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Life Insurance - Life Settlements Update - What a Difference a Year Can Make

Ticker	Rating	CUR	5/18/2006 Closing Price	Target Price	YTD Rel. Perf.	EPS 2005A	EPS 2006E	EPS 2007E	P/E 2005A	P/E 2006E	P/E 2007E	Yield
PRU	O	USD	75.50	89.00	2.1%	4.83	5.80	6.70	15.6	13.0	11.3	1.0%
AFL	O	USD	46.85	57.00	-0.2%	2.54	2.85	3.25	18.4	16.4	14.4	1.1%
LNC	M	USD	55.94	56.00	4.4%	4.83	4.70	5.35	11.6	11.9	10.5	2.7%
PFG	M	USD	51.80	51.00	8.1%	2.97	3.25	3.55	17.4	15.9	14.6	1.1%
MET	M	USD	50.75	53.00	2.5%	4.33	4.65	4.90	11.7	10.9	10.4	0.9%
NFS	M	USD	43.42	47.00	-2.4%	3.98	3.92	4.25	10.9	11.1	10.2	1.7%
SPX			1261.81			76.50	81.00	85.00	16.5	15.6	14.8	1.9%

O – Outperform, M – Market-Perform, U – Underperform

Highlights

In March 2005, we published a research note discussing our initial thoughts on the life settlement market, a secondary market for life insurance policies. Over the past 12 months, the settlement industry has received a great deal of attention from investors, regulators, attorney generals and primary life insurance companies. In this report, we revisit some of our initial findings and provide our perspectives on recent developments.

- **Original Thesis Revisited – Faster Than Expected Growth –** In March 2005, we estimated the life settlement market could grow from an in force of $13 billion in 2004 to $161 billion over the next several years. While we are sticking with this forecast, estimated 2005 transactions were $9-11 billion in terms of face value, double our estimate of $5 billion for 2004. Moreover, we understand 2006 is shaping up to be even stronger than 2005. As a result, the settlement market may reach $161 billion sooner than our original expectation. Separately, we had postulated that rapid growth in the life settlement market could alter lapse rates on life insurance policies relative to pricing assumptions. A recent analysis provided by Protective Life (not covered, ticker: PL) argues that lapse supported pricing does exist in the market and confirms how, as a result, the life settlement business can negatively impact the sector.
- **If You Can't Find Them, Make Them – Premium Financing, Insurable Interest and IOLI –** One of the more controversial aspects of the life settlement market pertains to Investor Owned Life Insurance (IOLI), where 3rd party investors initiate the purchase of new life policies, often using premium financing, with the intent to eventually purchase the policies as an investment. The Office of General Council for the New York State Insurance Department recently issued an opinion that a particular IOLI transaction violated the state's insurable interest laws. As this market continues to grow, we feel it is likely that other states will become more vocal with respect to their insurable interest laws. In our view, these issues highlight the potential risks to investors in both life insurance companies and certain life settlement transactions.
- **Is the Industry's Response Coming Up Short? –** The industry's response to life settlements has become more significant over the past 12 months. A year ago, the ACLI's primary issue seemed to be related to proper regulation and licensing of agents involved in life settlements. Today, the industry is arguing that rapid growth of life settlements, in particular the IOLI market, could lead the government to question the tax-free build up allowed in life insurance policies. We are not convinced that this argument

U.S. Insurance/Life

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is valid. On the one hand, the President's Advisory Panel on Federal Tax Reform has already recommended the elimination of tax-free build up within life insurance policies and annuities to level the playing field with other retirement savings products. It made no mention of the IOLI market. Moreover, the IOLI transactions are revenue generators for the IRS as investment gains are taxed. Separately, if IOLI transactions violate insurable interest laws, we feel the industry argument against the practice is on solid footing, much more so than based on the tax issue. Lastly, the industry has raised the so-called "moral hazard" issue (i.e., 3rd parties profiting from the death of another). That said, this issue exists even with standard life settlements as well as with payout annuities, where life insurers report mortality gains from time to time. Our view remains that if the industry wants to curtail the practice of life settlements in general (i.e., not just IOLI), its best response is to increase the value proposition of the policies they sell. Examples include offering accelerated death benefits (i.e., living benefits) or higher cash surrender values.

