Special Comment

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Psst! Wanna Buy a Used Life Insurance Policy?

Life Settlements: Where Life Insurance Meets the Capital Markets

Summary Opinion

The life settlement market has expanded in recent years from almost nothing in size to a significant, growing and controversial segment of the U.S. life industry. A life settlement can be generally defined as the purchase of an existing life insurance policy by a third party for investment purposes.[1] These existing life insurance policies are being purchased by these third parties as investments because they believe that these policies offer the favorable expected investment characteristics of both providing high expected yields and being subject to fairly low levels of risk.

An entire marketplace has developed to satisfy investors' growing interest in these investments. This marketplace includes representatives that market directly to the policyholders that might be interested in selling the policies that they currently own, intermediaries matching sellers and buyers, and other kinds of professionals that facilitate these transactions, such as life expectancy evaluators.

Moody's sees the following as key developments:

- The secondary market for life settlements and other policies that fully optimize the value in policies will expand and broaden over time.
- Expansion of secondary markets for these products and options will cause pressure on life insurers' profitability as value in policies is extracted and maximized by third party investors.
- Life insurers need to be more mindful and price for the embedded guarantees on their policies since there will be increasingly market efficient utilization of these guarantees and value in policies.

While Moody's believes that the life settlement market is here to stay, it is not likely — in itself -- to have a substantial financial impact on the life insurance industry. It might lower the profitability of some insurers' blocks of business, affect the pricing of some products over time, offer incremental value to qualifying policyholders that have a need to surrender their policies prematurely, and add some additional controversy to the industry regarding the appropriateness of these transactions.

1. *We are excluding from this discussion any life insurance policies that were issued with the original intent for use in various forms of investment purposes such as inclusion in Life Insurance and Life Annuities Based Certificates ("LILAC") transactions, although many of the issues that are discussed in this comment are equally applicable to these policies.*

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However, in Moody's view, the most interesting part of this market is its role as a continuing evolution where the life insurance industry and capital markets are increasingly intersecting in new and non-traditional ways. The life insurance products purchased in the secondary markets as investments that we have just discussed are but one part of this trend.

However, this phenomenon is not limited to life insurance in life settlements. We have begun to observe similar activities in the variable annuity market where annuity purchasers have attempted to arbitrage the value of secondary guarantees such as the guaranteed minimum death benefits offered on these annuities. Luckily for the life insurance industry, most of the attractiveness came out of this trade when equity markets several years ago recovered from their steep declines.

What Is A Life Settlement And Why Does A Policyholder Do It?

The benefit to the policyholder of the sale of a policy in a life settlement transaction is that the policyholder receives a greater payment for the policy from the third party than he/she would directly receive from the insurer if the policyholder instead surrendered the policy. However, critics of these transactions point out that the purchase price may be less than the intrinsic value that the policy would have been worth to the policyholder if the policy had been held until the policyholder's eventual death. Of course, the value of the two alternatives to the policyholder may depend upon subjective issues such as the policyholder's need for funds, tax situation, expected mortality and expected investment rate of return.

Moody's believes that the development of the life settlement market is but one manifestation of the increasing level of efficiency by which insurance policyholders are exercising their policy options. While policyholders are typically still far from exercising these options with perfect efficiency, it is clear that the marketplace has become more efficient and will likely continue to do so for the foreseeable future. Any company that thinks that it can ignore this fact does so at its own long run peril. The capital markets have further facilitated this process by permitting these options to be transferred to purchasers who have an interest in more efficient option exercise and have the ability to do so.

The challenge with these transactions, from the perspective of the insurers having sold the product in the first place, is that by reselling the policy to investors, the chance of a premature lapse of the product becomes virtually nil. **Consequently, an insurer that issues products whose favorable financial performance depends upon the occurrence of a sufficiently high level of lapses, is taking a substantial risk regarding the continued growth and development of the life settlement market. This is a growing concern for Moody's given the changing dynamics and increasing importance of lapse-supported products in the U.S. life insurance marketplace.**

Lately, life settlements have received a considerable degree of public attention. A life settlement may be generally defined as the purchase of an interest in an existing life insurance policy by a third party for investment purposes. Historically, the motivation for the third party purchase of life insurance policies for investment purposes arose from situations where individual insureds suffered from terminal illnesses. In some of these cases, the insured individual sold his or her life insurance to third parties for an upfront payment, an arrangement that is generally referred to as a viatical settlement. These arrangements had been viewed unfavorably by many in the life industry because of the insured's loss of valuable insurance protection and the impact on the policy's original beneficiaries.

