A Big Step Up

If the life settlement industry can make its business easier to understand, years of impressive growth could follow.

by Ron Panko

Institutional money managers may have invested more in life settlements last year—an estimated $10 billion to $15 billion in face amounts—than in the previous seven years combined. But while the industry is growing astronomically, financial professionals familiar with it say more efficiency and transparency are needed and would cause even more institutional investors to jump in.

Life settlements are the sales of in-force life insurance policies as investments. In its formative years, the industry puttered along matching sellers with buyers, even at the individual level. But with the coming of institutional money, the industry is poised to explode. Professionals expect that as more big money flows in, transparency will improve, in turn attracting more capital.

Darwin Bayston, president of Life Settlement Consulting and Management LLC, likened the situation to the 1849 gold rush in California. "There's been gold in the hills for a long time," he said at the fall 2005 conference of the Viatical and Life Settlement Association of America. "There are great challenges and opportunities, but full disclosure and transparency are lacking." Eventually, either the industry will provide them, or regulation will require them, he said.

Just how much gold is yet to be mined? A 2002 Wharton School study estimated $100 billion in face value available, while a Bernstein Research study last year pegged the amount at about $160 billion. These are policies owners no longer want, and buyers are willing to pay more than the cash surrender value. They keep the policies in force until the insured dies, then collect the death benefit. Insureds' life expectancies range from three to 15 or more years, and prices paid for the policies are determined by underwriting.

Only in recent years have institutional investors become big players in the life-settlement business, with most money coming from Germany. Estimates are that life-settlement purchases have ramped up from $2.5 billion of face amounts in 2003 to $10 billion to $15 billion last year. Private studies estimate 19,000 policies will have been bought in 2005, and 26,000 will be purchased in 2006.

But no one really knows. There is no single source of information, and reporting of the private transactions to state insurance regulators is inconsistent at best. "It's very hard to get information," said Bryan Freeman, the association president, at the convention. "We're left to speculate. We need numbers; they're important to the financial industry."

In an interview a month after the convention, Freeman said that while institutional investments would be greater if the industry were more transparent, they are, nonetheless, growing fast and will continue to increase regardless of any transparency improvements. "There's so much institutional funding, it's unreal, and more is coming daily in big chunks," said Freeman, president of Atlanta-based Habersham Funding LLC, a life-settlement provider.

Key Points

- Large investors in Germany have provided the capital that drove a surge in life-settlement funding last year. Greater business transparency could fuel more funding from investors in other countries.
- Life settlements can require much due diligence.
- Risks include legal and regulatory issues, the quality of life-expectancy analyses, interest rates, insurer credit-worthiness, and undisclosed commissions and fees.

Institutional Players, Old and New

A number of institutional investors have ventured into the arena of funding life settlements. CNA in the 1990s was the first, initially in viaticals, but stopped buying policies in 2001. In 2000, Dresdner Bank sponsored asset-backed commercial paper backed by a Lloyd's syndicate's stop-loss coverage. Berkshire Hathaway's General Reinsurance Group and American International Group became buy-and-hold investors in 2001, and German closed-end funds invested about $2 billion in 2003, according to Michael T. Crane, a director of global markets at Deutsche Bank. More recently, hedge funds have invested money using a variety of strategies, and banks outside the United States—including Deutsche Bank—have become market makers and liquidity providers, he said.

A key event in the history of institutional funding occurred a few years ago in Germany. According to Freeman, a "smart fund manager" heard about the life-settlement business and decided that if a closed-end mutual fund were properly structured, it could offer highly taxed German investors tax-free returns. Within months, other fund managers copied the product, and

Freeman said there are now about 20 such funds in the country. These funds also buy policies from the United Kingdom and Germany, but those purchases make up only a small part of the life-settlements market because they are endowment—or with-profits—policies (they mature over a specific term), and are arbitrage plays on their internal rates of return rather than mortality plays, as with U.S. policies.

