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Evolution of the Life Settlement Industry: *A Provider's Reflection on Trends and Developments*

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New and evolving challenges confront all participants in the life settlement industry as this marketplace continues to experience explosive growth. In order to understand the magnitude of this growth we simply need to look back at the past several years. As a measurement of growth, we can compare estimated aggregate net death benefits settled from one year to the next. The historical annual aggregate net death benefit thus far is only an estimate because, as of today, there is no official repository for this information. Still, it is possible to develop a fairly accurate estimate based on various state reporting requirements and information obtained from the Life Insurance Settlement Association (LISA, the primary industry trade association).

According to the 2006 Sanford Bernstein Study,¹ in 2004, the estimated aggregate net death benefit of settlements was \$5 billion. In 2005 that number increased to \$10 billion, and according to LISA² that number increased to \$12 billion in 2006. The Sanford Study followed with an estimate of \$16 billion in 2007 and indicated this number may reach \$161 billion over the next several years.

As in any emerging industry, along with growth comes regulation, conforming business practices, and an evolution of the product itself. The life settlement industry is no exception. This past year we have seen the departure of many of the original investors,

and we have seen new investors enter the marketplace. We have seen new regulatory developments, some that we consider helpful to the long-term growth of the industry and some that we feel may have a negative impact. On the structural front we have seen a shifting of roles and the development of new products. This article reviews these trends and developments and it probes new areas in this increasingly dynamic marketplace.

NEW CAPITAL MARKETS: A CONSTANTLY SHIFTING LINEUP OF PLAYERS

This past year we saw the continued departure of some of the original German investment funds. This phenomenon occurred primarily for two reasons. First, German authorities reversed favorable tax treatment within Germany so that the proceeds from a life settlement, which were not previously taxed, are now taxed, obviously reducing the investor's rate of return. The second, and more fundamental, reason has been the negative performance issues experienced by some of these funds. In order to understand the nature of these issues, let's step back and review the process of valuing a life insurance policy for a potential settlement.

There are two components that must be considered when analyzing a life insurance policy as an investment: premiums and life

expectancy. Generally, the industry relies upon approved independent life expectancy providers in order to determine expected mortality. This is necessary in order to determine the net present value of the future premium obligation and death benefit. Companies such as 21st Services, EMSI, AVS, ISC, and Fasano are often approved and used by the industry for this mortality determination. Several of the life expectancy companies changed their underwriting procedures during the last several years essentially creating more conservative (i.e., longer) life expectancies. This shift was due to the compilation of historical data and new medical information. Unfortunately, many of the early institutional investors relied on these early life expectancy reports. As a result, their portfolio performance has suffered, and they are now challenged to attract new investors.

On a positive note, we have seen new investors from around the world enter this space. We have seen continued interest from European funds and new interest from investors in Australia and Asia, such as the Life Settlement Fund and PacRim Capital. Domestically we have seen a new slate of funds, including Black Rock and Capstone Life Assurance, that are also dedicated to this space.

This past year the volatility in the international capital markets has also had its impact on the settlement market. One of the primary and appealing qualities that life settlements offer investors is that this asset class is non-correlated with the credit risk of the typical money manager's investment portfolio. In other words, the credit quality of bonds, stocks, and similar investments are influenced by economic factors, political factors, and natural phenomena. The credit quality of a portfolio of life settlements are not influenced by these factors but rather by the accuracy of mortality assumptions (assuming, of course, that the underlying credit quality of the insurance carrier is A or better). Therefore, a portfolio of life settlements serves to diversify the risk of the traditional portfolio. While the sub-prime turmoil has rocked the traditional capital markets, the life settlement industry has suffered comparatively less; nonetheless, it has not escaped unscathed by the fallout.

As the sub-prime debacle unraveled last summer, we initially expected an increase in demand for life settlements. This did not occur, and, in fact, there appeared to be a reduction in demand for several months. This was most likely due to liquidity issues. Some of the biggest investors in life settlements include the major investment banks that were involved in the residential mortgage market, such as Bear Stearns, Lehman, Deutsche Bank, Credit Suisse,

Goldman Sachs, and Morgan Stanley. The deployment of capital slowed, and in some cases, a moratorium on further investments was put in force. At least one of the institutions mentioned will never return to the life settlement space. I do believe that in time the demand for life settlements will increase, as investors rebound from the mortgage crisis and recognize the diversification benefits of including settlements in their investment portfolios.