- **A Boost from FASB –** In March 2006, FASB made a change to the accounting rules related to life settlements. The change essentially allows companies to book the life settlements they purchase at fair value rather than cash surrender value. Under the old regime, buyers were forced to record a capital loss at the time of purchase, which would ultimately be reversed when they collected the death benefit. Clearly, this accounting change eliminates an upfront penalty for buyers of life insurance policies, which could form another growth catalyst for the settlement market.

Investment Conclusion

What to do with the Stocks: We continue to recommend a market-weight in the space. Although we would argue that the life settlement market poses some risk to life insurers, the size of the market remains small compared to the over $9 trillion in individual life insurance in force.

Away from this issue, the median P/B multiple in life insurance is 1.7x, above its long-term average of 1.5-1.6x. Given our expectation that industry ROEs will remain in the 12-13% range going forward, we see limited upside and potential downside to current valuations. That said, we feel stocks that will outperform will be those of companies with strong growth drivers and active capital redeployment. As such, our top picks are PRU and AFL.

Please see page 12 for our price targets and valuation methodology.

Details

Original Thesis Revisited – Faster Than Expected Growth

In March 2005, we estimated the life settlement market could grow from an in force of $13 billion to $161 billion over the next several years (see exhibit 1). At the time, we cited two primary drivers, (1) the aging population and (2) our expectation that the life settlement industry would increase its penetration rate in its target market.

Over the past year, we have received numerous questions as to how we arrived at the $161 billion market opportunity for life settlements. Below, we review our methodology.

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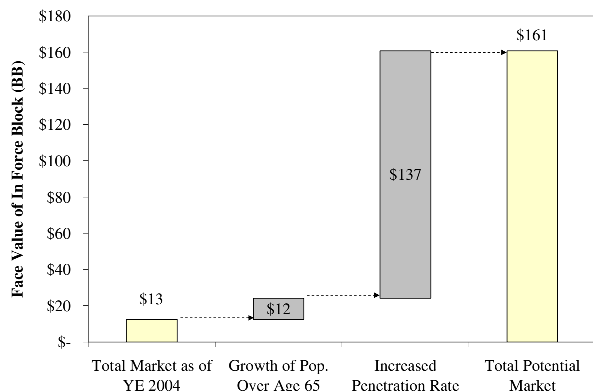
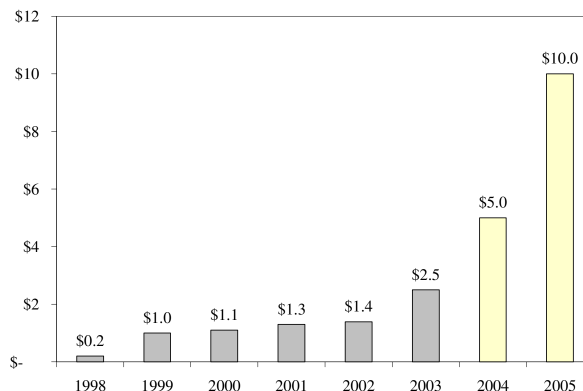
Exhibit 1
Dimensioning the Size of the Life Settlement Opportunity



Source: US Census Bureau and Bernstein estimates

Exhibit 2
Estimated Life Settlement Business Written – Face Value



Source: Bernstein estimates

Starting with the impact of the aging population, we note that individuals over the age of 65 represent 96% of all life settlement cases. An industry survey of consumer ownership of life insurance indicates that roughly 47% of individuals over the age of 65 have policies. Moreover, this same study suggests the average coverage for this age bracket is $23,600. Given that there are currently 37 million individuals over the age of 65, these statistics suggest this group controls roughly $416 billion of life insurance. Assuming that all of the $13 billion of in force settlement business relates to this population segment, we arrive at a penetration rate of 3%. Based on projections from the US Census Bureau, the over 65 segment of the population should increase to 72 million by 2030. Using the same percent ownership of 47% and average coverage statistic of $23,600 against this new base, we estimate that this segment will control $800 billion of insurance by 2030. Applying the current 3% life settlement penetration rate, we estimate population growth alone could add $12 billion of settlement business.

Industry sources also indicate that the 3% penetration rate is understated and the true potential is closer to 20%, which reflects expectations in terms of the proportion of policies with low cash values and the number of people willing to settle. If we assume the settlement business achieves this penetration rate, the industry could add another $137 billion of business. Based on these assumptions, the settlement business could increase from $13 billion currently to as much as $161 billion over the next few decades. Our estimate could prove conservative to the extent that increased awareness of the settlement option drives penetration above 20%, which we feel is possible. For example, every 100 bps of increase in the penetration rate would add $8 billion of in force business.

