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CURRENT TRENDS IN THE SECONDARY INSURANCE MARKET

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We are in 2008 and the actuarial industry is still in a quest to obtain empirical data on the insurance industry's secondary market with particular focus on life settlements. This article is based on emerging trends that we are seeing in the market based on our firm's work with select clients.

A life settlement is the sale of an unwanted life insurance policy that is in force today. If a sale of the policy is executed, it will typically be for an amount greater than the cash surrender amount offerred by the issuing life insurance company. In general, life settlements are policies held by older insureds (ages 65 and above) and with permanent insurance products, e.g., universal life, whole life, etc. The goal of this article is to provide information on some of the emerging trends in the life settlement and secondary insurance markets.

Our company has observed some recent emerging areas of interest in the secondary insurance market, and we have seen organizations interested in exploring the following:

- Purchase of beneficial interest policies.
- Exploring the synthetic insurance market.
- Development of bridge loan facilities.

Furthermore, we are also seeing organizations react to the impact of the subprime market and divesting investments including the secondary insurance market. In addition, this article will highlight additional trends in the market as recently reported by A.M. Best and some of the life settlement underwriters.

Growing Interest in Beneficial Interest Policies

What are beneficial interest policies? To understand a beneficial interest policy, we are providing basic information about the participants in a life insurance policy. For any individual or group insurance policy, we would have individuals (or corporations) defined for each of the covered insured, policy owner and beneficiary. A typical insurance policy might have an individual as the policy owner and covered insured, with the individual's family as the beneficiaries. For a beneficial interest policy, the owner and beneficiary of the insurance policy are listed as an insurance trust. The insured's spouse or child is often the beneficiary of the trust.

Upon selling a policy as part of a life settlement transaction, the covered insured will typically be the same as before. However, the policy owner and the beneficiaries will most likely be a different party, most commonly the company buying the policy, e.g., a life settlement company. The purchaser, which might even be another trust, acquires beneficial interest and makes the agreed upon payment to the trust's beneficiary. The owner and the beneficiary of the insurance policy have 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.

In cases of beneficial interest policies, the desired approach is to find beneficial interest policies whereby there is one beneficial interest party with 100 percent; otherwise, it will be difficult to complete a successful transaction. In our experience, any organization interested in beneficial interest policies that has more than one beneficial interest party is recommended not to explore the transaction since all parties need to be involved and agree with the decision, which can sometimes be a challenge. In this instance, the probability of a successful transaction will be low. Furthermore, once rights are purchased, the purchaser will require 100 percent ownership so that they can unilaterally make decisions on premium payments and levels of funding.

Our firm has seen a recent growth in demand for both the buying and selling of portfolios of beneficial interest policies. It will be interesting to see if this is a short-term phenomenon or an emerging trend.

Increased Interest in 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, i.e., hedge funds are a big part of the buyer community.
- A significant number of policies that are available for purchase are in the contestable period e.g., policies issued less than 24 months, or originated through premium financing or the combination of both. There tends to be a limited number of buyers for these types of policies.
- The financial impact, relatively high level of expenses, and ethical perception of the life settlement brokerage/buyer market has turned investors away from playing in the life settlement space.

As a result, we are seeing a bigger movement of investors in life settlements move into the artificial or synthetic market. In this market, investors are making investments in life settlements, but there are no actual insurance policies or pitfalls of the traditional life settlement market, e.g., layers of brokers looking to be compensated, insurable interest issues, life settlement licensing/regulatory requirements, etc.

With synthetics, some of the actuarial formulas used are the same such as development of expected benefits and expected premiums, or the present value of these amounts, as well as return on investment (ROI). What is different is that there are no real policies, but illustrative ones. The lives valued are real and professional organizations are used to underwrite these individuals and administer the record keeping of these individuals. The policies created are a predetermined cash flow stream of 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 things easier when valuing ROIs, since synthetic policies do not have to consider the impacts of these items. The definition of life insurance under IRS code section 7702 and the seven-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 less moving parts and less regulatory and operational hurdles to jump through. 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 present value of other expenses, e.g., payment to policyowner to buy the policy, commissions to life settlement brokers, and other expenses to cover the 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 premium development and reserve valuation for life insurance. This would include selection of mortality tables, interest rate discounts, expense margins, and projected profit returns. Actuaries may be using commutation functions or life contingency functions such as A's, a's, V's, px's, qx's and many other actuarial formulas. A key selection area is the choosing of the correct mortality table and mortality loads to go with the table and applying a margin, whether implicit or explicit.

