Secondary Market of Life Insurance And Related Insurer Challenges Entering 2009

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Table of Contents

Executive Summary page 2

Transition: 2008 Prosperity to 2009 Recession page 4

Life Settlement Market Continues Its Strength Entering 2009 page 6

Capital Market Issues and Federal Involvement Impact Life Insurers page 7

Insurer Reserve Requirements Are Affected by Troubled Variable Products page 9

Lower Capital Requirements for Insurers Are Being Proposed page 9

2008 and 2009 Legislative Developments page 11

Industry Best Practices and Standards Are Needed page 12

Policy Value Loans Debut In 2009 page 15

Life Settlement Hedging and Synthetics Should Expect Regulation page 16

Conclusion page 18

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Executive Summary

As we enter 2009, the environments for the secondary market of life insurance and life insurance carriers are challenging and complex. Untold numbers of seniors have been devastated by the investment markets' 2008 collapse, and are searching for new ways to fund their retirement. Moreover, baby boomers, who historically have maintained lower savings rates and are destined to live longer than their parents, also find themselves searching for retirement liquidity. Fortunately, many seniors who own life insurance will discover its hidden asset value with the further development of the secondary market, however, determining the most appropriate way to monetize that value remains a challenge. Industry stakeholders and legislators need to ensure that the secondary market remains vibrant for all market participants.

The annual face amount of life insurance policies settled in the secondary market is expected to average $21 billion over the next ten years, reaching $31 billion by 2017. The market is projected to grow at 11.5% annually in the next five years and then slow to 8.2% annually the following five years.[1] The growth of this market is expected to be driven by expanded investment criteria including longer life expectancies, smaller policy face values and modified settlement structures, and overall increasing market demand for life insurance backed securities.

However, the secondary market of life insurance discovered it was not immune to the credit crisis of 2008 as investors retrenched, bank lines were not renewed, insurance carrier credit concerns heightened, and overall liquidity for policies in the secondary market dried up. Despite the difficult credit environment, investor interest in the secondary market of life insurance has escalated for reasons of: (a) non-correlated returns except for market influences on costs of capital; (b) stability of returns; (c) predictable liquidity; and (d) understandable and measureable risk. The reduction of investor liquidity and the increasing awareness of the secondary market among seniors and their agents have led to an increase in policy supply and higher yields for investors entering 2009.

The 2008 credit crisis has created a tremendous negative impact on life insurer liquidity and corresponding credit ratings which in turn directly affects the secondary market of life insurance. Accordingly, credit-rating agencies have come under intense fire for failing to provide advanced warning to investors about the U.S. subprime-mortgage meltdown and for giving investment-grade ratings to issuers holding material subprime assets. In response, the European Commission has proposed legislation that would subject the credit rating agencies to new restrictions, increased regulatory oversight, and penalties for infractions. Furthermore, the National Association of Insurance Commissioners ("NAIC") has disclosed plans to establish a new Nationally Recognized Statistical Rating Organization ("NRSRO") that could be in place in early 2009. The stated purpose of the NRSRO is to provide ratings independent of other rating firms.

In further response to the 2008 credit crisis, the U.S. Treasury Department gave authorization for the inclusion of life insurers in the Troubled Asset Relief Program. However, providing federal money for life insurance companies increases pressure on Capitol Hill for federal regulation of insurance. These movements fuel support for a federal insurance charter and federal oversight, a move the NAIC and state-based regulatory bodies strongly oppose.

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[1] Conning Research & Consulting, Inc., *Life Settlements: New challenges to Growth,* 2008.

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Collapse of the investment markets in 2008 has also caused life insurers to incur billions of dollars in losses in their equity and bond portfolios resulting in unanticipated deterioration of reserves held for variable annuities. There is now a growing fear that if these markets do not recover soon, or worse, if losses continue to mount, the reserves held by insurance carriers for their variable annuities may not be sufficient to cover the guaranteed portion of the annuities. The concerns over insurer reserves have caused state regulators and the American Council of Life Insurers ("ACLI") to consider switching from the long established "formula-based" reserve method to a "principle-based" reserve method, thereby lowering capital requirements for life insurance carriers. Proponents of this change argue that the formula-based approach fails to properly capture the underlying risks for a vast universe of products, especially products that offer guaranteed benefits. Opponents of this approach have concerns about the potential impact on insurers' balance sheets, lack of transparency, and difficulty in evaluating reserving approaches between companies. Any reduction of reserves should be of concern to state regulators who are responsible for the viability of state guarantee funds.

The 2008 credit crisis and investment market turmoil has impacted the secondary market of life insurance with: (a) tighter investor credit terms; (b) demand for greater accuracy and quality in life expectancy reports; (c) more specific policy acquisition criteria; (d) increased analyses on portfolio performance, including sensitivity to changes in longevity; and (e) expanded investor demand for life insurance policy backed financial products.

From a regulatory perspective, ten states adopted legislation regulating the secondary market of life insurance in 2008. Entering 2009, twenty-two states have comprehensive regulatory frameworks for senior life settlements, twelve states regulate viatical settlements only for terminally ill, one state (Arizona) regulates against only Stranger Originated Life Insurance ("STOLI"), and nine states have yet to adopt any regulatory framework. It is expected that thirty states will consider viatical/life settlement legislation in 2009, focused mostly on STOLI related transactions and insurable interest issues. The industry as a whole will be watching both California and New York for leading legislation in 2009.

Many industry participants are advocating for more consistency and best practices and standards for the secondary market. Not unlike credit rating agencies, the accuracy and lack of transparency of life expectancy underwriters are under fire. The diametric differences between life expectancies established by life insurers, reinsurers and for seniors seeking to sell policies should be brought into congruence. Research is needed to increase knowledge, understanding and prudent utilization of life expectancy evaluations, along with development of "best practices and standards" for life expectancy underwriters. In this regard, the secondary market still lacks a central database of research data. However, the Center for Retirement Research at Boston College ("CRR") has expressed willingness to become a confidential repository for such data enabling the secondary market to better secure standardization and uniformity among its participants. If the industry can find a way to support this effort, all industry stakeholders should realize substantial benefit.