STRUCTURAL TRENDS: STREAMLINING THE SETTLEMENT PROCESS (AND CONSOLIDATING THE PLAYERS)

The original structure of the life settlement industry was based on the structure set forth in the original 2001 National Association of Insurance Commissioners (NAIC) Viatical Settlements Model Act. Many states have adopted this model in whole or in part as a basis for their regulation. The problem was that the model was flawed. In order to understand this, we must first understand how the NAIC defined the various parties within the Model Act. These parties to a transaction were defined in the following manner: The seller was represented by a life settlement broker and the investor (defined as a "Finance Entity") was represented by a life settlement provider. The flaw lies in the fact that the broker, who, as mentioned before, has a fiduciary responsibility to the seller, is never in direct contact with the seller. Rather, standing between the broker and the seller is the life insurance agent or financial adviser whose client happens to be the seller. Early in the history of this industry the broker provided much value by creating awareness at the financial adviser level. These investment professionals simply had no idea that this new investment solution existed and did not understand how the industry worked.

Fast forward to the present. Today, we are being approached more and more directly by many agencies, broker/dealers, and other investment professionals who are in direct contact with their clients, the sellers. This underscores the concept of "producer authority," where the life agents can go directly to the provider as long as they have an active Life and Health Producer License. This eliminates the need for the broker and, in doing so, increases the potential proceeds of the transaction. This also increases the life agent's control of the transaction thus increasing the probability of completion. The state of Florida is the first to adopt this concept in its current statutes, and we expect to see more states follow suit.

Although there will always be a need for the traditional life settlement broker (in particular, the larger platforms) because certain agents will always choose to outsource this activity, we see consolidation and reduction in the number of brokers going forward.

REGULATORY TRENDS: VALIDATING A NEW ASSET CLASS

In 2007, state insurance departments continued to make progress towards regulation, albeit not always positively. Currently 28 state insurance departments have adopted regulatory requirements for life settlement companies. Generally most states have considered the 2001 NAIC Viatical Settlements Model Act as the basis for the regulation and then have modified it slightly to fit their own needs. Perhaps the most controversial element of this regulation involves the time period in which the original owner can sell his policy. Traditionally, states have required a two-year holding period consistent with the contestability period. This allows the insurance carrier two years to complete due diligence. At the completion of this period the policy owner (assuming no negative issues have arisen) may do whatever he pleases with his asset, the insurance policy.

During the last several years, certain insurance agents have developed a type of life insurance product referred to as Stranger Originated Life Insurance, or STOLI. This product results when an agent identifies a client with excess insurance capacity and convinces him to take a non-recourse loan, typically under terms that include high interest rates and some form of up-front consideration to the insured. The life insurance industry's concern is that these policies compromise the concept of insurable interest. Normally, the persons or entities that have the right to have insurance on a given person include direct family members, business partners, employers, and designated charitable organizations, but not a stranger that is merely providing a non-recourse loan where the lender will own the policy if not paid back in a timely manner.

The two promoters of uniform regulation and legislation that have weighed in on this topic are the NAIC and the National Council of Insurance Regulators (NCOIL). As a solution to this phenomenon, the NAIC, in its 2007 Viatical Settlements Model Act, has endorsed a five-year moratorium on the sale of a life insurance policy. So far this concept has been adopted by two states: North Dakota and West Virginia. NCOIL,

however, through the 2007 NCOIL Life Settlements Model Act, continues to support the two-year moratorium and instead promotes more stringent financial requirements and transaction transparency. The five-year preclusion of a secondary market sale is problematic because it greatly reduces the liquidity of all life insurance policies, not only STOLI, and as a result reduces the value of the policy to the consumer. In addition, the five-year moratorium does not precisely address the dangers of STOLI. Complete disclosure and transparency at the initial point of underwriting are more accurate remedies to the issues inherent in STOLI. Moreover, the five-year moratorium penalizes all consumers not just transactions involving STOLI programs.

Another regulatory trend continues to be the promotion of fee transparency. Historically the broker and the agent, both of whom have a fiduciary responsibility to the seller, have not disclosed their compensation. As a provider we see their compensation at the final closing of a life settlement because we distribute the settlement proceeds. Over the years we have often seen the agent and broker receive what I consider high compensation as a percent of total proceeds. More recently, and as this industry has matured, certain states and investors are requiring fee disclosure to the seller. As the CEO of a major provider I support this concept and feel it is a good business practice going forward. I would ultimately like to see all the states require this type of disclosure.

