WHAT ARE INSURANCE SETTLEMENTS?—HISTORY AND EVOLUTION

CHAPTER 1

A "Life Settlement" is the transfer of a life insurance policy in exchange for a consideration which is greater than the policy cash surrender value. Policies are purchased from individual policy holders, either directly or through insurance agents or brokers and are typically sold to investment institutions or pension funds. Life settlements as an industry have expanded exponentially over the past 15 years, but have in reality existed for hundreds of years. In the most basic sense, a life settlement is merely the sale of a life insurance policy by the policyholder to another party. But in today's secondary market, the reality of life settlements is highly complex. To understand life settlements one must understand their increasing dimensions and the many issues that the life settlement industry confronts. This chapter provides a broad understanding of life settlements, their beginnings, evolution, and issues. Subsequent chapters provide in-depth discussion of how this most interesting and complex financial industry works and the knowledge required to responsibly and professionally understand and work in the life settlement industry.

1. THE BEGINNING OF LIFE INSURANCE

Before it is possible to understand the concept of a life settlement, it is necessary to understand what life insurance is and how it works. Insurance is built on the concept of "shifting, sharing ('pooling'), or spreading risk." Early records indicate that the concept of "shared risk" began in China in about 5000 B.C. when traders and farmers who shipped goods in small boats realized they could avoid disaster when a boat sank by sharing their shipments among several boats.

Early records of life insurance go back to burial clubs (Fratres) in Rome (somewhere between 27 B.C. and 1453 A.D.), which were created to pay for the funerals of members and to provide financial assistance to survivors. Reports of these clubs suggest that members met regularly and at festivals, when it was expected that continuing membership and insurance fees would be paid. It is also suggested that new members were required to contribute an agreed amount of wine to the group, and that after performing sacrifices everyone shared a meal. There were other stipulations. For example, members who hadn't paid their dues for six months were not permitted to make claims for burial, and members who committed suicide could not be buried in the same cemetery as the other residents of the community, and their survivors could not make claims against the burial clubs for financial assistance. Thus, life insurance began for the purpose of providing protection to the poor, slaves, members of the military, and average citizens who were not wealthy enough to be sure they could afford to be buried when they died.[1] Further, during the Middle Ages (somewhere from the 5th century to 16th century), evidence shows that guilds established by labor groups provided life and disability insurance to members.

Traders, along with ship owners and merchants, became the organizers of insurance in England, meeting at The Lloyd's Coffee House, which became a predecessor to the famous Lloyd's of London. Seeing the growing need and demand for marine insurance, Lloyd's of London became one of the first established insurance companies. Ship owners and "underwriters" or backers met to formulate insurance contracts. The origin of the word, "underwriter," is Italian and is derived from the ancient practice of signing contracts for marine insurance in order to share in the profit or loss of a venture. Participants in the contracts signed their names to the contract at the bottom under the enumeration of risks accepted, thus "underwriter," including the specific amount of risk that would be assumed by each signer.[2]

The late 1600s found life insurance in England, during a period when Lloyd's of London was finding its footing in insurance, and it was during this time that the concept

of owning insurance on the life of another person was established. Until regulated by law, it was legally possible for any person to obtain life insurance on *any* other person, regardless of whether or not the beneficiary of the policy had any legitimate interest in the person whose life was insured. As such, the system of life insurance provided a legal loophole for a form of gambling, i.e., an insurance policy could be taken out on an unrelated third party, stipulating whether or not they would die before a set date, and relying on chance to determine if the "insurer" or "policy-holder" would profit.

The Life Assurance Act 1774[3] (also known as the Gambling Act 1774 and herein referred to as the "1774 Act") was an Act of the Parliament of Great Britain, which received the Royal Assent on 20th April 1774.[4] The 1774 Act prevented the use of the life insurance to evade gambling laws. It was extended to Ireland by the Life Insurance (Ireland) Act 1866, and is still in force. The 1774 Act is short with only four sections:

Section 1 stipulates that any policy written on a person in which the person or persons, or on whose account such policy or policies is written, has no interest, or if in substance is a gaming or wagering contract, shall be null and void.

Section 2 requires that all policies shall include the names of the person or persons interested therein for whose use, benefit or on whose account such policy is written. (This requirement was relaxed, by section 50 of the Insurance Companies Amendment Act, 1972, to allow insurance by reference to a defined class or description of a person.)

Section 3 mandates that in all cases where the insured has an interest in such life or lives, event or events, no greater amount shall be recovered or received from the insurer or insurers than the amount of such value of the interest of the insured in such life or lives, or other event or events (i.e. this disallows over insuring).

Section 4 excludes insurance on ships, goods, and merchandise from this Act.

Sections 2 and 3 were amended by the Statute Law Revision Act 1888. The 1774 Act did not define "insurable interest."

In early U.S. history, the states followed English precedent and adopted insurable interest laws which for the most part revolve around three main concepts: (a) the policy owner must have an interest in the life of the insured arising out of a close relationship by blood or by law, or substantial business relationships; (b) the insured must consent to the policy before it can be issued; and (c) the policy owner must have a lawful and substantial economic interest in having the life, health, or bodily safety of the individual insured continue.

The first American insurance company, which only provided fire insurance, was established in Charleston, South Carolina in 1732. The first life insurance arrangement appeared in the United States in 1735, created for the benefit of Presbyterian ministers' families, and was charted on January 11, 1759 with its name "The Corporation for the Relief of Poor and Distressed Presbyterian Ministers, and of the Poor and Distressed Widows and Children of Presbyterian Ministers." Today, 249 years old, this life insurance company operates as the "Presbyterian Ministers' Fund." By 1837, more than two-dozen life insurance companies were started, but less than six of them prospered and survived.[5]

The life insurance industry has evolved through many iterations of change, including but not limited to laws, case law, regulations, mergers, policy terms and marketing practices, and at the end of 2006 over $22 trillion in death benefits in the United States were in force[6] with approximately 1,170 life insurance companies. The life insurance industry was originally dominated by "mutual" companies owned by policy holders and now includes "stock" companies owned by shareholders and "fraternal" companies to assist fraternal members. Today, it is possible to find life insurance quotes provided in a "do-it-yourself" mode on the Internet, along with extensive educational pages covering the various types of life insurance.

2. EVOLUTION OF LIFE SETTLEMENTS IN ENGLAND, GERMANY, AND OTHER FOREIGN COUNTRIES

Life settlement market activity in England, Germany, Austria, Australia, Netherlands, and other international markets is important to understand because these markets cause major influence in the U.S. life settlement markets.

England

Life settlements for endowment policies have existed in England since 1843, making it the most mature life settlement market. But only since 1989 has the modern

market come into its own with "traditional" profits policies—it does not trade "unitised with profits" or "unit-linked"[7] policies. The modern market is regulated by the Financial Services Authority ("FSA"), providing consumer safeguards throughout the process. In the UK, endowment policies that have been sold are referred to as Traded Endowment Policies ("TEP"). The TEP market differs from the Senior Settlement or Viatical market which primarily focuses on the term insurance policies, having limited life expectancies through age or health. The UK's two markets are very different:

- A TEP in the UK has a fixed maturity date, but the value paid out at maturity depends on the insurer's investment performance.

- A UK Senior Settlement or Viatical policy has a fixed payout in the form of a death benefit, but the payout date is dependent on how long the insured lives.

FSA rules, specifically PS106, dictate that insurers must inform policyholders inquiring about surrender of alternatives, including selling the policy as a life settlement, policy loans or converting to a paid-up policy. Insurance agents and brokers have the same obligation when policyholders ask about policy surrender. And to protect consumers, there are also clear rules that prevent enticing policyholders to sell policies that they would otherwise be satisfied to keep, helping to prevent policy churning by insurance agents and brokers.

In early stages of the modern market, attitudes of UK insurers toward life settlements ranged from supportive to hostile. However, over time the vast majority of UK insurers have seen the advantages that the TEP market brings to them and their policyholders, including the advantage for life settlements, and now actively promote the TEP market to policyholders. Insurers see a number of advantages:

- Funds under management are maintained.

- Premium flow is maintained.

- Policies continue through to maturity enabling realization of the profit curve in the last few years.

- Future behaviour of the policy is more predictable as the new investor is less likely to surrender.

- A positive relationship is maintained with policyholders.

- The policy has greater transparency.

- Sophistication of investors enables more flexible policies.

- Opportunity for sales of new policies is increased.

As the UK market has matured, there has been a significant shift in policy buyers with the vast majority of life settlements now purchased by institutions.

In 1992, the Association of Policy Market Makers ("APMM") was founded in the United Kingdom to promote awareness and understanding of the TEP market, to ensure highest professional standards and assure adherence to the Association's Practice Guidelines. APMM member firms include those that buy and sell with-profits endowments and whole-of-life policies. APMM and it members are regulated under the UK Financial Services and Markets Act 2000 by the FSA.

Other Foreign Activities in Life Settlements Rapidly Expanded in 2004-2008

Life settlements in Germany began in 1997 with a few small investors, but really started in 1999, stimulated by the absence of tax on proceeds from "Capital Life Insurance"[8] policies. The primary focus of life settlements in Germany has been in the Zweitmarkt (Secondary Market for Life Insurance) which stems from the general practice of the middle to upper class to purchase their own private life insurance rather than via the Federal Renten/Lebensversicherung. The tax free law was changed in 2003 when proceeds from all new Capital Life Insurance became taxable.

Capital paid for life settlements in Germany has been reported[9] at 45 million Euros in 2001, 147 million Euros in 2002, 130 million Euros in 2003, 300 million Euros in 2004, and 400 million Euros in 2005. Overall cumulative capital invested in life settlements as of 2005 is estimated at 1.2 billion Euros. The volume decreased a bit in 2003 with the change in tax law, but clearly rebounded in 2004 and 2005.

In 2004, German investors had a transaction volume of $1.5 billion capital in U.S. life settlements, with a forecast of around $6 billion.[10] Clearly, German invest-

ment funds represent a strong source of capital for U.S. life settlement operators.

Aggregating U.S. life settlements into funds and wrapping them as a security is particularly popular in Germany where banks and investment houses wrap the product and then sell the security to institutional investors. As of 2005, one German fund, six British funds, and three American firms had offered such investment funds to investors in Europe.[11]

Interestingly, the only reported concern about U.S. life settlement asset-backed securities is the impact of changing exchange rates with the U.S. dollar.

Austria, Netherlands, Norway, and several Asian institutional markets, following Germany's lead, are allocating substantial capital to the U.S. life settlement markets and are creating investment funds asset backed with life settlements.

