



ANNUAL MEETING & EXHIBIT

SOA<sup>07</sup>

## **Life Settlements 101**

### ***Introduction to the Secondary Market in Life Insurance***

Anita A Sathe, FSA, FCAS, MAAA

Donald Solow, FSA, MAAA

Michael Taht, FSA, FCIA, MAAA

**October 15, 2007**

### **Presentation Outline**

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- History & Evolution of Secondary Market
- Overview of Secondary Market Terminology
- Market Facts
- Policyholder Considerations
- Investor Considerations
- Insurance Company Considerations
- Role of the Actuary
- Highlights

## History & Evolution of the Secondary Market

- Viaticals
  - AIDS patients needed cash for treatments
  - Policies worth more than the policy cash value due to the impaired health
  - Phased out by the Accelerated Death Benefit rider
- Traditional Life Settlements
  - Started in the 1990's as an extension of viaticals
  - Focused on impaired lives with longer life expectancies
- Investor Initiated or Manufactured Life Insurance (IILI)
  - Offshoot of premium financing transactions
  - Policies issued on individuals and are owned and financed by a third party investor

## Secondary Market Terminology

- Traditional Life Settlements
  - Offshoot of the viatical settlements industry
  - Consists of buying over a policy from a policyholder who has experienced an impairment in their health status since the policy was issued
  - At issue of the policy –
    - Issued to meet insurance needs of policyholder
    - No intention of selling policy to a third party investor

## Secondary Market Terminology

- Traditional Life Settlements (cont'd)
  - Plays on the leverage created by the differential in the cash value of the policy and the increase in the value of the policy due impairment
  - Policy re-underwritten by one or more external underwriter at the time of transaction
  - Typically requires more upfront investment by the buyer compared to Investor Initiated Life Insurance

## Secondary Market Terminology (cont'd)

- Investor Owned Life Insurance (IOLI)
  - Also called Stranger Owned Life Insurance
  - Investor purchases a policy on a stranger
    - Usually, within the contestable period, ownership is retained by the policyholder and premiums are paid by the investor
    - After the contestable period, policyholder has an option to repay the initial premiums plus interest and retain ownership of the policy or “flip” ownership to the investor
    - Upon inception of an IOLI contract, the policyholder is provided with some financial inducement
  - Target market is usually older aged individuals and large face amount universal life policies

## Secondary Market Terminology *(cont'd)*

- Investor Owned Life Insurance (IOLI) *(cont'd)*
  - Policyholder is underwritten twice – once by the insurance company and once by an external underwriter selected by the investor
  - Leverage stems from two sources
    - Insurance company under-pricing older age mortality
    - Lapse leverage
  - Risk of transaction is borne entirely by investor or insurance company; no risk to policyholder

## Secondary Market Terminology *(cont'd)*

- LILAC (“Life Insurance Life Annuity Combination”)
  - A life insurance contract and lifetime payout annuity are taken out on the same life
  - Owner is typically a charity and recipient of a portion of the death benefit
  - A loan is established to pay premiums, with annuity payments set to cover loan interest plus the life premium
  - Unlike life settlement or premium financing, typically involves unimpaired lives
  - Effectively life/annuity arbitrage, taking advantage of underlying mortality assumption discrepancy between the life and annuity contract
  - Recent regulatory scrutiny due to lack of insurable interest

## Why does the market exist?

- Competition and strict regulation of life insurance companies in the primary market lead to insurers offering reasonably competitive cash surrender values
  - But no differentiation of cash surrender values by current health status of insured
- Insureds with reduced life expectancies may have a higher economic value than the policy's underlying cash value

## Size of the market

- It is estimated that approximately \$15.0 billion in face amount was sold in 2006 in the U.S.
  - This is a 50% increase from 2005
  - Coventry First has approximately 30-40% market share
- Bernstein Research predicts that the market “will grow more than 10-fold to \$160 billion over the next several years”
  - Still a relatively small percentage of the approximately \$9 trillion of individual life business on the industry's books

## Drivers of the market

### **Life Settlements**

- Individuals in the U.S. are living longer, thus potentially outliving the usefulness of their life insurance policies
  - The target market for settlements (i.e., individuals above age 65) is expected to grow by 90% over the next 25 years
- Potential elimination of estate tax
- Decline in interest rates have led to lower cash values than originally illustrated
- Broker commissions

### **Premium Financing**

- Free or low-cost insurance to insureds
- Lack of asset collateralization (no assets pledged)
- Broker commissions

## Market participants

- Funding source
  - Could be institutional investor, private equity, hedge fund, financial services organization
- Settlement Provider
  - Coventry 1<sup>st</sup>
  - Life Equity
  - Legacy Benefits
  - Life Settlement Solutions
- Medical Underwriter
  - AVS
  - Fasano
  - 21<sup>st</sup> Century
  - EMSI
- Attorney
  - Lord Bissell
  - LeBoeuf

## Market participants

- Reinsurer
  - Innova Indemnity
  - HCC Insurance Holdings
- Rating Agency
  - Moody's
    - Rated 1<sup>st</sup> life settlement transaction in 2004 (Legacy Benefits)
  - S&P
- Monoline
  - FGIC
  - Ambac
  - MBIA
- Servicer & Tracking Agent
- Broker
- Policyholder