New products entering the marketplace in 2008/2009, including Policy Value Loans and Synthetic Life Settlements, promise to continue to transform the secondary market landscape. Unlike life settlements, Policy Value Loans are permanent loans that utilize the death benefit of the policy to secure the loan, thereby allowing the policy owner to access the market value of the policy without selling the policy. Such loans concurrently seek to preserve a portion of the death benefit for beneficiaries. Policy Value Loans may or may not be regulated as life settlements, leaving some uncertainty as to the regulatory framework governing such new products.

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Synthetic life settlement contracts are of two types: (a) individual notional insurance contracts based on a specific pool of monitored lives; and (b) hedge or swap contracts based on a longevity-linked index. In a Synthetic of the first type, an individual notional insurance contract is engineered and priced to emulate an actual life insurance policy having similar fundamental terms. The purchaser of such a contract pays the agreed premiums until the underlying life dies at which time the issuer pays the notional death benefit. In a Synthetic of the second type, a hedge or swap contract, a speculator agrees to pay a spread, i.e., a quantity times an outstanding notional amount, and a life settlement portfolio investor agrees to pay an amount based on the product of the percentage of deaths in the mortality index pool upon settlement of the swap and the notional amount. If mortality is greater than expected, the speculator benefits, but in the event mortalities are lower than expected, the investor benefits. Based on the announcement by New York Governor Patterson that all derivatives and swaps involving an "insurance" element will be regulated by the New York Insurance Commissioner, it should be expected that Synthetics and related hedges and swaps will be regulated in 2009.[2]

In conclusion, while the secondary market continues to address ongoing regulatory and structural issues in 2009, investor demand for stable and predictable assets continues to expand, and seniors, concurrently, seek increased liquidity to fund retirement. As we progress into 2009, all of the complexities facing the life insurance industry and secondary markets make one thing very clear: these industries will have to be nimble, thoughtful, and adaptive in their responses to challenges. But the end goal – to provide beneficial products to seniors, investors, market participants, and shareholders – remains compelling.

Transition: 2008 Prosperity to 2009 Recession

One year ago, Insurance Studies Institute published its first annual report on the Life Settlements Industry, "Understanding Life Settlements and Industry Issues Entering 2008." That publication served as a baseline account of the secondary market of life insurance's history, evolution, and its successes and challenges to date. The report helped to define the process, the participants, and the economic and social impacts resulting from the secondary market of life insurance policies. Various issues were highlighted that remain in the spotlight today, including: taxation, regulation, STOLI concerns, insurer responses, life settlement product alternatives, consumer awareness/education, and questions of insurable interest and insurable capacity. Moving forward, it is clear that 2008's economic meltdown will add further dimensions of difficulty to some aspects of the industry, but there is potential for opportunity in the midst of this quandary as well.

As we enter 2009, the recession and continuing credit crisis consumes our national consciousness. The ramifications of lost jobs, lost homes, and lost savings have shaken everyone, but perhaps no one more so than seniors in retirement and baby boomers on the threshold of retirement.

The baby boomer generation, 77 million strong, was behind the eight-ball in retirement planning long before the floor fell out of the economy. Blessed with longevity but lacking pensions, this group made a stab at saving through 401K's and mutual funds, but now is forced to watch, helplessly, as those funds lose value. Without income, savings or cash, these seniors are poised for a dramatic decline in their standard of living upon retirement and threaten to crush Social

[2] NAIC (website), News Release: *AIG: Regulators Inform Congress of Strength of State Oversight,* Washington, D.C., October 7, 2008, http://www.naic.org/Releases/2008_docs/aig_oversight.htm.

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Security.[3] This group is now left to wonder if retirement is even a viable option in the near term, and if it isn't, how will they find needed liquidity?

As concerns retired and retiring seniors, a recent CNNMoney.com article by staff writer Les Christie noted that "Over half of senior citizens say they are either postponing retirement or planning to return to work due to the economic crisis, according to a survey released by Golden Gateway Financial." Based on a poll of 800 homeowners over the age of sixty-five, 31% said that they are staying on the job longer due to their shrinking retirement funds, while another 22% plan to return to the workforce. Additionally, the study reports that 12% of seniors in search of liquidity are taking out home equity loans or are seeking reverse mortgages, and another 13% are currently trying to sell their homes.[4]

Many seniors will turn to their life insurance policies for relief. Some will seek conventional policy cash-value loans, and a lucky few may qualify for Policy Value Loans structured by their insurance carrier or other third-party finance firms. Conning Research & Consulting notes in its "Life Settlements: New Challenges to Growth 2008" that life insurer data suggests growth in the amount of outstanding policy loans from $113.5 billion in 2007 to over $115.5 billion in 2008.[5] This is evidence that policyholders are seeking more liquidity from their life insurance policies. And many seniors will employ a "cash conservation" strategy to reduce premium payments, lapse their policies, or surrender their policies for whatever cash value is available, which may be well below its full market value. However, the sale of a life insurance policy on the secondary market, known as a "life settlement," may be the better way for these seniors to realize the maximum inherent value from their policies.

The secondary market of life insurance provides a great social and economic value to seniors. For example, as reported in a new 2008 publication, "Tools and Techniques for Life Settlements," by The National Underwriter Company, the present value of a $1,000,000 policy sold as a life settlement including using the proceeds for personal living was over $378,000, versus a cash surrender value of $103,000. In addition, the present value of premiums saved from continuation of the policy was over $260,000. These total to over $638,000 present value to the 76 year old insured male having a life expectancy of 9.6 years. Concurrently, life settlement industry operators are estimated to earn approximately $40,000 present value and the investor is targeting approximately $180,000 net present value. All of this adds up to healthy economic and social value to the policy seller, industry operators and investors, plus it provides tax revenues to states and U.S. Treasury that would not occur if the policy were lapsed, surrendered or held to maturity by the policyholder.

The primary purpose of life insurance is to insure a risk, e.g., economic needs of survivors, paying off debt, business succession, etc. But when these needs are otherwise satisfied, the insurance becomes unneeded at which time continuation of the policy can only be justified as an investment. The value of such an investment is:

- The present value of the future policy death benefit less the present value of future premiums paid, or
- The policy cash surrender value, or

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[3] Americans for a Secure Retirement, *A Steady Paycheck for Life,* 2007, http://www.paycheckforlife.org/solution.

[4] Les Christie, *Seniors Face Grim Choices Amid Market Shock*, December 9, 2008, http://money.cnn.com/2008/12/08/real_estate/seniors_face_grim_news/index.htm.