3. LIFE SETTLEMENTS IN THE UNITED STATES WERE LEGALIZIED WITH THE 1911 U.S. SUPREME COURT DECISION EXPRESSED IN JUSTICE HOLMES' OPINION

Life insurance is an asset within an estate or financial portfolio to be managed for optimum returns; it is an investment—not only a risk contract to be held until death. This concept and right to sell a life insurance policy was addressed in the United States in the Supreme Court and set forth in the 1911 Holmes Supreme Court opinion for *Grigsby v. Russell* 222 U.S. 149 (1911).[12] In this case, the insurer refused to pay the policy death benefits on the argument that the policy had been sold and the beneficiary had no insurable interest in the insured. The salient findings of the Supreme Court are as follows:

- "A contract of insurance upon a life in which the insured has no interest is a pure wager that gives the insured a sinister counter interest in having the life come to an end."
- "But when the question arises upon an assignment, it is assumed that the objection to the insurance as a wager is out of the case."
- "It is a very different thing from granting such a general license, to allow the holder of a valid insurance upon his own life to transfer it to one whom he, the party most concerned, is not afraid to trust."
- "Life insurance has become in our days one of the best recognized forms of investment and self-compelled saving."
- "It is desirable to give to life policies the ordinary characteristics of property. This is recognized by the bankruptcy law, 70,1 which provides that unless the cash surrender value of a policy…is secured to the trustee within thirty days after it has been stated, the policy shall pass to the trustee as assets."
- "To deny the right to sell except to persons having such an interest is to diminish appreciably the value of the contract in the owner's hands."
- "Cases in which a person having an interest lends himself to one without any, as a cloak to what is, in its inception, a wager, have no similarity to those where an honest contract is sold in good faith."
- "It has been decided that a valid policy is not avoided by the cessation of the insurable interest, even as against the insurer, unless so provided by the policy itself. *Connecticut Mut. L. Ins. Co. v. Schaefer*, 94 U.S. 457."

4. THE LIFE SETTLEMENT MARKET WORKS BECAUSE OF ARBITRAGE OPPORTUNITIES BETWEEN THE SURRENDER VALUE AAND THE MARKET INVESTMENT VALUE OF A LIFE INSURANCE POLICY

In economics and finance, arbitrage is the practice of taking advantage of a price differential between two or more markets. The term is typically applied to trading in financial instruments, such as bonds, stocks, derivatives, commodities, and currencies. In the case of life insurance policies, arbitrages, i.e. price or value differential, exist between the amounts the insurer will pay to a policyholder versus the amount the secondary life insurance market will pay. There are four arbitrages that when aggregated together often provide sufficient value differential to enable the life settlement market to provide attractive offers to policyholders seeking to surrender or lapse their policies, while concurrently affording attractive commissions and fees to life settlement intermediaries and ultimately to the investors.

- **Expense Reserve Arbitrage** is created by the practice of insurers to hold back some portion

of a policy account value at time of policy surrender. Universal life, variable universal life, and whole life policies include investment returns based on interest rates set by the insurers, dividends declared by the insurers, or investment returns from funds in which the policy account values are invested. These investment returns accumulate in the policy account value, representing the asset value of the policy belonging to the policyholder. But insurers typically retain an "expense reserve" resulting in a reduction of the account value available to policyholders upon a policy surrender, the net amount of which is referred to as the policy "surrender value."[13] Life settlement investors plan to hold policies to maturity and thus this expense charge becomes irrelevant to their investment decisions, while the expense charge is real and current to the policyholder upon surrender, resulting in an arbitrage in favor of the policyholder when a policy is sold as a life settlement.

- **Mortality Arbitrage** is created by mortality tables used by insurers versus mortality tables used by life settlement investors. Basically, insurers bet that an insured will live longer while life settlement investors bet that insured will die sooner. When pricing a policy, insurers typically begin with reinsurance manuals, based on populations with ages of 40-60, and then add debits and credits representing the insured's medical conditions. In addition, insurers and agents aggressively compete for business and tend to favor data that qualify insurance applicants for "preferred" ratings to offer competitively lower premiums. On the other hand, investors in life settlements obtain specific reviews of insured medical records by professional life expectancy estimators based on tables specifically fitting to people at ages 65 and older. The result is the life expectancies used by settlement investors will be shorter than the life expectancies used by the insurers to set premiums. This difference results in an arbitrage in favor of the policyholder when a policy is sold as a life settlement.

- **Policy Lapse Arbitrage** results because the life insurance industry did not foresee the development of the life settlement market and their policy pricing did not factor in the reality that policies purchased by investors would not lapse. Insurers often use lapse assumptions to set lower prices on policies, more so in recent years, but life settled policies remain in force to maturity causing insurers to rely on full term policy economics rather than lapse term economics. This results in an arbitrage in favor of the policyholder when a policy is sold as a life settlement.

- **Capital Cost Arbitrage** occurs when capital markets enable investors to operate with lower yield requirements and greater efficiency than insurers built into their life products. When a policy is issued, its economics are in part set by the insurer's cost of capital at that time, which in turn affects the policy premiums paid by the policy owner. Except for interest paid on account values, insurers cannot change the economics built into a policy without concurrently applying the change to an entire class of policies. But in lower capital markets, investors can target lower yields and thus create higher policy value. The result is an arbitrage often in favor of the policyholder when a policy is sold as a life settlement.

5. HOW LIFE SETTLEMENTS DIFFER FROM VIATICAL SETTLEMENTS

A "life settlement" differs from a "viatical" in that it is based on longer life expectancies. During the AIDS years, the industry and most state regulators used the term "life settlements" to define the sale of policies written on an insured having a life expectancy of more than 24 months or not otherwise having terminal health, and used the term "viaticals" to define settlements on policies written on an insured having a life expectancy of 24 months or less or is otherwise terminal. Some states issue separate licenses to operators for life settlements and viatical settlements. But note that North Dakota, West Virginia, Iowa, Nebraska, Florida, Montana, Nevada, Mississippi, Ohio, Kentucky, North Carolina, Tennessee, Connecticut, Indiana, Utah, Kansas, and New Jersey refer to all life insurance settlements as "viaticals" and do not distinguish between the two classes of settlements. This has led to some consumer confusion and the life settlement industry has preferred to maintain a distinction between "life settlements" and "viaticals" because regulations, tax laws, and many transaction requirements materially differ, and because the investor market generally prefers to avoid terminally ill cases where a nominal change in longevity can cause a material change in returns.

6. AIDS AND IMPACT OF AIDS REMISSION

When the human immunodeficiency virus ("HIV") and people diagnosed with the acquired immune deficiency ("AIDS") syndrome approached epidemic rates in the U.S. in the 1980s, and the disease was terminal and required high treatment costs, the need for financial assistance became paramount to many victims. Viatical settlements became popular because the immediate liquidity available from life insurance policies often provided materially greater cash to the victims and their families than the future value of the death benefits.

Most insurers stopped issuing new life policies for applicants who tested positive for HIV or AIDS. During the early years of AIDS, many insurers offered insureds who were terminally ill with AIDS opportunity to receive their policy death benefits while they were still alive. But in most of those cases, the diagnosis had to be that the insured had one year or less to live, and even then, some insurers would only accelerate a portion of the policy.

According to an article in the July 31, 1992 issue of *The Wall Street Journal*, "the first viatical settlement company was started in 1989 by Robert Worley, Jr., an Albuquerque, NM financial planner."[14] He reportedly got the idea from "a radio talk show when a caller was complaining that his life insurance company would not buy back his policy—even at a 50% discount. Mr. Worley made some inquiries and decided he could fill the need, despite the difficulties in trying to predict when someone will die."

Pricing of AIDS policies was based on reviewing T-cell counts of the insured AIDS victims. "T-cell count was a reasonably accurate predictor of life expectancy, which typically ranged from six to 24 months, with some up to 36 months."[15] Many early investors realized exceptionally high returns, sometimes egregious, on these policies as the life span of an AIDS victim was relatively predictable enabling the transaction to be valued with a reasonable degree of precision, and because the victims did not have attractive alternatives…earning the reputation of "death bed" settlements.

By 1991, an estimated $50 million of viatical settlements had been sold. The industry grew rapidly with $500 million in policies viaticated by 1995 and $1 billion in policies viaticated by 1998.[16] But during the 1990s, treatment of AIDS progressed. "With protease inhibitors and other antiretroviral drugs readily available, life spans began to increase substantially. In fact, the selling (viaticating) of life insurance policies often became a way to buy these life-extending drugs—creating a self-fulfilling investment failure."[17] By the late 1990s, many AIDS victims could look to a reasonably normal life, and life expectancies continued to extend such that by early 2000s, AIDS ceased to be accepted as a health factor in valuing life insurance policies. This was fortunate for AIDS victims, but unfortunate for many early investors who found it necessary to pay costs-of-insurance to maintain policies long past the term that had been used to project profits…turning many of these early viatical settlements into economic losses.

A few viatical settlement firms remain active as of early 2008, but most insureds having any history or diagnosis of HIV or AIDs are generally excluded from life settlements because of the inability to establish reliable life expectancies.

7. LIFE SETTLEMENTS MARKET EXPANSION AND MATURING

Advancement of drugs and medical treatments succeeded in putting AIDS into substantial remission, causing viatical settlements to diminish and leading to major expansion of "life settlements" from the late 1990s to 2008. Viatical settlements operators and investors had discovered the arbitrages that exist in life insurance policies and realized that by using life expectancies estimated by medical underwriters, life settlements as opposed to viatical settlements could return attractive profits—albeit less than they experienced with viatical settlements—of upwards of 20% IRR. These operators discovered that life settlements represented a significantly greater market opportunity than did viatical settlements. Life settlements expanded rapidly to "an estimate of $6.1 billion of face amount…in 2006, an increase from an estimated $5.5 billion in 2005 and $3.3 billion in 2004."[18] Life settlements in 2007 have been estimated by industry leaders at $15-18 billion in policy face amount purchased, and it is estimated that the market could range up to $140 billion in policy face amount by 2016.[19] This is an average of over a $15 billion increase per year.

Life settlements can generally be divided into three groups: (1) small policies, under $250,000, for which pricing typically does not require life expectancy estimates; (2) large policies, $250,000 and larger, for which life expectancies typically are required; and (3) premium-financed policies. Each group has slightly different processing requirements. Age requirements typically start at age 65 and older, and life expectancies

start at 25 months and longer, typically topping out at about 240 months with the norm approximating 36 to 168 months. Some transactions involve "wet" policies which are policies that have not fully passed through the contestability period.

