RESS CAPITAL

MARKET INSIGHT ON THE ETHICS OF INVESTMENTS IN LIFE INSURANCE POLICIES

Ress Capital wants to contribute to a sustainable investment industry. Ethics is the key sustainability factor for investments in life insurance policies. In this Market Insight we discuss the ethical aspects of this highly regulated market. Ress Capital is confident that its investment strategy meets the highest ethical standards.

EXECUTIVE SUMMARY

- **The secondary market for US life insurance policies enables consumers to receive a financial compensation for an unneeded insurance policy.**
- **The transaction where consumers sell their policies to financial investors are executed in an informed and transparent manner, making sure that the individual policy sellers are treated fairly.**
- **The market is regulated with an objective to protect consumer interest. This enables high ethical standards.**

BACKGROUND

Ress Capital is active in the *secondary market for* US *life insurance policies*. The secondary market for US life insurance policies, also known as the *life settlement market*, offers individual policyholders the opportunity to sell their life insurance policy. Individuals selling their policies are usually retirees who no longer have the need for life insurance coverage.

A key consideration for Ress Capital in its investment activity is:

Is it ethical to purchase and own a life insurance policy from an individual who no-longer wishes to keep their policy?
In this paper we will discuss this ethical question in detail, in three sections. Firstly, we will explain why the secondary market for life insurance policies exists. Secondly, we will discuss ethical issues within the market. The ethical issues, in our view, can be divided into three sub-questions; 1) In general, is it ethical to own and be the beneficiary of a life insurance policy on an unrelated person? 2) Are the seller and their relatives treated in an ethical manner during the transaction process? 3) Does Ress Capital act in an ethical manner during the investment period? Thirdly, we will discuss possible moral issues facing the asset class. A short conclusion of our discussions is found at the end of the paper.

WHY THE SECONDARY MARKET FOR LIFE INSURANCE POLICIES EXIST

The existence of a secondary market for US life insurance policies is a consequence of a structural inefficiency in the primary market. The inefficiency can be explained through the fact that standard terms for life insurance in the US is often valid until the person reaches the age of 120, while many individuals do not actually need life insurance coverage once they have retired.

Most policyholders are not aware about the possibility to sell their policy. As a result, most polices lapse and never pay out. In 2022, policies with a total face value of approximately 650 billion US dollars lapsed according to data gathered by the Life Insurance Settlements Association (LISA).

When policyholders contact their life insurance company, they will often not receive the inherent financial value of the policy. In some cases, the policy holder can be paid a so-called *cash surrender value* by the life insurance company at cancelation. It is unusual that the surrender value is in line with the financial value of the policy. Fund managers, like Ress Capital, thus provide liquidity for the seller and ensure a better pricing mechanism since they are willing to pay the financial value of the policy. Thus, an individual who do not want to keep their life insurance coverage can sell the policy to a fund manager, and thereby be fairly compensated for inherent value of the policy.

The reason why some life insurance policies will have a financial value is that the agreed future stream of premium payment is not reflecting the person's actual survival probability. Put in other words, the future premiums that the policy holder must pay are too low relative to the expected survival probabilities of the insured.

A prerequisite for the secondary market to exist is the right to sell a life insurance policy, which is the case in the US. That is not true for many other jurisdictions. In the transaction where a policy is bought by a fund manager, the fund becomes the owner and the beneficiary of the policy.

POSSIBLE ETHICAL ISSUES

1.) IS IT ETHICAL TO OWN SOMEONE ELSE'S LIFE INSURANCE POLICY?

The key observation to make regarding this question is that the sales process is initiated by the owner of the policy or by an insurance advisor working on behalf of the policy owner, and the sale of a life insurance policy benefits the consumer financially, as noted in the section above.

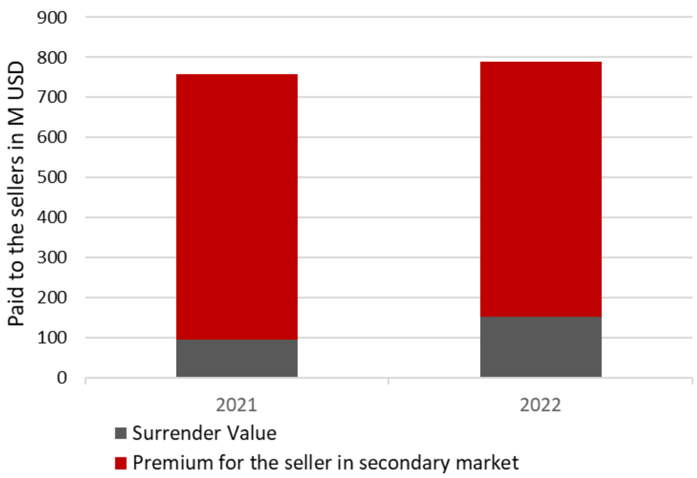
At retirement age, a person who has paid insurance premiums on a policy for many years, may own a life insurance policy with a significant positive value. Since the insurance policy has a positive value, the individual policy holder owns a *financial asset* worth a considerable amount of money. Investors in life insurance policies, like Ress Capital, are therefore allowing the policy holder to capitalize on this asset and receive a fair value.