A life settlement differs from a viatical settlement in that the insured is typically in significantly better health than in the viatical case. The insured may even be in good health for his or her age. A life settlement typically has these basic characteristics:

- The life insurance policy was in force for a period of time prior to its purchase by the third party.
- The life insurance policy was originally purchased by the policy's owner for a traditional reason for which life insurance coverage is normally purchased (such as death protection for beneficiaries, estate planning, funding a business ownership transition, funding a trust upon death, etc.) The policy was not originally purchased in contemplation of being owned primarily as an investment.
- The policy in question is no longer needed or wanted by its original owner because of a change in circumstances, or the ongoing required premium payments are no longer affordable by the policy's owner and the policy might be consequently in danger of lapsing or being surrendered.
- The policy is of large enough dollar size to make the sale transaction and associated transactional costs worthwhile. Face amounts of policies sold in life settlements are often $1 million and up and have to be of substantial size to be economically viable.
- The insured individual named in the policy is typically in an older age range (an attained age of 70 or older on the insured is quite common) and the individual may also possibly, although not necessarily, be in impaired health. The older and/or sicker the insured is, the more the policy will be worth to a third party investor.

- The policy is sold for cash to a third party investor who has purchased it solely for investment purposes. The policy's buyer has no "insurable interest" in the insured as normally defined in insurance law and regulation.
- The policy is purchased by the investor based on his estimation of its economic value. The economic value of the policy is calculated as the net present value (NPV) of the policy's expected future death benefit less the expenses associated with the acquisition and ownership of the policy (including ongoing payment of policy premiums, acquisition cost and payment to the policy's previous owner). The policy's NPV is calculated based upon a variety of assumptions including: (1) the rate of return that the investor requires from the investment; (2) the transaction costs associated with implementing the transaction such as commissions paid, legal fees, etc.; (3) the age, sex and health of the insured, which determines the expected timing of the death of the insured and the associated claim payment from the insurer; and (4) any required ongoing premium payments required to keep the policy in force until the insured's date of death.

Life Settlement Purchasers

Originally, purchasers of life settlement transactions were individual investors seeking non-traditional investment opportunities offering unusually high rates of return at modest risk. As the market developed and grew, this market became increasingly attractive to institutional investors due to the high rate of return offered for a fairly modest level of risk, especially when large numbers of policies are aggregated into a larger, more predictable pool.

Moody's believes that current funding for life settlements acquisitions is primarily institutional in nature. Investors in these products have included insurance companies, hedge funds, German closed end funds and specialized structured transactions. American International Group, Inc. and Berkshire Hathaway Inc. are two very well known investors that have both publicly commented upon their substantial ownership interest in life settlements. A Guernsey based offshore fund recently launched to invest in life settlements on behalf of retail clients serves as additional evidence of the continuing expansion of the investor base for this asset class.

Institutional ownership of these instruments has become sufficiently widespread that the Financial Accounting Standards Board (FASB) is currently working on a project to develop an improved accounting methodology for these investments.[2]

The Key Market Challenge: Sourcing The Product

Identification and the availability of the collateral for these transactions are probably the most challenging aspects of the life settlement market. These transactions are based upon the pooling of contracts originally purchased for reasons that may no longer exist. Consequently, potential participants in this market must first identify policyholders that are willing to sell their existing contracts. Moody's believes that there may be only a limited number of these contracts available for purchase in the secondary market at any given point in time and the successfully identification of these purchase opportunities is a critical component of success in this area.

Policies purchased as life settlements typically have to be sourced one policy at a time from the individuals or institutions currently owning them since ownership of these policies is generally very fragmented.