Investor portfolio parameters and balancing requirements often, but not always, put further limits on life settlement transactions. For example, a portfolio of life settled policies generally tries to create normalized distributions of risks, i.e., life expectancies, policy size, ages of insured, insurer risk ratings and medical conditions of the insured. These limitations can at any time place limitations on the policies that may or may not be marketable.

The life settlement industry is maturing into a sophisticated network designed to secure highest prices for policy sellers, set high professional standards, deliver non-market-correlated life settlements to investors and protect the confidentiality of insured for their remaining lives. Life settlement industry primary players include

- **l**ife insurance agents who source policies from policyholders;
- **w**holesale brokers representing agents in presenting policies to the market for best prices;
- **p**rovider firms who, in representing investors, review and bid on the policies and oversee closure and servicing;
- **e**scrow firms that hold funds for the transaction and assure that distributions are paid to the appropriate parties in a timely manner and pursuant to state laws and regulations;
- **i**nvestors represented by international investment banks, pension funds, hedge funds and syndicated investment funds; and
- **r**egulators to enforce laws applicable to viatical and life settlements.

9. LIFE EXPECTANCY ESTIMATES AND UTILIZATION OF APPROPRIATE MORTALITY TABLES

Life insurance economics are largely based on probability and odds, giving it characteristics of gambling. But in reality, it spreads the cost of financial risks among many. Gambling is an attempt to achieve a gain by means of a venture based on *un*known factors, i.e., it is pure chance. Insurance, on the other hand, takes into consideration all the factors that may affect the hazard insured against and the factors that may prevent loss from such hazard.

Life insurers calculate policy pricing with intent that the premiums will be sufficient to fund payment of death benefits, cover administrative costs, and to make a profit. Underlying their pricing is a calculation defined as "cost of insurance" ("COI"), which is determined using mortality tables calculated by actuaries for various populations. Thus the economic basis of life insurance is founded in the theory of probabilities which derive from events that do not lend themselves to an absolute schedule but which occur with sufficient random regularity to enable a "law of probability" to be established from a sampling of the random events, i.e. deaths for a selected population. Such a law of probability establishes the expected occurrence of the random events such that certain risk confidences can be used in conclusions applicable to expected number of periodic deaths in a large population.

Using theories of probability, the Society of Actuaries ("SOA") collect population data to develop and periodically publish mortality tables containing the probability of living or dying within a future time interval, typically annually. Insurers, life expectancy estimators, and life settlement operators derive life expectancy estimates from these mortality assumptions, which estimates are utilized in evaluating the present value of un-matured life insurance policies.

Looking back, the three main variables in a mortality table have been age, sex, and use (or nonuse) of tobacco. But more recent preferred class specific tables have been introduced in the U.S., with additional focus on occupation, education, and income. Many tables have been issued, but through the 1980s and 1990s the primary tables used were the SOA 1975-80 Basic Select & Ultimate tables. These tables were replaced by the SOA in 2002 with the 2001 VBT tables, including the 2001 VBT Ultimate and Select table, which became a predominant table used by the life settlement industry.[20] In early 2008, the SOA released the 2008 VBT tables based on 2002-2004 data, with overall results being 74% of the 2001 VBT.[21] The 2008 VBT tables are expected to be adopted as the life settlement standard by the end of 2008. But there are other mortality tables used by some firms. The most notable change in mortality tables from 1975 is longer life expectancies among older people.

Mortality tables are used in conjunction with the health and family history of the insured to estimate the insured's life expectancy, typically stated in months. "Life expectancy"(LE) is an actuarial calculation and is best represented in formulaic form. An LE is a determination of the average future lifetime of someone currently at age *x*, and is typically denoted by the symbol e_x. In formula form, life expectancy is

$$e_x = \sum_{t=1}^{\infty} {}_1p_x + .5$$

Where *tpx* is the probability of living from age *x* to age *x+t*, and includes calculations through the end of the assumed mortality table (age *x=oo*), which is some age greater than 100 for all recent tables. On average, people will live halfway through their year of death so expectancy is modified to add 0.5 to denote a complete life expectancy.[22]

Another way of viewing the life expectancy is this: if 1,000 people were alive at age *x*, then roughly half of them would still be alive at their life expectancy, or age $x + e_x$, *or* roughly half would also have died. (While this is a reasonable estimage—a 50/50 chance to live to one's life expectancy—the theoretical calculation does differ from this by a few months due to the actual shape of the mortality curve, so that slightly more than 50 percent of a population will typically die before their life expectancy is reached. This is particularly noticeable for older ages and/or mortality assessed with impairment ratings.)[23]

For the most part, life expectancy estimates have been provided by four major underwriter firms through 2006, but newer firms have been established offering advanced methodologies and efficiencies and are gaining traction in the life settlement industry. The longer established firms have tracked actual deaths of the people for whom they have issued estimated LE reports and have published claims of 96-98% accuracy. But it is known that LE estimates from separate firms have contained widely different LE values, up to 200%, and those databases containing large quantities of LE reports from multiple firms show consistent spread in LE estimates between underwriters. So the meaning of the self-published reports is somewhat unclear.

10. INSURERS RESIST, ADAPT, AND SUPPORT THE LIFE SETTLEMENT INDUSTRY

The life insurance industry was caught somewhat off guard by the rapid expansion of the life settlement industry in the early 2000s. As noted above, as early as 1911, insurers resisted life settlements, but were told by the U.S. Supreme Court that the sale of a policy that started with a valid insurable interest was legal. But with rapid expansion of life settlements from 2000 and most notably during 2004-2007, insurers became concerned about the potential negative impact life settlements can cause to insurers' earnings and reserve requirements, and undertook major efforts to curtail the success of life settlement operators. These efforts have been seen in messages to policy holders, agents, new products, legislators, and media.

Several life insurance industry lobbying groups have been effective at influencing legislators, regulators and government associations including NAIC and NCOIL to draft model life settlement acts that have been promoted to the states for adoption into law. Much of such efforts has been recognized by the life settlement industry as good for consumers and for the industry, but some of the early efforts were clear attempts to curtail and even put an end to the life settlements industry. The life industry's main lobbying groups that have pushed for regulations include the following:

- **American Council of Life Insurers (ACLI)**. ACLI represents 353 life insurance companies covering 93% of the industry's total assets. It provides a forum for the life insurance industry to discuss issues affecting life insurers and their policyholders and to develop public policy positions on legislative and regulatory proposals. ACLI is a valued resource on issues ranging from retirement security to international trade to regulatory modernization and reform. It works with the administration and members of Congress from both parties—often testifying before, and submitting testimony to, congressional committees and federal agencies. At the state level, ACLI is in close contact with state insurance commissioners, governors, and legislators to ensure state laws and regulations meet the needs of life insurers and the consumers they serve. ACLI engages in international trade policy development and negotiations to ensure regulatory efficiency and transparency that will lead to fair competition and free market access for U.S. insurers with interests abroad.[24]

- **National Association of Insurance and Financial Advisors (NAIFA).** NAIFA is a nonprofit group that works on behalf of its members to promote favorable regulations, provide profes-

sional education services and ensure ethical professional conduct for insurance and financial advisors. NAIFA's Political Action Committee is the top PAC in the insurance industry and ranks among the top one percent of all 3,700 PACs registered with the Federal Election Commission. In the last election cycle (2007), the national IFAPAC and the 50 state IFAPACs contributed approximately $3 million to federal and state candidates and committees.[25] In a release published by NAIFA on August 1, 2004, this statement was made: "If your state is contemplating or has decided to consider a viatical/life settlement law or regulation, please contact (NAIFA) to discuss the proposal and any comments or amendments your state may want to make to assure that a separate viatical/life settlement broker's license and testing or training are included in the proposal." Since then there has been a move by many states to allow licensed life agents to handle life settlements without separate licensing, but some states still require licensing.

- **Association of Advanced Life Underwriters (AALU)**. AALU was founded in 1957 and has been devoted to protecting advanced life insurance planning and the tax treatment of life insurance, as well as unifying and strengthening the industry's joint defense of life insurance. In addition to many issues addressed by the AALU, it has taken strong positions on both issues related to "Investor Owned Life Insurance" and "Stranger Originated Life Insurance" and has worked on a joint industry basis to try to protect life insurance against risk from practices that violate the purpose of state insurable interest laws.[26]

During early expansion of life settlements following viatical settlements, insurers voiced material concern that life settlements would cause economic losses resulting from reduction in lapsed policies. Some insurers admitted inclusion of assumed policy lapses when pricing policies while some denied this practice. When a policy is lapsed, all premiums paid to that date for that policy are retained by the insurer and none are paid to the policy holder, unless the policy has an accrued cash surrender value which is paid to the policyholder. Inclusion of assumed lapses in policy pricing is a sensitive issue for insurers. By including the insurer's lapse rates, the insurer can place a lower price on the policy and establish lower reserves, making the policy more attractive and competitive to consumers. The insurer bets it will never pay the policy death benefit, but there is no actuarial population data to rely on to estimate the rate of lapses other than the insurer's own experience based on its other policies which may have materially different policy economics and different demographic policyholders. The reality is that if *all* such policies are held to maturity, the insurer may not have sufficient funds to pay the contracted policy death benefits and the insurer may be underwater, leaving the policyholders in the lurch. Insurers increase their underwriting risks and potential risks to policyholders by including unreasonable lapse assumptions in policy pricing to enable setting of lower policy premiums to be competitive.

The life settlements industry argued back that if a policy had been "properly priced" to pay the death benefit based on applicable mortality data, and the premiums continued to be paid as occurs with life settled policies, the continued payment of premiums should fully sustain the policy economics for the insurer. As life settlements expanded and matured and as regulations took hold, the voices expressing concern for loss of revenues from policy lapses slowly diminished but have not totally vanished. The life insurance industry looked internally to manage these concerns—and of course in some cases—increased premiums to make up for policies which can no longer be expected to lapse.

However, elimination of lapses on insureds having below average life expectancy, which is the norm for most life-settled policies, can cause reduction of the average mortality among all insured within an insurer's portfolio of policies, resulting in increased reserve requirements. This is a different economic issue from the above lost revenue issue and continues to be under evaluation.