Incipient Risks

Crane and Emmanuel Modu, head of structured finance at A.M. Best Co., argued in presentations at the conference that the risks of investing in life settlements may not be well understood. "You need to make a serious commitment of resources," said Crane. "You can't do it on an ad hoc basis." He said the legal issues alone are not trivial, and he advised institutional investors to hire their own attorneys or retain outside consultants.

Many firms investigating life settlements mistakenly believe they are cheap assets that can return 10% to 30% annually. That just isn't the case, Crane said. Potential buyers often fail to recognize there is interest-rate and credit risk, and they downplay the fact that rather than collect interest, as with many investments, they have to pay to keep the policies in force. He also pointed out that policies are difficult to aggregate in order to securitize them. Furthermore, the number of available policies may fall short of the appetite of institutional investors, said Crane. Institutions often seek to deploy $600 million to $1 billion or more at a time, according to Freeman.

Crane also warned that insurance to cover the "tail risks"—or long-term risks of owning life settlements—may not be easy to find.

Other issues ought to give potential investors cause for concern: the quality of life-expectancy estimates, tax and regulatory issues, high fees and commissions by providers, complex paper trails and long start-up times. Moreover, Crane said the market as it currently works "does not exist for investors." Providers seek out the cheapest-cost money so they can buy as much as possible to generate the most fees (usually a percentage of face amounts), and promised yields are frequently not obtainable in the market, he said. Moreover, any policy issued in 2003 or later may have insurable-interest issues, he warned. That may occur when brokers recruit people to become the insureds of life policies the brokers intend to use in life settlements rather than to provide protection to beneficiaries.

On the issue of underwriting alone, Crane said Deutsche Bank has calculated that more than two-thirds of the time, purchased policies are based on an estimated life expectancy that is less than the actual life expectancy, meaning buyers of those policies would have overpaid. In fact, the incentive for policy providers is to use the shortest life expectancies to provide more spread, not to boost the return of investors, Crane said. In the past year, there has been intense life-settlement industry self-examination about whether life expectancies have been too liberal, said Modu. He said Florida is crafting disclosure regulations with which medical examiners will have to comply, and that more states will probably follow Florida's lead.

> Concerns over transparency and fees may be overblown.
>
> *—Bryan Freeman, Habersham Funding LLC*

Modu said that effective regulatory oversight and empirical data on mortality trends within existing portfolios would make investors more comfortable to enter the life-settlement market. Pricing transparency, market efficiency, more-favorable accounting treatment and more-effective policing by the industry, such as that sought by the association, would also raise investor interest, he said. Modu added that rating-agency standards and a willingness by bond insurers to underwrite securities backed by life settlements would help draw investors.

Freeman suggested that concerns over transparency and fees may be overblown. He said transparency is already good between a large financial institution and a provider that buys policies for it, such as Habersham. "If there's any lack of transparency, it's between brokers and their clients," he said. "And some states, including Ohio, Pennsylvania and Florida, require brokers to disclose their commissions."

Licensing, Accounting Improvements

There is some positive news on the regulatory front. As of November 2005, 33 states required licensing of brokers and providers, and the Securities and Exchange Commission and state regulators have been "weeding out" some of the more unscrupulous market participants, Modu said. Also, the industry, led by its association, has supported self-policing, he said.

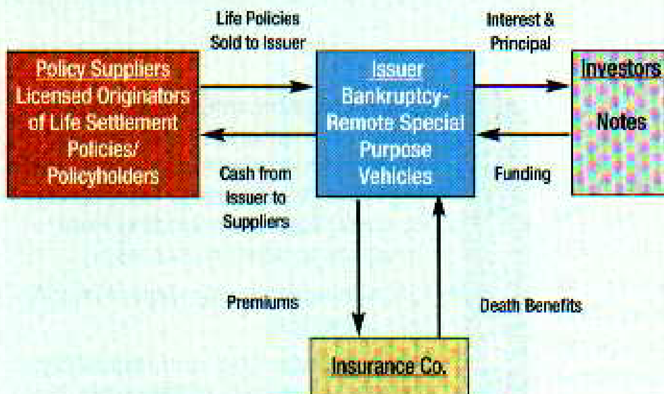
There is also good news on the accounting front that is likely to make institutional investors in the United States more interested in buying life settlements. Freeman said the Financial Accounting Standards Board, after years of lobbying by the association and its members, will no longer require life settlements to be carried on corporate ledgers at cash value. Instead, they may be carried at fair market value. "If you spent $1 million for something, but the cash value is $200,000, it didn't make your books look too good," said Freeman. "Now, you might carry it on your books at $1.5 million. Frankly, it's more realistic because it is worth more than you paid for it, or you wouldn't have paid that for it." Freeman said the FASB took action on accounting issues because so many life-settlement investments were being made. BR