[5] Conning Research & Consulting, Inc., *Life Settlements: New challenges to Growth,* 2008.

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- The market value of selling the policy.

Determining the most appropriate way to monetize life insurance policy value remains a fundamental challenge for all policyholders, and general market developments as we enter 2009 are expected to make it even more difficult.

Life Settlement Market Continues Its Strength Entering 2009

Estimates of the total face value of life settlement transactions in 2007 in the U.S. range from $12.2 billion[6] to $15 billion.[7] Conning estimates the annual face amount of life settlements will grow from $12.2 billion in 2007 to approximately $21 billion in 2012 (11.5% annual growth), and in the subsequent 5 years grow to $31 billion annually, a slower annual rate of 8.2%.[8]

Conning measures life settlement market maturity as the relationships between (a) Gross Market Potential (total face amount of all in-force policies that meet life settlement investor criteria); (b) Net Market Potential (total face amount of all in-force policies that policyholders desire to sell); and (c) In Force Amount (the cumulative face amount of all life settlements where the insured is still alive). Conning notes that unless Gross Market Potential or Net Market Potential is growing as fast if not faster than the In Force Amount the result will be slower growth.[9] However, these measures are not currently tracked within the industry and as such, the absolute magnitude of these measures are not accurately known. Thus no one knows if the senior market for life settlements is anywhere near maturity or only scratched. Further, these measures are subject to many variables including investor funding and criteria, regulations, senior awareness, seniors' need for liquidity, alternative investment opportunities, longevity resulting from improved health care, etc. But one aspect seems certain: as investor criteria expands to longer life expectancies, smaller policies and modified settlement structures, the market will expand.

Conning notes that "2007 represents the strongest annual growth since 2005 driven by: (a) increased consumer demand due to financial turmoil and awareness; (b) increasing tertiary market settlements; and (c) lower investor criteria expanding the market."[10] Countering these positive factors are three issues: (1) development of insurance industry alternatives to life settlements; (2) tighter credit markets reducing the ability of some investors to acquire and finance portfolios; and (3) the realization among investors that life expectancy estimates on some early life settlement transactions were incorrect, resulting in lower returns and investor disappointment. However, Conning notes that these may be positive developments for the life settlement industry in that:

- The development of life settlement alternatives by life insurers signals the recognition by the insurance industry that consumers want alternatives to traditional lapses or cash surrenders.
- Increasing awareness among policy owners that life insurance is a financial asset offering economic value other than death benefits.
- Tighter credit markets should lead to stronger capitalized providers and investors.
- Incorrect life expectancies have already led to improved underwriting and policy valuation by investors and service providers.

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[6] Conning Research & Consulting, Inc., *Life Settlements: New challenges to Growth,* 2008.

[7] Estimated by Doug Head at Life Insurance Settlement Association (LISA).

[8] Conning Research & Consulting, Inc., *Life Settlements: New challenges to Growth,* 2008.

[9] Ibid.

[10] Conning, 2008.

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Capital Market Issues and Federal Involvement Impact Life Insurers

The credit issues in 2008 have caused an overall retrenchment of capital that includes the secondary market for life insurance, even though the non-correlation of insurance backed investment structures has kept them among the more desirable asset classes. In spite of reduced credit costs, lenders cut back loans as reinsurer credit ratings suffered and turmoil in the capital markets was evaluated. Then in October, 2008, the credit crisis became so acute that virtually all lending ceased. Lenders and investors reassessed business models, investment criteria, and asset classes in their entirety. Fortunately, the secondary market of life insurance has surfaced among the more desired investments for several reasons:

- Non-correlated returns, except for costs of capital
- Steady returns
- Predictable liquidity events, and
- Understandable and measureable risks

The overall retrenchment of capital available to participate in the secondary life insurance market resulted in a "buyers" market in late 2008, continuing into 2009. Higher IRRs are being reported, up to 16%, and consequently lower policy prices are favoring investors. This is a material change from the market pricing experienced in 2006 and 2007, where IRRs were reported at the 8% to 11% range, with higher policy pricing that favored policy sellers.

A new dimension of the credit crisis that emerged in 2008 is the overall market's impact on life insurer credit ratings. Credit-rating agencies who analyze the risk of companies that issue bonds and other financial instruments have been under intense fire for failing to provide advance warning to investors about the U.S. subprime-mortgage meltdown. In today's world of structured finance, credit rating agencies have become an integral part of the securitization process. However, credit rating agencies are being criticized for providing investment-grade ratings to firms that hold material amounts of sub-prime assets. The failure of credit rating agencies to serve institutional investors has caused, and continues to cause, a crisis of confidence in all asset based lending and securitization industries.

Citing the enormity of this failure, the European Commission's response has been to propose legislation that would subject the credit rating agencies to new restrictions, increased regulatory oversight, and penalties for infractions. In addition, the credit rating agencies will be required to publish an annual report detailing the accuracy of their opinions along with assurances against conflicts of interest.[11]

The NAIC has also disclosed plans to establish their own agency. It is possible that a new NAIC Nationally Recognized Statistical Rating Organization ("NRSRO") could be in place by the first quarter 2009. However, NAIC representatives say the rating agency concept is unrelated to the current global financial crisis. The purpose of the NRSRO is to provide ratings independent of Moody's Investors Service, Fitch Ratings, Standard & Poor's Corporation and others. [12]

Following the federal $85 billion bailout of AIG on September 16, 2008, the U.S. Treasury Department gave authorization in November, 2008 for the inclusion of life insurers in the Troubled Asset Relief Program ("TARP"). The Treasury stated that insurance companies linked to a federal regulatory entity, such as a bank holding company or thrift, could participate in TARP. However,

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[11] Adam Cohen, *Europe Would Boost Oversight, Penalties,* Wall Street Journal, November 13, 2008.

