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Session 33 OF Life Settlements Go Mainstream

Track: Product Development

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Panelists: Chris Conway[†]
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Steve Boger

Summary: Life settlements are becoming an increasingly attractive option for policyholders, spawning a new industry for investors. In this session, attendees learn why life settlements exist, pros/cons of life settlements for an individual policyholder and potential implications for insurance companies.

MR. MICHAEL J. LEBOEUF: I'm a consulting actuary with AON Consulting in Avon, Connecticut. Our panel is going to provide you their knowledge, their experience and their comments with regard to the area of life settlements.

Chris Conway is the senior business development officer with Legacy Benefits Corporation. Chris has over 17 years of training and experience in the life insurance and financial services industry. Chris holds a bachelor's degree from Brown University in Providence, Rhode Island. He has served as both an agent and registered representative selling insurance and investment products to private investors as well as to businesses. He has also held positions as national marketing director for two financial service consulting firms specializing in alternative financial planning products and services. Additionally, Chris co-founded a life settlement

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[†]Christopher Conway, not a member of the sponsoring organizations, is senior business development officer at Legacy Benefits Corporation in New York, N.Y.

Note: All handout materials are available through the link on the table of contents.

company back in 1992 and was responsible for the development and the operation and management procedures for the firm. Chris' responsibilities at Legacy include market development for policy origination, policy contract analyses, agency development, marketing, training and communications.

John Skar is a senior vice president and chief actuary at Mass Mutual. There he leads the corporate actuarial division responsible for coordination of actuarial functions across the enterprise. Those responsibilities include oversight of pricing, product development, reserve adequacy, interest crediting, risk management, reinsurance and policyholder dividends. More recently, John took on the additional title of chief risk officer and is involved in a variety of strategic financial and business development initiatives for Mass Mutual. John holds a BA in economics and mathematics from St. Olaf College, is a fellow of the Society of Actuaries and a member of the American Academy of Actuaries, in addition to being a Chartered Life Underwriter and a Chartered Financial Consultant.

Jay Vadiveloo currently is professor and director of the Deloitte/University of Connecticut (UConn) Actuarial Center as well as senior manager for Deloitte in its Hartford office. The Center is a partnership between Deloitte and UConn to combine the academic resources of UConn with the professional expertise of Deloitte in order to develop more effective approaches in actuarial education, training and applied research. Prior to his current position, Jay worked in senior actuarial positions for several of the major insurance companies in the greater Hartford area. Jay is a Fellow of the Society of Actuaries, a Chartered Financial Analyst and holds a doctorate in statistics from the University of California, Berkeley.

Steve Boger is the practice leader for life settlements at Milliman in Chicago. Prior to joining Milliman, Steve had over 25 years of experience with both Combined Insurance and Allstate. Steve has served in various capacities at these companies. Most recently, he was running the structured settlement business unit for Allstate Life. In addition, Steve has also served as president of the National Structured Settlement Trade Association. Steve holds a bachelor of science in actuarial science degree from the University of Illinois, is a Fellow of the Society of Actuaries and is a member of the American Academy of Actuaries.

MR. CHRISTOPHER CONWAY: Hopefully we'll be able to describe for you the market in which we operate every day and have done so for the last 13 years and give you some perspective with respect to how we see that market and our role in it, as well as some of the other companies, consultants, financing entities and so on that we interact with every day.

Legacy is one of the oldest, if not *the* oldest, licensed life and viatical settlement company in the country. We operate in approximately 40 states, about half of which have some sort of regulatory requirement in terms of licensing. There's a lot of variety within that environment, but in general we serve a national audience with respect to the policy brokers and other intermediaries who submit cases to us for

the valuation as to whether they qualify as a life settlement. Without going further into our background, I think you'll get a sense from the presentation of what we do and how we do it.

To define our terms and how we position ourselves in the market, we define a life settlement literally as the sale of an unwanted or unneeded life insurance policy for a percentage of the policy's net death benefit. That policy typically covers an individual, sometimes two individuals, whose current state of health is such that an independent medical analysis indicates that they have a limited and ascertainable life expectancy. Typically that means that someone has a life expectancy evaluated by an outside firm of being somewhere south of 13 years. You all know better than we do how much variability there can be in those analyses, and we typically are working with more than one such life expectancy report or analysis when we do the work that we do.

We view ourselves as sitting between the policy owner and the insured and the financing entities that we serve. Our clients on the capital side of our business are large financial institutions—insurance companies, investment banks, banks, mutual fund companies and a whole host of different financial structures—in the aggregate representing a minimum of \$50 million in investible capital, usually highly structured, usually involving a very high degree of analysis on an independent basis as to whether or not that structure functions within our marketplace and their requirements with respect to underwriting and other criteria that we would use to acquire policies in the market. At the other end of the spectrum are a group of policyholders typically served by financial advisors and other intermediaries, often insurance agents, lawyers, accountants, CPAs or in some cases perhaps people from your profession, who are assisting them in coming to the decision as to whether or not to approach our market with their policy.

As an estimate of the market size at this point in time, 2004 looks to produce about \$10 billion in face amount in submitted business, the vast majority of which does not qualify. Somewhere between 20 percent and 25 percent will get through the underwriting system of any one of a settlement provider's companies, of which we are one of perhaps a half dozen with institutional capital. There may be a number of smaller firms with different financing structures that are also evaluating those assets. The increases that our business has experienced since perhaps mid-2000 are, from year to year, exponential. The volume of submitted lives and submitted policies covering those lives doubles each year and has continued to do so over the last three-and-a-half years. The rate of that growth continues even today. Typically in the fall we see a vast increase in business as agents and other intermediaries become more productive into the holiday season. So far our numbers indicate internally that that growth rate continues. The average case involves a male, age 75. The average face amount of the policy that we actually transact in the market exceeds \$1 million in net death benefit, and the life expectancies typically fall below 12 years.

With respect to how the market functions in its valuation exercise, we are similar, in the way that we look at a given life, to the immediate annuity market. We are basing our calculations on the expectation that the insured will not survive beyond that 12-year or 13-year point in time. Based on the independent information that we get, we use that to do a calculation that is not dissimilar to the immediate annuity market. As a matter of fact, in our own securitization transaction, which is the only one of its kind rated by Moody's, we used immediate annuities as part of the structure to correlate to the life expectancy work that was done independently.