While we are sticking with this forecast, the market is growing faster than we originally expected. For example, if we simply straight line the projection shown in exhibit 1 over 26 years (i.e., from 2004 to 2030), the annual increase would be about $5.6 billion per year. A leading industry participant that we spoke to estimated 2005 transactions were $9-11 billion, close to double the annual estimate implied by our $161 billion forecast (see exhibit 2). Moreover, we understand 2006 is shaping up to be even stronger than 2005. As a result, the settlement market could reach $161 billion sooner than we originally expected. A catalyst

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that we did not consider in our initial estimate is the rapid growth of the IOLI market, which we discuss later in this report.

Separately, we had postulated that rapid growth in the life settlement market could cause the industry's actual experience to differ from the assumptions embedded in pricing models. The lapse rate assumption is one such example. In general, life insurers build an assumption for expected lapses in their pricing models. If a policy lapses, the insurer will not have to pay a death benefit. That said, the life insurer had been collecting premiums on and presumably building reserves for this policy. Therefore, an insurer can use the reserves formerly allocated to policies that eventually lapse to fund the death benefits of the policies that remain in force.

At the time we published our initial work on life settlements, some of the feedback we received from some life insurance companies was that they use realistic and low lapse rate assumptions. In terms of the former, they may assume that an unhealthy individual, who would likely be an ideal candidate for a life settlement, will never lapse. On the other hand, a policy belonging to a healthy individual that would likely be unattractive to a settlement company is more apt to lapse. With respect to the level of lapse rates, we note that at the 2006 AIFA conference, executives from AXA Financial and Manulife Financial indicated their assumed lapse rates were between 1-3%, which seems quite low.

Therefore, a logical question is if lapse rate assumptions are low and realistic across the industry, why should the life insurance sector worry about life settlements? We feel there are two reasons. First, some players in the market use lapse supported pricing. Second, the procurement of life insurance specifically for the purpose of selling it to 3rd party investors may violate insurable interest laws and lead to headline risk for the sector.

Turning back to lapses, a recent analysis provided by Protective Life (not covered, ticker: PL) and presented at the company's March 14, 2006 Investor Day argues that some industry players use lapse supported pricing. The company's executives went on to show that the combination of low cumulative lapse rates and low available investment yields could result in negative returns for some life blocks.

Taking these one at a time, exhibit 3 shows a real life illustration of the pricing assumptions used for a $10 million face value UL policy with a no lapse guarantee that is sold to a 72 year old male. As shown, this level of coverage requires a single premium of $4 million dollars. According to PL executives, the premium is based on an average of 3 actual quotes from life insurers. PL then reverse engineered this policy to determine what investment rate was required just to make the policy work. In order for the life insurer to make a $10 million payment in 12 years, it would need to invest the $4 million single premium in an asset with an annual yield of 7.8%, well above where life insurers have been able to invest premiums at similarly maturities for the past several years. Importantly, the 7.8% required investment return assumes the life company has no other expenses such as marketing, underwriting and maintenance costs, and also does not earn a profit. PL's conclusion was that the only way these companies can sell this product at a profit is if they are counting on lapses.

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Exhibit 3
Single Premium Universal Life with a No Lapse Guarantee Pricing Example

Model Parameters	Assumptions
Candidate	Male, age 72, non-tobacco
Underwriting category	Table 4 to Standard
Death benefit	$10,000,000
Average single premium [1]	$4,069,127
Life expectancy	12 years
Required investment yield to pay death benefit [2]	**7.8%**

Notes:
(1) Average of 3 companies' single premium net of commission of 11.5%
(2) Assumes: 1) no other costs (marketing, underwriting, taxes, maintenance, etc.) exist and 2) the life insurer does not earn a profit.