[12] NCOIL Newsletter, November 2008, www.ncoil.org.

money made available to insurance carriers through the federal government will not come free of scrutiny as federal legislators on Capitol Hill may now insist on a much larger say in how these companies are regulated.[13]

Moves to federally regulate insurance entities would add formal support for those in favor of a federal life insurance charter, a move the NAIC and state-based regulatory bodies oppose. In an October 6, 2008 letter from Sandy Praeger, Kansas Commissioner of Insurance and President of NAIC, addressed to Henry Waxman (Rep.), Chairman, Committee on Oversight and Government Reform, Ms. Praeger stated:

> It is also imperative that any legislative actions resulting from these important hearings build upon, and not undermine, the expertise and strengths of State insurance regulators. Even if the conservative accounting and solvency requirements of State regulation had not been sufficient to protect the AIG insurers and they became insolvent, covered policyholders would have remained protected up to specified limits by the State network of guaranty funds. While the AIG insurance businesses and their State regulators were not part of the problem, they will be a key part of the solution. If the proposed optional Federal charter (OFC) for insurers had existed, and some or all of AIG's insurance companies had chosen that Federal charter, the problems at the AIG holding company would still have fallen outside the jurisdiction of that Federal insurance regulator. Supporters of the OFC proposal routinely cite their desire to have a system akin to the banking system, which is the very model that has led to the problems taxpayers must now bail out.[14]

In testimony to the U.S. House of Representatives Committee on Oversight and Government Reform hearing on "The Causes and Effects of The AIG Bailout," New York State Insurance Superintendent, Mr. Dinallo stated:

> I am open to some federal role in regulating insurance and the non-insurance operations of large financial services groups such as AIG. But what happened at AIG demonstrates the strength and effectiveness of state insurance regulation, not the opposite.[15]

However, proponents of an Optional Federal Charter ("OFC") believe a federal regulatory scheme will remove regulatory blind spots of the state-based system and establish consistent national regulation capable of better overseeing insurers operating in the global marketplace.[16]

State versus federal regulation of insurance carriers has mixed appeal for participants in the secondary market of life insurance. Dealing with licensing and regulatory requirements in compliance with many different states is costly, while operation under one set of federal regulations could be more efficient. However, one has to question if federal regulation would provide more or less protection to policyholders. For example, would federal regulators be easier, or more difficult, to work with; and, might a federal regulatory system become captive to life insurers which have opposed consumer freedom with respect to financing and sale of their policies? These questions are significant to the secondary market of life insurance as the

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[13] Leslie Scism, Michael Crittenden, Matthew Karitschnig, & Matthias Rieker, *Insurers Buy Banks in Effort to Get Aid,* Wall Street Journal, November 17, 2008.

[14] NAIC (website), News Release: *AIG: Regulators Inform Congress of Strength of State Oversight,* Washington, D.C., October 7, 2008, http://www.naic.org/Releases/2008_docs/aig_oversight.htm.

[15] Ibid.

[16] John Sununu, Tim Johnson, Melissa Bean, Ed Royce, *Insurance Companies Need a Federal Regulator*, Wall Street Journal, September 23, 2008.

proponents and opponents of state and federal regulatory frameworks argue their respective positions.

Insurer Reserve Requirements Are Affected By Troubled Variable Products

With increasing market volatility in the late 1990's, consumers demanded more guarantees and better returns in their insurance and annuity products. The insurance industry responded with creative variable products offering complex guarantees in both insurance and annuity contracts. Variable annuities and variable life insurance have two components: (1) a guaranteed benefit; and (2) a performance-based, variable investment return. Insurers are obligated to pay guaranteed benefits regardless of financial conditions or market trends. Performance-based benefits, however, are tied to financial markets and are affected by market fluctuations. The guaranteed portions of these products, along with the premiums paid in and the purchase price, are backed by the insurers' general investment funds, i.e., the insurers assume the risks.

Of particular concern are variable annuities issued by insurers over the past decade. Although the annuity owner bears the risk for the variable investment selections, the systemic damage caused by the 2008 financial crisis raises concerns over the viability of variable annuities. Typically, variable annuities with guaranteed minimum benefits are not as sensitive to market fluctuations as equity based annuities having no guarantees because they are backed by investments in insurer's conservatively invested assets. However, there are growing concerns that if the current stock market doesn't recover quickly in 2009 and losses continue to mount, insurer reserves for variable annuities may not be sufficient to cover the guaranteed benefits. Should this happen, insurers' general funds will have to cover the difference. Goldman Sachs analysts estimate that the insurance industry could face a $50 billion liability from guaranteed minimum income benefits associated with some variable products.[17] According to SmartMoney Magazine, variable annuities represent $1.5 trillion in invested capital, and analysts say the bigger that figure gets, the riskier the industry becomes. [18]

The magnitude of variable reserve requirements directly affects insurer capital requirements and consequently their credit ratings.

Lower Capital Requirements for Insurers Are Being Proposed

State regulators, along with the ACLI, have been considering adopting regulation that will lower the capital requirements for life insurance carriers. While this move could provide some relief to the battered insurance industry, it could also raise concerns over consumer protection. Such a move increases concern among secondary market investors as to valuation of life insurance policy portfolios and the ultimate payment of death benefits, by putting the claims paying ability of insurance carriers at risk. Insurance industry representatives claim that current reserve requirements are too conservative and unrealistic for today's market conditions. Contrast to this, in a Wall Street Journal article, Rosemarie Mirabella, an analyst at A.M. Best, cautioned the industry and regulators against loosening reserves because "We think there is going to be much more downward pressure on earnings, and part of that is on the variable annuity side."[19] (See discussion above regarding variable products.)

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[17] Alistair Barr, *Hartford Shares Give Back Friday's Gains and More*, Market Watch, November 17, 2008.
[18] Janet Paskin, *Variable Annuities Spell Fuzzy Math to Some*, SmartMoney Magazine, June 30, 2008.
[19] Leslie Scism, *Insurers Cash Rules May Loosen*, Wall Street Journal, November 14, 2008.

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Based on the current formula-based reserving methodology for assessing the guarantee liability, insurers are required to assume that their equity holdings will drop 20% from the value on the last day of the year and will recover only 3% annually.[20] Normally, this does not have much of an impact because changes in the market occur gradually over time; but given the state of the current market, this could be detrimental to insurance carriers due to the stock market's recent severe drop in value. This position is further complicated because insurers are not allowed to account for hedging techniques when calculating reserve requirements.

