A response to the FSA's view on TLPS

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Synopsis: Peter Smith, Head of Investments Policy, Conduct Policy Division at the FSA, recently told delegates at the European Life Settlements Association's inaugural conference that traded life policies carried a number of risks that meant they were only suitable for sophisticated investors. Furthermore, he said the marketing literature for TLP products contained major flaws. "It is simply unacceptable to produce complicated products and downplay the risks to customers," he said. To what extent was Mr Smith correct and fair in his analysis? And to what extent has he missed some of the subtleties of this relatively new asset class?

Traded life policies (TLPs) passed a significant milestone towards gaining greater recognition in the UK when FSA Head of Investments Policy Peter Smith made them the subject of his address to the European Life Settlements Association's conference in February.

Mr Smith's speech will not be remembered as a resounding endorsement of TLPs, or life settlements as they are also known. But the fact that the FSA is now talking about TLPs is a major step.

TLPs are United States-issued whole of life policies sold by policyholders so that they can enjoy some of the benefits in their own lifetimes. By investing in a diversified portfolio of them and applying prudent actuarial analysis, it is possible to use them to deliver predictable, incremental returns.

Mr Smith's main concern was that the information provided by product providers is woefully inadequate and fails to explain the risks associated with investing in TLPs. In particular, Mr Smith said there was a particular risk of unrealistic performance illustrations being provided as a result of fund managers manipulating valuations by using shorter life expectancy figures to calculate future payouts. Other risks he highlighted included longevity, liquidity, volatility of returns, counterparty and potential for loss.

We would agree it is imperative that the product and marketing literature for TLP products is accurate, detailed and informative. We could not agree more that there is an education gap in the industry. So much so, for the last three years we have commissioned Professor Merlin Stone of the Bristol Business School to produce a comprehensive report on the subject, examining all the benefits – and risks – of TLPs. These reports are available to anyone for free on our website.

We did not agree however with Mr Smith using the term TLP Investments, or TLPIs, to cover any products that invest in TLPs, senior life settlements or viatical settlements. This leads to a potential misunderstanding or misinterpretation of risk in grouping TLPs (also referred to as senior life settlements), life settlements, viatical settlements and indeed those that Peter Smith has not mentioned such as premium financed policies, contestibles and longevity derivates. The risk profiles of these are all completely different.

Mr Smith was completely correct to focus on how an accurate estimation of life expectancy is the single most important factor in assessing the price of each underlying policy in a TLPI and that the primary risk is that the underlying policyholders live longer than expected.

But there is a massive difference between a medical underwriter assessing the potential mortality profile of a 35-year-old with a terminal illness and an 80-year-old with severe heart disease; the potential for error would be far more debatable with a younger person than an octogenarian. This was illustrated in the 1980s when the viaticals market failed to give investors the returns they expected. Viaticals are policies sold on lives assured that have terminal illnesses. This market grew exponentially during the AIDS crisis but medical advances meant that many HIV-positive sufferers who sold their policies lived beyond the expectations factored into the sale prices.

Common sense would tell us that to acquire a portfolio of more elderly lives will significantly reduce mortality (or longevity) risk: the older a sample of lives becomes, the more accurate the Life Expectancies (LEs) are likely to be.

To smooth out returns, the manager of a TLP fund must produce a valuation basis that equitably unwinds an absolute return over a variable period, and plan for the future premiums that must be paid until a maturity occurs. When a policy is purchased by a fund, the LEs based on medical evidence should be extended each month to factor in improving mortality generally. This should be done with reference to the US population mortality table - the Valuation Basic Tables (VBT) - that is re-published every seven years. An ongoing re-assessment of LEs ensures that there are no spikes or troughs in performance and that the present fund value represents the true value of the underlying policies held at that time. While it is important not to underrate longevity risk, it is not impossible to determine mortality.

Mr Smith pointed out that with sufficient diversification in a TLP fund and accurate actuarial calculations on longevity, volatility in terms of performance should be low. However, he said, experience has shown that there is a real risk of a lack of diversification of policies. He also said that despite the size of the US traded-life policy market, as a tradable asset class the underlying investments are rather illiquid due to their specialised nature.

There are potential liquidity risks (as there are, and to an even greater degree, with many other assets, such as commercial property for instance) but that in itself is not a reason for avoiding such asset classes. It simply highlights the need to assess any fund’s management of this risk.

As with structured products, Mr Smith said, there is an equivalent counterparty risk if the insurance company becomes insolvent and is unable to meet the death benefit claims. This is correct. There is, however, arguably far less counterparty risk in a life settlement fund compared to a structured product – or even many bond funds.

Firstly, all US life assurance in issuance has to be fully reinsured. Thus there would need to be a failure of both the underlying insurer and the re-insurer for a problem to exist, and then there are State guarantee schemes to provide further protection. Thus, this risk is far less than in most, if not all, structured products. This risk can be managed by only purchasing policies where the underlying insurer is of a high credit rating and ensuring that there is considerable diversification within the Fund across many insurers.

One point that Mr Smith did not identify, which is possibly the most significant risk factor of them all, is that TPLIs are United States issued life insurance policies and are therefore a dollar-based asset. IFAs should make sure that a product has a disciplined hedging strategy to deal with this.

In summary, we would lay down a six-point check list for IFAs. They should avoid:

1. Higher risk funds that invest in viaticals, contestables or other type of life settlement where longevity risk is much harder to manage

2. Funds with high charges because the only way to gain Alpha is by lower charges when there is a competitive market for the purchase price of policies
3. Funds that charge performance fees; not only because the higher the fees are, the lower the investment return will be but also because there is a significant moral hazard in financially incentivising a fund manager to achieve higher returns when it is using a valuation model to achieve them
4. Financial products offered by organisations that avoid seeking FSA regulation. The FSA has a strict code of practice that requires regulated parties to give a high level of disclosure and to accept responsibility for providing investment professionals with sufficient information to identify the risks associated with an investment opportunity and be equipped to assess its suitability for an investment client or portfolio
5. Funds that do not have critical mass or a reasonable track record that enables an investment professional to judge on its own merits
6. Funds that do not have a good track record in managing the currency risk

While Mr Smith’s speech was a landmark, it was only the latest in many that TLPs must pass as they move ever closer to the mainstream. They still constitute a relatively new asset class and much has still to be understood about them. But they are growing in popularity around the world as investors recognise the benefits they can bring when they are handled in the right way.