Source: Protective Life 2006 Investor Day presentation

Exhibit 4
Returns Impacted by Lapses and Asset Yield

Cumulative Lapses	Annual Lapse Equivalent	Annual Investment Yield			
		5.0%	6.0%	7.0%	8.0%
30%	2.9%	8.17%	13.43%	17.83%	21.77%
20%	1.8%	Negative	7.44%	13.17%	17.77%
10%	0.9%	Negative	Negative	7.33%	13.39%
0%	0%	Negative	Negative	Negative	7.93%

Source: Protective Life 2006 Investor Day presentation and Bernstein estimates

Exhibit 4 takes this analysis to the next level. This matrix shows the returns (i.e., IRR) a policy would generate based on various assumptions for annual investment yields and cumulative lapse rates based on a block of policies similar to that shown in exhibit 3. In terms of the cumulative lapses, we estimate a 1% annual lapse rate over 12 years would equate to about a 10% cumulative lapse rate. Based on the model PL constructed, if available investment yields fall in the 5-6% range and annual lapse rates fall to less then 2%, this block of policies would generate negative returns.

In our opinion, the key takeaways from these exhibits are (1) some industry participants are using lapse supported pricing, particularly on high face value, single premium policies and (2) to the extent their lapse supported products become the targets of life settlements, these companies could see negative returns if yields remain at current levels. While we discussed the potential for both of these issues in our previous report on life settlements, the analysis from PL shown above provides confirmation from a leading life insurance company.

In addition, we feel another driver of the industry's exposure to the life settlement business has been the recent growth in single premium universal life sales, similar to the product featured in exhibit 3 above. Based on data from LIMRA, single premium UL increased from 16% of total whole life premiums (i.e., excluding term insurance) in 2001 to 27% in 2004 (see exhibit 5). Moreover, this product represented 60% of the total increase in premiums over the same period. We expect a large percentage of these policies included a no lapse guarantee feature. The decline from 2004 to 2005 could reflect the fact that life insurers were pulling back from the single premium UL product, given greater awareness of the life settlements as well as the impact of higher reserves for UL related to Actuarial Guideline 38 (A-XXX).

We are excluding term insurance, which represents 15% of total industry premiums. The reason is our view that since these policies do not have cash surrender values, they are not likely to be the target of life settlements.

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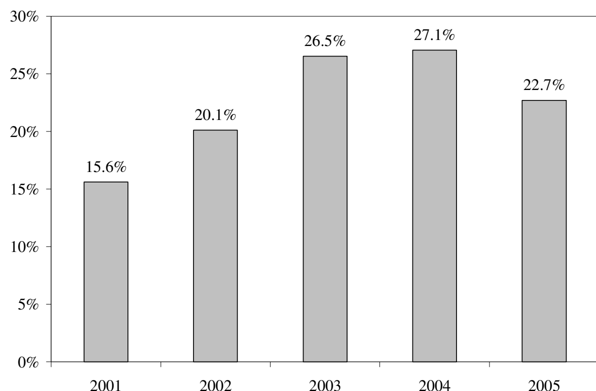
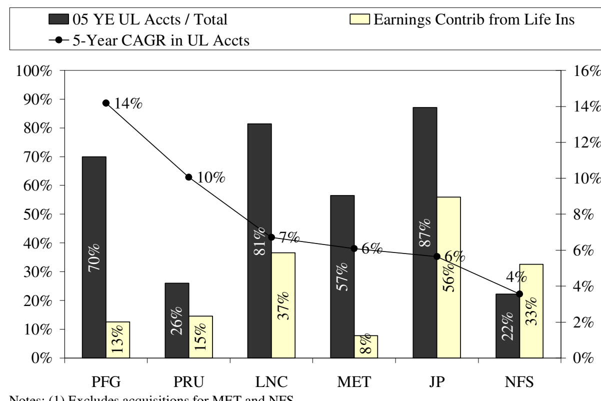
Exhibit 5
Life Insurance – Single Premium UL Sales / Total Whole Life Sales



Source: LIMRA and Bernstein estimates

Exhibit 6
Life Insurance – Growth in UL Accounts, Earnings from Life Insurance and Mix of UL/VUL Account Balances (1)



Source: Corporate reports and Bernstein estimates

In general, life insurers do not provide their mix of single versus recurring premium business on the books. That said, given industry trends, we expect most insurers have some exposure to the life settlement market, despite their efforts to avoid it. For example, on its 1Q:06 earnings conference call, we asked MetLife's management team how they knew if a new policy was destined for the IOLI market. CEO Rob Henrikson answered: "it's only obvious if you're looking for it through a microscope every single day." He went on to say: "It's conceivable it can get into your business and you're not even recognizing that that's occurring to you."