We represent in the marketplace an alternative to lapse or surrender of the policy, not an alternative to keeping it in force on the part of the policy owner. We do not advise the consumer, nor do we interact with the consumer directly. We typically are dealing with an audience that I'll describe later, but it's typically the top-level producing agents, financial planners, CPAs, lawyers, accountants and so on. They are people with a lot of letters behind their names who interact with high-net-worth clients with respect to their financial planning generally, not just their life insurance asset.

Under normal circumstances, sellers receive a multiple of the cash surrender value in a life settlement transaction with us or any other legitimate provider. The estimated statistic is somewhere around five times cash surrender value. It's paid net to the seller at the end of the transaction. The market is increasingly open. There are a lot of spaces in which regulation is not yet a force, and for that reason there are more and more people—institutions, entities, individuals, advisors, consultants and so on—entering our marketplace every day, usually at the highest levels of late. The business is becoming less and less retail-oriented, as its history would indicate, and more and more institutional as volume continues to increase.

The characteristics of our marketplace in general are exponential growth rates and policy supply driven by intermediaries who interact with the consumers and who actually sell the consumers' policies. There's a strong international demand from the capital markets overseas to buy these assets. The business is becoming increasingly regulated. There are a number of bills in play with respect to adding life settlements to the regulation that's applicable to our business, not just viatical settlements. That's becoming more prevalent, more uniform and more consistent. There are certain analogies in the growth of our market to that of the mortgage market and the secondary market for mortgages, home equity products and other liquidity products associated with equity and real estate. The capital markets are engaged at varying levels in our industry on an ongoing and growing basis every day.

Sellers typically are represented by financial structures: trusts, corporations and charitable organizations, as well as individuals. It is more common than not for the policy to be owned in some sort of legal structure as opposed to an individual, but we still do transact business where the policy is owned by either the insured or individuals related to the insured through insurable interest. The policy is presented

to us with a variety of ownership structures, and the owner has made a decision to enter our marketplace before we have any knowledge of the owner's existence. Again, they come to us through intermediaries. They are making a decision that we believe involves a number of options, one of which is to keep the policy in force. There are a couple of decisions that must be made. Who's going to pay the premiums? The owners may believe that they themselves as individuals will not benefit from keeping the policy in force, but, of course, the beneficiaries will. They also have the option to lapse the policy, surrender the policy or enter the settlement market and sell that policy. Again, if they sell it, we have a very strong incentive to keep the policy in force. The owner gets a direct benefit when we purchase his or her policy.

With respect to the option to sell, the decision is made before they enter the marketplace. Their advisors are advising them as to how our market functions and how to present that asset to the business. Those advisory structures or individuals are our clients on the policy side. The providers, Legacy Benefits being one, are neither advisors nor appraisers. We buy assets. We sit on the other side of the negotiating table, if you will, from the sellers and their intermediaries. The settlement is simply an open market alternative to the monopsonistic option of surrender. They now have more than one buyer that will pay them x for that asset, and they can compare that with the insurance company that's willing to pay them surrender. The policy owner and what they want out of the transaction is what we see as being relevant because that's what's presented to us. They have an idea of what they want for the asset.

The participants on the policy side include policy owners, insureds, insurance agents, financial planners, lawyers, accountants, policy brokers and so on. On the financing side, as I mentioned, there are banks, insurance companies, hedge funds, mutual funds, private capital and to some extent, although very limited at this point, individual capital.

On the provider's side, in terms of how the market functions, there are very few firms that do what we do. There are perhaps a half dozen that are structured similarly and a small number of others that have slightly smaller operations (they buy fewer policies and may do so in a different way). We stand as the bridge. We hold up the barbell between the capital markets and the interests of the sellers who want to sell their assets. We act as originators for our financing entity clients. We buy the assets and place them in their portfolios based on a set of criteria that they impose upon us through negotiation. We don't have direct contact with the sellers of the policies. It is extremely rare for us to do so because, again, the intermediary is bringing that business to the market and representing their clients' interests. We have contractual obligations to our financing entities to buy the assets according to their criteria, and we operate in a regulated environment that is becoming increasingly more so.

Policy owners will occasionally submit a case to their attorney who may submit it directly to us or to a policy broker. Our primary clients at this point in time remain policy brokers, who are people whose primary business is submitting life settlement cases to life settlement providers, not selling insurance or financial products or other financial instruments. The process is fairly simple. We get an application, typically from the broker. We get releases and authorizations to allow us to examine the information. We get an in-force illustration and two years' worth of medical records. The records are sent out for life expectancy estimation to a small number of independent organizations that use medical and actuarial techniques to tell us the life expectancy of the underlying insured.

The premium analysis involves the use of software-based tools to reverse engineer the cost of insurance of the contract in question, which is a key element in the pricing calculation. We need to know how much money it will take to keep the policy in force over our term. There are four companies that do medical underwriting that have reputations in the industry. There may be others, but they're not prominent. Their methods are all proprietary and different, but they have certain similarities, and that is combining medical and actuarial components to derive that analysis. Life expectancy is always stated in months, which I'm sure everyone knows. The financing entities define how they will use the data produced by the medical underwriters to impose upon us a calculation methodology to determine the value of the policy. They can each use that data in a slightly different way, therefore yielding a different price.

The policy analysis side can also vary from provider to provider. Some use the in-force illustrations. Others use software-based analyses to reverse engineer the policies. Others may have different approaches. Data sources are in-force illustrations and what we call "verification of coverage" (VOC) forms (current values, as-of dates, information on policy loan data, dividend structure, interest crediting rates and so on). We use software, as do most of our major competitors. Premium reserve over the term is calculated, and that has a certain impact on the price.

The price is calculated based on an expected rate of return from the financial institution providing the capital for the transaction. We do a net present value calculation, apply the premiums and the costs, and we identify a maximum offer. At that point a negotiation occurs. It is a purely negotiated market. It's a very competitive market. You make a best offer. The intermediary decides who will get that deal. We go through a brief but aggressive competitive bidding process. The offer is accepted or rejected. If it's accepted, a set of contractual documents is sent out, typically to the intermediary, and then presented to the seller. It is very much like a real estate closing at that point.