An elaborate infrastructure has been developing in recent years in an effort to improve the efficiency of sourcing the collateral for these transactions, and has consequently made the institutional ownership of these assets more feasible. This infrastructure includes: (1) insurance agents who are normally in the business of selling insurance to buyers instead helping third parties purchase these policies back from their current owners; (2) brokers that specialize in marketing these policies available for resale to multiple purchasers in an effort to get the best price for the policy for the policy's current owner, including the approximately two dozen members of the Viatical and Life Settlement Association of America; (3) firms specializing in the purchase and warehousing of these contracts for resale to investors; (4) investment managers or investment funds that specialize in investing in these instruments, such as Coventry First; and (5) medical specialists that evaluate life expectancies of the insureds.

This infrastructure has grown and adapted in recent years in an effort to supply the substantial volumes of this product that the market is eager to purchase. Recently, articles and advertisements have been run in general interest financial publications discussing the possible potential advantages and disadvantages of these transactions to a policyholder.[3] The idea of these advertisements is to develop additional leads for the sales process and thereby help further the growth of the market.

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2. *See http://www.fasb.org/project/life_settlements.shtml for more information on the FASB's current project status for the reporting of ownership of life settlements.*

Why Might A Sale Of The Policy Make Sense For The Policyowner?

Most, but not all, contracts that are eligible for these transactions have what is referred to as a cash surrender value (CSV). The complexity of the technical computation of the CSV for a specific policy is beyond the scope of this special comment. However, it is important to understand that the CSV is a contractual right that is required by insurance law and regulation as a minimum level of payment to a terminating policyowner. This minimum value is paid to the policyholder regardless of the reason for the policy's cancellation. The CSV is calculated by the issuing insurer on an actuarially specified basis, consistent with insurance law and regulation, and using detailed assumptions that are specified in the insurance policy at its issuance, but which do not incorporate information about the insured's health. This value may be quite low relative to the true economic value of the contract at that point in time.

Historically, a policyowner who no longer needed or wanted a life insurance policy had only two choices with his policy: (1) to "sell" it back to the insurance company at its CSV (which can even be zero in many cases) or (2) to continue holding on to the policy and paying any necessary premiums. In cases where the CSV was zero but premiums remained due, the policyholder would typically lapse the contract (i.e. sell it back to the insurer for zero payment in order to be relieved of the obligation to continue making ongoing premium payments). If the policyholder lapsed or surrendered the contract, in many cases, the policyowner had in effect sold the policy back to the issuing insurer at a price very favorable to the insurer and, consequently, unfavorable to the seller.

With the rise of the life settlement market, the policyowner now has a third option, the sale of the policy to a third party investor at a market determined price in excess of the CSV. The policyowner will exercise this third option only if he receives incremental value for the policy over and above the CSV offered by the insurer for the surrender of the policy. Moody's believes that in many cases a life settlement firm can offer an amount considerably above the CSV to purchase a policy. In some cases, it may even be multiples of the CSV.

For a very large policy, this difference could amount to millions of dollars in incremental proceeds.[4] The price gap could be especially large if the insured's health has deteriorated significantly since the policy was originally issued or if the policy purchased was a low cash value oriented design such as many no lapse universal life (NLUL) policies being sold today.

Interestingly, in the U.K., insurers are required by law to inform policyholders surrendering a contract that higher offers might be available from independent third parties. No similar requirement exists in the U.S. when a policy is surrendered to an insurer.

The flip side of this is that the purchaser of the policy is motivated to make the investment (to purchase the policy) only because he expects the investment to offer a substantial return, and with a limited amount of risk. One article has estimated that the purchasers of these policies could earn a 10% to 15% return on their investment inclusive of all acquisition costs. The actual rate that will be earned could vary widely depending upon the price paid for the policy(s) and the actual mortality experience occurring in a given policy or block of policies.[5]

This relatively high expected rate of return to the investor, even after the substantial transaction costs for arranging the transaction, means that the selling policyowner may be paying a high opportunity cost for early access to these funds. This purchase price will be accepted only if it is more favorable than the one offered by the insurer if the policy is instead surrendered by the policy's owner. In addition, the former policyowner who sold the policy to a third party may be exposed to less favorable income tax treatment on the policy sale proceeds than if he had instead waited until the ultimate collection of the eventual death benefit on the insured's death.