Exhibit 6 shows the 5 year CAGR for universal life insurance account balances across our coverage. In order to dimension the potential exposure to life settlements, we are also showing the mix of year-end account balances between universal life and variable universal life. We feel variable universal life policies are less likely to attract life settlements given buyers of the policies would be assuming equity market risk. Lastly, we are showing each company's earnings contribution from life insurance. Therefore, we suggest investors focus their attention on companies with large blocks of UL business that have experienced strong growth in recent years and that also generate a large percentage of earnings from life insurance. Based on these variables, LNC/JP appears to stand out within our coverage universe.

If You Can't Find Them, Make Them – Premium Financing, Insurable Interest and the IOLI Market

Of the two growth drivers for life settlements shown in exhibit 1 above, the more significant is increasing penetration of the potential pool of life insurance policies. Again, we had estimated that the ratio of in force settlements to in force life insurance owned by individuals over the age of 65 was 3%. Further, based on conversations with industry participants, we felt a 20% long-term penetration rate was a reasonable assumption for this market.

We cited several potential drivers for this increase in penetration, including:

- As longevity increases, individuals may outlive their need for life insurance.

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- Cash value life insurance policies may be underperforming expectations given life insurers have been reducing crediting rates on in force business for the past few years as interest rates have declined.
- The potential elimination of the estate tax could render some survivorship policies obsolete.
- Continued awareness of the life settlement market and its various options could result in a new fiduciary duty on the part of financial planners to highlight this alternative.

John Skar, Chief Actuary for Mass Mutual, published a report in the Journal of Practical Estate Planning indicating his view that less than 1% of life insurance policies should be considered for life settlements[1]. We had an opportunity to speak with Mr. Skar in April 2005. A key component of his argument is that it is more accurate to compare a settlement offer to a policy's underlying economic value (i.e., the value of the death benefit less future premiums paid) rather than to its cash surrender value. If this concept were explained to policyholders, Skar concluded that many would retain ownership of their policies. If Skar's 1% assumption is accurate, it would clearly suggest our 20% penetration assumption is significantly overstated. Still, we would make two points to support an increase in penetration. First, it is difficult to predict consumer behavior. Individuals may decide that cash in hand today is better than the promise of cash tomorrow. As such, they may opt to engage in a settlement even if the offer is below the true economic value of their life policies. Second, as capital continues to enter the settlement market, it is certainly possible that settlement offers will increase, lowering the gap relative to policies' underlying economic value. At the end of the day, our 20% penetration assumption is an estimate of the potential size of the market, not an endorsement of the practice of selling life policies.

Over the past year, another growth driver that we did not cite above has drawn much attention: IOLI and the premium financing of life insurance policies. Although there are probably numerous ways to construct such transactions, exhibits 7 and 8 review one that was examined by the Office of General Council (OGC) for the New York State Insurance Department.

This transaction has four principals: (1) an older individual who does not have life insurance, (2) a bank, (3) a life insurer and (4) a 3rd party investor (which was labeled by the OGC as a hedge fund). At the outset, a bank makes a loan to an individual to purchase a life insurance policy. At the same time, the hedge fund commits to purchasing the life insurance policy two years later. Said another way, the hedge fund gives the individual a no cost put option that is exercisable in two years. The two year period is consistent with the typical contestable period for new policies. The contestable clause states that if the insured makes any misrepresentations or withholds any relevant underwriting information on the policy application and dies within the first two years following issuance, the insurer can deny the claim. Once this period is over, however, the insurer must pay the death benefit. If the individual dies during the contestable period and the life insurer finds no instances of misrepresentation, it pays the death benefit and a portion of the proceeds is used to repay the initial loan.