There are some common misconceptions about our marketplace. We are, again, not advisors to consumers. We serve the financing entities as originators. They are our primary clients. Policy brokers represent the sellers in the marketplace. Policies are

not, so far as we know, in any legitimate form or fashion actively traded at this point. It's certainly a possibility. There are a lot of rumors and myths that fly around the market about portfolios trading. We've seen very little data in over 13 years of operating that proves that any of that really happens. We are aware of portfolios that are not trading that would very much like to trade for a variety of reasons, but we don't see any real activity occurring in that market. It's not to say that it doesn't, but we're unfamiliar with any approach that appears to work, and we receive many.

We don't track the health of the insureds whose lives are covered by the policies we buy. It's irrelevant. We need to know their whereabouts and that they're still living, but the calculation is based on the life expectancy at the time the transaction is closed. We also don't believe that current privacy regulation argues successfully for our ability to do that anyway, in the long term. Most of our competitors do not do that either. It's possible that some argue that they do, but it's practically impossible in the long run. The market is extremely competitive. There's a tremendous amount of capital chasing relatively few but growing supply of qualifying assets. So, each transaction is not easy. It's actually very complicated to get them done to negotiate a price.

We think the future of our business boils down to a life liquidity business, not dissimilar to the mortgage market. The use of the term "life equity line of credit" and others are just ideas that have been floated both internally and externally to Legacy. We also see a lot of activity in the premium finance arena, which is starting to interface with our industry and our business particularly. We see that area as a growing area. Of course, the life arbitrage transactions that have been observed in the last year or so are also very much a growing area that we think may represent an opportunity for growth for our marketplace.

To conclude, what we're saying is that policy owners have one other choice to sit alongside the others that they've had traditionally. We pay a direct benefit to a living individual, the policy owner. Given the dearth of complaints or other issues arising from sellers viewing our industry as having a positive impact, we believe that we offer a service that the consumer market that interfaces with our business through their intermediaries sees great value in.

MR. JOHN R. SKAR: I'd like all of you to imagine that you are a financial advisor. Even if you're not, try to get into that mindset because that's what I'm going to be focusing on. You've been hired to advise someone about whether or not this person should sell his or her life insurance policy. The specific question that you are being paid to answer is, when is the sale of that life insurance policy the most appropriate recommendation? As Chris has already mentioned, his firm does not get involved in the business of advising. They're simply order takers or they process transactions. The real question is, who does advise the advisors? My observation is that most of the education that is being provided to potential advisors is coming from the life insurance industry and leaves quite a bit to be desired.

If you're a financial advisor, it probably makes sense to do some quantitative analysis. I'm going to cover three different ways of looking at the cash flows of the transaction. It doesn't matter which of these three you choose to use. Use whatever works best for you in your advisory capacity or whatever makes the most sense to your client. We'll look at expected rates of return, a discounted cash flow approach and we'll look at an alternative investment approach.

Let's start with a couple of things of which we are pretty sure. The first one is that someone who's interested in purchasing a life insurance policy is expecting a high rate of return. As Chris mentioned, most of the funding for this comes from sophisticated financial institutions (insurance companies, investment banks, etcetera), and they definitely want a high rate of return. The second thing we're quite confident of is that these investors incur rather high transaction costs. These transactions, as Chris mentioned, are complicated. They involve commissions, underwriting and issue expenses, tax on the death benefit, marketing expense, in some cases reinsurance expense and, of course, hopefully some profit for all the parties involved. As the financial advisor, if you have these two facts in front of you, what can you conclude about the foregone rate of return that the seller is giving up? I'll let you think about that.

To answer that question, let's get into a specific example. This is oversimplified, but I think it's still realistic. Let's take a \$1.5 million universal life policy. The issue age was 55. The original life expectancy was age 80. The insured is now 65 and has incurred some health problems, so life expectancy has dropped to 72. Let's assume that the required annual premium is \$30,000 and, again, for the sake of simplicity, there's no cash value to worry about. A competitive life settlement offer has come in at \$280,000.

Let's take a look at how this cash flow turns into a rate of return to the investor (see Skar slide 2, page 3). At time zero, the investor has the \$280,000 settlement expense, the first year's premium of \$30,000 and expenses that total \$180,000. I've present valued those expenses. Obviously some of them would not be first year; they might be recurring as well. The internal rate of return (IRR) in this transaction, if the insured dies at life expectancy, is 10 percent. Notice that the \$1.5 million death benefit is reduced for the taxes that the investor is going to have to pay because, again, this is an investment asset once it has been transferred to the investor.

Now let's take a look at the same cash flows, but from the standpoint of the insured's estate or the insured's beneficiary (see Skar slide 1, page 4). There's the \$280,000 settlement offer in time zero, the \$30,000 premiums and then the eventual \$1.5 million death benefit. The IRR is 20 percent, which is double the investor's return. I've played around with this, and that doubling of the return works pretty well as a rule of thumb. So whatever the investor's return, the expectation is that the foregone return to the estate of the beneficiary is about double that.

What if the insured person happens to live longer than expected? Of course, all rates of return will be lower. The return to the estate will still be much higher than the return to the investor. There's some crossover point where it would have been better to sell the policy, with the benefit of hindsight. Let's take a look at that crossover point. Where does that occur? We'll compare that \$280,000 settlement to the discounted cash flow of future premiums and the death benefit. At a 7 percent discount rate, the insured would have to live 14 years or, in this case, twice the life expectancy. This particular discounted cash flow method was first presented by Peter C. Katt in the *Journal of Financial Planning* in July 2002. Peter's estimation, which I think generally holds true, is that there's less than a 10 percent chance that taking the life settlement is superior to keeping the policy in force, from the estate's or the beneficiary's standpoint.

I have another chart that shows the present value or discounted cash flow method of analysis (see Skar slide 2, page 5). We have various years of death along the left column. You can see how the year of death would compare to the \$280,000 offer. For example, if death occurs in year seven at a 7 percent discount rate, the estate would be \$462,000 ahead of the game. You can see the crossover point at twice life expectancy in year 14.

There's a third way of looking at these cash flows. It might make sense to look at accumulating the cash flows in the case where the insured person is thinking about reinvesting the settlement proceeds for some other reason. The insured would need to live for 10 years and earn 12.4 percent on the reinvestment in order to equal the death benefit, or 14 years at a reinvestment rate of 7.4 percent (see Skar slide 1, page 6).