The counter-argument 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 time older issued policies had a material change in mortality, e.g., preferred became standard or substandard over time. If investors are making the mortality bet, then 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 my chances of winning being 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 both the investor perspective as well as companies offering, or potentially developing, these kinds of products.

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Premium Finance Bridge Loans

With the growth of the premium finance market, the market is seeing new financial products such as bridge loans for the secondary insurance market. For example, a 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 policyowner is unwilling to come out-of-pocket and be at risk for their policy, this is where 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 the client agrees 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 the policy is conveyed to the purchasing provider. The client then receives proceeds from the sale of the policy and the bridge loan company is repaid from these proceeds.

This appears to be a growing market. Some of the requirements to make this work would be that the policyowner has multiple offers from the secondary market to buy the policy. This resembles a home loan concept since the loan companies would want a loan-to-value ratio below 100 percent, ideally less than 80 percent, to ensure that they will be able to collect on the repayment of the loan.

Upon completion of the sale of the policy, the bridge loan, including the principal and all loan fees, are to be paid back by the purchaser or the appropriate escrow agent handling the transaction by disbursing funds to the loan company with the remaining amount being disbursed to the seller.

Some of the requirements to execute a bridge loan would include obtaining closing/sale documents from the purchasing company so that the transaction is ready to be executed. This may also include a letter from the purchaser that their due diligence is complete and ready to close. The bridge loan company might want information on additional offers received to make sure that they have any backup in case of a failed closing, plus may require multiple life expectancy valuations by third-party underwriters, that are current (within six to 12 months).

Subprime Market Impact Resulting in Divesting Portfolios

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 for purchasing. This includes both organizations interested in purchasing as well as others providing other securities and instruments, e.g., financing, reinsurance/life extension coverages similar to Lloyds of London's Goshawk syndicate. 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, typically policies less than two years old, in the market. This may be the result of a combination of purchasing of policies through premium financing and beneficial interest portfolios.

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 is an update from previous releases which provides details of: (a) A.M. Best's rating policy, (b) A.M. Best's analytical approach, (c) evaluating 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: *http://www.ambest.com/debt/lifesettlement.pdf* for additional information.

Recent Release and Use of 2008 VBT Table for Medical Underwriting

One of the larger players in the market, 21st Services, announced that it will be moving to a new mortality table, which is the 2008 Valuation Basic Table. Other organizations have announced that they will be using the table as well. For example, a new underwriting organization, Global Life Underwriting, announced this September that it will be providing underwriting for the life settlements market using the 2008 VBT table.

The market perception of medical underwriting, in our opinion, is that several of the key underwriting organizations, or possibly the industry as a whole, has 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 may even result in potential losses in their portfolios. Actuaries valuating life settlements today should take notice of this since clients may request reassessments or additional sensitivity analysis in their portfolios.

Furthermore, there have been discussions recently in the industry with regard to developing a more consistent basis and standardization for underwriting life expectancy, e.g., moving to a more consistent underwriting basis. It will be interesting to see if this could be implemented and this will be an area that will need to be monitored further by the industry.

Opportunities and Pitfalls for Actuaries

Many organizations involved in the life settlement arena, including synthetics and beneficial interest policies, will require assistance in 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, which are the basis of actuarial math. 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 that they will be providing services to. 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. For example, actuaries will want a formal contract with the company that they are doing business with.

Even with a strong contract, and we strongly recommend that you have one, you may find that the parties may not ethically be willing to comply with the agreement nor have the financial strength to meet the obligations on the contract. If you are providing services to a newly formed organization or an organization with limited financial strength, then it may be recommended to obtain a financial guarantee from another organization in case your client goes insolvent.

In addition, some other tips for consulting actuaries are to check references on your clients. An organization investing in life settlements may want to do the same thing. Checking references may seem like common sense, but becomes an important consideration. A retainer fee on these types of projects is also not a bad idea in case your client is unable to meet its financial obligations. ✹