[1] John R. Skar, Advisors Should Provide the Best, Not Just "Better Than" Advice, Journal of Practical Estate Planning, August - September 2005

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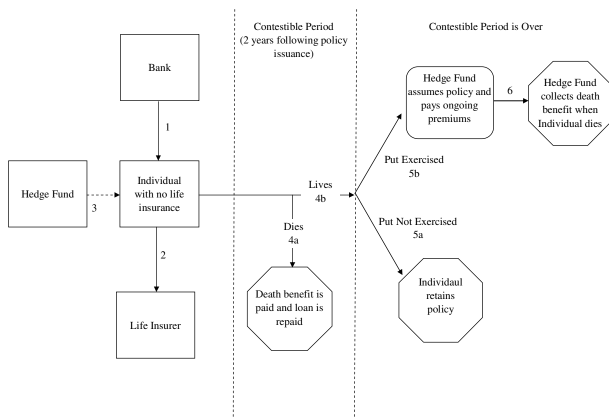
Exhibit 7

Premium Financing Transaction Addressed by OGC of New York State Insurance Department (Flowchart)



Source: State of New York Insurance Department and Bernstein estimates

Exhibit 8

Premium Financing Transaction Addressed by OGC of New York State Insurance Department (Description)

Initial Transaction	
1	Bank makes a loan to a individual with no life insurance
2	Individual uses loan to purchase a life insurance policy
3	Hedge fund gives individual a put option on the life policy (i.e., give a commitment to purchase in the future)
During Contestable Period	
4a	Individual dies and life insurer pays death benefit, a portion of which is used to repay the loan
4b	Individual survives the contestable period
After Contestable Period	
5a	Individual retains policy and repays the outstanding loan
5b	Hedge fund assumes the policy and pays ongoing premiums
6	Individual dies and hedge fund receives the death benefit

Source: State of New York Insurance Department and Bernstein estimates

Assuming the individual survives the contestable period, the put option becomes exercisable. The individual can choose not to exercise the put, repay the loan and keep the policy. If the put is exercised, however, the hedge fund assumes ownership of the policy, continues to pay annual premiums and ultimately collects the death benefit.

What makes this transaction different from a typical life insurance policy is that it is extremely likely that the individual will exercise the put, especially if there is an upfront inducement to do so, meaning the policy will not lapse. Therefore, unless the life insurer uses a 0% lapse rate assumption when pricing this business, its IRR will be lower than expected. Again, as shown in exhibit 4 above, even if life insurers make this realistic assumption, it is unlikely they will be earning an appropriate return in the current interest rate environment.

Separately, the OGC issued an opinion that the transaction described above is not permissible under New York Insurance Law because no valid insurable interest exists at the time the policy was issued. In its opinion, the OGC referenced two provisions of New York Insurance Law 3205(b) (see exhibit 9). Exhibit 10 provides the definition of insurable interest per New York Insurance Law.

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Exhibit 9
Excerpt from NY Insurance Law Pertaining to Life Settlements

New York Insurance Law 3205(b)

(b) (1) Any person of lawful age may **on his own initiative** procure or effect a contract of insurance upon his own person for the benefit of any person, firm, association or corporation. **Nothing herein shall be deemed to prohibit the immediate transfer or assignment of a contract** so procured or effectuated.

(2) No person shall procure or cause to be procured, directly or by assignment or otherwise any contract of insurance upon the person of another **unless the benefits under such a contract are payable to the person insured or his personal representatives, or to a person having, at the time when such contract is made, an insurable interest in the person insured.**

(Emphasis added)

Source: State of New York Insurance Department

Exhibit 10
Excerpt from NY Insurance Law Pertaining to Insurable Interest

Insurable Interest:

(A) in the case of persons closely related by blood or by law, a substantial interest engendered by love and affection

(B) in the case of other persons, **a lawful and substantial economic interest** in the continued life, health or bodily safety of the person insured, **as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the insured**.

(Emphasis added)

Source: State of New York Insurance Department

Based on our read of exhibits 9 and 10, premium financed life insurance polices that are procured for the sole purpose of life settlement contacts are illegal in New York State. That said, there appears to be a lot of gray area with respect to this issue. For example, the New York opinion also makes reference to Hota v. Camaj, 750 N.Y.S 2d 119 (2nd Dept 2002), where it was determined that "the assignee of the policy did in fact possess an insurable interest in the life of the decedent by virtue of the fact that the assignee therein was a creditor of the decedent." Said another way, the extension of a loan to fund the life insurance policy could create an insurable interest. The OGC goes on to say that the position of the creditor would be "enhanced in value" by the death of the insured, which violates the state's insurable interest law. Again, this points to the fact that each circumstance is different and investors in the life settlement market need to perform extensive due diligence.

Another concern of the New York OGC is the practice of rebating. Here, the insured receives a refund for the premiums paid in the first two years following issuance from the proceeds of the policy sale. Per the New York OGC, this practice is not permissible.