As the financial advisor, what do we conclude from all of this? The life policy in question is probably the highest-yielding asset in the insured's estate. It doesn't make sense to sell the policy, with one exception. The exception is if the insured no longer has an estate plan. In other words, if the insured no longer has any beneficiary or estate plan, it might make sense to liquidate. I thought of one other exception. What if the settlement offer is mispriced? What if it's just a bad offer on the part of the investor? It could be a good offer on the part of the seller. The first question, as the advisor to the seller, is, how do you know it's a bad price? What kind of analysis are you going to do? Maybe some of the actuaries in the room could do that, but most agents or attorneys probably wouldn't be able to determine if it was mispriced. Second, it's more likely that a mispricing would come from an individual investor rather than from an institution. Again, the assumption is that these institutional investors are sophisticated, so they are not mispricing.

Let's talk about what the financial professional's role then should be in these cases. You should help the client understand the high rate of return on future premiums when health has declined. You should be helping your client find an alternative to either sale or lapse of the policy. You should ask a question: If an astute investor is

willing to incur significant expenses to obtain your policy, what does that imply about the rate of return to your estate by simply retaining it?

There are some non-financial concerns that we can just flip through, but they might be relevant. Ownership may change many times. There is an ongoing tracking of the insured's health, at least to determine whether he's alive or not. There certainly is a possibility of the original beneficiary's disappointment down the line.

I'd to talk about the life insurance industry's concerns about life settlements. I think there's a popular myth going around that life companies don't like this business because it hurts our financial results. I'm here to tell you that I don't believe this industry has any significant impact on our results. There are at least two reasons why this is a myth. The first is that actuaries assume that lapses are anti-selective. When we price products, we assume that the healthy lives are the ones that are going to lapse. Again, this isn't hurting our pricing assumptions. The second reason is that if life insurance wanted these contracts to lapse, why am I standing up here saying that they shouldn't?

The real reason that life insurance companies are concerned about this is the way they're being marketed. There's the potential for life insurance agents to be recruited into this business and provide bad financial advice. While we are very clear with our agents that if they perform these transactions they are not acting on behalf of Mass Mutual (they are, in effect, doing an outside business activity), it still matters to us if they're providing good or bad financial advice. The final thing I'd say about the impact of this business is that the projected \$2 billion that's talked about in terms of annual life settlement business works out to be exactly .00013 percent of life insurance in force, which I don't think is significant.

I'd like to talk a little about life settlement marketing. Let's review the typical sales pitch that you, as an advisor, might encounter if you started to do some research on this market. Then I'll talk about the potential for misleading financial advisors, planners and consumers. The question that we're going to ask is: Is this industry providing a better alternative for a policy that is about to lapse, or is it proactively searching for seniors in poor health who can be persuaded to sell their policies and then use the proceeds for another product sale? I'll let you be the judge. I'll just go through some of these things.

There are typical questions that are asked. Is the policy "under-performing"? Are the premiums still affordable? Does the client need extra income? There is one important question that you never see on any of these lists: Is the client interested in leaving an estate, whether to family members, religious or charitable institutions? You never see that question. It just happens to be the most important question. As an advisor, will you still have clients who insist on selling their policy? Absolutely! Absolutely you will. It's an emotional thing. They don't think they're going to die. They're being offered cash that exceeds the cash surrender value. Of course they're going to do it. The question is, what's your job as the advisor?

Life settlements have been talked about as financial planning tools. There are a bunch of reasons that they've been given that designation. Estate needs have changed. The policy owner has more pressing needs. The policy owner's priorities have changed. These are interesting questions, but if the client is eligible for a life settlement and still has estate needs, this particular policy should be retained to meet those estate needs and some other asset should be liquidated instead.

Here are five reasons that agents or financial planners are typically given for doing life settlements. They earn fees on the settlement, keep renewal commissions, sell a new investment or annuity, sell a new life policy (one in three) and for term conversion commission. They all involve commissions. The only thing not on this list as a reason is "to help your client make the right financial decision."

There are a bunch of pre-qualifying questions that the marketing literature has that you're supposed to ask. Again, if you're a financial advisor, you're supposed to ask these questions. Has the insured outlived the beneficiaries? Is the policy premium unaffordable? Has health changed for the worse? Is the insured a retiring "key man"? Are estate taxes changing? Again, what's the one question you don't see on this list? It's the only question that matters.

How about use of settlement proceeds? I like these lists. It can be used for gifts to family members. Buy a new life policy. Make an investment for the heirs. Make a charitable donation. Buy another insurance product where an estate need still exists. Again, I think we've already talked about why those particular things don't make sense.

A subset of this market is the corporate owner of life insurance, where the key man insurance is no longer needed. The policy could be used to pay off company debt. There has been a change in the deferred compensation program. A buy/sell program is no longer needed, or there's a bankruptcy. But again I would submit to you, as the financial advisor, that this policy probably represents the highest-yielding asset on the balance sheet of this corporation. Why would they sell it for pennies on the dollar?

There are supposedly actual cases that life settlement companies have on their Web sites as examples of transactions that actually took place. I'm not going to spend time on them, but I would suggest to you that based on the analysis that we've done, I haven't seen a single one that makes financial sense.

How large is the market? We've talked about it. It's large policies, over age 65 and not contestable. There's a deterioration in health. Life expectancy is two to 12 years. Those first five criteria cut down the market considerably, but when you add the sixth criteria that I've been talking about (no interest in leaving an estate), that cuts it down substantially.

As the advisor, what is your potential liability in this area? Do you have a liability if you fail to tell your client about the life settlement? Perhaps. But how about if you recommend the sale of a policy rather than keeping it? Wouldn't that be a more substantial liability? How about if you recommend selling an existing policy in order to buy a new one? I believe that financial advisors should provide the most appropriate recommendation, not just a "better than" recommendation. In most cases, this will be, "Find a way to keep the policy."

In conclusion, life settlement is rarely the best financial recommendation. Agents, advisors and consumers are getting bad advice from the marketing material that's out there today. Better alternatives will evolve. As Chris mentioned, some kind of a line-of-credit alternative is the most obvious evolutionary step.

MR. JEYARAJ VADIVELLOO: I'm going to be talking about a comprehensive three-month study that was done this past summer by the Deloitte/UConn Actuarial Center. The research team involved students and faculty from the actuarial science department and the department of finance, plus a group of professionals from Deloitte. This is a very comprehensive study that took more than three months to complete. I believe it's the first such study that looks at the life settlements industry from an actuarial perspective. Every attempt has been made to make sure that every assertion or assumption that's used in the study is backed by solid facts and uses sound and rigorous actuarial reasoning. I don't have the time to go through this entire study, but I'll highlight the main points of it.

