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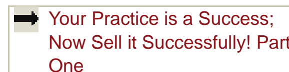
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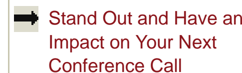
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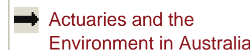
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December EA Section Webcast:
Starting Your Practice; Ready for Success
Dec. 9, 12:00 - 1:00 EST

Join this webcast with featured writer David Rintoul for practical guidance in setting up a consulting practice, giving you the legal and business tools to succeed. The session will cover such issues as:

- The form of business entity to use,
- Preparing before you leave your current employer,
- If your non-compete is enforceable,

Current Trends in the Secondary Insurance Market

by Michael L. Frank

We are in 2008, and the actuarial industry is still on a quest to obtain empirical data on the secondary insurance market, with particular focus on life settlements. A life settlement is the sale of an unwanted in-force life insurance policy. If a sale is successful, it will typically be for an amount greater than the available cash surrender value. Life settlements policies are typically permanent insurance products (universal life, whole life, etc.) on older insureds (ages 65 and above). The goal of this article is not to teach the reader Life Settlements 101, but rather to provide information on some of the emerging trends in these markets.

Over the past four years, our firm has provided consulting services and research to more than 40 investment bankers, hedge funds and research analysts around the insurance market, with a significant focus on the life settlement and secondary insurance market. In addition, our organization, through its work as a broker and reinsurance intermediary, obtains marketing information and data from the secondary insurance market—the market perceives our organization as a producer.

Beneficial Interest Policies

Our firm has seen a recent growth in demand for both the buying and selling of portfolios of beneficial interest policies, where the owner and beneficiary are listed as an insurance trust. The insured's spouse or child is often the beneficiary of the trust. Selling a policy as part of a life settlement transaction typically will not change the insured. Usually the beneficiary of the policy will change, and the life settlement company buying the policy will become owner of the trust that owns the policy. The purchaser, which might even be another trust, acquires beneficial interest and makes the agreed-upon payment to the trust's beneficiary. The owner of the insurance policy, and in some situations the beneficiary, has not changed. The rest of the transaction resembles a life settlement, since once the policy is sold and the insured is no longer the owner of the policy, all premium payments and obligations become the responsibility of the purchaser.

The goal is to find beneficial interest policies where one beneficial interest party holds 100 percent of the policy; otherwise it is difficult to complete a transaction. In our experience, organizations should not explore transactions where this is not the case, since it can sometimes be a challenge for all parties to be involved and agree with the decision. And once rights are purchased, the purchaser

- Assembling a "virtual firm,"
- Structuring your deal with partners,
- Managing intellectual property,
- Independent contractors vs. employees, and
- Taking a minority interest in a business.

Find more information here on the SOA Website.

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requires 100 percent ownership to unilaterally make decisions on premium payments and levels of funding.

Synthetics
Today, the life settlement industry is faced with significant obstacles including:

- A compression in funders due to the challenges of the subprime market and its adverse impact on buyer capacity in the market, particularly hedge funds.
- A significant number of policies that are available for purchase that are in the contestable period (first 24 months), originated through premium financing or both. There tends to be a limited number of buyers for these types of policies.
- Adverse financial impacts, relatively high level of expenses and a perception of poor ethics in the market have turned investors away.

As a result, we are seeing a bigger movement of investors in life settlements into the artificial or “synthetic” market. In this market, investors are making investments in life settlements, but there are no actual insurance policies traded. Pitfalls of the traditional life settlement market are avoided, such as layers of brokers looking to be compensated, insurable interest issues and licensing/regulatory requirements.

With synthetics, some of the actuarial formulas used are the same, such as development of expected benefits and expected premiums, the present value of these amounts and return on investment (ROI). What is different is that there are no real policies, only illustrative ones. The lives valued are real, and professional organizations are used to underwrite and administer the record keeping of these individuals. The policies created are a predetermined cash flow stream based on death benefits and premiums. The premiums are based on the expected mortality cost, with adjustments for a risk/profit charge plus a cost to run the facility.

Cash values are not a factor in the synthetic market, which makes it easier to value ROIs. Regulatory requirements like the definition of life insurance under IRS code section 7702 and the 7-pay test are not in play, since there is no life insurance.

Why are organizations excited about this market? For the reasons stated above, there are fewer moving parts and fewer regulatory and operational hurdles through which to jump. The traditional life settlement proposition is that investors will have a present value of future benefits greater than the present value of future premiums plus the other expenses (payment to policy owner to buy the policy, commissions to life settlement brokers, licensing/administration of the life settlement provider/buyer of policies).

Methodologies used for pricing these types of programs may be similar to those used by actuaries today for life insurance premium development and reserve valuation. Both require selection of mortality tables, interest rate discounts, expense margins and projected profit returns. Key issues are choosing the correct mortality table and loads to go with it and applying a margin, whether implicit or explicit.

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A criticism is that this sounds like Las Vegas meets the life settlement industry, since the house (the organization setting the premium rates) controls the odds so that the present value of future benefits (the payout) will be less than the present value of future premiums (the amount bet). In the life settlement arena, individuals are taking a bet that over the time since their issue older issued policies had a material change in mortality, e.g., preferred became standard or substandard. If investors are making the mortality bet, how off will their bet be if material changes in underwriting are not anticipated? Does this scenario look like blackjack odds (a game that I still love to play despite the fact that the chances of winning are less than 50 percent)?

