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Life Settlements—Is There a Cause for Concern?

by Michael J. LeBoeuf

Life settlements seem to be causing much concern in the life insurance industry at present. This concern is especially found among certain actuaries whose fears over life settlements are resulting in a loss of sleep, hair and the ability to concentrate on improving their golf game. Are these concerns valid? This article takes a look into the life settlement business to see if the concern is well founded or not. This article does not address the suitability issue for policyholders who are considering settling their contracts. Another area not addressed is investor-originated life insurance products, where the policy is applied for with the intention of "settlement." These are topics that would take up whole separate articles.

Life Settlements – Background

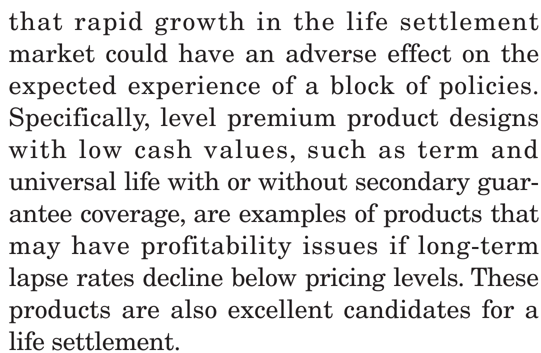
First of all, for those less familiar with this topic, let's define a life settlement. According to the Viatical and Life Settlement Association of America, "A viatical and/or life settlement is the sale to a third party of an existing life insurance policy for more than its cash surrender value but less than its net death benefit."

Although not in the definition, the key condition to a successful life settlement transaction is that the present value of the expected death benefit must be higher than the expected cost of purchasing and maintaining the policy. Profitability for the life settlement investor is linked directly to the insured's life expectancy. In general, the less time the insured lives following a life settlement, the less cost for the life settlement company to maintain the policy and the greater their return. For this reason, such products are usually marketed to older individuals, potentially in impaired health.

These products emerged in the early 1990s and have continued to grow over the past decade and a half. At present, it is estimated that there is $13 billion of in-force settlement business. Further, optimistic projections have this business growing rapidly, due to several factors. First, it is fueled by the growth in individuals age 65 and older, a group growing three times faster than the total population. Second, lower interest rates have resulted in lower than expected cash values for life insurance products, rendering life settlements more attractive. Finally, the elimination of estate taxes would reduce the need for death protection at the later ages. It is this rapid growth expectation that has fueled concerns over this market.

Why the Concern over Life Settlements?

Why are life insurance companies concerned over life settlements? If a life settlement company assumes a life insurance policy, the policy continues in force and premiums continue to be paid to the life insurance company by the life settlement firm. On the surface, it does not appear that there is any impact on the insurance company except for a change in the owner and beneficiary. However, this is not the case. Actuaries are concerned



that rapid growth in the life settlement market could have an adverse effect on the expected experience of a block of policies. Specifically, level premium product designs with low cash values, such as term and universal life with or without secondary guarantee coverage, are examples of products that may have profitability issues if long-term lapse rates decline below pricing levels. These products are also excellent candidates for a life settlement.

Lapse rates are an important variable in pricing life insurance products. The pricing actuary makes an assumption on the expected lapse experience for a block of business. Those concerned about the life settlement market worry that, given the option of entering a life settlement for a cash amount greater than the policy cash value, people will cease lapsing their policies. Under this scenario, lapse rates could effectively move toward zero, well below pricing assumptions, therefore compromising profitability.

Compounding this concern about lapse rates is the belief that the reduction in lapse rates will be more pronounced for unhealthy lives. The effect of this will be deterioration in the experience of the block of business. This also would undermine product profitability.

Are the concerns valid?

While it appears that the life settlement market is a growing market, it is uncertain that it will grow rapidly as anticipated in the optimistic assumptions discussed above. Even if these optimistic growth assumptions were realized, life settlements would still be a relatively small percentage in relation to total life insurance in-force (currently over $9 trillion). Given this small percentage, the risk of life settlements "ruining" the industry is probably not realistic.

Life settlements are a transaction driven by life settlement brokers and insurance agents. Generally speaking, these brokers and agents target large policies to maximize their own income potential. The average size of a policy that is settled is $1 – $1.5 million. This high average policy size is due to inefficiency in the settlement business where only around 20 percent of policies submitted for a life settlement transaction actually close, as well as agents and brokers desire to satisfy their own economic needs. This high average policy size should minimize concentration of life settlement business in most companies, limiting the impact of life settlement business on emerging experience.

Looking at the impact on pricing assumptions, the impact on lapses would be generally limited to large face amount policies and not distributed throughout a block of business. In addition, the belief that everyone considering a lapse will opt for a life settlement is unfounded. Again, it is a broker/agent driven transaction. Life settlement companies will not drive the transaction for all policyholders, only those policies with large face amounts.

Further, the belief that unhealthy people were planning on lapsing their policies, but instead chose a life settlement, is also unfounded. It is this belief that fueled the argument that life settlements would result in the deterioration of mortality experience for companies. Companies may need to make minor pricing adjustments to respond to the changes in experience from life settlements, however, the impact should not be as significant as some fear.

Finally, if life settlements become a viable market for all consumers and for all size policies, we expect life companies will respond with product design changes to address this demand as was done with accelerated benefits about 15 years ago. So relax. Don't lose sleep, don't pull out your hair, life settlements are not coming to destroy the industry. Oh, and get back to work on that golf game. ☐

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