Life Settlements

Actuaries Club of the Southwest

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Agenda

- Introduction of vehicles
- Market & players
- Deriving the “LE”
- Capital market influence
- Life insurance industry reaction
- Regulation

Introduction of Vehicles

Life Settlement

- Sale of an existing life insurance policy to a third party, typically an institutional investor, for an amount greater than the underlying cash value of the policy
- Traits of a typical policyholder
  - Impaired (but not terminal)
  - Age 65 or older
  - Life expectancy of 6 to 11 years
  - Large face amount ($1 million+)

Premium Financing

- Sometimes referred to as “Investor Owned Life Insurance” or “Stranger Owned Life Insurance”
- Inherent concept is similar to that of a life settlement, with the following general distinctions:
  - Investor, via a broker or other third party, may initiate the application of a life insurance policy through a prospective insured
  - A loan is made to cover at least the first two-five years of premium
  - After the loan period, the insured is given several options:
    - Retain the policy, after paying back the initial loan plus interest and fees
    - Default on the loan, possibly sharing in any gain derived from selling the policy into the secondary market

Continued . . .

Premium Financing

- Premium financing may not necessarily involve selling the policy
  - Investor pays all premiums
  - Investor receives 90-95% of face amount, insured receives remainder to pay estate taxes
  - Allows wealthy seniors with lack of liquid assets ability to afford large premiums

Life Insurance/Life Annuity Contract (“LILAC”)

- A life insurance contract and lifetime payout annuity are taken out on the same life
- Owner is typically a charity and recipient of a portion of the death benefit
- A loan is established to pay premiums, with annuity payments set to cover loan interest plus the life premium
- Unlike life settlement or premium financing, typically involves unimpaired lives
- Effectively life/annuity arbitrage, taking advantage of underlying mortality assumption discrepancy between the life and annuity contract
- Recent regulatory scrutiny due to lack of insurable interest

Market & Players

Why does the market exist?

- Competition and strict regulation of life insurance companies in the primary market lead to insurers offering reasonably competitive cash surrender values
  - But no differentiation of cash surrender values by current health status of insured
- Insureds with reduced life expectancies may have a higher economic value than the policy’s underlying cash value

Size of the market

- It is estimated that approximately $15.0 billion in face amount was sold in 2006 in the U.S.
  - Coventry First has approximately 30-40% market share
- Bernstein Research predicts that the market “will grow more than 10-fold to $160 billion over the next several years”
  - Still a relatively small percentage of the approximately $9 trillion of individual life business on the industry’s books

Drivers of the market

Life Settlements

- Individuals in the U.S. are living longer, thus potentially outliving the usefulness of their life insurance policies
  - The target market for settlements (i.e., individuals above age 65) is expected to grow by 90% over the next 25 years
- Potential elimination of estate tax
- Decline in interest rates have led to lower cash values than originally illustrated
- Broker commissions

Premium Financing

- Free or low-cost insurance to insureds
- Lack of asset collateralization (no assets pledged)
- Broker commissions

Products with appeal in the secondary market

Primary products

- Universal life (80-90%)
  - with extended NLGs
  - without NLGs

Secondary products

- ROP term
- Term
- Whole life

Market participants

- Funding source
- Settlement Provider
- Medical Underwriter
- Attorney
- Reinsurer
- Rating Agency
- Monoline
- Servicer & Tracking Agent
- Broker
- Policyholder

Deriving the “LE”

Life expectancy is typically based on a mortality rating from a life expectancy provider applied to a standard mortality basis

- The mortality rating is provided by the life expectancy ("LE") provider and is determined using life insurance underwriting processes modified for the life settlement market
  - Generally expressed as a percentage of standard where standard is 100%; mortality ratings typically 150% to 300%
- Standard mortality basis is typically a percent of a standard life insurance mortality table
  - Typically based on 2001 VBT
    - — Differing opinions exist as to appropriate duration to move to ultimate mortality
  - Provision for future mortality improvement may also be included in the standard mortality basis

