Fund Law Report*, Vol. 2, No. 20 (May 20, 2009).

Rationales for Infrequency of Life Settlement Securitizations

On September 24, 2009, the Capital Markets Subcommittee of the House Financial Services Committee held hearings on "Recent Innovations in Securitization" that focused on, among other things, life settlement securitizations. At those hearings, Daniel Curry, President of rating agency DBRS, testified that DBRS has reviewed 14 proposals for life settlement securitizations but has not issued any ratings with respect to those proposed securitizations. Two of those proposals are still under consideration while the remainder did not meet DBRS' ratings criteria or did not proceed for other reasons.

Steven H. Strongin, Managing Director at Goldman Sachs & Co., testified during the same hearing that just over \$1 billion in life settlements have been securitized since 2000. "This remains one of the smallest and most sporadic of the

securitization sectors, and while we have never been involved in a life settlement securitization, we see little investor interest in such a market given its size as well as numerous structuring challenges," Strongin told the Subcommittee.

However, Katten's Coan disagreed with the idea that interest in life settlement securitizations has been minimal. "While there haven't been that many that have closed to date," she observed, "there is a lot of interest in doing securitizations and making the process work. Among the factors to be evaluated include the extent to which investors feel the need to buy notes that are rated and the added cost, time and expense that a rated deal takes to complete, versus the return on the various tranches of notes. In a rated transaction, the investors' expectation would be that the model for performance of the underlying portfolio would be tested more rigorously than in an unrated transaction, leading to lower levels of risk in the notes. However, if the returns were attractive enough, certain investors might be willing to invest in a securitization even without a rating."

But Bryan Freeman, President of life settlement provider Habersham Funding LLC, noted additional challenges in executing life settlement securitizations. For one, the potential issuer would need significant cash and liquidity up front to buy the amount of policies needed for a successful and sufficiently diversified securitization. "You also need to have the market access to be able to buy that many life settlements and most people in the industry just don't have that. So, just the scale needed is one of the biggest things that has prevented these securitizations from happening."

Benefits of Life Settlement Securitization

Life settlement securitizations offer various potential benefits to hedge fund investors, both on an absolute basis and also

relative to other types of investment in life insurance policies or life settlements.

Uncorrelated Assets

On an absolute basis, the return on the notes issued in a life settlement securitization will not be closely correlated with the return on other assets. Securitization does not materially change this benefit of life settlement investing.

Diversification

However, securitization does offer efficient diversification, especially relative to independent attempts to compile a life settlement portfolio. That is, investing in securitized life settlements offers immediate diversification, while attempting to compile a diversified portfolio of life settlements independently can result in concentration, high costs and ramp-up risk.

Avoidance of Ramp-Up Risk

Ramp-up risk is the risk that a party trying to assemble its own pool of life settlements will not do so quickly enough – that is, that the outflows during the assembling of the pool will outweigh any potential returns on the pool. As explained by Thomas Weinberger, another Partner at Stroock: “Until you buy a certain number of policies, you’re at risk that someone living too long would throw off your whole investment. You can avoid that by investing in an existing pool through a securitization structure, but it’s expensive.”

Outsourced Monitoring of Longevity Risk

Yet another advantage of investing in life settlements via securitization as opposed to directly is the ability to

“outsource” initial due diligence and ongoing monitoring (e.g., of whether the insureds in the pool are still alive) to a third party, namely, the securitization sponsor or its agent. However, this outsourcing has at least two downsides: first, fees, which can be considerable because the area is more bespoke than other investment categories, and second, error, or the possibility that the sponsor will misjudge relevant risks.

Benefit to Consumers and Potential Regulatory Receptivity

During the Capital Markets Subcommittee securitization hearing on September 24, Kurt Gearheart, Global Head of Regulatory and Execution Risk in the Life Finance Group at Credit Suisse, identified another benefit – that securitization would offer consumers another way to monetize their life insurance policies, which could result in higher cash payments for policies (from insurance companies and other sources). Stroock’s Ziser echoed this point, noting that securitizing life settlements “will create a more efficient market by increasing competition for policies. Because securitization will be an available source of financing for those policies, consumers will benefit because they will be able to command higher prices for their policies.” Regulators may be more receptive to life settlement securitizations if life settlement securitization sponsors and other life settlement industry participants can persuasively demonstrate the potential benefits to consumers.

The Downside of Securitization

On the other hand, there are also potential drawbacks to life settlement securitizations, both from the investor and sponsor perspective.

Limited Liquidity

Most significantly, because only a relatively small number of policies are available to create pools, the ramp-up period necessary to build a diverse portfolio can be long, costly and uncertain.

Capital Intensive

As Habersham Funding's Freeman noted: "You need a large scale of policies and you need a lot of cash to buy them and maintain them before you can even think of securitizing them and getting them rated." Freeman also emphasized this point, noting that a life settlement securitization sponsor needs a significant amount of cash to purchase the volume and depth of policies required for both diversification and cost-spreading. On costs, Freeman noted that scale can be a benefit in life settlement securitization because certain fixed costs can be spread over a wider base of policies. On the other hand, the absence of scale can be an impediment.

