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Life Settlements—A Window Of Opportunity For The Life Insurance Industry?

By Michael Shumrak

Michael Shumrak, FSA, MAAA, FCA, is president of Shumrak & Company, in Dallas, TX. He can be contacted at MichaelShumrak@gmail.com.

While measured in terms of the percentage of U.S. face amount of life insurance in force, the secondary market accounts for perhaps about 1 percent, the life settlement market has generated much discussion amongst life insurers, their reinsurers, their regulators and rating agencies.

Most of the discourse has been negative revolving around issues including: (a) moral risk associated with insurable interest; (b) mortality and persistency arbitrage given how life insurers priced their products; and (c) poor product quality defined as the difference between a life-settled policy's gross and net settlement value due to the greed and inefficiency in this market. The industry has applied much energy to curtailing or even outlawing this business with limited success to date. While some of these efforts have focused on protecting the consumer, the primary focus has been on efforts to mitigate the financial economic impact on life insurers and reinsurers and to try to convince all stakeholders of the life insurance industry that the concept is bad. Much less of the effort has been focused on financially and ethically sound ways to provide this benefit to consumers—a rapidly growing and sustainable demand.

DEMAND DRIVEN BY CONSUMERS AND INVESTORS

"The cat is now out of the bag" in that increasing numbers of consumers have become aware of the possibility of realizing liquidity from their life insurance policies. Those who own or who might consider buying life insurance often value this flexibility. The growing positive consumer view of this product concept, the rapidly increasing proportion of our population reaching higher age groups and the recent financial crisis have created, and will continue to drive, substantial demand for post policy issue, and worsened health-state based demand for liquidity from life insurance policies. Similarly, there appears to be increased demand for reverse mortgages, another liquidity/longevity-based product whose perceived and real value historically has been relatively low. The other key driver of life settlement demand has been from investors—private equity firms, hedge funds, pension funds and other institutional investors. Life settlements as an asset class are compelling due to their potential stable returns uncorrelated to their traditional holdings in bonds, stocks and commodities. This demand has, in the past, provided the life settlement marketers and providers with the capital required "up front" to fund life settlements.

MARKET SIZE, TRAJECTORY AND INEFFICIENCY

While the industry does not track sales and in-force volumes on a regular consistent basis, one might characterize the sales volume measured in face amount settled to have grown from a few billion several years ago to over $10 billion in recent years. Some researchers have projected this will continue to grow at double-digit rates over the next several years when it is expected to exceed $30 billion. While this would still represent a single digit percentage of the life insurance industry's total in force, the dollars involved to the marketers, providers, investors and policyholders (sellers) is considerable. For example, policyholder's agents and life settlement brokers who approach the life settlement providers on their behalf collectively get paid about 4 to 8 percent of the face amount. Provider and servicing fees generally run about the equivalent of 2 to 4 percent of the face amount. Since the life insurance settlement cash paid to the insured(s) is generally in the range of 20 to 40 percent, if we recast various components as a percentage of the policyholder's net cash proceeds, these expenses are much higher than the costs to sell, issue and service life and annuity insurance products—this is a very expensive business model.

AMATEURS RUNNING A LONGEVITY RISK BUSINESS

Professional actuaries, underwriters and others with experience in underwriting, pricing and analyzing longevity risk, have been actively involved in supporting the life settlement industry. However, generally their role has been as advisors and vendors where they have no "skin in the game" as they would have had if they were legal entity life insurance companies taking on longevity risks. Typically, these businesses have been started and operated by a combination of marketers, promoters and other investors with very limited experience in these matters—amateurs in the longevity risk business. A risk that even the mortality/longevity experts—life insurance companies—have not fully developed up to now despite the considerable technical expertise these companies possess.