Insurers Resist Life Settlements

Major insurers issued statements to agents and the public to provide education and warnings, and having the intent to at least assure that life settlements were entered into for good reason, if not to discourage life settlements. Many life settlement industry leaders believe that insurers engaged in these practices to discourage agents and policyholders from entering into life settlement transactions. The following are samples of such notices and warnings:

- Late 2004—this language was found in a policy:

"You may change the owner of the policy by making an absolute assignment or you may pledge the policy as collateral by making a collateral assignment. You may make an absolute assignment only to a charitable organization or to a person having an insurable interest in the insured."

- February 2005—an insurer issued this statement to its agents (excerpted):

  "(*Insurer*) generally prohibits representatives from participating in viatical or life settlements. Viatical and life settlement business activities have raised controversy. Recent publicity has highlighted examples in which either sellers of contracts or purchasers of interests in contracts (or pools of contracts) have been victimized by unscrupulous promoters. Moreover, the regulation of these activities is still unsettled. Recently it has come to the company's attention that several organizations have created arrangements where life insurance applications are submitted to insurance companies where there is a probable intent by the policy owner to sell or transfer the policy to a third party (that is, a life settlement company) soon after the contestability period has expired. Issuance of life insurance which is intended to be sold to life settlement companies who have no insurable interest in the insured is against public policy and corrosive to our business. Accordingly, *(Insurer)*, effective with applications dated March 7 and later will require that financial professionals certify on the life insurance application that they or their client has no intent to use this policy for any type of viatical settlement, senior settlement or any other secondary market."

- April 2005—a major life insurer issued a "Disclosure and Acknowledgement of Risk" or warning form for policy owners to sign upon requesting the insurer to effect a transfer of a life insurance policy to a viatical or life settlement company:

  "I *(the policy seller)* understand that:

  The person(s) assisting me, including the Financial Representative named below (if any), with the sale of my insurance policy to the Viatical or Life Settlement Company: is/are not acting on behalf of *(Insurer)* or any company or person affiliated with *(Insurer)* (all such entities and persons are referred to as "*(Insurer)*"), *(Insurer)* is not a party to, nor assumes any responsibility for, this transaction; *(Insurer)* has in no way recommended this transaction to me, and I will have no recourse against *(Insurer)* if I become dissatisfied with this transaction. I further acknowledge and understand that by selling my insurance policy:

  - I may be forfeiting valuable rights and benefits available under that policy;
  - The beneficiary listed in the policy will not receive the proceeds from this policy;
  - Persons or entities unknown to me may obtain an interest in my death;
  - Persons or entities unknown to me may obtain access to my personal health records;
  - My policy may be sold and resold many times without my knowledge or consent;
  - There may be ongoing tracking of my health until I die; and
  - 1 am forfeiting a financial asset that probably has a higher rate of return than any other asset in my estate."

- October 2006—the same insurer issued to its distributors these statements representing some but limited acceptance of life settlements:

  "Recently, we have received requests for the issue of new policies funded by the settlement of existing non-*(Insurer)* contracts. We are concerned about the implications of this trend for clients and the insurance industry."

  "Therefore, *(Insurer)* will no longer accept applications for life insurance funded by settlement proceeds where the policy being settled is less than five years from the date of issue."

- December 2006—a major life insurer issued this statement (excerpted) to its agents:

  "There's been much written by a number of you about a concept called Investor-Owned Life Insurance or IOLI. *(Insurer)* has been a

major player in the older age, affluent market segment, the Universal Life business, even before the IOLI issue. ... we've become concerned about concentration, lapse rate, mortality, the secondary market and regulatory issues. As a result of these concerns, we decided to limit our exposure and continue our leadership position by exiting that business."

- March 2007—a major life insurer issued this disclosure and/or warning letter to a policyholder, presumably to many policyholders, considering selling life insurance policies:

  "By receipt of your signed authorization to release information, you have authorized us to provide certain information to (name of secondary market company), a viatical or life settlement company.

  If you are contemplating the sale of your life insurance policy, we want you to be aware of the following points:

  - The purchaser(s) of the policy will have a financial interest in the insured's death.

  - This policy will remain in force on the insured's life after the sale. Because the policy will remain in force, if you wish to purchase additional life insurance coverage, then the amount of insurance for which you qualify may be reduced.

  - There are possible alternatives to viatical and life settlement contracts, including accelerated death benefits or policy loans that may be available to you within your life insurance policy. An accelerated death benefit provides immediate cash, typically by paying some of the policy's death benefit before the insured's death, for those insured's that are facing a health crisis. It may be a way for you to get cash from a policy without selling it to a third party. Also, if you have cash value in your policy, you may be able to use some of it by requesting a loan to meet your immediate needs and still keep your policy in force for your beneficiaries. You may also be able to use the cash value as security for a loan from a financial institution.

  - Any monies that you receive in the sale of your policy, in excess of the premiums paid on the policy, may be taxable currently. If you retained the policy, the proceeds upon death would typically be paid to the beneficiaries free of income tax.

  - The agent brokering the sale of your life insurance policy will likely receive a commission and, under many state laws, must disclose to you the mount and method of calculating this compensation.

  - While you may know the identity of the immediate purchasers(s) of your life insurance policy, there is no assurance that the purchaser(s) will not later transfer the policy to other unknown persons."

- In an A.M. Best Newswire, March 13, 2007, these statements of several major life insurers were reported (excerpted):

  - "UL [universal life] sales were down for us by 40% year-over-year. The big drop was in our independent distribution channel, and…because we will not be in the IOLI business, in the life settlement business, irrational pricing with respect to older age underwriting, we have seen a hit there."

  - "We've now come out in May 2006 with a new [UL with secondary guarantee] product that we think hits the appropriate middle ground. With the reserve refinements that we made during the year, we believe it's appropriately reserved at a level that will allow us to achieve appropriate levels of profit."

Insurers Adapt and Support Life Settlements

The above actions and statements in part show the resistance of the life insurance industry to the life settlement industry. But as the life settlement industry matured into 2007, some insurers acknowledged its reality and the value it brings to consumers and investors. The following are examples of how some life insurers are supporting and becoming involved in the life settlement industry:

- In 2006 and 2007, a major life insurer attempted adding a provision to its life policies that would

require the policyholder to notify the insurer of any life settlement offers and giving the insurer a first-right-of-refusal. The policy provision was submitted to several states for approval but was rejected. The insurer pulled the policy and later created its own life settlement division.

- In September 2007, Paul Rutledge, President of Transamerica Reinsurance, expressed his views on these *(life settlement market)* trends:[27]

  Rutledge agreed with many others in the life insurance industry that concerns around insurable interest and other potential abuses must be addressed as quickly and effectively as possible. But looking beyond these current challenges, Rutledge envisions long term advantages for the development of a secondary market for life insurance products—advantages for both the insurance buying public and for life companies.

  Rutledge indicated that life settlements are a natural evolution of life insurance products, noting that a life insurance policy is a financial instrument to be treated like any other asset in a consumer's financial plan, with access to its market value. He noted that until recently, the only option that consumers had to liquidate their insurance assets was to collect the cash surrender value, which value is governed by regulations and does not consider the insured individual's health, which the policy is based on. He further noted that newer policy designs have created larger gaps between surrender value and economic value, causing the surrender value to not reflect the policy's economic value. Today the life settlements business has evolved to better serve this market need.

  Rutledge further noted that life insurers are in a good position to boost efficiency by streamlining the transaction *(life settlements)* and removing distribution and administration redundancies that they are already performing within the existing life insurance product. In doing so, the life insurer, independently or in partnership with a life settlement company, can provide its customers with a settlement option that should be at least as competitive as other offers. But current regulations are unclear as to what role life insurers could play in repurchasing their own issued policies. Establishing new regulations enabling insurers to do so would be beneficial. Not only should this be an advantage to the policyholder, it should benefit the insurer as well. Rather than having a policy mature to the benefit of an outside investor, the insurer would have the option of paying an amount less than the death benefit and erasing the corresponding death benefit liability off the books. There is a middle ground where the policyholder reaps a better value and the insurer can come out with value at the same time.

- Phoenix Life Solutions presented its position in the life settlements industry at the Fasano Associates November 2007 Life Settlements Conference, summarized below:

  1. What opportunity does Phoenix see in the life settlement industry?

     - To apply its core skills in mortality underwriting, actuarial pricing, and product design and structuring

     - To leverage its reputation in a new market with innovation and principled delivery of solutions to high net worth markets

     - A natural hedge for its core business

     - To partner with investors, distributors, investment banks, and life expectancy evaluation firms

  2. Phoenix sees the secondary life market as not going away, as an opportunity and not a threat. Phoenix sees a need to address challenges head on and leverage its resources in partnering opportunities.

11. INTRODUCTION OF HIPAA WAS AN EARLY MAJOR REGULATION FACED BY THE LIFE SETTLEMENT INDUSTRY

Congress recognized the need for national patient record privacy standards in 1996 when it enacted the Health Insurance Portability and Accountability Act of 1996 (HIPAA). The law encouraged electronic transactions of medical and patient information and required new safeguards to protect the security and confidentiality of such information. In November 1999, the Department of Health and Human Services (HHS) published proposed regulations to guarantee patients rights and protections against the misuse or disclosure of their health records. After extended discussions and debates, President Bush

and Secretary Thompson allowed the rule to take effect on April 14, 2001 and made appropriate changes in 2002 to clarify the requirements and correct potential problems that could threaten access to or quality of care.[28]

The HIPAA rules caused some turmoil in the life settlement industry. The life settlement industry required personal medical records to evaluate insured life expectancies and to track individuals insured by settled policies. HIPAA release forms were created for insured to sign, but later updates of HIPAA enabled insureds to rescind such forms at any time. Then the life settlement industry created special powers of attorney and/or irrevocable empowerment to family members to authorize future release of medical records if needed. Of course, it became necessary for life settlement operators to adopt tight procedures to keep all insured medical and personal information confidential. Some state legislators and regulators honed in on the HIPAA requirements and added specific regulations in state life settlement and viatical laws to further protect private information.

Today the system to enable life settlement operators to access required private information of insureds is not perfect. Critics are concerned about the transfer of such information when portfolios of life settled policies are sold to major investors, notably international, particularly upon future re-sales. A typical practice to protect such information is to deposit the policies with major institutions for safe keeping and servicing, and to share only the essential data required by operators and investors to evaluate portfolios and handle sale transactions.

12. LEGAL CASES FURTHER DEFINE LIFE SETTLEMENTS

As viatical settlements and life settlements expanded across the country and in volume, it followed that legal arguments would require the courts to resolve vagueness in law and regulations. The following sample cases (excerpted from Westlaw reports) are illustrative of how the courts have further defined and entrenched viatical and life settlements as valid and binding transactions.