Minimum Required Number of Policies

On September 29, 2009 and October 1, 2009, the International Quality and Productivity Center held a "Life Settlements and Longevity Summit" in New York. During a panel titled "Securitization of a Life Settlements Pool: Uncovering New Opportunities for New Kinds of Investors," speakers noted that the minimum number of policies often cited by rating agencies as required for a life settlement securitization to be viable is 300. However, the speakers noted that the actual number is likely closer to 500 because not every policy would be a diversifying asset to the pool. With the average face value of a policy estimated at \$1.2 million, an issuer would need roughly \$500 million to \$1 billion in order to fund the policies.

Bespoke Assets

Weinberger added the while assembling a large enough pool of policies is daunting, an additional challenge is collecting the right pool with the right parameters. "You have to remember that unlike other assets where there may be much more uniformity in the type of asset, these are all unique and have different properties and you really have to get the right blend and that takes time."

Infrastructure

Coan noted that even if a manager or issuer were able to finance the purchase of the requisite number and diversity of life settlement policies, the issuer still would need sufficient infrastructure to conduct proper due diligence and servicing. "In a way, the due diligence process doesn't differ that much in a securitization transaction from an investment in the physical policies," Coan explained. "Whether one is evaluating a pool or individual life settlements to purchase with the intention of holding them as an investment or with the intention of securitizing them, very careful legal due diligence needs to be done to confirm the validity of each policy on the date of issuance and the chain of title of that policy from the original policy owner to any successor owners."

Specifically, Coan suggested: "You need to examine carefully the original application by the original policyholder to make sure information such as the name, age, sex, health impairments, social security number, net worth and all the identifying information with respect to the individual seems to be consistent with any other information about the individual set forth in the transfer documents to the life settlement provider."

Regulatory Developments

Life insurance securitizations must comply with a patchwork of federal and state regulatory frameworks. At the federal level, securitization generally is subject to the private offering regulations under the Securities Act of 1933. And at the state level, Stroock's Ziser noted that a majority of states regulate the life settlements market generally and, via state securities laws, securitization specifically. "It's not that there isn't already a regulatory framework to which these transactions are subject," Ziser said.

California is the most recent state to add life settlement regulations with the passage of Senate Bill 98. Senate Bill 98 prohibits the sale of an existing life insurance policy to a third party for more than its cash surrender value but less than its death benefit for two years after it is issued. Senate Bill 98 also requires individuals brokering or soliciting life settlement transactions in the state to be licensed by the state insurance commissioner and to complete 15 hours of state-approved training in settlements.

However, additional regulation may be in the offing. The SEC has formed a life settlements task force. Paula Dubberly, Associate Director of the SEC's Division of Corporation Finance, said that the task force will look into whether corporate sponsors of life settlement securitizations are providing clear and adequate risk disclosure.

Also, during the September 24 Capital Markets Subcommittee hearings, Representative Paul Kanjorski (D-PA) expressed concern with the very existence of a life settlement securitization market. "The improper securitization of life settlements could ultimately leave countless seniors penniless and innumerable investors

broke," he said. "The idea of institutional investors profiting from a person's death also seems, to say the least, unsettling and immoral. It leads us down a slippery slope that might eventually result in indexes based on divorce rates and swaps tied to gambling losses."

As Coan noted, "in light of potential concerns by federal regulators about life settlement securitizations overall, measures may be proposed to regulate the sale of life settlements on the back end in the tertiary market. Paula Dubberly of the SEC's task force expressed in the recent Congressional hearings the SEC's concern that there may be a regulatory gap that state insurance departments have not sufficiently addressed, and that, as a result, some kind of federal securities regulation is appropriate for sales of life settlements from providers to investors."

Life Settlement Swaps

Another growing area in the life settlement product market involves life settlement swaps, or "longevity swaps."

Vis-à-vis direct investments in life settlements, swaps reduce longevity risk and enhance liquidity because they are standardized and tradable.

A typical life settlement swap portfolio is based on a portfolio of synthetic life insurance policies. These swaps generally reference an index, such as the Goldman Sachs QxX Index, to track the performance of an underlying portfolio of policies.

There are two well-known structures: the mortality-experience structure – which pays a fixed amount per death – and a pass-through structure where the cash flows are based

on the actual performance of the underlying pool.

With life settlement swaps, counterparty risk is the biggest concern. There is no pool of collateral that can be drawn upon or foreclosed upon if there were a default under the swap, so investors must evaluate the credit risk of the relevant counterparties.

Since life settlement securitizations require a pool comprised of hundreds of policies, swaps may be beneficial for managers with smaller pools of policies looking to create a structured product.

However, market interest in life settlement swaps has not been conclusively established. As Weinberger noted: “These are highly customized transactions that are used in very specific instances to structure a deal between two parties. There are a lot of people looking at them but because they are bespoke transactions they require a lot of documentation and there is no uniformity to what the swaps look like. There are groups working on more uniform documentation so that may change, but for now they are highly negotiated transactions. This has hindered the development of these products, in my opinion.”