Possibly one of the biggest contributions of the study is that we recognize three options available to a policyholder with impaired mortality, not just two, which is common in the life settlements literature. More importantly, we quantify the third option. The first option is to surrender the contract to a life insurance company. The second option is to sell the contract in the secondary market to a life settlement company. The third option, which is a new option we introduced, is to retain the contract, but what was important was that we quantified this third option.

In the life settlements literature, you see comparisons between the cash surrender value and the life settlement value. The differences are obvious. Cash surrender value is something determined at issue, doesn't vary with the health of the policyholder and is set by regulation. That is very different from the life settlement value, which is determined at settlement, varies with the health of the policyholder and is set by the life settlement company. It stands to reason that a life settlement value is significantly higher than a cash surrender value.

Then you get to the third option, retaining the contract, which we introduced in our study. The way we quantified this was that we created this definition called the "intrinsic economic value." It's a prospective measure. The formula is the actual present value of future benefits minus the actual present value of future premiums. It looks very much like a prospective reserve calculation, with some differences. The mortality assumption that's used in this calculation is based on the impaired

mortality of the policyholder at the time of settlement. The future premiums here are the actual gross premiums being charged. The discount rate we are using here is not the valuation interest rate but a risk-free interest rate.

Based on this definition of this intrinsic economic value, if you compare it with the life settlement value, you see a lot of similarities. Both are measures that are determined at the time of settlement. Both use the impaired mortality to make the calculation, but that's where the similarities end. Intrinsic economic value doesn't incorporate any transaction costs and uses the risk-free interest rate, while the life settlement value incorporates all the transaction costs and uses a hurdle rate for discounting.

We did several kinds of analyses in our study to compare the intrinsic economic value with the life settlements value. We did a theoretical actuarial analysis. We did an analysis similar to what John Skar did, but we did it almost from a finance theory perspective. We did what's called an empirical analysis, which is what I'm going to talk about. The results are quite revealing.

To do this empirical analysis, we looked at the New York filings of all life settlement companies for calendar years 2000 through 2003. Most of the information was contained in Schedules 7 and 8. Schedules 7 and 8 show all new life settlement sales, and that's from prior sales in the 2000 to 2003 period. We also coined a new definition. We called it the "lost economic value," which is simply the difference between the intrinsic economic value and the life settlement value. That difference is mainly comprised of transaction costs and the profit element involved in the life settlement sale.

We decomposed this lost economic value into all the various transaction-type expenses. To do that, we used assumptions. For expenses, we assumed brokers commissions of 4 percent to 8 percent of face amount, selling commissions of 5 percent to 10 percent of gross proceeds, providers origination fees of 5 percent of gross proceeds, and manager's and servicer's fees of 5 percent of gross proceeds. We assumed gross premium of \$20 per \$1000 face amount, a risk-free rate of 5 percent, a hurdle rate of 8 percent and a 35 percent tax rate on net proceeds to the life settlement company. It wasn't very easy to come up with these assumptions because the expenses of life settlement companies are not standard. They vary from company to company. We had to do an extensive review of the Web sites and the 10K filings to come up with what we think are pretty representative assumptions.

A schematic of the process of a life settlement transaction is quite interesting because you can understand where a lot of these transaction costs come about; there are many parties involved in a life settlement sale.

I'm going to share with you the results from Schedule 8 (see Vadiveloo slide 13). Schedule 8 represents all the new sales from 2000 through 2003. If you look at the

very last column, you'll see that on the average, life settlement companies paid about 20 cents to a dollar of face amount on every new sale. That is significantly higher than the cash surrender value that would have been obtained if you surrendered your contract. However, if you look at the intrinsic economic value, that's about 62 cents to a dollar. That means that for every dollar of face amount sold, about 42 cents was lost because of transaction costs and the profit component.

If you break down the lost economic value into its various components, you'll see that the majority of the costs are transaction-related costs. The pure profit element, what we call the risk profit, is only about 29 percent of the lost economic value.

Now because transaction costs seem like such a significant part of a life settlement sale, we looked at a comparison of life settlement transaction costs against other common investment types, like stocks and bonds, and even more esoteric-type investments like real estate and art sales. Life settlement transaction costs measured as a percentage of the asset sale price is quite significant, from 40 percent to 42 percent. For bonds, the transaction costs are from 1 percent to 2 percent. For real estate, the transaction costs are from 5 percent to 8 percent, and for art, the percentage is from 10 percent to 15 percent.

We did an extensive review of marketing materials—similar to what John did but we did it more academically—to see whether there was any reference at all to the option of holding on to a policy or measuring the value of a policy for an impaired policyholder. We summarized in our study all the common themes that were found in most of the life settlement marketing solicitations. I don't want to focus on this. I want to focus on what I think has been missing in all the marketing solicitations. For example, only one source mentioned the option of retaining the life insurance contract. Only two sources asked if the policyholder had estate needs. One statistic I want to share with you is somewhat disturbing. About 41 percent of the sources suggested using the proceeds of a life settlement to buy another policy, but there's no mention of compliance with replacement regulations.

Next we went into the regulation. We wanted to see whether there was anything in the regulation that talked about, even qualitatively, the value of retaining a contract. There are two big regulations from the life settlements industry. They are the NAIC model regulation and the National Conference of Insurance Regulators (NCOIL) Life Settlements Model Act. There are a lot of disclosures and a lot of requirements that both these model regulations talk about, but, again, I want to focus on what I think is important but missing. We have recommended that some of these things be included in any kind of regulation on the life settlements industry. For example, model regulation should require mentioning all three options, quantifying the third option in particular, disclosing transaction costs where they are quite significant and, if the life settlement proceeds are being used to

purchase another policy, we think it's important that the replacement regulation should apply.

What can we conclude from this study? We believe that when this study is disseminated to the public, there will be a lot of people who can benefit from it, including the insured, the beneficiary, the life insurance agent, financial advisors and regulators. We believe that some of the findings of our study are very important because, if you think about it, the life settlements industry is targeting possibly the economically most vulnerable section of the population, senior citizens whose health is impaired. We think it's important that proper disclosures are made and the agents are trained to be able to communicate these disclosures, so that a policyholder with impaired health can make an educated decision as to whether he or she should retain the contract or sell it.