Protective Life Insurance Company vs. Dignity Viatical Settlement Partners, L.P., Massachusetts, March 24, 1999. The life insurer brought suit seeking to rescind a life insurance policy on grounds of fraud. The U.S. District Court for the District of Massachusetts rescinded the policy. The viatical settlement company appealed. Massachusetts Supreme Judicial Court ruled for the viatical settlement company.

Gander v. Livoti Missouri, 2001. May 14, 2001. Children brought action against their father, who had entered into a viatical agreement, and the purported beneficiary named by the father's assignee, seeking rights to the death benefits in light of the divorce settlement agreement between their father and mother that required the proceeds of the policy to be held in trust for children's benefit. The U.S. District Court for the Eastern District of Missouri entered judgment in favor of the children, and the court of appeals confirmed the decision.

*Accelerated Benefits Corp. v. Department of Insurance***.** Florida, February 26, 2002. The Department of Insurance (DOI) alleged that the viatical provider knew or should have known that the life insurance policies sold by certain viators were obtained unethically as a result of misrepresentation as to the state of health of viator. The DOI revoked the provider's license to operate as a viatical settlement provider. The court found in favor of the DOI.

Zales v. Habersham Funding, LLC, Michigan, March 16, 2006. Former beneficiaries of a contract that was sold pursuant to a viatical settlement contract brought action against the purchaser of the policy alleging that the contract was void for failure to contain certain disclosures required by Viatical Settlement Contracts Act. The court found in favor of the purchaser.

American United Life Ins. Co. v. Martinez, Florida, March 7, 2007. Life insurers brought tort suit against viatical settlement companies and their court-appointed receiver, alleging that the defendants knowingly purchased and/or serviced life insurance policies from HIV-positive individuals who submitted fraudulent insurance applications stating that they had never been diagnosed or treated for AIDS or any other blood or immune system disorder. The U.S. District Court for the Southern District of Florida dismissed the suit, and an appeal was denied.

Life Partners, Inc. v. Morrison, Virginia, April 30, 2007. A viatical settlement provider challenged the validity of the Virginia life settlement law. The court found in favor of Virginia.

Southwestern Life Ins. Group v. Morehead, North Carolina, August 16, 2007. The issue involved whether or not a viatical settlement is binding if the operators were not licensed as required by the State of North Carolina. The court found that the contract was binding.

Goshawk Dedicated Ltd. v. American Viatical Services, LLC, Georgia, November 5, 2007. The plaintiffs sought the defendant's in-house database, all prior versions of the database, and all available backup copies. The database contained detailed information about the life expectancy data defendant used in purchasing life insurance policies, in procuring insurance from the plaintiffs, and in analyzing whether its actuarial data was accurate. The defendant claimed that the database contained significant amount of actuarial data not relevant to the litigation and that the database was a non-discoverable trade secret. The defendant contended that the "methodologies, policies, and practices" of its life expectancy evaluations are protected trade secrets and thus should not be subject to discovery. The U.S. District Court for the Nothern District of Georgia found in favor of the plaintiffs.

Prudential Ins. Co. of America v. Life Partners, Inc., Minnesota May 8, 2008. An insured family claimed rights to the distribution of death benefits from a life insurance policy issued on the life of the insured who had transferred the beneficiary rights of the policy death benefits to a third party, Life Partners, in exchange for a payment of the agreed price. The court held that Prudential had deposited the death benefits with the clerk of court and was discharged from any and all liability arising out of the policy, and that all claimants were restrained and enjoined from instituting any proceedings against Prudential with regard to the policy. The court found in favor of Life Partners.

13. GUARANTEED RETURNS AND LONGEVITY RISK MANAGEMENT

Life settlements in England have utilized TEP life insurance policies that provide a payout at a certain date making it common for investors in UK policies to expect payout at a target date, regardless of when the insured dies. But life insurance policies in the U.S. do not provide time certain payouts and investors have been concerned about longevity risk, leading them to seek some form of guarantee or protection. Longevity and mortality risks stem from the risk that actual lifespans differ from expected lifespans, creating economic consequences, such as a change in the underlying life insurance policy value. Holders of "mortality risk," including institutions such as insurance carriers and reinsurers, are economically exposed to a decrease in lifespan, while holders of "longevity risks," including pension funds, annuity writers, the Social Security trust fund, and life settlement investors, are exposed to an increase in lifespan.

The first policy guarantee arrangements, provided by the Goshawk Dedicated, Ltd. syndicate at Lloyd's of London, began with viatical pools in 1997-1998 and were later extended to life settlements. Goshawk guaranteed to pay the death benefit at the insured's life expectancy plus 24 months if the insured had not died as of that date. Unfortunately, actual mortalities of the insured turned out to be materially longer than the expected mortalities used to purchase policies and the guarantees were not all fulfilled. The 24-month extension on life expectancy was not consistently fair, in that 24 months added to a two-year life expectancy provided excessively greater relative contingency than 24 months added to an eight-year life expectancy. Fees for the guarantees ranged from 2-5% of the policy face values. Goshawk ceased the guarantee service in about 2002.

Following the Goshawk withdrawal, investors sought other guarantees, opening the door to spurious operators. One such fraudulent guarantee offering came from a group in NYC and Montreal claiming they had arranged with an Indonesian office of a major international insurer to issue guarantees through reinsurers. They wanted payments and fees approximating 4-7% of the portfolio aggregate death benefit. Initial investigation revealed possible fraud, and further investigation by the FBI revealed criminal backgrounds of the operators. (The international insurer was not involved and its name had been fraudulently used). Other guarantee programs based in Scotland, Ireland, Italy, and the Bahamas were circulated but their authenticities have not been verified.

The problems and issues of early guarantees underscored the concern for longevity risk management in portfolios, i.e., the risk of insured living beyond the portfolio mortality curve. This is referred to as "stochastic mortality." Because life expectancy estimates are just that, "estimates," investors seek methods to hedge and/or assure minimum yields.

A variety of new guarantee instruments have been created for life settlements and new products such as the Goldman Sachs QxX LS Mortality Index, Swiss Re Mortality-Risk Bonds, and Credit Swiss Longevity Index help enable them. The following are representative of current offerings:

- Purchase insurance to assure the portfolio's aggregate mortality curve, or purchase insurance to assure payment of a single policy at some future time point. Several specific program are available including: Fasano & Associates/Augur Capital,

- The QxX.LS index swaps, offered by the Goldman Sachs Group, Inc., enable market participants to hedge or gain exposure to longevity and mortality risks, providing reliable, real-time pricing information and execution. The index facilitates measuring, managing, and trading exposure to longevity and mortality risks in a standardized, transparent, and real-time manner. The QxX is a sample of the US senior insured population over the age of 65, referencing a pool of 46,290 lives medically underwritten by AVS Underwriting, LLC. It is updated and published monthly, providing real-time mortality information. Actual mortality is tracked using the Social Security Death Index.

Creative other models for pricing mortality derivatives have also been proposed. These models focus on stochastic mortality as a major determinant in setting the value of life-settled policy portfolios and in pricing mortality guarantees. Such models may also facilitate calculation of reserves needed to hedge longevity error in a way that would be consistent with an arbitrage-free pricing framework.[29] Examples of such derivatives models or contracts include the following:[30]

- **Survivor Bonds** where coupon payments are linked to the number of survivors in a given cohort. The concept of survivor bonds which deal with longevity risk has recently been addressed by Blake and Burrows (2001) and Lin and Cox (2004). Their origin dates back to Tontine bonds issued by a number of European governments in the 17th and 18th centuries. The first such bond was issued by Swiss Re in 2003.

- **Survivor Swaps** where counterparties swap a fixed series of payments in return for a series of payments linked to the number of survivors in a given cohort. A few survivor swaps have been arranged on an over-the-counter basis, but have not been traded and only benefit the parties to the contracts.

- **Annuity Futures** where prices are linked to a specified future market annuity rate.

- **Mortality Options** providing a range of contracts with option characteristics whose payout depends on an underlying mortality table at the payment date.

14. CHANGING LIFE SETTLEMENT MARKET DYNAMICS

The early secondary life insurance market was formed by anyone who held themselves out to be a life settlement expert. Licensing was not required and regulations did not exist. But the abuses that occurred during the viatical years (1980-2000) drew attention and complaints. In 1993, the NAIC[31] responded by producing the first "Model Viatical Settlement Act" (the "Model Act"), with the aim of regulating the sale of life insurance policies by a protected class of terminally ill individuals. Several states followed by passing early viatical laws in 1996. As the industry expanded, the need for more laws and regulations became apparent, and, in 2001, the Model Act was broadened to include the life settlement market and to provide for increased investor protection, advertising guidelines, enhanced examination powers, and increased disclosures and protection against fraud. In June, 2007 the NAIC again updated the Model Act with the "Life Settlements Model Act Revision" to include STOLI ("Stranger Originated Life Insurance") regulations. But NCOIL[32] also found the need to draft its "Life Settlements Model Act," released on November 16, 2007. Both the NAIC and NCOIL Acts were recommended to states for adoption. By early 2008, forty states had rigorous viatical and/or life settlement laws, with bills pending in five more states and Puerto Rico.