3. *For example, see Recognizing Life Insurance's Value, Wall Street Journal, May 31, 2005, page D2.*
4. *For example, Frozen Food Express Industries, Inc. announced on April 25, 2005 that it had sold in a life settlement transaction a $10 million amount of life insurance on the life of its former Chairman and that the policy's CSV was $2.3 million while the sale price in a life settlement was $6.1 million.*
5. *See Moving the Market -- Tracking the Numbers / Outside Audit: `Viaticals' May Draw More Insurers, Wall Street Journal, May 18, 2005, page C3.*

Why Does This Matter To The Life Insurer Who Issued The Policy?

All of this, while interesting, might not matter much to the life insurance company that issued the policy. After all, the life insurer that issued the policy is not a party to the transaction nor are its cash flows directly affected.[6] Therefore, why would it have a direct financial interest in whether this transaction occurs or not?

The answer to this question has to do with the underlying pricing assumptions that the insurer made in designing the insurance policy. **If the product were designed to be fully self-supporting and there was no anti-selection in the health of insureds selling their policies, then the longer the policy stays in force, the better the profitability, all else equal.** In fact, the company may even be better off if the policy stays in force through the life settlement purchase since the company should be making money every year the policy stays in force. Consequently, the longer it stays in force, the better. The policy might have lapsed or surrendered had the policy not been sold to an investor who intends to keep the policy in force until the insured's death.

The problem is that many policy and product designs in the market today are not fully self supporting. This is especially true with many long-dated term contracts and many of the NLUL policies currently being sold. In addition, there might be anti-selection against the company through the life settlement process. Those insureds in poor health are less likely to lapse their policies if they have access to a favorable bid for the policy that reflects their poor health and relatively shorter expected remaining lifespan.

With lapse supported products, the insurer may lose money on each policy that stays in force for its full term to the insured's death. In such products, the insurer is essentially betting that the excess profits that it makes on policies that don't make it to the end of their term will more than make up for the losses on the policies that do. The insurer uses its policyholder lapse experience to the extent available and its educated judgment to determine the likelihood of these policies persisting from year to year and remaining inforce to the insured's death. Products such as these are generally described as "lapse-supported" products.

Consequently, for lapse supported products, higher persistency, which normally is a positive factor for a company's financial performance, instead becomes a negative factor**. In an extreme case, where policy persistency is much better than expected, the insurer can be subject to substantial losses on these policies.**

In the eyes of the insurer then, third party purchases of policies that otherwise would have likely lapsed at little or no CSV, are now remaining in-force until they become an eventual death claim. This happening to a small number of policies should make little difference to the issuing insurer. However, if this were to happen on a regular and sustained basis, it could invalidate the fundamental actuarial assumptions upon which the policies were designed and priced. The net result of this increased persistency could be significantly reduced profitability to the insurer from this block compared to original expectations, or even worse, the absorption of substantial losses on the block.

As you would expect, these losses would be a credit negative for the insurer. If this happens on a substantial scale, the reduced profitability or incurred losses could result in a meaningfully negative effect on the insurer's overall financial position and creditworthiness.

Size Of The Market: Today And Prospects For Its Future

The life settlement market is generally a secondary, not a direct, market. By that, we mean that life settlements can occur only after a buyer who had purchased a life insurance policy years previously later decides that the policy in question might no longer be necessary for its original intended purpose (such as estate planning, funding a buy/sell agreements, etc.). Consequently, the policy's owner may now be willing to consider the sale or surrender of the unnecessary policy. If the original life insurance product purchase had never occurred years ago, there would be no policy available for resale today in a life settlement transaction.

This market is based upon substantial difference of perceived value in these policies between the selling policyholder and the purchasing investor. Without this difference in perceived contract value, many of these transactions would not take place.