What's the implication of our study for the life settlements industry? We believe that in its current structure, with complete disclosure, there's only going to be a small segment of the current target market that could truly benefit from a life settlement sale. However, we also believe that this secondary market is important and can be more efficiently structured. There are several ways of doing it. One way, of course, would be for the insurance industry itself to enter into this market by offering, say, an impaired health liquidity rider as part of an insurance contract. In this way they can reduce a lot of the transaction costs, and this benefit can then be more attractive to the target market. This would be a topic for another discussion.

MR. STEVE BOGER: Since the life settlement industry is relatively new probably to many of you (it's actually still relatively new to me, too), I thought it would be useful to compare the risks and the activities (the actuarial analysis, so to speak) that take place in the life settlement industry with the actuarial practice assumptions analysis that you're probably already more familiar with as life insurance actuaries.

The life settlement transaction is filled with some uncertain and contingent future events, so it's very well suited to actuarial methods, as is a life insurance pricing exercise or a life insurance experience analysis exercise, of course. I'm going to skip the life insurance business on the premise that you're already very familiar with that, but the "big three" of pricing in a life settlement or a life policy are expenses, interest and mortality. Expenses are quantifiable. I'm not saying that it's easy, but you can get your arms around your expense structure. Interest is quantifiable for life settlement practitioners, and that's because they tend to run the cash value down to the least amount possible, minimizing their investment. Consequently, there's very little interest to be credited. It's not very important. However, mortality is quite uncertain, and so that becomes the big moving part in a life settlement transaction or exercise.

If you look a little deeper, the mortality is a two-dimensional issue for a life settlement purchaser. There's the first one, which is the cost of insurance (COI),

the mortality charges. What level of charges are they going to experience in the policy, and will they change in the future? That's an expense structure for the life settlement purchaser. What pattern of future mortality should they expect among the insureds? That's going to determine the timing and rate of return on their investment. In the aggregate they're probably looking at 200 or more percent of standard mortality. It's a pretty big number, and it is, again, *the* moving number, *the* event.

Let's talk about the patterns of mortality. Insured mortality is well understood, but a viable life settlement candidate has a decreased life expectancy (LE) since his or her original purchase. Put another way, the candidate's mortality has increased by quite a bit. There's an excess of mortality there. What pattern might that excess take? You could look at the life settlement experience tables, except that there aren't any. You could just solve for a multiple of standard insured mortality or take the underwriter's word for the multiple that the underwriter gives you. By the way, underwriters don't usually tell you what table they're giving you a multiple of, but they do give you a multiple, so that's somewhat handy. You could solve for a flat extra add-on to the base insured mortality that you think is reasonable, or you could exercise some judgment and follow another pattern. There are a lot of opportunities here to have an effect on the cash flow projection and on the price.

What has been the experience? What can you learn from looking at that experience? How can you use that in your work? The business is only about five years old, first of all, and it has been a relatively exponential five years, as Chris described. In other words, most of the experience is only one or two years old. I estimated on the back of an envelope that the industry as a whole would have expected less than 5,000 deaths to date, and I think that number is actually a fair amount high.

There are little organized data for you to rely upon. If you want to get some data, how are you going to do it? Would you like to assess excess mortality based on the underwriter? As Chris described, there are about four underwriters with a material volume of business. You could review their experience. That has some advantages. There are a lot more files reviewed, so you can get a bigger study. The disadvantage is that the contracts that weren't purchased aren't being tracked very actively, so you're not actually sure if the person is alive or dead. You do the best you can using Social Security data or whatever, but it will be imperfect. You can assess the results by purchasers, and look only at the experience of the industry for those contracts that were actually purchased. On the plus side, those contracts are being tracked very well and there are good data there, if you can get it. On the downside, there are obviously a good deal fewer of those contracts. No matter what you use for your source of data to try to determine the pattern of excess mortality, you're going to be experiencing some under-reporting of deaths, particularly if you're doing your study based on the underwriter's results rather than the purchaser's results because, again, the tracking is less active.

There is some experience coming forward. A few studies have now been done. I can tell you that the experience of the industry is still volatile. Just to make things more difficult, the underwriters are continuing to refine their practices. For example, if underwriters change their view of the significance of breast cancer as an impairment and reduce their debits from 200 to 150 but don't let you know that, then comparing their experience from 2002 with their experience from 2004 is going to be difficult. I picked one impairment, but they do this across the board as their business changes. That makes the year-to-year comparisons even more difficult.

There are some patterns that I've seen. The ultimate mortality table is a better base for projecting life settlement transactions than the select and ultimate. That was my opinion a month ago. I would now say that I believe the answer is somewhere in between. Life settlement transactions do not experience, in my opinion, fully select mortality, nor do they experience fully ultimate mortality. The slope is somewhere in between. I offer some observations about actual-to-expected ratios. They drop modestly as duration increases, increase modestly as LE increases and decline as the insured's age at transfer increases. Finally, I'll just let you know that the patterns are obviously still emerging. There's a lot of judgment required if you were to predict the mortality experience of the life settlement business. Again, most of the business is probably only two to three years old. It's very early to project whether things are better or worse than a seven-year life expectancy after two.

In summary, there are some areas of similar complexity relative to life insurance and life settlements. Expenses come to my mind. That's a quantifiable item. Both the life insurer and the purchaser can get their arms around their expense structure. Then there are some areas of difference. Lapsation does create some risk for the insurers, but almost none for purchasers because they purchase with the intent to maintain the contract until death. Interest rates create disintermediation risk for insurers. It's a big topic; it's probably on the agenda of this meeting a number of times. There's almost no such risk for a purchaser. Realistically, you're looking at crediting rates today that are close to the guaranteed rate and very low cash values to earn that. You can hardly miss. But mortality is a big difference. It's a predictable risk for insurers, and the law of large numbers does come into play. I think John highlighted the difference in relative volumes very nicely. It's an extremely uncertain item for purchasers. Both the pattern and the level of excess mortality are not yet clear, and the law of large numbers has not come into play. There's a fairly big difference on that assumption.