It is important to note that exhibits 9 and 10 and the related discussion above only refer to New York law. While other states likely have statues in place regarding insurable interest, they may differ from the opinions expressed in the above exhibits.

In addition, although premium financing and life settlements have become intertwined in the industry's lexicon, the practice of financing life insurance premiums has been around for years. In fact, the premium finance industry has a non-profit trade association called the Life Insurance Finance Association (LIFA). In March 2006, LIFA issued a press release voicing its concern that state regulators investigating the life settlement market "have cast an overly wide net which may inadvertently capture legitimate premium finance transactions." Although the LIFA opposes the practice of the buying or selling life insurance

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policies where no insurable interest exists, its concern is that some premium finance transactions could be characterized as life settlements, even though the insured retains ownership of the policy.

We feel the above discussion points to the complexity of the life settlement market. Given recent growth has been above expectations, we feel it is fair to conclude that the industry is attracting large sums of capital, which will increase competition and put pressure on participants to identify and settle policies as quickly as possible. As we stated in our initial work on life settlements, a key criterion for future growth is that business is conducted in a responsible manner. As such, we feel investors interested in participating in this market should perform careful due diligence. Based on our research of this market and discussions with industry participants, we would highlight the following issues as potential red flags (i.e., if the answer is yes). To be clear, the list reflects some issues that have been raised in our discussion with industry participants and is by no means exhaustive.

- Was there an upfront inducement paid to the insured that effectively means the policy will have to be sold after 2 years?
- Is the policy being purchased still in the contestable period?
- Is there any sharing of the death benefit between the investor and the insured before the policy is sold (i.e., during the contestable period)?
- Are there any restrictions or limitations around who the insured can sell their policy to?
- Are there any penalties assessed against the insured for not settling?

Is the Industry's Response Coming Up Short?

In our opinion, the industry's response to life settlements has become more significant over the past 12 months. A year ago, the ACLI's primary issue seemed to be related to proper regulation and licensing of agents involved in life settlements. Today, the industry is raising larger and potentially more controversial concerns. Exhibit 11 summarizes what we feel are the most significant arguments being made by the life sector against the settlement market as well as our view on each.

Exhibit 11
Life Insurance – Sample of Industry Arguments Against the Life Settlement and IOLI Market and SCB Comments

Issue	Industry View	SCB Agree or Disagree	SCB Comment
Taxation of Life Insurance	Growth of IOLI market could cause the US government to review tax-free build up allowed in life policies.	Disagree	Bush's Advisory Panel on Federal Tax Reform already recommended elimination of tax-free build up in life and annuity products to level the playing field across retirement savings products. There was no mention of IOLI. IOLI is a tax generator for the US government.
Insurable Interest Laws	Under certain circumstances, IOLI transitions violate insurable interest laws.	Agree	Investors in the IOLI market need to carefully review transaction specifics.
"Moral Hazard"	It is bad public policy to allow 3rd parties to profit from the death of another.	Agree but we feel the life sector is being inconsistent	The moral hazard issue exists with all life settlements, including those which are not under scrutiny by the life sector. On certain individual and group annuity contracts that have guaranteed payouts for specific periods, life insurers benefit from the death of a individual.

Source: ACLI, Corporate reports and Bernstein estimates

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The first considers the taxation of life insurance. Recently, industry executives have raised a concern that rapid growth of life settlements, in particular the premium financed IOLI, could lead the government to review the tax-free build up allowed in life insurance policies. While predicting changes in the tax law is an exercise in futility, we would make two points. First, it appears that the US government is already considering the elimination of tax-free build up of life insurance and annuities completely independent of the life settlement issue. In its final report dated November 1, 2005, the President's Advisory Panel on Federal Tax Reform, a bi-partisan committee, recommended passage of Save for Retirement accounts. These accounts would allow taxpayers to allocate $10,000 to tax-free accounts that would replace "existing IRAs, Roth IRAs, Nondeductible IRAs, deferred executive compensation plans and tax-free "inside buildup" of the cash value of life insurance and annuities." In addition, the Panel voiced its concern that "some life insurance policies and annuities allow for nearly unlimited tax-free savings" and recommended "the increase in value in those policies would be treated as current income, and therefore would be subject to tax on an annual basis, just like a savings account." To us, it seems their recommendation is an attempt to level the playing field across retirement savings products. Importantly, there was no mention of the life settlement market in the related discussion.