The operating dynamics of the life settlements market have changed from its early haphazard structure to an increasingly complex and sophisticated structure that, as of early 2008, continues to change and mature. The current market provides several structures for bringing a life insurance policy to market:

a. **The most prevalent arrangement** typically begins with the life insurance agent identifying a policyholder having a policy that may qualify for a life settlement. But sometimes the policyholder initiates the process with the agent. The agent should determine the need or appropriateness of the policyholder to sell, and gather required policy and insured information and release forms and submit the package to one or more brokers. Typically these brokers are large national firms that are networked to agents and to providers, with staff highly experienced in life settlement transactions. Brokers verify the policy and insured information and qualifications, circling back to the agent for missing information, and most often obtaining one or two life expectancy evaluations and

reports on the insured before submitting the package to provider firms. Providers evaluate the package of information and determine the price their investors are willing to pay for the policy. Providers make offers to the brokers who in turn pass the offer to the agent representing the seller, and the process of negotiation continues until the seller accepts the market's best offer. Then the winning provider handles the closing, invoking escrow agents as necessary to pay net sale proceeds to the seller and commissions to the broker, who in turn pays commissions to the agent. Most often the policy resides in an investor trust that is serviced by an institutional trustee. Most life settlement state laws and regulations reflect this prevalent structure.

b. **Master General Agents ("MGA")** have begun to see opportunities for additional revenues by acting as a life settlement broker for the agents under the MGAs' wings. The structure is essentially the same as (a) above, but here the MGA replaces the broker role and works directly with the agents and providers.

c. **Providers' networking directly with agents or through MGAs** has always been an option, and several providers have endeavored to make such structures happen with the goal to streamline the process and increase efficiencies. And as life agents learn more about life settlements, many seek direct business relations with providers with the hope of retaining more of the available commissions.

d. **Policyholders directly contacting providers** is increasing as consumers become more informed of the secondary life insurance market. This is not a structure that providers seek because of much inefficiency, mostly stemming from the seller's lack of knowledge in transacting a good life settlement.

e. **Insurers competing with life settlement operators** are becoming a new and yet unfolding practice, i.e., they are directly purchasing policies from policyholders. Of course they have an inside competitive advantage and can eliminate all or most intermediary commissions. Insurers are not required to be licensed as a life settlement operator because they are licensed and regulated as a life insurer.

f. **Investors purchase policies at all levels in the market.** Most state laws exempt financial institutions from life settlement licensing because they are regulated by banking laws and regulations. Numerous major banks and investment banks operate in the life settlement arena by seeking policies at all points, i.e., through agents, brokers, and providers, and direct from the policyholder. But they typically have not advertised or publically promoted such practices.

g. **Charitable organizations are exempt from many state laws** and as such, they have played the market in several unique ways. Charities have arranged for prospective donors to allow policies to be purchased on their lives but with the charity owning the policy, and after holding the policy through the typical two-year contestable period, such policies are offered for sale in the secondary insurance market. Some policies were offered to the market *during* the contestable period as "wet policies." Charities have also encouraged policyholders to bequest their policies to the charity rather than surrendering or selling them, and after it is gifted the charity offered such policies for sale in the secondary market.

h. **Premium finance structures have created chaos** in the life settlement market during 2006 and 2007 by offering individuals payments for allowing policies to be issued on their lives but pursuant to a structure where the insured has no control over the policy and no beneficial interest in the policy. The premium finance operators pay all premiums in the form of a non-recourse loan until the policy is sold, and then retain all or most of the proceeds. These structures have been labeled "Stranger-Originated Life Insurance" ("STOLI") or Investor-Initiated Life Insurance or SPIN-Life and have been made illegal in a number of states because the promoters and finance companies had no "insurable interest" in the life of the insured. Most insurers and life settlement operators oppose STOLI transactions. But new premium finance programs are being offered as of early 2008 that comply with legal requirements, but their success is yet to be tested.

i. **Life settlement trading platforms** entered the market in 2006 and are gaining some acceptance as of early 2008. Such platforms solicit selling

representatives to list policies on an exchange where registered providers and investors place bids in a manner similar to eBay. Two such platforms include

- **Life-Exchange, Inc**. (LFGX, on OTC BB) claims to be designed to provide security, transparency, and efficiencies by employing advanced electronic trading technology. It claims to provide tools and functionality that significantly reduces time and costs associated with life settlement transactions, while getting the highest market price for listed policies.

- **LEXNET**, The Life Settlement Network, is an online marketplace that enables the trading of life insurance policies in a secure environment using three unique systems. Its "Auction Trading Platform" is for policies of $250,000 face value and above, and the policyholders, working with their producer/advisor, sets the reserve price at which they are comfortable selling their policy. The policy trades when the auction meets or exceeds that price. LexNet's uses its "Bulletin Board" system to handle tertiary trades or lower face policies (below $250,000) where the seller and buyer have the ability to modify the bid and the ask in real time. Once the bid matches the ask price, the trade is executed. Its "Combinatorial Portfolio Platform" is for institutions seeking to sell a portfolio of policies. The system allows bidders to bid on the whole portfolio, or groups of policies and/or individual policies in the portfolio. The combinatorial auction algorithm calculates in real time the combination that yields the highest price to the seller, while allowing buyers to bid on particular policies within their buying parameters.

One of the major challenges of the industry has been lack of understanding among consumers, making them vulnerable to predator business practices. Another challenge is lack of knowledge and understanding among some legislators who have learned of the life settlements industry from angry consumers and news articles and lobbyists, but often do not have sufficient in-depth knowledge of the industry to construct laws that fairly balance the industry among its many players while protecting consumers. In response to these challenges, several industry associations have formed to establish standards from within the industry, provide education to industry operators, the public and to legislators, and to engage in lobbying to help guide the drafting of laws and regulations. These major associations include the following:

- **LISA ("Life Insurance Settlement Association")**, formed in 1995, is America's oldest, largest and most widely recognized trade association in the life settlement industry, participating in legislative and regulatory matters in all 50 states, Puerto Rico, and Canada. It is comprised of over 170 member companies in North America, Europe, and Australia, providing LISA with the broadest and most authoritative voice in the life settlement industry. LISA provides information for consumers, member companies, regulators, legislators, and all other interested parties. Its mission is to promote the development, integrity, and reputation of the life settlement industry and to promote a competitive market for the people it serves.

- **LSI ("Life Settlements Institute")**, formed in 2002, to facilitate capital markets access to the life settlement industry. Its membership is limited to life settlement providers and life expectancy underwriters. LSI works with government regulatory agencies, legislators, and the life insurance industry to promote the creation and compliance of strict regulations and comprehensive standards and practices for life settlements. Other missions of LSI include increasing knowledge and increasing awareness of the life settlement industry among insurance and financial planning professionals; awareness of life insurance policyholders, insurance and financial professionals of the option to obtain more value for life insurance policies than otherwise would be available from surrender or lapse; development of the use of institutional financing in the life settlement industry along with laws and regulations that foster the prudent use of such institutional financing; and prevention of fraud and dishonesty in life settlement transactions.

- **ILMA ("Institutional Life Markets Association")**, formed in April of 2007 by Goldman Sachs, Credit Suisse Group, Bear Stearns Company, Mizuho International, UBS, and West-LB AG. ILMA is a not-for-profit trade association comprised

of a number of the world's leading institutional investors and intermediaries in the longevity and mortality marketplace. It was formed to encourage the prudent and competitive development of a suite of evolving mortality and longevity related financial businesses, including the businesses of life settlements and premium finance. By creating innovative capital market solutions, ILMA members seek to expand consumer choice in one of their most important assets—their life insurance. The Association endeavors to establish best practices and raise awareness in this growing and vital industry. ILMA's mission is to expand and apply capital market solutions in life insurance, educate consumers that their insurance may be a valuable asset, expand consumer choices about how to manage it, and support the responsible growth and regulation of the industry. It believes that expanded consumer choice and full disclosure of all fees is good for the consumer and for the industry.

15. CAPITAL EXPANSION AND SECURITIZATION

Small independent investors were first to see the opportunity in life settlement investments, purchasing a few policies and taking the risk. Quickly recognizing the adverse risk of investing in only a few policies, investors formed small groups with individuals taking partial interest in multiple policies. That quickly led to the formation of firms that aggressively marketed partial ownership in multiple policies to a wide market of independent investors. But these firms came under fire from federal and state securities regulators claiming they were selling securities. But based on a 1996 case, *SEC vs. Life Partners, Inc.*, in which the U.S. Court of Appeals for the D.C. Circuit ruled that a sale of a life insurance policy was not a security, these firms fought back and ploughed ahead. A landmark resolution occurred in 2004 when Mutual Benefit Corporation was shut down by the SEC for violation of securities laws, and all policies held for investors were placed in a receivership for management. Since then, others have been closed or have changed their business practices to conform to federal and state securities laws. Partial investments in life settlement policies remain as a practice of several firms, but the growth of the market has been driven by large institutional capital.

By 2003 large institutions became aware of opportunities in life settlements and began investing substantial amounts ranging from $50 million up to $500 million from both domestic and international funds—investment banks, hedge funds, pension funds, special purpose funds, etc. By 2008, numerous institutions from many foreign countries have become major players in the industry. Specific numbers have not been recorded, but based on reported volumes of policy face value that have sold, total capital invested as of 2007 could likely exceed $8 billion, growing from a current annual rate of about $3 billion annually to $28 billion annually by 2016.

The next logical evolution for life settlements would be securitized portfolios to extend investment opportunities to multiple investors. In March of 2004, Legacy Benefits Corporation became the first life settlement company to successfully conclude a rated securitization of life insurance settlement assets. This transaction was underwritten by Merrill Lynch, was rated by Moody's, and represents a milestone in the life settlement industry. The notes were sold in two tranches; the Class A notes were rated A1 and pay a coupon of 5.35% and the Class B notes were rated Baa2 and pay a coupon of 6.05%. Life insurance policies in the portfolio insure individuals with an approximate weighted average age of 77. As of early 2008, this is the only successfully completed publicly-rated securitization backed by life insurance policies in the U.S.[33]

Advancement in securitization of life settlements (referred to by some as "death bonds") continues. Goldman Sachs and other firms consider these instruments a logical sequence in a trend that started with mortgage-backed securities in the 1970s. Germany and the UK have been active in life settlement unrated securitizations since 2006, and syndications have expanded to Australia and the Netherlands. As of 2007, only one rated deal had been completed in the U.S. and one other that had been rated became unrated because the operator could not aggregate the policies by the required target date. But through 2007 and into 2008, banks and investment banking houses continued to aggregate large portfolios of life settlements in anticipation of syndications to come. In early 2008, Merrill Lynch reported activity on a new unrated fund.

The next evolution points to mutual funds. "The product *(life settlements)* just lends itself to securitizations, like what has been done with mortgage-backed securities," reported the head of the "longevity derivatives" group at Bear Stearns & Co.[34]

16. MARKET TESTS SMALL POLICIES

Life settlement operators and investors are looking at efficient ways to purchase small life settlements, typically policies having face value under $250,000. This is happening for two reasons: (a) investors understand the value of having broader diversity of risk in portfolios (more insured and less exposure to large policies), and (b) the small policy market, not having been developed, represents a potential $17.8 trillion future life settlement business opportunity. Of course most of this will dissipate in lapses prior to the insured reaching age 65 when senior life settlements are typically considered. Nevertheless, the logistics for such policies are different than for large policies, and regulators are expressing concern for some policyholders.

The NAIC reports that 78% of policy owners have policies of $100,000 to $200,000, while only 7% of policyholders have policies of $750,000 or higher. Given the total number of policies held by individuals as of 2006, this means that nearly 120 million consumers with small policies may find potential benefit in life settlements—and this does not count all those with group life insurance that can be converted. Of course, many of these are not over age 65 as of this data and do not now qualify for life settlements, but most can expect to reach senior status at some time in the future.