Formula-based reserving approach applies the same methodology to each situation, while the alternatively proposed principle-based approach uses assumptions to create stochastic simulations that should, theoretically, provide a better measure to set capital reserve requirements for products. Proponents of principle-based reserving argue that the formula-driven methodology, which has been used by U.S. regulators for several decades, worked well when products and risks were relatively consistent but is out-of-date for the vast array of products offered today. They argue that the formula-based approach fails to properly capture the underlying risks for a vast universe of products, especially products that offer guaranteed benefits, resulting in inconsistencies in the way reserves requirements are assessed. These proponents further claim some new products exploit loopholes in the formula-based methodology to reduce reserves while excessive capital reserves are required for other product designs.[21]

Milliman, Inc., a leading provider of actuarial consulting services to the life insurance industry announced its support of efforts to develop a principle-based valuation framework. Bradley Smith, Chairman of Milliman stated, "As the current state of the economy illustrates, there are times when the nation's insurers require access to the capital markets. Overly conservative and prescriptive standards for statutory-based reserves, asset valuations, and capital requirements serve only to drive additional capital away from the affected industries, seriously impairing insurers' ability to operate effectively in the best interest of their policyholders."[22] Milliman's director of Life Insurance Consulting, Bruce Winterhof, further added "If the current standards are not changed to realistically represent the underlying, sustaining strengths of the business, then counterproductive regulatory hurdles may ensue, which will hurt the policyholders of affected companies as well as shareholders and employees."[23]

Despite strong support for the proposed principle-based reserving, there are those in the industry who question the practice of reducing capital requirements. In July of 2008 Fitch Ratings ("Fitch") issued a statement expressing concern with changes to reserve calculation methods. Fitch's main concern is that principle-based reserving creates the potential for fewer assets to be held in reserve, which may result in a weakened balance sheet, as well as increased volatility in earnings and capital. Further, Fitch fears that the potential lack of transparency will make evaluating reserve requirements more difficult because the process will be based on the evaluator's interpretations, which can substantially vary, leading to inconsistent results. Fitch's Managing Director, Douglas Meyer, states that "From a philosophical standpoint, principle-based reserves make sense.

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[20] Leslie Scism, *Insurers Cash Rules May Loosen*, Wall Street Journal, November 14, 2008.

[21] Elinor Friedman, Hubert Mueller, *A Principles-Based Reserves and Capital Standard*, Emphasis, March 2006.

[22] Press Release, *Milliman Advocates Reasonable Valuation and Capital Standards*, Milliman Inc., November 25, 2008.

[23] Ibid.

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However, we have significant concerns about the potential impact on the insurers' balance sheet and lack of transparency and difficulty evaluating reserving approaches between companies."[24]

At this point, the sides are divided. Most agree that a change in the way reserve requirements are assessed could benefit the industry without putting the consumer in jeopardy. However, many are concerned that this change could be exploited and lead to excessive risk taking when assessing the amount of capital to hold in reserve. The message out of Washington D.C. is that politicians will gravitate towards more, not less, regulation of financial entities. Thus, in the face of the current regulatory climate, the fight for modified capital requirements will be heavily balanced against the need for continued liquidity stimulus and reform for critical financial services industries.

One aspect of insurer ratings seems clear, i.e., the consistency and accuracy of life insurer credit ratings directly affect valuation of life insurance policies in the secondary market and correspondingly the expected returns demanded by investors.

2008 and 2009 Legislative Developments

State legislative and regulatory activity in 2008 focused almost entirely on "stranger *originated* life insurance" which has been deemed illegal in most states. The question must be asked: Why? Long before the current focus and legislative activity, the law of the land in all states has been, strangers having no "insurable interest" in the life of an insured, and anyone who arranges to own a new life insurance policy issued on a stranger and having no insurable interest in the insured, are considered to be "gambling" on the life of another which is against public policy.[25] Unfortunately, the conceptual definition of STOLI has been promoted by some to include "stranger *owned* or *oriented* life insurance," implying that all policies owned by investors are in violation of the law. This expansive conceptual definition of STOLI conflicts with the same well established law in which life insurance is deemed property and which insurable interest in the insured is not avoided with the transfer to a stranger.[26]

In 2008, ten states adopted legislation applicable to regulation of the secondary market of life insurance and another eighteen considered legislation but did not adopt a law. Upon entering 2009, twenty-two states have comprehensive regulatory frameworks adopted, twelve states regulate viatical settlements only for terminally ill insured, one state (Arizona) regulates against STOLI transactions only, and nine states have yet to adopt any regulatory framework.

In late 2008, California passed and submitted comprehensive legislation to Governor Schwarzenegger who vetoed the bill. In New York, regulators, industry participants, and legislators devoted substantial effort to drafting legislation but it also failed to get passed. In 2009, the industry as a whole will be watching both California and New York for leading legislation. It is expected that thirty states will consider viatical/life settlement legislation in 2009, again focused mostly on STOLI related transactions and insurable interest issues.

The various legislative positions of industry participants are becoming fairly well established in the form of legislation being proposed across the country. "The American Council of Life Insurers ("ACLI") has asserted that they will offer legislation in every state. The Life Insurance Settlement Association ("LISA") believes that this plan will yield to reality eventually. The National

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[24] Press Release, *Fitch Report: Principle-Based Reserves – Credit Implementations Mixed*, Fitch Ratings, July 15, 2008.

[25] *Grigsby v. Russell*, 222 U.S. 149 (1911).

[26] Ibid.

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Association of Insurance Commissioners ("NAIC") has split, and they are going their own way, state by state. The National Council of Insurance Legislators ("NCOIL") will push legislation in a few select states. LISA will support legislation modeled on the California bill and/or a revised and improved version of the NCOIL Model. LISA will oppose legislation modeled on the NAIC proposal."[27]

In concert with this legislative activity are new federal court decisions on matters of insurable interest and STOLI related transactions. One such case of particular significance was rendered on December 3, 2008 by the United States District Court, State of Minnesota in *Sun Life v. Paulson*.[28] In this case, the Court ruled in favor of the defendant Paulson and against the plaintiff Sun Life, effectively holding that: Hard evidence of intent to sell a policy at the time the policy is issued is required to show that the parties did not have legal insurable interest. The following states the essence of the case and its conclusion:

> Sun Life had no evidence that Coventry, Atticus or Orca communicated with Paulson prior or contemporaneous with his procurement of the disputed policies or that any of the companies paid the policies' premiums. Sun Life argued that the identity of the third party buyer is unnecessary to establish mutual intent because evidence of Paulson's intent to sell the policies permits an inference that another party intended to buy the policies at the time they were issued. However, the law in this case requires evidence of intent of a third party to buy the policies at the time they were procured, which necessarily requires identification of that party. Sun Life also argued that evidence of Paulson's agreement with Antonello and Petracek to help Paulson obtain and transfer the disputed policies satisfied the mutual intent requirement. But no evidence supported such an agreement with Antonello and Petracek.[29]

The court's ruling in *Sun Life v. Paulson* makes it more difficult for insurers to void policies based on financing transactions that lead to a sale of the policy. The concept of "intent" has to be substantiated by tangible evidence, not just coincidence of circumstance. This holding also makes it more difficult for insurers and regulators to control STOLI transactions. Based on this ruling, there may be an increased effort by states to more carefully define laws applicable to STOLI and other financing transactions.