There are multiple derivations of these synthetics. Organizations in the banking industry have been introducing these products to the market. We anticipate additional programs to be rolled out in the market, and have received inquiries on these programs from companies interested in both investing in and offering or developing these kinds of products.

Premium Finance Bridge Loans

With the growth of the premium finance market, we are seeing new financial products such as bridge loans for the secondary insurance market. For example, short-term bridge funding enables clients to pay off a premium finance loan so that the life insurance policy can be sold in the secondary market. The purpose of the bridge funding is to release any security interests on a policy, allowing financial professionals to help their clients realize a policy's value even while a loan exists. When a policy owner is unwilling to come "out-of-pocket" and be at risk for their policy, a bridge funding provider might be able to provide a solution.

Why is a bridge loan needed? A policy that is premium financed will have a collateral assignment attached to the policy to secure the loan. Typically policies cannot be purchased by the secondary insurance market when a collateral assignment exists. The bridge loan removes the collateral assignment and allows the policy to be sold in the secondary market.

How does this work conceptually? The client enters into an agreement with a bridge loan company, in which they agree to sell the policy to a life settlement provider and the bridge loan company agrees to pay off the premium finance loan directly. When the payment is made, the collateral assignment is released against the policy, and it is conveyed to the purchasing provider. The client then receives proceeds from the sale, and the bridge loan company is repaid from these proceeds.

This appears to be a growing market. The situation resembles a home loan in that the loan companies want a loan-to-value ratio below 100 percent, ideally less than 80 percent, to ensure that they will be able to collect repayment. For a transaction to work, the policy owner should have multiple offers from the secondary market, to validate the first offer and provide a potential backup solution if it fails to close.

Upon completion of the sale, the bridge loan, including the principal and all loan fees, is paid back by the purchaser or the escrow agent handling the transaction by disbursing the loan value to the loan company and the remainder to the seller.

Another required step in a bridge loan is obtaining closing/sale documents from the purchasing company so that the transaction is ready to be executed. These may include a letter from the purchaser that its due diligence is complete and ready to close. The bridge loan company might want information on additional offers received to make sure that it has backup in case of a failed closing, and may require multiple current (within six to 12 months) life expectancy valuations by third-party underwriters.

Subprime Market Impact

The subprime market has adversely hit the life settlement market. We have seen a significant reduction in requests from organizations interested in exploring life settlements. This includes both organizations interested in purchasing life settlements and those providing other securities and instruments, e.g., financing and reinsurance/life extension coverages. Hedge funds that have purchased policies are now exploring exit strategies to cover the financial impact of the subprime market.

We have seen several organizations with portfolios of contestable policies in the market. This may be the result of a combination of policies purchased through premium financing and beneficial interest portfolios. These are typically more challenging for companies to sell, and the impact of the subprime market has reduced the number of buyers even further.

A.M. Best Updates

A.M. Best released an update of their Life Settlement Securitization document in March 2008. The information included in this document provides details of: (a) A.M. Best's rating policy; (b) A.M. Best's analytical approach; (c) how to evaluate the credit risk of the securities; and (d) other related items pertaining to life settlements. Individuals interested in learning more about life settlements should reference this document. It provides information and important considerations for participants considering investing in the life settlement arena, whether or not they want to have their portfolios debt rated. Visit A.M. Best's Web site for additional information.

2008 VBT Table

Several organizations have announced that they will be moving to a new mortality table, the 2008 Valuation Basic Table. These include 21st Services, one of the larger players in the market, and Global Life Underwriting, a new organization that will be providing underwriting for the life settlements market.

There is a market perception that several of the key underwriting organizations, or possibly the industry as a whole, have underestimated life expectancy. The move to more conservative underwriting practices, combined with the use of a more current mortality table, is an indication that life expectancy calculations will be higher than prior projections. This move may lower the life settlement purchase prices and reduce the number of successful life settlement transactions. Organizations holding portfolios of life settlements may also be impacted if their portfolios are re-evaluated with more conservative life expectancy assumptions—this may ultimately lower their return and even result in potential losses in their portfolios. Actuaries valuing life settlements today should take notice of this since clients may request reassessments or additional sensitivity analysis on their portfolios.

There have even been discussions recently in the industry on developing a consistent standard for underwriting life expectancy. It will be interesting to see if this could be implemented. This will be an area to watch.

Opportunities and Pitfalls for Actuaries
Many organizations involved in the life settlement arena will require assistance evaluating policies, risk models and portfolios. Many of the formulas required for these types of analysis are the fundamental actuarial calculations, e.g., life contingencies and commutation functions. As a result, actuaries have a unique skill set in this area.

Actuaries consulting in this arena should make sure to underwrite and assess the parties to whom they will be providing services. The players in the secondary market do not necessarily play by the same rules as those we traditionally deal with when consulting for insurance companies. We recommend that actuaries working in this field consult outside assistance when evaluating opportunities.

Even with a strong contract, which we strongly recommend, you may find that the parties are not willing to comply with the agreement or don't have the financial strength to meet their obligations. If you are providing services to a newly formed organization or one with limited financial strength, we recommend obtaining a financial guarantee from another organization in case your client goes insolvent. Some other tips for consulting actuaries include checking references on your clients and considering a retainer fee in case your client is unable to meet its financial obligations.

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