After having sold their policy, the individual can use the proceeds for either consumption, amortizing debt, or investments in other financial instruments.

It is worth noting that the investors in life insurance policies have a competitive advantage relative to the initial policy owner, since investors can diversify through buying many policies. For a portfolio of life insurance policies, the longevity risk (which is the main investment risk) will be reduced. In statistics, this is often referred to as the *law of large numbers*. In brief, as the number of policies in a portfolio grows, the actual outcome gets closer to the expected value. Through that mechanism, the risk defined as the uncertainty of outcomes will be reduced. An individual policy is therefore more valuable to an investor than to its original owner.

The fact that policies are worth more when they are aggregated in a fund, is however not an ethical issue. Rather, it explains the rational why fund managers are willing to pay more, and consumers receive a higher price when selling their policies.

The fact that fund managers pay more than the surrender value can be seen clearly in the graph below. The graph shows that financial buyers in 2021 and 2022 paid significantly more than the surrender value. On average, the seller has historically received 6-8 times more than the cash surrender value paid by the life insurance companies according to data gathered by the Life Insurance Settlements Association (LISA).



Source : Life Insurance Settlements Association (LISA).

2.) IS THE TRANSACTION ETHICAL?

For many households in the United States, a life insurance is an essential part of a family's financial protection for unforeseen events. It is therefore of great importance that the sale of a life insurance policy occurs in a way that safeguards the interests of the whole household. This has been acknowledged by regulators, and the secondary market is currently regulated by law in 45 States.

When investors purchase life insurance policies, intermediaries are used. These intermediaries facilitate the sale of life insurance policies from policyholders to investors. Regulation stipulates that life insurance policies can only be purchased using brokers who are registered and authorized by the regulator in each State, often the State Insurance Commissioner.

In order to enable the individual household to make an informed decision, it is important that the sales process is transparent. Therefore, brokerage fees must be reported in a clear and transparent manner to the consumer.

Additionally, the consumer must receive information about the possible repurchase price (surrender value) that the life insurance company is willing to pay for the insurance policy. As a part of the transaction process the policyholder must certify that he, or she, makes a conscious decision to sell the life insurance policy. Furthermore, it is a requirement that the beneficiaries agree in writing to the sale of the life insurance policy. For most life insurance policies, it is the policyholder's spouse or children who are beneficiaries.

In addition, investment managers active in the asset class should have internal rules that contribute to the protection of the consumer interest's and make sure that all transactions take place in an ethically justifiable manner. Ress Capital has several guidelines relating to ethics and sustainability. These can be downloaded from the company's webpage: www.resscapital.com/responsible-investments/ .

3.) ETHICS DURING THE HOLDING PERIOD

After Ress Capital has bought a life insurance policy from an individual through a regulated broker, Ress Capital will service the policy by paying premiums. Ress Capital will, via the company's securities intermediary, be in contact with the life insurance company who has issued the policy. A typical request from Ress Capital would be related to information on required future premium payments. Ress Capital will also instruct a dedicated service provider to contact the life insurance company to make sure that premiums have been received for the policy in question.

For each policy sold in the secondary market, there is a contractually designated person to contact for questions related to the seller. Important to note, Ress Capital will never directly or through a third party contact the individual who has sold the policy to Ress Capital.

Therefore, no ethical issues will occur during the investment period. This is also true when a policy matures. There is a systemised process for the settlement to take place and no contact will occur between Ress Capital and the original beneficiary of the policy.