The raw material for new life settlement transactions is limited to the universe of existing in-force life insurance policies. In addition, policies that can be economically involved in a life settlement transaction may also be limited by additional factors such as the policy's face amount size, the insured's attained age and current health status. One industry rule of thumb is that a life insurance policy is not likely to be a suitable candidate for a life settlement unless the policy's face amount is at least $750,000 and the insured's attained age is at least 65. Typically, policies with older attained

6. *The life insurance company does have certain administrative responsibilities related to this transaction such as changing the name of the policy's owner in its records and to issue any necessary tax documents.*

ages are most attractive for life settlement transactions since this reduces the variability to the investor of the length of time that he will have to wait to collect on the investments. At younger insured ages, the length of time to collect on the life insurance policy will be longer and subject to greater uncertainty.

It is Moody's belief that the percentage of existing permanent life insurance policies meeting the above discussed age and size criteria is very small, possibly on the order of 1% or less (but significantly more in terms of outstanding CSV) of the number of current policies in force. However, smaller size policies have also been successfully used in some cases, although the transactional costs in smaller size policies could make the settlement of these policies somewhat less economic.

The result is that the identification of existing life insurance policies that can become the collateral for a life settlement transaction is challenging. As we said above, a very small percentage of the existing life insurance in-force meets the requirements for this kind of transaction. Moody's believes that there is clearly a natural limit to the number of policies that are economically attractive for these transactions.

Moody's views the life settlement market as a supply constrained market whose growth is in large part limited by the ability of prospective purchasers and their agents to convince owners of existing policies to sell these policies to life settlement originators.

As we have already discussed, Moody's believes that the market efficiency and optimization of the value embedded in insurance policies will likely grow over time. **Moody's believes that the efficiency of insurance option exercise is likely to expand over time to other types of policies.** For example, the option value contained in a variable annuity could be captured in the capital markets if and when there is value in the product's guarantees. Secondary markets will develop with third-party investors eager to purchase these options at values attractive to both the buyer and seller. However, the insurer may unfortunately have found itself in a situation where it has substantially underestimated the value of the option that it has sold.

Moody's is not aware of comprehensive and reliable data on the current size of the life settlement market due to its fragmented situation. However, due to the factors we have just discussed, Moody's believes that this market is quite small compared to the value of the total life insurance market.

Given the nature of the market, it is very difficult to get accurate data on the size of the market. According to a June 2005 Bernstein Research report, this market was expected to be about $13 billion in 2005 and is expected to grow rapidly during the next few years. While the current size of the market may be in doubt, there is no doubt that this market has been growing rapidly in recent years and is likely to continue to do so given the current environment.

However, Moody's believes that the continuing expansion of this market is limited by the supply constraints discussed above. Even if the development of this market induces more individuals to purchase more life insurance for the potential sale of the policy down the road -- a situation that we think is highly unlikely -- it would still take many years for this to make a measurable difference to the size of this market.

Market Arbitrage Opportunities Using Insurance Products

Moody's has seen insurance products purchased in the primary market, direct from insurers, as sophisticated investments and/or arbitrage vehicles. Sophisticated investors are purchasing these products in an effort to earn attractive rates of return while incurring limited risks. In some cases, the insurer selling the product may not even be aware of the nature of the buyer's intentions with the product.

One example of such purchases is the Life Insurance Life Annuity Based Certificate (LILAC) transactions. LILACs are structures where lifetime payout annuities are purchased in tandem with life insurance policies, with both policies purchased on the same individual. The annuity and life insurance policy are purchased from different insurers. The purchaser is in effect arbitraging the life insurer's mortality expectations versus that of the annuity provider. These transactions can result in risk free (except for the risk of default by the insurers) arbitrage profits for their arranger, profits that will occur regardless of market conditions or the insured individual's lifespan.

In a less foreboding and more helpful manner for the life insurance industry, we have also seen capital markets intersect with the life insurance business through embedded value securitizations and to fund certain required statutory reserves that market participants believe to be redundant.

It has become increasingly clear that life insurance companies and their products must be considered in context of an overall capital market framework. Insurers that do not carefully and thoughtfully design and market their products could rapidly find themselves subject to exploitation by capital markets participants through methods which they may find unexpected and financially painful.

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