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**Food for Thought**

*By Rachel Min*

**Securitization of life settlement contracts**

In a September 2009 article, "Wall Street Pursues Profit in Bundles of Life Insurance," the *New York Times* (NYT) claimed that Wall Street had found a new investment vehicle in the securitization of life settlement contracts. The idea of using mortality risk to diversify portfolios has been gaining momentum for some time and an investment in life settlements provides access to such risk exposure. At the time when this article was featured, there were fears that the growth in the securitization of life settlements would parallel the growth that was seen with the securitization of subprime mortgages. The insurance industry was alarmed that the securitization would fuel the growth in the life settlement market, and the Securities and Exchange Commission (SEC) set up a task force to conduct an investigation of the securitization process. Investment banks however, have since then lost interest in the life settlements due to loss of appetite among the investors who have become wary of exotic securities. Even though it seems unlikely that the life settlement would become the next security to implode the market, it is worthwhile to consider the implications of its securitization to the insurance industry.

What is a life settlement?

A life settlement is a financial transaction in which an ill or elderly policyholder sells his/her unwanted or no longer affordable life insurance policy to a third party for a cash amount. This cash amount is decided based on the life expectancy of the policyholder and is less than the face value but is greater than the surrender value that would be offered by the life insurance company. After the transaction, the purchaser becomes the new beneficiary and is responsible for the future premiums. Upon the policyholder's demise, the purchaser would receive the policyholder's death benefit. Therefore, the purchaser is essentially speculating on the policyholder's time of death. The longer the policyholder lives, the lower the return for the purchaser of the life settlement.

The life settlement has been around since the 1980s, and the life settlements at that time were mainly obtained by those with terminal diseases who wanted to sell their policies to pay for their medical costs. Nowadays, in a life settlement transaction, the

policyholder is usually of age 65 and above and is not terminally ill.

How does the securitization work?

Securitization is a process by which illiquid assets are pooled and packaged to back the issuance of new securities. Thus, to securitize the life settlement contracts, an issuer would purchase or gather a pool of life settlements and resell the claims on the future death benefit payments to the investors through the issuance of bonds. The returns to the investors depend on the timing of the deaths of the policyholders, and the risk undertaken would be the longevity risk that people will live longer than expected. The investment banks earn fees on the service they provide in helping to structure the new securities and find potential investors.

The challenge of securitization of life settlement contracts is in making the investment more predictable and transparent. The life settlement market itself still faces many challenges including regulatory hurdles and negative public perception, and there are many outstanding issues regarding its sales practices and privacy rights. To avoid problems similar to the ones seen with the subprime mortgage market where some brokers made fraudulent loans that were packaged and sold to the investors, some control measures are needed to ensure that the origination of life settlements is a monitored process. Furthermore, there are concerns about inconsistencies and variances in the medical underwriting procedure, which determines the life expectancy of the policyholders of the life settlement contracts. This is an important issue because the investors cannot measure the longevity risks involved with the investment without the proper estimates of the policyholders' life expectancies.

What are the implications to the insurance industry?

Even though life settlements existed before, its market was small and was of little concern to the well-being of the life insurance industry. With the securitization of the life settlements, it is possible that the market for life settlements would expand substantially. There is definitely a potential for growth in the market; according to the *NYT* article, there are \$26 trillion of life insurance policies in force in the United States, and the aging of the population with gutted retirement portfolios means that more people may be looking to sell their insurance policies for cash. If the securitization is successful and the life settlement market grows significantly as a result, the implications to the insurance industry will be non trivial.

When a life insurance policy is no longer needed or affordable, the policyholder typically lapses the policy, which means the insurance company does not have to make a payout in the future. This policyholder lapse behavior is taken into account when insurance premiums are set. If policyholders sold their policies for cash in life settlements instead of lapsing, however those policies will stay in force and result in more payouts for the insurance companies. All the lapse assumptions that were used in pricing the insurance premiums would be wrong and the insurance companies' profits would decrease due to the unexpected increase in payouts that weren't properly priced. Eventually, the insurance companies will have to increase premiums for everyone. The supporters of the life settlements argue that creating a market that

will allow the elderly to unlock their money by selling unwanted or unaffordable insurance policies is a public service. On the other hand, it should be noted that the fundamental purpose of a life insurance is not to be an investment or a speculative product.

Recommended Further Reading

*The Wall Street Journal*, February 5, 2009, "Life–Settlements Industry Sees Growth"

*The New York Times*, September 6, 2009, "Wall Street Pursues Profit in Bundles of Life Insurance"

*The Wall Street Journal*, September 16, 2009, "SEC Will Examine Insurer Settlements"

DBRS, February 2008, *Methodology: Rating U.S. Life Settlement Securitizations*