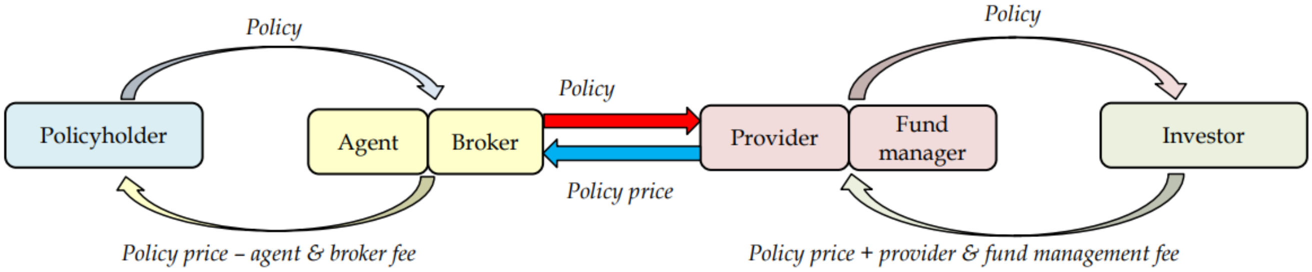
Ress Capital is member of several trade associations and actively work for prudent and stringent regulation of the life settlements market. The company promote development of industry standards and a "best practice" centred around the interest of the consumer.

POSSIBLE MORAL ISSUES FACING THE ASSET CLASS

Moral questions are sometimes asked about investors being beneficiaries of life insurance policies for unrelated individuals and that an early demise will have a positive value for the investor. We will below explain why there are no moral issues with investing in a portfolio of life insurance policies.

It is true that a policy paying out earlier will be beneficial financially. But, keep in mind that the opposite holds where individuals outlive their life expectancy. Going back to the statistics, we know that 50% of original policy holders will outlive their life expectancy and that 50% will have an early demise. However, the asset class is not about a single individual's death, it is about a large pool of policies that will either pay out earlier or later, relative to mortality expectations.

The secondary market for life insurance is technically a transfer of payment streams between two parties. As discussed above, both parties can benefit from this transaction. Longevity risk must be estimated when executing the transaction at a given purchase price. A deep understanding of statistics, and insurance mathematics is paramount to correctly assess risks and calculate a fair price.



Source: Harvard Business school, Introduction to Life Settlement, N9-218-289

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Since the focus on portfolio management is to create a portfolio with policies that on average pay out as expected, the possible moral dilemma with exposure to longevity and mortality can be compared to that present in a *defined benefit pension fund* or for a financial institution issuing *annuities* to clients.

In a defined benefit pension fund, the level of cashflows paid to members will depend on the return of the fund's investments and on the survival probabilities of members. Members who live a shorter life than expected will subsidise members who live longer than expected. Thus, a steady pay-out to older members can only be possible if some members have a shorter life. Clearly, this business model is not regarded as immoral.

Annuities are financial products sold by financial institutions, often insurance companies, and the product offer clients a guaranteed income stream for a fixed period or for the rest of the client's life. Also in this case, individuals whose actual life is shorter than initially estimated will subsidise clients who live a longer life. Therefore, assessing the longevity of individual clients is also required to price such products.

In essence, any product that promises cash-flows linked to longevity will be facing a situation where some clients are benefitting relatively more from the product than other clients. However, at a portfolio level, the fund or financial institution will only be affected by changes in the average longevity of clients. Therefore, it is important to neither under- nor overestimate longevity. This is true for pension funds, financial institutions issuing annuities as well as for funds that invest in life insurance policies.

It should be mentioned that for life settlements, where the seller has been fairly compensated in the market for their policy, at the time of the transaction, there is no financial loss to the initial beneficiary. Upon demise a contractual settlement with the insurance company and the new owner will take place. As pointed out in many parts of this paper, the strategy exploits structural inefficiencies in the US insurance market rather than individual mortality.

CONCLUSION

The transaction where an individual consumer sells his or her life insurance policy to an investor benefits the consumer. The transaction process is transparent, and the consumer is guided in the transaction process by a regulated advisor. After the transaction is completed, no contact is made from the investor to the original policy holder. In summary, these factors ensure that the market is ethically sound. In Ress Capital's sustainability strategy, the company commits to promote initiatives that will strengthen consumer protection to safeguard the ethical aspects of the US secondary market for life insurance policies.

ABOUT RESSCAPITAL AB

Ress Capital is an alternative investment fund manager (AIFM) regulated by Finansinspektionen in Sweden. The company employs nine people at its office in Stockholm. We have since 2011 purchased life insurance policies on behalf of Ress Life Investments, which is listed at NASDAQ Copenhagen.

The management team has extensive experience in life insurance markets, complimentary backgrounds, and international experience from having worked at major banks and hedge funds.

Proprietary portfolio management systems and pricing models have been developed internally which gives us a competitive advantage when selecting policies. Ress Capital also collaborates with external medical underwriters, specializing in senior mortality in order to provide more accurate assessment

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