Industry Best Practices and Standards Are Needed

Many industry participants argue that practitioners within the secondary market of life insurance lack consistency and transparency in their practices and standards. Furthermore, many operators and investors express desire for "best practices and standards" to be established across the industry. After months of extensive work, in November 2008, LISA, in cooperation with its members, responded with the release of a draft "Life Settlement Transaction Checklist" (broker/producer checklist) which is available to LISA members on the LISA website."[30] While LISA does not represent this checklist to be part of an effort to establish "best practices and standards," it does start the process of industry operators working together to establish consistencies in the broker/producer realm.

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[27] Life Insurance Settlement Association (website) 2008, LISA, Orlando, FL., viewed November 30, 2008, http://www.thevoiceoftheindustry.com/.

[28] *Sun Life Assurance Company of Canada v. John R. Paulson*, 0:2007cv03877, (U.S. District of Minn. 2008).

[29] Ibid.

[30] Life Insurance Settlement Association (website), 2008.

In a further development towards best practices and standards The National Underwriter Company, Inc. published the first comprehensive book on life settlements in November 2008: "Tools and Techniques for Life Settlement Planning." This treatise covers nearly every aspect of life settlements and furthers the industry towards the establishment of best practices and standards.

The need for best practices and standards is substantially evident within the practices of life expectancy medical underwriters. The continuing accuracy of life expectancy estimating is under fire. Investors and providers are demanding more accurate and comprehensive reports, as well as transparency to underlying methodologies. In October 2008, medical underwriter 21st Services changed its underwriting methodology which increased its life expectancy estimates by 20-30%. In November 2008, American Viatical Services ("AVS") changed its underwriting methodologies which increased its life expectancy estimates by 5-25%. In May, 2008, Fasano and Associates released the Fasano 2008 Mortality Tables which varied the shape of the mortality curve depending on the overall mortality rating of the case. Fasano also implemented formulaic debit adjustments at the older ages (75 & up) to adjust for the sharp increase in the slope of the mortality curve at the higher ages. The impact of the Fasano changes was believed to extend life expectancies, on average, by about 2%. And finally, in January 2009, ISC announced it had changed its underwriting methodology resulting in some changes to its life expectancy estimates.

The issue of life expectancy adjustments and its impact on the secondary market for life insurance policies was recently addressed by Matt Brady in an article titled **"**How Will Longer Life Expectancy Estimates Impact Settlements?"[31] This piece appeared in "Settlement Watch," published by National Underwriter:

> Michael Fasano, president of Fasano Associates, a Washington D.C. based underwriting firm, stated that "clearly it's had a chilling effect" on the market, and is one of the reasons for the turmoil being seen in the life settlement industry. Michael Coben, senior vice president of national distribution at Coventry, Fort Washington, Pa., says the changes could have a "significant impact." Fasano says he expects one form of transaction—those involving financed policies sold not long after the 2-year contestability period has ended—will fade away entirely. Fasano further noted: One of the contributing factors to inaccurately short life expectancy estimates, has been "an unhealthy misalignment of interests" in which brokers and providers put a top priority on a policy's price and the ability to complete more transactions. "There has been some shopping for short life expectancy estimates," he said. As a result, significant discrepancies had existed among medical underwriters, as much as 25% to 30%. This, Fasano notes, "scares off a lot of capital."[32]

The secondary market is supported by investors who place substantial reliance on the accuracy of life expectancies provided by medical underwriters Fasano, AVS, 21st Services, and ISC. While longevity risk involves variation between the expected and actual date of death, underwriter risk involves the ability to accurately estimate the life expectancy. Longevity risk can be diminished and hedged, underwriter risk cannot. A flawed approach by medical underwriters can be systematically replicated across an entire portfolio of insured.

Fasano Associates ("Fasano") requested the Institut für Finanz- und Aktuarwissenschaften to conduct a study of the mortality experience of insureds underwritten by Fasano since its inception, and this work was completed in April 2007.[33] In preparing the analysis, a number of adjustments were made: (a) files reviewed multiple times in the same year were taken out of the study; (b) files

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[31] Matt Brady, *How Will Longer Life Expectancy Estimates Impact Settlements?,* Settlement Watch, by National Underwriter Company, December 3, 2008.

[32] Ibid.

[33] The confidential report is available from Fasano upon request.

with unverifiable SSN or DOB or DOD discrepancies were eliminated from the study; and (c) claims were adjusted to include deaths estimated to have been incurred but not yet reported. In addition, Fasano fitted a mortality probability curve to each given life expectancy using a multiple of a standard mortality table and adjusted the multiple such that the life expectancy resulting from the curve coincided with the Fasano life expectancy.

Other life expectancy underwriting firms also produce analyses of mortality experience, making their own assumptions and adjustments. The issue is not whether the Fasano methods are better than others' assumptions and adjustments, but to call attention to the need for consistency and full disclosure of methods and assumptions used to enable all such reports to be comparable.

21st Services, another major life expectancy underwriting firm, publishes it performance reports on its website. The format and representations in the 21st reports have changed over the past several years. Clearly, the methodology used by 21st differs from that used by Fasano, and "21st Services believes that no single actual to expected statistic can properly capture the performance of life expectancy providers." [34]

Deutsche Bank, Goldman Sachs Group, Credit Suisse and others have established systems for hedging and trading of synthetic life insurance contracts based on pools of insured data, but the life expectancy data and individual life expectancy estimating practices are not transparent.