These life settlement businesses do not have the typical constraints of the life insurance industry—there are no in-house underwriters and no regulatory reserving, risk-based capital or other accounting standards required; there are no prescribed mortality expectations; these life settlement operations use a range of reserving methods or none; they generally do not price for, nor maintain, risk-based capital, and fully rely on expected mortality assessments provided by outside vendors, albeit experienced underwriters. One likely reason the prudent governance practices with which we are familiar in the insurance industry are absent in the life settlement business is that these companies are not vertically integrated. The economics for the agents, the life settlement brokers, the life expectancy providers (underwriters), the life settlement providers (companies who screen potential life settlement investments for investors), the administrators (who keep track of premiums and death claims) and the investors, never reside within a single entity, but are largely separate. The only ones with "skin in the game" are the investors.

The largest market for secondary life insurance today is the so-called "senior life settlement market." The target market is people who purchased large policies in the past when they were healthy or mildly sub-standard and who now are older and not as healthy. Other segments include those who may still have untapped capacity to apply for life insurance coverage because they have none, or have less than might be justified through financial underwriting. This segment has come under the greatest attack since there is limited public policy justification for these cases because the applicant never intended to buy these life insurance policies for insurance purposes but rather is allowing investors to speculate on when they may die in return for a very small portion of the death benefit. This is the segment commonly referred to as STOLI (Stranger-Owned Life Insurance) although technically almost all life settlements are policies purchased by people who are strangers to the policyowners. For the balance of this discussion, we will be referring to the sale of in-force policies.

FINANCIAL IMPACT ON LIFE INSURERS AND REINSURERS

There is a range of views as to the economic impact of life settlement activity on the financial results of life insurers and their reinsurers. Some say the impact will

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" … THE QUANTIFICATION OF THE FINANCIAL IMPACT OF LIFE SETTLEMENTS ON LIFE INSURER'S FUTURE EARNINGS IS COMPLEX. … "

grow to be significant soon, while others say it will be minimal. Two dimensions need to be considered:

1. The percentage of all policies that are or will be settled, and;
2. The financial impact to the insurer and reinsurer, given a policy is settled.

Earlier we noted that, to date, only about one percent of all life insurance policies have been settled and even with the growth rates in new life settlements projected by various researchers, this will not increase to a very large percentage. Regarding the financial impact on an insurer and/or reinsurer given a life settlement has taken place, those that argue the impact is minimal reason that proper pricing of mortality and persistency dictates that, after policy issue, one would expect healthy lives to lapse and surrender and the unhealthy lives to persist—the so-called "anti-selective lapse" dynamics. Qualitatively, this makes sense and has been proven to be the case based upon mortality studies focused on this phenomena. Quantitatively, this would also be true if we assumed rational policyholder behavior resulted in zero lapses for the unhealthy and 100 percent for the healthy. However, we do not assume zero lapses. In the absence of life settlements, this makes sense and has been borne out through experience studies because policyholders are not perfectly rational. Therefore, we do not expect actual lapse rates for everyone including the less healthy will be zero. Life settlements guarantee these will be zero. The financial impact is the difference in future financial results between the non-zero pricing lapse basis and the results if lapses were zero. Most life settled policies are Universal Life (UL) which can involve a range of situations relative to the degree of savings vs. protection, but buyers of life settlements may focus on "optimizing" the flexibility in the UL contracts to maximize death benefits while minimizing future premiums. Depending upon any secondary UL guarantees, this suggests a degree of lapse support priced into the products that will not be realized with zero lapses under life settlement scenarios. For term life policies that are life settled, the lapse support effect is very material. In summary, the quantification of the financial impact of life settlements on life insurer's future earnings is complex and probably not immaterial.

The impact of life settlements on reinsurers has been more dramatic because they are one step removed from the source, they assume a larger share of the risk on larger policies, and have much less credible data for policies issued or in force at higher ages.