Variance in mortality on a portfolio can come from many different sources

Sources of Mortality Variance

Mortality Volatility Risk

- Standard random fluctuation in mortality
  - Given the limited number of lives in a portfolio, this fluctuation may be material
- Fluctuation in population mortality due to various environmental factors
- Fluctuation due to catastrophic events
  - A cure for cancer would be a catastrophic mortality event for life settlements/IOLIs

Mis-estimation Risk

- Mis-estimation of mortality rating
- Mis-estimation of standard mortality basis
  - Both initial level and mortality slope

Mis-estimation of the level of mortality

- Differences in LE could be a result of two primary reasons:
  - LE underwriter assesses the life as more substandard than it actually is
    - — Anecdotally, one large LE provider indicated that their mortality ratings today would be 20% to 30% lower than what they estimated five years ago
  - The difference could also result from a difference in definition of standard mortality

Life Expectancy for a Male 77 Nonsmoker Using Base Mortality Table w. Mortality Improvement		
Base Mortality Definition	**% Standard***	**Life Expectancy**
100% of 2001 VBT Select & Ult.	225%	9.1 yrs.
100% of 2001 VBT Select & Ult.	100	12.8
80% of 2001 VBT Select & Ult.	225	10.2
80% of 2001 VBT Select & Ult.	100	14.1

* LEs calculated assuming that 25% of extra mortality wears off over time.

Capital Market Influence

Capital market influence

- In recent years the capital markets have been paying increased attention to the life insurance industry
  - XXX/AXXX securitizations
  - Life settlements
    - — Investors always seeking a new asset class…especially one with a lack of correlation with existing investments
- Upside: additional sources of capital (e.g., life insurance securitizations)
- Downside: arbitrage opportunities can be exploited (e.g., non-recourse premium finance)

Impact of secondary market on insurance carriers

- Increase sales at older ages
- Experience may differ from assumptions used in pricing
  - Better persistency
  - Mortality antiselection
  - Reduced overfunding of UL policies
- Potential for fraud

Is your company's product a prime candidate for a secondary market transaction?

- How much focus do you put on older age pricing?
  - Have you addressed older ages specifically, or is mortality simply assumed to be a level % of a standard table for all ages?
  - Is the product lapse-supported?
  - Are profits from minimum funding scenarios subsidized by highly funded scenarios?

Life Insurance Industry Reaction

Insurance industry reaction

- Increased focus on pricing at older ages
  - Mortality
  - Lapse
  - Funding levels
- Attempt to identify secondary market cases
  - Issue ages 70+ with $1M+ face amount
  - Illustration shows 1st 2 years of premium upfront, then YRT premiums after contestability period
  - Agent questionnaire
  - Change in ownership/beneficiary
- Consider different set of assumptions for in-force business identified as secondary market cases

Insurance industry reaction

- Adoption of strong underwriting procedures for proposed insureds over age 70
- Closer monitoring of underwriting exceptions (i.e., “table shaving”)
- Closer monitoring of producers
  - Warning letters
  - Include supplement with application asking both applicant and producer to sign confirmation that applied-for policy is not being purchased with intent to re-sell
- Restricting change of ownership

Reinsurance

- Reaction of 3rd party reinsurers
  - Increased scrutiny of older age mortality
  - Increased monitoring of underwriting and exceptions
  - May not accept cases identified as secondary market cases
    - Specify criteria used to filter such cases
- Non-traditional reinsurance
  - Contestability reinsurance
  - Longevity reinsurance

Regulation

Regulation

- Insurers continue to pressure regulators to tighten regulation of secondary market
- NAIC reaction
  - Regulators have adopted a resolution opposing the loosening of state insurable interest laws
  - NAIC currently considering revised viatical model
    - — Requires most policyholders hold policies 5+ years before selling
- Congress considered creation of an excise tax on any re-sale of a life insurance policy within 5 years of sale