The concern of mortality considerations, life expectancy accuracy, and the wide variety of methodologies and practices has been noted by many leaders and analysts in the insurance and life settlement industries. The following several excerpts highlight the concern of many industry leaders and imply a call for "best practices and standards" to be developed by life expectancy estimators both in the insurance and annuity industry and the life settlement industry:

1. In March, 2008, Ed Mahoric, Milliman, USA, and Robert Kinney, Phoenix Life Solutions noted numerous variations and concerns of life expectancy estimators in their report, Life Settlement Mortality Considerations and Their Affect On Portfolio Valuation, March 1, 2008.

2. At the 2007 conference, US Life Settlements, It's All About Curves, Cordares Capital noted: "As regards medical underwriter reporting, not all provide the mortality table used for the insured."

3. DBRS, a full-service credit rating agency noted in its February, 2008 report, Rating U.S. Life Settlement Securitizations: "While there is no requirement that files contain medical information covering a certain length of time, life expectancy calculations from multiple and independent medical underwriters are necessary to abate the risk of an incorrect life expectancy calculation and should generally be no more than 12 months old."

4. Best's Rating Methodology noted in its March 24, 2008 report, Life Settlement Securitization, March 24, 2008: "Growth of life settlement securitization will depend on increased clarity and standardization of the general methods for predicting life expectancies (including release of data on the performance of medical examiners."

5. Conning Research & Consulting noted in Life Settlements New Challenges to Growth, 2008: "While the process of assigning debits and credits seems straightforward, underwriters develop their own variations. One of the ways investors are responding to the challenge of calculating life expectancies is "by increasing emphasis on the risks of inaccurate underwriting."

In addition, there appear to be diametric differences between life expectancies established for insurance carriers, reinsurers and seniors seeking to sell policies, which should be brought into

[34] 21st Services (website) 2008, 21st Services, Minneapolis, Minnesota, viewed December 5, 2008, http://www.21stservices.com.

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congruence. In order to achieve this, greater and understandable transparency is needed. Reinsurers and investors are investing billions of dollars in insurance policies in the secondary market, and the current capital market turmoil underscores the need for more understandable, accurate and consistent estimates of life expectancies. Research needs to be supported to increase knowledge, understanding and prudent utilization of life expectancy evaluations, along with development of best practices and standards for life expectancy underwriters.

As further regards best practices and standards, the secondary market still lacks a central data repository. While proprietary protection of data has to be respected, the industry is hurting itself by not engaging in a central repository of transaction information. Such information adds greater credibility among regulators, consumers and investors, and research becomes more accurate and contributes greater knowledge that benefits all. Insurance Studies Institute ("ISI") has been working with the Center for Retirement Research at Boston College ("CRR") to research the benefits that a market for life settlements offers to current and prospective policyholders. Through this project, ISI has approached CRR with the concept of becoming a confidential repository for such data. While CRR has expressed some willingness in the repository project, such project will be beneficial only if there is widespread industry acceptance of such a project. If the industry can find a way to support this effort, all industry stakeholders would realize substantial benefit.

Policy Value Loans Debut in 2009

Historically, life insurance policyholders seeking relief from further premium payments had two choices: (1) stop paying premiums and allow the policy lapse; or (2) surrendering the policy for its net cash surrender value. In recent years, the secondary market for life insurance policies provided a third option for policyholders by selling the policy in a viatical or life settlement transaction. Now, a fourth option for policyholders appears to be emerging in the secondary market for seniors: the "Policy Value Loan."

A Policy Value Loan utilizes the death benefit amount (the face value of the policy) as collateral, thereby allowing for substantial access to the full market value of the policy. Such loans also seek to preserve a portion of the death benefit for beneficiaries. This is a unique product, much different in structure and purpose than conventional cash-value loans and accelerated death benefit loans, which are provided by the policy insurers based on specific terms written into policies.

The concept of loans collateralized by policy death benefits is not new. Traditional commercial bank financing for businesses often requires life insurance policy death benefits to be assigned as collateral to secure the loans. Premium finance arrangements have been structured such that the premium loans are collateralized with policy death benefits. And there have been efforts to consider life insurance loans secured by death benefits that emulate reverse mortgages. However, ISI is aware of only two entities that currently offer true Policy Value Loans to life insurance policyholders:

- New York Life's "Access Plus" became available in 2006, and leans more towards the "accelerated benefit" philosophy: it is offered only to NYL policyholders; the insured must be at least 65 years of age; in grave health; and have a policy death benefit of $250,000+ that has been in force for two or more years.[35]

[35] New York Life Insurance Company, *Access Plus: A Policy Preservation Program*, New York, NY., May 2007.

- Legacy Funding's "LegacyLoan," set for rollout in the first quarter of 2009, is individually constructed to meet the specific objectives of policyholders and investors, and does not require that the insured be in terminal health. The structure always preserves a minimum of 10% of the policy's face amount for the policyholder beneficiaries. The plan may involve simple premium financing, an upfront cash advance plus premium financing, or an ongoing stream of monthly advances for retirement income plus premium financing.[36]

The Policy Value Loan, similar to a life settlement, enables the policyholder to tap the full market value of their life insurance policy. However, a Policy Value Loan, unlike a life settlement, does not result in a transfer of the ownership of the policy and the transaction is reversible with repayment of the loan. The LegacyLoan is such a new offering, it is not possible to predict its growth trajectory, or to forecast its ultimate impact on life settlements. Though it seems life settlements and Policy Value Loans might compete for consumer interest, it could be argued that as policyholders become more educated about the equity within their life insurance policies, they will come to understand and appreciate the expanding choices available for accessing that value – and *both* options will gain from this exposure. Accordingly, the impact of this product innovation on life insurers also cannot be predicted at this early stage. The ultimate goal of such loans is to preserve the policy to its maturity (just like life settlements); however, it seems life insurers are showing interest in investing in such loans. Regardless of whether life settlements and Policy Value Loans compete, and/or competitive loan programs are offered, the consumer is likely to benefit.