HOW THE ECONOMICS OF THE LIFE SETTLEMENT BUSINESS HAS EVOLVED

The trajectory of the life settlement business model to date can be characterized as follows:

1. *The Good Old Days.* In the early years, investors priced life settlements to yield around 20 percent after-tax cash on cash IRRs—similar to the lower end of returns generally required by the private equity and hedge fund organizations that drove much of the early market activity on the funding side. These returns could be further leveraged if the funds were borrowed. They relied upon three to four life expectancy providers (LEPs) where they typically favored one and used one or more other quotes as a secondary input in their selection and pricing processes.

2. *Rude Awakening.* About three to four years ago, early longevity experience was running longer than the LEs used to select and price cases expected. The investors expressed their disappointment and concern to the LEPs. The LEPs reconsidered their original assumptions and underwriting approaches. The result was most, but not all, of them refined their approaches resulting in longer LEs—generally 5 to 25 percent longer. As a means of understanding the financial impact of this, in a typical case selected for an investor, if the IRR was expected to be 10 percent, if the actual LE exceeded expected, this would nearly cut the IRR in

half to about 5.5 percent. Of course, going forward the LEs used their new longer LEs and the investors wanted to price for their original 20 percent IRR, but with the high expense model, this forced the resultant net proceeds to the insureds down toward the level of the cash values the insured's otherwise could access through their insurers. Rather than exit the market, investors lowered their hurdle rates to 8 to 12 percent, much lower than private equity/hedge fund targeted returns, but still attractive due to the asset classes non-correlation and stable returns.

3. *The Good and the Bad Impact of the Financial Crisis*. The "bad" for the life settlement companies was that the life settlement market's primary sources of funding—many private equity firms and hedge funds—went into a survival model as the market value of their holdings melted away as a result of the financial crisis. Rather than growing their life settlement portfolios, they were retrenching and in many cases looking to sell them to raise money for the wave of redemption calls they faced. One of the "goods" for the life settlement industry was the already growing consumer demand for life settlements accelerated due to the impact of the crisis on individuals where they looked to their existing life insurance policies as a source of liquidity. The other "good" was the opportunity to increase targeted IRRs back up towards 20 percent given the demand/supply imbalance. The "bad" for consumers was that the relatively low levels of cash to face amount decreased materially to make up for the higher IRRs.

THE WINDOW OF OPPORTUNITY FOR LIFE INSURERS AND REINSURERS

Rather than focusing on killing this market for a product that an increasing number of consumers value just because it is being run by greedy and inefficient amateur outsiders, and is providing a less than quality product to consumers, perhaps there is a better way forward? The timing to do this right now is perfect. With conventional funding sources for life settlements constrained while consumer demand has accelerated, life insurers and their reinsurers could work together in the following ways to mitigate the adverse impact of life settlement activity on their in-force business and also drive, rather than react to, future demand for life insurance policy liquidity by developing new products designed and priced to meet this need on an efficient, financially sound basis.

Professionals should be developing consistent approaches for tabulating actual vs. expected longevity experience. The life settlement industry's longevity studies are not very credible due to the relative newness of this business and due to the lack of consistency in how the data is used in computed performance. This same data might prove useful in supporting other longevity products such as underwritten payout annuities and new products yet to be conceived.

The current life settlement paradigm with respect to the underwriting function is based on accepting all the risk on cases underwritten by those with absolutely nothing at stake in the mortality results. Product pricing and portfolio management would be driven by professional actuaries rather than MBAs, statisticians and others. Proper consideration to the mix of type and severity of impairments, ages at settlement, policy sizes, reserves and risk capital would result in credible pricing bases leading to achievable actual financial results.

Rather than helping the life settlement industry's more aggressive participants' claims that life insurance companies' guaranteed cash values are a "rip off" as compared to life settlement market values by trying to completely shut down this business, the industry should take the lead to explain, guide and provide consumers with the facts and products that meet their needs on a sound basis upon which they can depend.

Should this take place, we would then see opportunities to further improve the efficiency in this market with the help of capital markets players through securitizations backed by credible, consistent longevity data. ■