MR. DWIGHT K. BARTLETT, III: I'm a self-employed consulting actuary, but I'm also speaking from the perspective of a former insurance regulator, as former commissioner for the State of Maryland. As I thought about this business and its development and so on, I felt that the NAIC model regulation for this area should be modified or amended to require that the person or company that's making a settlement offer for a policy should be required to disclose, as a part of that offer,

what the life expectancy is, such that when you discount the cash flows, including the death benefit paid at the end of that life expectancy period. Those discounted cash flows at some riskless rate equal that settlement offer. That puts the policy owner seller in a position of at least making some judgment as to whether this seems like a reasonable view of his own self-assessment as to his mortality.

MR. VADIVELOO: I certainly would like to react to this because this is exactly the definition of the intrinsic economic value that you just gave. I think this is very important to disclose because that is a measure of value of a life insurance contract, when your health is impaired.

MR. CONWAY: I don't agree that the transaction is riskless, so I don't understand the choice of a risk-free rate of return. If the life insurance industry would like to propose such regulation, I think the life insurance industry needs to guarantee that its indeterminate premium contract will never change, because that's one of the risks that's being ignored. It was mentioned that one of the reasons you might want to conduct the transaction is that the life settlement offer has been mispriced. Gee, do we have any blinders on? Is it possible that the life insurance policy was mispriced? Is it possible that the insured doesn't have a good value in their insurance contract? These are not even-handed presentations that are being given, and I think that the community needs to step back and consider whether or not it's being fair or partisan.

MR. VADIVELOO: I want to make one statement about the risk-free interest rate. It depends on from which perspective you are looking. From the policyholder's perspective, a risk-free interest rate is appropriate because the cash flows, with the exception of maybe universal life-type policies, are not going to be influenced by market conditions. From the policyholder's point of view, an appropriate discount rate to be used is the risk-free interest rate. From the life settlements company's point of view, it might be different.

MR. FREDERICK S. TOWNSEND, JR.: This has been a very interesting discussion to me. There are two observations that I wanted to bring out. Mr. Skar and Mr. Vadiveloo have argued that even if there is no longer any insurance need (the insured is over-insured, doesn't have a need for insurance or he can't afford to pay the premium), the premium should be paid because of the increased value of keeping the policy versus selling it. I think that would assume that if somebody can't afford to pay premiums that the person has a cash value contract. The person can borrow on the cash value to keep it in force. Don't the dynamics change if the insured has a term insurance policy that he or she is submitting to a life settlement company when either the insurance coverage is no longer needed or the insured finds the term insurance premium beyond his or her budget at that point in time? For example, term insurance premiums may increase at some specified durations or attained age, or you may be faced to convert it to keep that policy in force at some future point in time.

MR. SKAR: Fred, the point I was trying to make is that the insured needs to ask the question whether he or she still has any kind of an estate need. If the insured is planning to pass assets to charity, to family or to whatever, then the insurance policy should be the last asset that the insured should consider liquidating. In fact, the insured could cash out another estate asset. The insured could go to the charity or the other beneficiary and ask them to take over the premium payments. There are lots of options. But, again, the key question is, do you still have an estate need? The question is not, are you over-insured? That's the point that I was trying to make.

MR. TOWNSEND: The other observation I have is directed to Mr. Boger. I think you referred to the inability to predict what the mortality pattern would be or the level of actual-to-expected mortality, etcetera. That suggests to me that if somebody submits or asks for a bid on a life settlement contract and the person is getting bids from a half dozen funding companies, and it's so difficult and so inaccurate to predict mortality, then the most liberal bid is likely to be mispriced. Therefore, there is a greater chance of the policy being a benefit to the seller.

MR. BOGER: I think there is a wide range of offers being seen, and I think it's almost inevitable that the high one is mispriced. I think that takes place regularly. Chris referenced the fact that there's a lot of money looking for a high return. They can't all be fully informed and they can't all be doing it properly. Yet in spite of the fact that there's a lot of money looking for places to go to work, there are also a lot of people looking to grow their funding corporation. There are plenty of competitive stresses there, and I have no doubt that some people are pricing too aggressively. It's going to show up in succeeding years. Some people are getting some real fine offers.

MR. SHAWN D. PARKS: Chris, do you ever see this marketplace getting to the point where it will be expanded to where you will have the offers available to the broader population of policyholders, other than the advanced ages and limited life expectancies?

MR. CONWAY: Do you mean that we would find a way to value a policy based on a life expectancy that's longer? That's really a function of the underlying products that are being designed. With respect to Steve's most recent comment, the mortality information that we receive and then use to develop an offer varies from financing entity to financing entity because their approach to mortality, in consulting with their actuarial advisors, their financiers, and so on, results in a decision, a set of criteria, a formula, if you will, that we use to make an offer on their behalf. If I have four or five financing entities all willing to build portfolios, they will all have slightly different offers. When John mentioned with respect to our belief that over time there may be some other liquidity option, I used the term "life equity line of credit," or LELOC, just because "HELOC" has become synonymous with the home equity lines of credit about which everybody gets six pieces of mail a

day. The life equity line of credit is possible with respect to a broader base of the population.

The only other thing I'd say about the population that we interact with at the transactional level is that they are by no means, from a holistic perspective (so far as we know, because we don't collect the data), economically vulnerable, in the sense that the vast majority of the people from whom we buy a policy or who are covered by a policy we buy are multimillionaires, many of them household names, with volumes of life insurance far beyond what my 20 years of experience would have led me to believe anybody could even get. That's not always the case, but the average face amount continues to rise. It's approaching \$1.5 million, and it will get bigger and bigger. The efficiencies in our business right now are a function of the amount of time it takes such that to underwrite a life covered by a \$100,000 policy or a \$5 million policy is exactly the same. Because of the way the intermediary side of the market functions. There's not an incentive at this point for the valuations that you're talking about for broader populations. That whole mechanism would have to become much more efficient and much more formulaic for that to happen. It does offer some value from the standpoint of the clients we serve on the financing side, because the more lives in the portfolios, if you will, the broader their diversification and, theoretically, the better risk characteristics they would have. However, so far the market is not that mature yet. Certainly it's possible if the products continue to evolve the way that they have over the last 20 years. Our business would not function if universal life did not exist.

MR. PARKS: One other term that you had in your presentation was "life arbitrage." What is the definition of that?

MR. CONWAY: I'm referring to transactions wherein new life business is issued concurrent with the issuance of a single premium immediate annuity (SPIA), and the rated age for the SPIA contract is much higher than the underlying costs for the newly issued life contract.