At a Glance: Life Settlements

Evaluating a Transaction

Institutional Funding's Structure

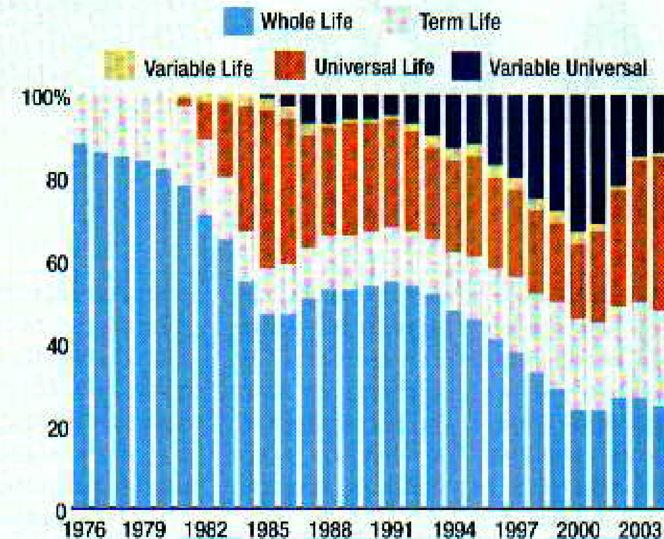
A financial institution packages purchased policies in a special-purpose vehicle. Large, institutional investors then purchase notes issued by the SPV.



Source: A.M. Best Co.

Policy Eligibility Criteria

Market Share of Eligible Life Products



Source: Limra International

How the Life Settlement Market Is Growing

Though the number and size of life-settlement transactions are not known, best estimates illustrate a robust trend. The numbers in the table equal a compound annual growth rate of 71% through 2004.

Year	Life Settlement ($Billions)
1998	0.20
1999	1.00
2000	1.10
2001	1.30
2002	1.40
2003	2.50
2004	5.00
2005 Projection	**10-15**

Source: Bernstein Research, A.M. Best Co.

Factors That Will Influence the Growth of the Market

Life Expectancies in Life Settlements

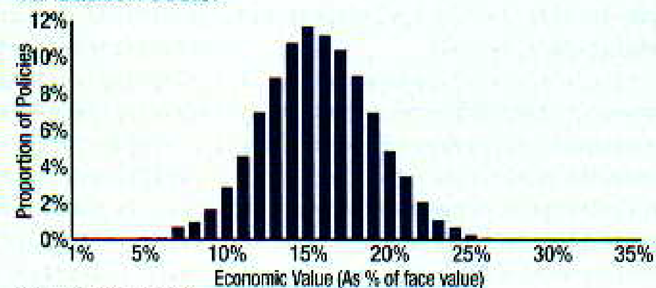
Among those who try to sell their life policies, 60% have life expectancies from six to 12 years.

Life Expectancy (LE)	% of Insured in LE Category
LE<=36 months	1
36 months<LE<=72 months	12
72 months<LE<=108 months	30
108 months<LE<=144 months	30
144 months<LE<=180 months	17
180 months<LE<=216 months	8
LE>216 months	2

Source: Estimates by A.M. Best Co.

What Life Settlements Are Worth

Assuming common characteristics of life-settlement transactions, Monte Carlo analyses by A.M. Best of a real portfolio showed that the average economic value of a portfolio of policies with 9-10 year life expectancies is 15% of face value, while the range is from 4% to 26%. The observed price to investors is usually 25% to 30% of face value, an indication that investors pay hefty transaction costs.



Source: A.M. Best Co.