Finally on the regulatory front, in the proposed pending legislation currently being considered in New York (AB 10401 and SB 7356), we have seen the introduction of a new concept: one of "registration" of finance entities. Historically, finance entities (life settlement investors) have not been subject to any such type of registration and, as a result, have remained anonymous. They have preferred this because some investors want to keep their investment strategies confidential, while other investors don't want to be scrutinized by the U.S. insurance departments that may not understand their business structures. This has the potential of creating a "chilling" effect on the entry of new investors into the life settlements space.

As this has only been proposed in New York and no other states have adopted this concept, the long-term effect is not known at this time. However, to the extent investors will not conduct business in a state as a result of the requirement, demand for life settlement will be reduced, and the consumer will ultimately be hurt. It is noteworthy

that New York has traditionally been in the forefront of insurance regulation, and their regulatory efforts are frequently followed by other states.

NEW PRODUCT DEVELOPMENT: CLEAR SIGNS OF EFFICIENCIES

Further signs of maturation are evidenced by the introduction and development of new products. The most promising ones may include “small policy program” initiatives that have recently been launched by several brokers and providers. By way of background, few institutional investors have shown much interest in life settlements with face values less than \$500,000. The reason is quite simple: The transaction costs are the same as those of larger face values because it takes the same amount of time to close a transaction. Larger face values afford the investor an opportunity to deploy more funds.

Early in the development of this industry, investors followed the strategy of “picking the low hanging fruit first,” pursuing life settlements that had the most attractive rates of return while allowing them to deploy reasonable investment dollars. Two things have changed over time. First, the demand for these traditional life settlements (face values of \$500,000 to \$5 million with life expectancies between 36 months and 144 months) have continued to increase, thus lowering the possible returns. Second, the efficiencies of closing procedures and systems have continued to improve to the point where much of the contract documentation at the end of the settlement process can be automated. With these new efficiencies, small policy programs have been launched that offer investors reasonably high rates of return. These higher rates are attainable because, at this time, demand for small policies remains less than for traditional policies. Another advantage of a small policy portfolio is that for the same amount of investment dollars the resulting portfolio will have much better diversification. For example a \$20 million investment in 80 \$250,000 policies has much better diversification profile than the same amount of investment in 20 \$1 million policies.

We view this opportunity as temporary. As the market continues to mature and become more efficient over time, the rate-of-return advantage should approach and ultimately become similar to those of traditional policies. This may be a while, however, as small policies represent up to 70% of the overall life settlement market, and the market is still largely untapped. Some of the groups

that are now offering small policy programs include Life Policy Group, CIELO, Peachtree, Coventry, and Cantor Fitzgerald.

Finally, we have also observed an evolution of premium finance programs. Some of the early premium finance included a loan to the insured for purposes of paying the first two years of premiums. This loan was typically 100% non-recourse and secured only by the policy. At the end of two years, as the policy emerged from contestability, it would theoretically qualify as a life settlement. At that point the borrower could choose to pay off the loan or walk away from the policy, in which case the lender would assume ownership. Not only did these loans often carry egregious interest rates, but often the borrower would receive an up-front payment as consideration for the issuance of the policy. The concern quickly became one of violating the concept of insurable interest (as discussed earlier). Now we are seeing modifications to the original loan product that legitimize these new programs. These modifications include programs that are often with partial recourse, fully disclosed to the carrier, with reasonable interest rates, and with no up-front consideration given to the borrower. It is generally agreed that these new features will allay any concerns the insurance carriers may have with the concept of insurable interest.

CONCLUSION: DYNAMIC ENVIRONMENT THAT IS ULTIMATELY MATURING

Clearly the market continues to grow at a very fast pace with the potential of becoming one of the bigger financial markets in the United States. There is long way to go, however, as states continue to develop regulation with the hopes of supporting best business practices and protecting the consumer. Structurally, the industry is maturing and settling into a more efficient and effective marketplace. New product development is a clear sign of growth, and we expect this to continue at a rapid pace. At the same time we are learning from early mistakes and adjusting our analytical techniques to meet the expectations of new investors. It should be an interesting 12 months ahead.

ENDNOTES

¹Sanford Bernstein research report, May 19, 2006.

²Marketwire, July 26, 2007.

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