MR. LARRY J. BRUNING: I just want to ask a question to make sure I understand this right. On the sale, on that change of ownership, that makes the death benefit, in essence, taxable. Is that correct?

MR. CONWAY: Yes.

MR. BRUNING: Wouldn't there be a more tax-efficient way to do it without actually having the owner sell his right in the insurance policy but, in essence, change the beneficiary and have that beneficiary be irrevocable and receive value for that? Would that pass muster?

MR. SKAR: No. That would still be a taxable event for the corporation that owned the life insurance. They don't own it in the same way that you or I would.

MR. BOGER: It would be transfer for value.

MR. BRUNING: I'm saying that the owner stays the policy owner.

MR. SKAR: It doesn't matter.

MR. BRUNING: It doesn't matter?

MR. SKAR: I don't think any of us are tax experts, but I think the phrase is "transfer for value."

MR. BOGER: Yes. If the original policy owner receives value, the IRS would look through the transaction. However it's legally transacted contract-wise, the policy owner is still receiving a sum of money for his or her policy, and that didn't magically appear.

MR. BRUNING: Right. I have a second question. You mentioned the high value of these clients, and also that one of the reasons is that they couldn't afford to pay the premiums. Something doesn't connect there. Also, given the high value of the clients, typically they would be astute investors themselves (or one would hope that they would be) and could figure out the lost economic value in doing the transaction.

MR. CONWAY: What we're dealing with typically, albeit an intermediary, is someone who advises someone that, based on their application for life insurance and the information that we're required to collect from a regulatory perspective and the forms that we must use and so on and so forth, is sophisticated and is, in general, high net worth. That's not to say that the history of the industry isn't based on interactions up through mid-2000 with people who were more economically vulnerable or less wealthy, and theoretically less sophisticated, at least in terms of their balance sheets and so on. The other thing I'd like to point out is that to some extent the term "need" as a practical matter is not something that motivates most people to do many things. What we find is that people are making decisions, for better or worse, with good or bad advice, based on what they want, whether they're doing the analysis or not. We believe that many of them are doing the analysis, because to close a transaction involves a lot of interaction with some very sophisticated people typically, not just on the financing side but also those representing the seller's interests. While we're not a party to the discussion between the seller and the seller's advisor, they are not often people who need to stop paying the premium to buy milk, bread and cheese. They are people who have purposely chosen to not pay it and to sell the policy for some other reason that, frankly, is none of our business but, if revealed to us, typically can involve some other financial transaction or a plain and simple matter of opinion like "I don't want it anymore." Often they are not selling us all of their coverage. They're selling us that coverage that they deem they no longer want or need. That's not to say that we couldn't objectively analyze the situation and argue for a need, but the

consumer is making that decision of his or her own volition based on his or her own advice. Mathematics aside, I was trained in the life insurance industry that life insurance is not bought; it is sold. Super-heaped commissions and so on and so forth are indicative of that market distribution methodology still being very much in play. For better or worse, most of these folks do what they want to do. They do consider their needs with their advisors, but they tell us outright, "If you don't buy it, somebody else will." We interface with them when they're in the market post-advisory counsel.

MR. SKAR: I think Chris just touched on an important point. The life insurance is sold; it's not bought. It gets back to this very basic human emotion that we're not going to die. That's why it's so difficult to get people to realize the necessity to buy life insurance. Conversely, I think it's a relatively easy emotional sale to get people to sell it.

MR. JEFFREY T. ROBINSON: There's one thing that I didn't hear, and that's because I gather that the industry has evolved. When this thing started out, it was viatical settlements to cancer patients with expectancies of life of two years or less. However, there were medical improvements and advancements, and I think that changed things. In those situations, there was a need—people who had tremendous medical expenses. But there's one thing I didn't hear you get to, and I think it's a function of the question that was asked about this area broadening. Now we're talking of life expectancies of 12 years or less. What about medical advancements when you look at these impaired risks? Nobody brought that up. Is that an issue? Is that no longer an issue? Are we not talking about cancer or terminal patients anymore? Is that not a pricing item in your consideration?

MR. CONWAY: I don't think that the life settlement industry is looking at terminal patients by and large, and maybe not at all. But they are looking at folks with impairments and with a shortened life expectancy. The viatical market, by the way, was primarily an AIDS-based market, not cancer.

MR. ROBINSON: Right, yes. And it changed.

MR. CONWAY: That pointed to a basic investment strategy in any market, which is to diversify your risk. The life settlement market is a lot more diversified, although you're still going to see the primary impairments of age being the primary risks at which you're looking. I'm sure different people price differently as to whether or not they assume improvement. Say they're pricing October 2004. Do they assume improvement in 2005? In 2006? In 2007? I think if they assume cure, obviously they don't win any cases and they close their doors pretty quickly. So just looking at it logically, their improvement assumption can't be very robust.

MR. SCOTT J. WITT: Life settlements are clearly inefficient, but we do have a universal life (UL) nonforfeiture system in place right now that allows for low or no cash values on products that have full guarantees, sometimes even for a lifetime. It

seems that in those instances life settlements still provide a better alternative to folks who otherwise would have lapsed the policy for absolutely nothing, literally zero cash value. If you put two and two together, the fact that it's a lapse-supported policy, which is almost inevitable if you're giving low or no cash values and you're assuming any sort of positive lapse rate, it seems to me that if you do have the life settlement market go mainstream, you're going to have companies opposed to that very fact simply because it's going to hurt their financial results if these policies don't lapse and they stay in force.

MR. SKAR: Scott, I'd just like to reiterate what I said during my remarks. As a senior financial officer for a major mutual company, I'm not worried about life settlements in terms of our financial results. I'm sure Chris and Steve could tell you that whole life policies are also eligible for life settlements, not just UL and not just term. There are a substantial number of whole life policies that get life-settled every day. Again, the concern that I have is not a financial one at all. These represent a very small percentage of the contracts and when we price contracts, we assume full anti-selection on lapse. It's not hurting the pricing assumptions at all.

MR. BOGER: Whole life does work, although I think that folks that I talk to see an awful lot less of it. Chris commented clearly that the industry wouldn't exist without universal life. So, yes, whole life is viable. Second-to-die contract is a viable purchase. It happens more commonly when one spouse has died and it's really now a single life policy, but a wide array of products is available.

MR. SKAR: Whole-life-with-term blends also work quite well.