Caution is necessary because life settlement sellers of small policies could end up losers—they may not understand the trade-offs of "cash now" versus "death benefits later." As of early 2008 there are only a few providers and investors willing to purchase such policies because the processing and servicing costs are nearly as great as for large policies making the returns materially lower. And, commissions available to agents and brokers are small, making it unattractive for them to support small policy transactions. Nevertheless, small policyholders should be entitled to the same economic advantages large policyholders enjoy when policies are sold into the secondary market versus surrendering them or allowing them to lapse.

The migration of the baby boomers into senior status is expected to create a groundswell of policy sellers, and a large number of these will be small policies. As this market develops, it will be built on volume, automation, and standardization. Medical records gathering and life expectancy evaluations are not typically undertaken because of cost. Standard mortality tables are used, perhaps with some simple classifications such as gender, smoking, income, and education. Firms in this market segment use direct customer retail marketing, e.g., TV ads, direct mail, inserts, etc.

It is essential that systems developed to transact small policy life settlement be efficient, but also they must be fair to the sellers. Legislators and regulators will not tolerate any system that is "predatory" in nature or that does not provide "best market pricing" to the policyholders. Streamlined and automated transactions can make it more difficult for average people to understand all they need to know before selling.

17. LIFE SETTLEMENTS' IMPACT ON INSURERS AND SECURITIZATIONS HAS BECOME THE FOCUS OF MAJOR RESEARCH

Substantial research published by several major institutional research firms, including Bernstein Research Call, Conning Research, Fitch Ratings, and The Wharton School, has focused on the expanding life settlement industry, reflecting its evolution and maturing. The findings and conclusions from these various research projects provide independent views of issues and opportunities for the life settlement industry. The following are noteworthy:

- "**Life Insurance Long View—Life Settlements Need Not Be Unsettling**," conducted and reported by Bernstein Research Call, March 4, 2005, evaluated the size and growth of the life settlements industry and possible impact on the life insurance industry. Highlighted conclusions include the following:
    - "Over the long-term, we feel the settlement business, if conducted in a responsible manner, could have favorable ramifications for policyholders and the life insurance industry."
    - The life settlements industry will grow *(from $16 billion in aggregate face)* to over $160 billion in aggregate face policy amount over the next several years.
    - Rapid expansion of the settlement business could adversely alter some of the experience embedded in existing blocks of insurance business relative to prior expectations. Specifically, the industry prices its products using long-term averages for lapse rates and

mortality. To the extent that the life settlement business causes adverse change in these assumptions, the industry could see lower returns on certain existing blocks of business, but we expect the impact on consolidated profitability should be modest.

- Despite the impact on pricing assumptions, expansion of the settlement market may not be all bad for primary insurers. A critical assumption here is that the business is conducted in a responsible manner. The increased liquidity provided by a secondary market for life insurance might make individuals more willing to purchase cash value life insurance policies. Moreover, insurers may conclude that having lapse supported pricing is not in their best interests or those of their clients. Therefore, they may encourage persistency by offering features such as accelerated death benefits or guarantees on cash value performance that could also increase the appeal of their products. Second, greater familiarity on the part of institutional investors with respect to the life insurance market could serve as a catalyst for securitizations, which could mitigate some of the capital pressures facing the industry. Lastly, life companies may themselves begin to offer settlement options for their clients, particularly if they can roll the cash proceeds into payout annuities, which play into the trend of increasing longevity. In summary, we feel that expansion of the settlement business could ultimately benefit all parties involved, again, assuming business is conducted in a responsible manner.

Conning Research has published four studies ranging from an examination of viatical settlements and the insurance industry and consumer perspective to a focus on capital moving into the space and in-depth analysis of the realities of life settlements on lapse rates and policy economics to the insurers.

- **"1999 Viatical Settlements—The Emerging Secondary Market for Life Insurance Policies":** "Conning's first report on the viatical and life settlement industries examines the characteristics of the three viatical markets and future prospects for each, the keys to success for settlement companies, insurance industry response and consumer/investor attitudes toward viaticals."

- **"2003 Life Settlements—Additional Pressure on Life Profits":** "Life settlements continue to attract increased attention, sparked both by the companies offering them as a means to promote their business growth and by insurance companies as they attempt to either slow them down or eliminate them. Following a review of life settlement activity over the past four years and an actuarial analysis of their profit impact to a life insurer, Conning draws several conclusions about the impact these settlements will have on the life insurance industry, and why. While still small in absolute terms today, life settlements should be on the radar screen of insurers, policyholders, investors, and other key stakeholders due to their implications to each group."

- **"2006: Life Settlements—The Concept Catches On":** "Conning again analyzes the life settlements market in this strategic study. With roots in the viatical settlements market during the 1990s, the life settlements market has grown substantially. It provides seniors with a secondary market for existing life insurance policies, and an alternative to lapse and/or surrender for policies no longer needed or wanted. However, some have a less rosy view of the current life settlements marketplace. They see aggressive marketing and lack of transparency, and question whether a life settlement is the best option in many situations. Life settlements remain an emerging market, one that has established some traction but is clearly not yet mature.

- **"2007: Life Settlement Market—Increasing Capital and Investor Demand":** "Conning's *(4th)* study analyzes the current life settlement market and its growth potential, with estimates and supporting argument. This review makes it clear that the life settlement market is increasingly being driven by the demand from investors for life insurance contracts and policies. The study therefore goes on to analyze the infrastructure supporting life settlement investing and its impact on the traditional life insurance market. Companies are emerging that provide backroom services at point of sale; actuarial services firms are involved in pricing offers; investment managers provide capital and drive market demand. The study explores

the buy-side, which represents investors who purchase the policies; the supply-side, which are policyholders looking to sell their policies; and the providers, who act as market makers, bringing together buyers and sellers. The study further examines the challenges and concerns around this infrastructure that may prevent life settlements from reaching its full potential.

Insurance Studies Institute has published three studies focused on analysis and education of the life settlement industry:

- **"Understanding Life Settlements and Industry Issues Entering 2008":** The synergistic economics and social values of life settlements, premium finance and alternatives being considered by insurers, are complex issues that require more research and evaluation in order to ensure the adoption of effective and fair laws. There remain numerous issues. The primary unanswered issues include the following:
    - The legal definition of insurable interests as determined by state law varies among states and is not clear in some transactions.
    - Measurement of the gross product revenue from all aspects of the life settlement industry, including tax revenues and tax code evaluation.
    - Potential economic loss to consumers and insurers by forcing a five-year holding period.
    - Who should control ownership of life insurance: Owners? Insurers? Government?
    - Should the insurance industry be controlled at the federal level or left to the states?
- **"Taxation of Life Insurance Policies in an Evolving Secondary Marketplace":** The *(Internal Revenue)* Code is not clear on the proper tax basis calculation for policies sold as life settlements in the secondary market.
- **"Introduction to Methodologies Used to Price Life Insurance Policies in Life Settlement Transactions":** Depending upon the medical actuarial assumptions used to calculate the life expectancy, results *(the policy price)* will vary widely among life settlement investors regardless of the pricing model used. Market participants cannot assume any one firm will consistently offer better prices than another, and should be alert to impact of changing interest rates, economic cycles and investor risk sensitivities. Sellers should also be alert to the ability of the settlement firm to complete the transaction in a timely and efficient manner, comply with all applicable laws and provide prudent and considerate follow-up during the insured's life.
- **"An Empirical Study on the Lapse Rate: The Co-integration Approach,"** September 12, 2007, reported by Fitch Ratings: Fitch believes that the life settlement market exposes life insurers and their reinsurers to a variety of risks in their core individual life segment. The primary risk is that the buying and selling of insurance policies in a secondary market will distort the very purpose of life insurance by breaking the insurable interest link between an insurer, policyholder and beneficiary. This in turn invites new challenges to the tax-advantaged status of life insurance with the argument that it is an investment product rather than a product that protects families and businesses from the premature death of a breadwinner or key employee. The life insurance industry greatly benefits from the tax-advantaged nature of its products. A change in the tax paradigm would have negative consequences for the industry, including the potential for adverse rating actions. The target market for life settlements is high net worth seniors 65 and older with life expectancies of two to 10 years. They are being blitzed with offers to buy new policies or sell existing policies in exchange for "free" insurance and large cash payouts, respectively. If any of this sounds familiar, it is because it is reminiscent of the bad old days in the 1980s and 1990s when misleading sales practices came back to bite insurance companies, some of whom were hit with multi-million-dollar settlements. The focus of life settlements on senior citizens increases the risk that sales today could lead to problems tomorrow. The difference now is life insurers are as likely to be victims of fraud as individuals. On the other hand, some insurers may be complicit, not wanting to turn away revenue in a very competitive market environment.

- **"Securitization of Life Insurance Assets and Liabilities,"** The Wharton School, submitted to TIAA-CREF Institute, January 3, 2004. The following are excerpts:

  - Securitization *(of insurance and annuities)* can improve the efficiency of securities markets by creating non-redundant securities, such as mortality risk bonds, which have low covariance with market systematic risks.

  - In the long-run, it is likely to be advantageous to insurers and to the market as a whole to forego some of the *(underlying policy and insured)* private information in order to develop a more efficient market for risk-management and risk-transfer.

  - Life insurance and annuity securitizations will not achieve the level of success of mortgage-backed securities and other types of asset-backed securities until a substantial volume of transactions reaches the public markets.

  - For a public market to develop, some degree of standardization and simplification of transactions will be required.

QUESTIONS AND ANSWERS

Question – If life expectancies consistently and significantly differ between underwriters, how can both claim 96-98% accuracy?

Answer – There is no generally accepted method for reporting actual experience, nor are there any independent audit services for the industry to use when tracking and reporting actual deaths versus estimated deaths. This remains a concern to life settlement providers, investors and rating services and it is their desire that such standardization and audit practices are established. If the life expectancy estimators in the industry do not develop acceptable standardization from within the industry, there should be an expectation that legislators and regulators will establish some standards.

Question – What issues represent challenges for the life settlement industry to resolve as it continues to mature to a fully mature niche in the U.S. financial markets?