A separate but related issue is that the IOLI market is a revenue generator for the Internal Revenue Service. Specifically, investors in settlements have to pay taxes on the difference between the death benefits they receive when the policy is paid off and their investments. Therefore, we have a hard time making the connection that rapid expansion of the IOLI market will drive less favorable tax treatment of life insurance policies.

The second concern raised is that IOLI transactions violate state insurable interest laws. As noted above, the OGC of the New York State Insurance Department already issued an opinion that one particular premium financed transaction was not permissible under current law. As such, we feel the industry argument against this practice on the grounds of insurable interest laws is on solid footing. That said, we note that each state has different laws and each IOLI transaction has different parameters. Investors interested in participating in this market need to pay careful attention to all of these factors.

Lastly, the industry has raised the so-called "moral hazard" issue. Specifically, the sector is arguing that it is bad public policy to allow 3rd parties to profit from the death of another. While we agree with this concept, we feel it is important for the life industry to be consistent. For example, some industry executives (e.g., speakers at this year's AIFA conference) already indicated they are not opposed to traditional life settlement transactions (i.e., as opposed to IOLI). We would argue that the moral hazard issue exists with these transactions as well. Separately, we note that life insurers themselves can profit from the death of an individual. The most frequent example is the mortality gains reported by companies that sell certain individual and group annuity contracts. If the holders of these contracts die ahead of actuarial assumptions built into pricing, the life insurer may report an earnings benefit.

Our view remains that if the industry wants to curtail the practice of life settlements, its best response is to increase the value proposition of the policies they sell. Examples include offering accelerated death benefits (i.e., living benefits) or higher cash surrender values.

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A Boost from FASB

In March 2006, FASB made a change related to the accounting for life settlements. In the past, companies that purchase life insurance policies had to take an initial capital loss, which represented the difference between the settlement offer and the cash surrender value. In addition, the buyers had to continue to book losses as they paid ongoing premiums. These losses would eventually be offset by the death benefit. Earlier this year, FASB changed this accounting. Now, buyers of life settlements have two options. First, they can adopt the so-called investment method, where the settlement is booked at the initial transaction price plus capitalized future premiums, rather than the cash value. Alternatively, buyers can choose the fair value method, where again the settlement is booked at the initial transaction price and this value is marked to market each reporting period.

Comments from Brian Pardo, Chairman, CEO and President of Life Planners Holdings Inc (not covered, ticker: LPHI), a publicly traded settlement company, indicate that the prior accounting regime put the company at a competitive disadvantage. In addition, Pardo stated "by its adoption of these new rules, FASB has recognized the significance of life settlements as an emerging alternative asset class."

Valuation Methodology

Exhibit 12 shows our price targets. For stocks other than AFL, we employ an equal-weight valuation framework that considers each company's:

- relative price to earnings multiple versus an industry or company specific target
- relative price to book multiple versus an industry or company specific target, and
- the historical relationship we have identified between price / book and risk adjusted ROE (i.e., ROE / cost of equity)

We value AFL using a 17.5x P/E multiple against our 2007 EPS estimate of $3.25.

Exhibit 12
SCB Price Targets

	Price 5/18/06	Price Target	Appreciation Potential	Rating
AFL	$ 46.85	$ 57.00	21.7%	O
PRU	75.50	89.00	17.9%	O
NFS	43.42	47.00	8.2%	M
MET	50.75	53.00	4.4%	M
LNC	55.94	56.00	0.1%	M
PFG	51.80	51.00	-1.5%	M
Median			6.3%	
Average			8.5%	

Source: Bernstein estimates

Risks

In terms of our market-weight recommendation for the sector, upside risks include improvements in the operating environment, led by a gradual increase in new money rates. In addition, product innovation in

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asset accumulation and insurance segments could drive higher growth in product sales. Third, M&A activity that includes high takeover multiples could result in outperformance. Lastly, favorable legislation out of Washington, such as the passage of tax reductions on annuity distributions could result in renewed interest in annuity products.

Downside risks to our market-weight recommendation include continued headline risk from various investigations of the sector. In addition, stocks could be adversely impacted by an increase in corporate credit losses, higher capital requirements on insurance and annuity products, lower equity markets and wide swings in interest rates, either up or down.

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