## Policyholder Considerations

- **Sacrifices valuable estate needs** for liquidity needs in the case of life settlements
  - Life settlement value is significantly less than the intrinsic economic value of the policy
  - Policyholder may not qualify for new insurance policies since he may be uninsurable
- Amount received by the policyholder is substantially less than the value of the policy due to high transaction costs in a life settlements transaction
- For IOLI, risk that **policyholder may not qualify** for additional insurance because of over-insurance
- **Lack of insurable interest** at the time of claim for both IOLI & Life Settlements

## Traditional Life Settlement: Good for the Consumer?

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- Answer: "it depends"
- Is the coverage needed? If yes, then probably best to retain the policy.
  - But there have been cases where an impaired insured sells a policy and uses the proceeds to buy a new policy at preferred rates!
- If no, then a life settlement is better than a surrender.
- Many reasons for not wanting to keep the policy:
  - Insurance and estate planning needs change
  - Tax laws change
  - Premiums can't be afforded
  - Funds are needed for long term care
  - No one to leave the death benefit to (children financially independent)
- A financial advisor, accountant, or insurance agent is often needed to determine the best course of action.

## The Insurable Interest Question

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- In life insurance, insurable interest need only exist at time of policy issue
  - Differs from almost all other forms of insurance, where insurable interest must exist at time of claim
  - "... [A] valid policy is not avoided by the cessation of the insurable interest, even as against the insurer, unless so provided by the policy itself." [U.S. Supreme Court in Grigsby v. Russell, 1911]
- A policy can be contested at any time for lack of insurable interest at inception, not just during the contestable period (exception: NY and MI)
  - Increases the risk to the investor buying premium-financed policies
  - "[C]ases in which a person having an interest lends himself to one without any, as a cloak to what is, in its inception, a wager, have no similarity to those where an honest contract is sold in good faith." [U.S. Supreme Court in Grigsby v. Russell, 1911]
  - New York Insurance Department letter opinion of December 19, 2005 stated that no insurable interest really exists in an investor-initiated transaction (but this is just an opinion)
- **Conclusion: investors should seek legal counsel on the insurable interest question**

## Investor Considerations

- **Longevity Risk** that policyholder outlives underwriting LE
- Risk that external underwriter **understates true LE** of policyholder
- Risk that the **mortality slope** used in pricing life settlements is **misestimated**
- Risk that current **illustrated premiums are increased** in the future for IOLI
  - Less of a risk for life settlements since most of the leverage is based on change in health status of the policyholder

## Reasons for Investor Interest

- Asset class uncorrelated with general credit risk cycles
- Payment obligation comes from highly rated U.S. insurers
  - Historically, even in insolvency, death benefits are paid
- Expected unlevered returns of 9% to 12% (12% to 18% for contestable paper)
- Favorable accounting (option to use fair value or cost basis)
- Low probability of loss of principal (for a large-enough portfolio)
- Willingness to accept systematic risks
  - Longevity (other than random fluctuation)
  - Legal / Regulatory
  - Increases in COIs across the industry
- Ability to obtain leverage, boosting ROE to 15% to 25%

## Insurance Company Considerations

- Risk of **increased persistency** of impaired policyholders for life settlements
  - Fundamental actuarial pricing typically assumes healthy policyholders lapse and unhealthy policyholders persist
  - Lapse rates for older policyholders in ultimate durations are generally low
  - The true risk is the subset of impaired policyholders who cannot afford to keep the policies in force and would have lapsed if not purchased by the life settlements companies
- **Litigation risk** due to agent misrepresentation for life settlements
  - Policyholder may be better off holding on to the policy
  - Life settlements value could be significantly lower than the intrinsic economic value of the policy
  - Inadequate disclosure of all transaction costs

## Insurance Company Considerations (cont'd)

- Implications of IOLI
  - Two levels of mis-pricing older age mortality:
    - Assuming a certain level of lapses in pricing which will not be realized
    - Aggressive older age COI rates which imply a longer LE than the external underwriter estimate
  - Cherry picking by investors to target
    - Lapse supported policies
    - Underwriting practices which are based on table shaving
    - Policies with aggressive current assumption premiums
    - Back end loaded policies

## Role of the Actuary

- Business relies heavily on actuarial principles
- Actuaries work for Providers:
  - Building models to price policies
  - Portfolio models
  - Stochastic analysis
  - Tracking experience
  - Analyzing the approaches of the medical underwriters
  - Keeping current on older age mortality
- Actuaries consult:
  - To Providers
  - To investors
  - To accountants (for development of fair values)
- Actuaries are becoming more involved with the LE shops
- Actuaries are employed by banks looking to lend against, or to securitize, the assets
- Demand for actuaries in this business should grow as the market grows

## Highlights

- Secondary market currently includes transactions related to IOLI & Life Settlements
- Investor should consider longevity risk, LE understatement, misstatement of mortality slope, increase in illustrated premiums and policyholder defaults among other risks
- The policyholder should consider estate needs when entering these transactions
- Insurance companies should consider impact of increased persistency, litigation risk, old-age mispricing, lapse supported policies, etc with the rise in the secondary market transactions

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**THANK YOU!**