Answer – (1) Insurers must resolve how to adapt their product pricing and marketing to remove the issue of lapses and reserves, and they must come to understand the benefits accruing to insurers from life settlements, i.e., funds under management are maintained, premium flow is maintained, policies continue through to maturity enabling realization of the profit curve in the last few years, future behaviour of the policy is more predictable as the new investor is less likely to surrender, a positive relationship is maintained with policyholders, the policy has greater transparency, sophistication of investors enables more flexible policies, opportunity for sales of new policies and annuities is increased. (2) Legislators and regulators need to construct laws and regulations that assure all consumers are eligible to realize benefits that life settlements can provide to policyholders, including those with small policies. (3) Life settlement industry operators need to continue advancing business standards, education, and efficiencies throughout the market. (4) To advance the industry to the projected volumes of $140+ billion of annual business, and to sustain such levels of business, the life settlement industry must enhance and retain its value to major investors with greater efficiencies and transparency, and with reliable longevity management tools. (4) Industry wide standards and practices to assure lifetime protection of insured personal data will be essential, and if the industry does not do it, legislators and regulators will.

Question – Will it be necessary for the insurance industry to accept and endorse life settlements for the industry to remain successful?

Answer – No, but it is counter-productive for the insurance industry to continue in an adversary mode. The life settlement industry is entrenched and consumers have a right to enjoy the highest and best terms they can obtain in a free capital market for their assets. It will serve consumers best when insurers and life settlement operators work together to assure efficient and mutually profitable business practices, with high business standards and transparency.

Question – What impact will the five year freeze or ban on the sale of new life insurance policies have on the life settlement industry?

Answer – This is a highly contentious topic and there are strong and opinions on both sides. The five year ban on new policy sales (with numerous ex-

ceptions)[35] is a new provision as of 2008 in several states that have adopted the NAIC Model Act. Some authorities have stated that it has no affect on the life settlement industry, but it can have a material negative effect on consumers' rights to manage and sell their assets. They claim it is the only known law that prevents a U.S. citizen from selling a legal asset and that the constitutionally of this law is questionable. For the life settlement industry, it means that there is a longer wait before a newly-issued financed policy can be purchased in the secondary market. These authorities claim that the intent of these laws is to discourage STOLI ("Stranger Originated Life Insurance"), but a five-year holding period can cost serious money to policyholders who otherwise seek to manage their life insurance assets. They state that these laws make not one dollar difference to the insurers. Other authorities claim that such a moratorium is necessary to discourage and disincentive investors who would "manufacture" policies specifically to be sold in the life settlement market. Some states have adopted hybrid rules with *both* the NAIC five-year moratorium and the NCOIL definition and characterization of a STOLI policy as a fraudulent act. What is clear is that there is almost unanimous agreement by life insurers, life settlement leaders, legislators, and regulators that STOLI should and must be stopped—but a great deal of dissension and disagreement as to the proper means by which to accomplish this end. Such heated discussions and lobbying for various wording can be expected to continue beyond 2008.

Question – Will life expectancy estimators reveal the methods and mortality tables they use and the actual mortalities of their cases compared to estimates?

Answer – These firms carefully guard their proprietary practices and currently will not disclose them except perhaps pursuant to confidentiality agreements with major clients. But some authorities have stated that some standardization must be established among these firms to provide meaningful reporting to the life settlement operators, investors and rating services. Absent such standardization, these authorities feel that a government unit, such as FINRA or the SEC, may take this on as a regulatory issue.

Question – Should insurers be required to advise policyholders who are considering surrendering or lapsing policies of all other options, including life settlements?

Answer – The average policyholder is rather uninformed when it comes to investments, insurance and other financial transactions. CPAs, estate attorneys, financial planners, trust officers, and fiduciaries operate under various professional obligations to assure that certain minimum advice is provided to clients. Insurers do endeavor, but are not legally required, to advise policyholders of alternatives involving policy loans, conversions, accelerated benefits, paid-up policies, etc. Insurers argue that to include advice regarding life settlements would be costly and complicated and may entail liability if perchance a policyholder claims such advice was not provided. English law does require insurers and insurance agents to disclose the option of life settlements. It seems that in the U.S., given its proclivity to legal action and government protection of consumers, it would be wise to err on the side of full disclosure to consumers. The authors' opinion is that consumers should be apprised of all their legal options and that when a life settlement might be appropriate, a "hold-fold" analysis as suggested in this book be performed.

Question – Can insurers offer to purchase a policy from a policy seller at market value without making the same offer to the entire class of policyholders?

Answer – After a life insurance policy has been designed and priced by an insurer, and approved by State Insurance Commissioners, the terms and pricing of that policy cannot be changed for any one policyholder without making the same change to the entire group of policyholders holding that class of policy and its various approved iterations. It seems that if an insurer purchases a policy from a policyholder for an amount greater than the surrender value derived by the formulas built into that class of policy, such amount and terms have to be offered to the entire class of policyholders. Thus the answer at this time seems to be, "No."

Question – Will securitizations of life settlement portfolios or investment funds based in life settlements be needed to assure the future growth and sustainability of the life settlement industry?

Answer – As of early 2008 only one rated life settlement securitization had been successfully completed. More will be needed and doubtlessly occur. Private capital from hedge funds, pension funds, investment banks, etc. represent a huge resource, but as evidenced by the reaction of these funds to the

sub-prime market issues, it is not wise for any one industry to rely solely on such funds for capital. Securities backed with life settlements can be valuable investment alternatives for average investors. Such securitizations will not only provide stability of capital for the life settlement industry, its requirements for industry standardization, mortality reporting, transparency, and consumer protections will benefit the industry.

Question – Are products like mortality indices and other longevity risk management tools, including guarantees, required to attract more capital to the life settlement industry?

Answer – Issues of the sub-prime market collapse and capital market reaction increase the need for investor confidence in investment yields. The greatest risk in life settlements is longevity, i.e., will actual mortalities match or exceed the expected mortalities. Benefits, costs, and logistics of using mortality indices and other longevity risk management tools are just beginning to be understood and some utilization is occurring. Investors want such tools, but at affordable prices. So the answer lies in cost/benefit analyses, and the investors should begin to flush this out in 2008.

CHAPTER ENDNOTES

1. History of Life Insurance, 2007 Globe Life and Accident Insurance Company.
2. See above.
3. Life Assurance Act 14 Geo 3c. 48.
4. Annual Register for the year 1774, p. 212-3.
5. History of Life Insurance, 2007 Globe Life and Accident Insurance Company.
6. American Council of Life Insurers.
7. "Unitized with profits" or "Unit-linked" policies are a combination of an investment fund and an insurance policy. A major part of the premium amount received on such policies is invested in the stock market by the insurer in select funds depending on the risk level chosen by the customer.
8. "Capital Life Insurance" has been the most popular of four different forms of life insurance offered in Germany as reported in "The Secondhand Market for Life Insurance Policies", 2006, Josef Eul Verlag, Lohmar, Germany.
9. See above.
10. See above.
11. See above.
12. *Grigsby v. Russell,* 222 U.S. 149 (1911).
13. Example: A $500,000 policy may have an account value of $50,000 with a reserve or surrender charge of $10,000 leaving only $40,000 available to the policyholder.
14. The American Cash Flow Corporation, *The Journal of Risk and Insurance*, Vol. 71, No. 4, (Dec. 2004), pp. 643-675, American Risk and Insurance Association.
15. "Life Settlement Mortality Considerations and Their Effect on Portfolio Valuation," March 1, 2008 by Ed Mohoric, FSA and MAAA, and Robert O. Kinney M.D. and FLMI.
16. National Viatical Association, 1999.
17. National Viatical Association, 1999.
18. Life Settlement Market Increasing Capital and Investor Demand 2007, Conning Research & Consulting, Inc.
19. See above.
20. Society of Actuaries.
21. "Mortality Considerations and Their Affect on Portfolio Valuations", March, 2008 by Ed Mohoric, FSA, MAAA and Robert O. Kinney, M.D., FLMI.
22. "Mortality Considerations and Their Affect on Portfolio Valuations", March, 2008 by Ed Mohoric, FSA, MAAA and Robert O. Kinney, M.D., FLMI.
23. "Mortality Considerations and Their Affect on Portfolio Valuations", March, 2008 by Ed Mohoric, FSA, MAAA and Robert O. Kinney, M.D., FLMI.
24. American Council of Life Insurers.
25. National Association of Insurance and Financial Advisors.
26. Association of Advanced Life Underwriters.
27. Life Settlements and Risk Opportunities, by Michelle Moloney, Transamerica Reinsurance, September 4, 2007.
28. Diversified Radiology Of Colorado.
29. An arbitrage-free model assigns prices to derivatives or other instruments in such a way that it is impossible to construct arbitrages between two or more of those prices. Arbitrage-free pricing utilizes observable market prices to set prices that are not observable, e.g., formulas for pricing forwards, swaps and debt instruments. In complete markets, arbitrage-free pricing can be used to set a price for any instrument, but in incomplete markets, it can only place bounds on certain prices. For example, if an option pricing formula assigned prices to put and call options that violated put-call parity, that model would not be arbitrage-free. While technically not required by the definition, arbitrage-free models used for trading are generally calibrated to one or more market prices to preclude arbitrages between prices assigned and quoted prices.
30. Pricing Frameworks for Securitization of Mortality Risk, June, 2004.
31. State insurance regulators formed the National Association of Insurance Commissioners (NAIC) in 1871 to address the need to coordinate regulation of multistate insurers. The first step in that process was the development of uniform financial reporting for insurance companies. Since then, new legislative concepts, new levels of expertise in data collections and delivery, and a commitment to even greater technological capability has moved the NAIC forward in its role as a multidimensional, regulatory support organization. Today, the NAIC is comprised of insurance regulators from all 50 states, the District of Columbia, and all five U.S. territories. The mission of the NAIC is to assist state insurance regulators in serving and protecting the public interest, promoting competitive markets, facilitating fair and equitable treatment of insurance consumers, promoting reliable, solvent and financially stabile insurance institutions, and supporting and improving state regulation of insurance.

32. The National Conference of Insurance Legislators ("NCOIL") was created in October 1969, to help legislators make informed decisions on insurance issues that affect their constituents, and to declare opposition to federal encroachment of state authority to oversee the business of insurance, as authorized under the McCarran-Ferguson Act of 1945. NCOIL is the "voice" of state legislators in Washington, and works to a) educate state legislators on current and perennial insurance issues; b) help state legislators from different states interface effectively with each other; c) improve the quality of insurance regulation; d) assert the prerogative of legislators in making state policy when it comes to insurance; e) speak out on Congressional initiatives that attempt to encroach upon state primacy in overseeing insurance.

34. Legacy Benefits Corporation.

35. "Profiting From Mortality," Business Week, July 30, 2007.

36. See K. Kingma and S. Leimberg, "Deterring Stranger Owned Life Insurance: Comparing Two New Model Acts," Estate Planning, July 2008.