

The Settlement Market ▼



Supply and Demand for Life Settlements In the Global Marketplace

by Clifford M. Brown

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In less than a decade the life settlement business has exploded from a small domestic industry characterized by simple organizations into a complex market driven by sophisticated companies striving to meet the needs and requirements of institutional investors around the world. The resiliency of the life settlement business in the wake of industry-specific scandals and turmoil in the global capital markets confirm that life settlements are widely accepted as legitimate and desirable financial assets that belong in institutional investment portfolios. The tipping point for this asset class has been reached.

The entire industry quotes the enormous growth experienced over the past nine years, estimating that the face amount of policies purchased increased from \$0.2 billion in 1998 to almost \$12 billion in 2006. Growth is projected to continue as the pool of potentially eligible policies, driven by aging 'baby boomers' swells to as much as \$161 billion in constant dollars by the year 2030.

Statistics citing the billions of dollars of face value sold or 'settleable' simultaneously highlight and obscure some interesting truths. First is that the actual amount of money invested is a fraction of the face amount purchased (probably about 25 percent on average when factoring in all costs). Second is that that penetration (amount purchased relative to amount available) is actually quite small.

While the overall potential market size (defined by face amount) will be driven by the pure demographics of the nation's aging population, the growth in actual cases closed will be a function of both global demand for investments and increased awareness by domestic policy holders that the marketplace actually exists.

Global Demand

That capital may now flock to this asset class should come as no surprise. The market is benefiting from the convergence of several

forces that virtually ensure its continued development.

Institutional investors constantly seek ways to obtain an optimal mix of risk and return in their portfolios. Truly diversified life settlement portfolios will likely generate total rates of return in the nine to 12 percent range with reasonable underwriting. While that may seem modest compared to industry rumors, it is robust for what would essentially be low risk fixed-income portfolios.

More importantly, returns from life settlements are largely uncorrelated with returns on other asset classes. Adding life settlements to an investment portfolio therefore will enhance the efficiency of the portfolio because the volatility of the expected returns from the portfolio will be reduced. This has enormous value to portfolio managers.

The need for assets like life settlements and the attractiveness of the stability they may provide is highlighted by the current turbulence in the global capital markets. While virtually all kinds of securities are being negatively impacted, market prices for life settlements have been largely unaffected.

With the collapse of the mortgage industry, Wall Street, which is always looking for new and innovative ways to make money, has begun to deploy billions of dollars of capital in an effort to develop multiple ways for investors to get exposed to the asset class. Products that have been or are expected to be developed will enable institutions to go long or short exposure to mortality or longevity risk and will do so in both cash and synthetic forms and in equity and debt structures.

As Wall Street develops these products, it will need to sell them. And they will be sold to investors on every continent. The process of selling these products will result in increasing awareness of the asset class among institutional investors. The fractionalization of products and the availability of synthetic exposure to the asset class will mean that small institutions that cannot afford to build large portfolios will be able to gain exposure.

Increased demand for the asset class will ensure that at least some of the alternative structures being developed by Wall Street will be

widely accepted, resulting in a phenomenon seen with many other financial assets—the volume of synthetic and derivative securities tied to the asset class will dwarf the actual cash market.

The development of synthetics and derivatives will, however, require the cash market to continue expanding. Global demand for the asset class is likely to continue to exert downward pressure on rates of return which means higher prices for consumers.

Local Supply

Several recent developments portend the continued rapid expansion of policy supply for many more years. Broadly speaking these developments fall into the categories of insurance company embrace of the industry, compensation disclosure and fee compression and direct-to-consumer marketing. Current trends regarding these issues represent a full scale assault against some of the forces that have worked to restrain the advancement of the industry.

Insurance companies are setting up their own life settlement operations. They will be buyers of the assets that many of them have worked diligently to legislate out of existence. Also, insurance companies are realizing that they cannot keep their agents and affiliates from educating clients and policy holders about the options that exist for the policies that they own. More education and awareness will increase supply.

Regulation, investor demand and fear of litigation are resulting in an increase in transparency to consumers regarding compensation and fees involved in transactions. This trend will not stop until there is universal acceptance of standard documentation and all fees and expenses are disclosed on every settlement, just like consumers receive when they get a mortgage. Disclosure results in fee compression (which means higher prices for sellers) and increased consumer comfort and, leading to an expansion of policy supply.

Industry observers estimate that the average face value of policies actually bought over the past several years exceeded \$1,500,000 . But the average face value of policies outstanding is only about \$97,500. In order for that \$161 billion market to be meaningfully penetrated the industry needs to efficiently obtain and process “small-face” policies. Many “direct-to-consumer” programs have been developed to penetrate this market segment. The success of these initiatives is critical if the supply of policies is to reach its full potential.

Life settlements are here to stay. The investment thesis is too compelling for professional money managers to ignore. Driven by Wall Street, capital from around the world will continue to flow to the sector as long as people can actually deploy their money. Increased demand for cash and synthetic products will require more policy supply. Irreversible trends to increase the number of policies put up for settlement exist. Nevertheless, the question of whether or not the local supply of policies can meet the global demand for policies remains open.❖