Life Settlement Hedging and Synthetics Should Expect Regulation

Are synthetic life settlement contracts good or bad for the life insurance secondary market? There are two fundamental types of synthetic life settlement contracts:

1. **Individual Notional Insurance Contract:** Such contracts are not real life insurance contracts, but are economic contracts tied to someone's actual life expectancy. The contract issuer supposedly is the only party that knows the identity of the underlying life which is selected from a pool of monitored lives. The contract is engineered and priced to emulate actual life insurance policies having similar fundamental terms. The purchaser of a synthetic policy pays the agreed premiums until the underlying life dies at which time the purchaser collects the notional death benefit, or until such time the purchaser otherwise trades the synthetic policy away. Clearly, this is a wager contract written on a specific underlying life because there is no financial or other interest connected to the underlying life. But, because there is no actual "life insurance" policy issued, the issuers of these wagers claim they are exempt from the 1911 Supreme Court decision, which states "A contract of insurance upon a life in which the insured has no interest is a pure wager that gives the insured a sinister counter interest in having the life come to an end." [37]

2. **Longevity Index Linked Contracts:** Such contracts are based on a longevity-linked index that enables market participants to hedge or gain exposure to longevity and mortality risk. Here are several examples:
   - A Fixed Payer (a market maker or speculator) agrees to pay a spread, i.e., a quantity times an outstanding notional amount, and (b) A Fixed Receiver (life settlement portfolio) agrees to pay an amount based on the product of the percentage of death in the mortality index pool upon settlement of the swap and the notional amount. If mortality is greater than expected, the Fixed Payer benefits as the amounts paid by the Fixed Receiver will increase relative to the amounts the Fixed Payer has agreed to pay. In the event mortalities are lower-than-expected, the Fixed Receiver benefits as the amounts paid to the Fixed Payer will be smaller relative to the amounts the Fixed Receiver receives.
   - For an investor in life settlements with an interest in hedging its exposure to an increase in longevity, i.e., a decrease in mortality, entering into a swap as a Fixed Receiver can serve to partially reduce such exposure. As

[36] Larry Fondren, Founder and President of Legacy Funding Group, Inc., Email Interviews, December 3 – 14, 2008.

[37] *Grigsby*, 222 U.S. 149.

the life settlements portfolio decreases in value with increasing longevities, the investor's index position increases in value as the expected receipts should outweigh expected additional premium payments.

Synthetics, hedges, options, and swaps have been offered by Goldman Sachs, Swiss Re, Credit Swiss, Deutsche Bank and ICAP Capital Markets.

Synthetic structures and hedges operate much like "credit default swaps" and are technically "derivatives," which are now suspect relative to the current capital and credit market turmoil. In an October 26, 2008 interview by Steve Kroft on 60 Minutes, several experts made these comments about derivatives:[38]

- Warren Buffet once called credit derivatives or credit default swaps, "financial weapons of mass destruction."
- Frank Partnov, law professor at University of San Diego, explained, "A derivative is a financial instrument whose value is based on something else. It's basically a side bet. They are essentially private insurance contracts that pay off if the investment goes bad, but you don't have to actually own the investment to collect on the insurance."
- Eric Dinallo, insurance superintendent for New York State, says credit default swaps have been totally unregulated and that big banks and investment houses that sell them do not have to set aside any money to cover potential losses to pay off their bets. Three of the nation's largest financial institutions, Bear Sterns, Lehman Brothers and AIG, made more bad bets than they could afford to pay off. "It's legalized gambling…with absolutely no regulatory controls." Dinallo said.

Steve Kroft explained that the vehicle that allowed this was an obscure but critical piece of federal legislation called the Commodity Futures Modernization Act of 2000. The Act not only removed derivatives and credit default swaps from the purview of federal oversight, but also Congress pre-empted the states from enforcing existing gambling and bucket shop laws against Wall Street. Within eight years, unregulated derivatives and swaps helped produce the largest financial services economy the United States has known. Estimates of the market for credit default swaps grew from $100 billion to more than $50 trillion, allowing betting on anything from the solvency of communities to the fate of General Motors.

> "The credit default swaps was the key of what went wrong and what's created these enormous losses," said Harvey J. Goldschmid**,** a Commissioner at the United States Securities and Exchange Commission. "senior (management) levels only vaguely followed what was going on and when it tumbled, there was some genuine surprise not only at the board level where there wasn't enough oversight but at senior management level."[39]

Mr. Dinallo further noted (see above reference to testimony to the United States House of Representatives Committee on Oversight and Government Reform):[40]

> In an interview with the New York Times, (NY) Governor Paterson called credit default swaps "gambling" and noted that they were a major cause of AIG's problems. He told the paper that "when we peeled back the onion, we found out that AIG had so many credit default swaps that we couldn't calculate how much money they probably had lost."

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[38] Steve Kroft, *The Bet that Blew Up Wall Street*, CBS News - 60 Minutes Segment, October 26, 2008, http://www.cbsnews.com/stories/2008/10/26/60minutes/main4546199.shtml

[39] Ibid.

[40] NAIC (website), News Release: *AIG: Regulators Inform Congress of Strength of State Oversight,* Washington, D.C., October 7, 2008, http://www.naic.org/Releases/2008_docs/aig_oversight.htm.

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> On September 22, Governor Paterson announced that New York State will, beginning in January, 2009, regulate part of the credit default swap market which has to date been unregulated. The State will regulate transactions where credit default swaps are used as "insurance" to protect the value of investments held by the purchaser. These are, both functionally and legally, financial guaranty insurance policies.
>
> Governor Paterson also called on the federal government to regulate the rest of the massive $62 trillion market, which has been a major contributor to the emerging financial crisis on Wall Street.

A synthetic life insurance policy requires "a life" on which to base it. Such life is real and its data exists in the firm's cohort pool. A question is: What mortality underwriting is undertaken when manufacturing the synthetic life policy? It is common knowledge that mortality underwriting by insurers frequently differ materially from life expectancy underwriting for life settlements. That difference is one of the material arbitrages that exist for life settlements, i.e., premiums assessed by insurers tend to be lower than if they were based on more appropriate mortality tables, which give life settlement investors opportunity to price such policies based on shorter life expectancies derived from mortality tables more fitting to seniors.

Further, if the measuring life has a life expectancy in the firm's cohort pool, how was that determined and when? How might the life expectancy of the measuring life be less vulnerable to longevity risk? The synthetic policy will not pay benefits until the actual measuring life dies. Thus the presumption is raised that the life expectancy used for the measuring life in the synthetic life settlement is more accurate than LEs used in actual life settlement contracts. If such could be true, the life expectancy underwriting firm that provided the pool of measuring lives may be operating with different standards when issuing life expectancy reports for life settlements.

Based on the structure of synthetic life settlements, and the announcement by NY Governor Patterson that all derivatives and swaps that involve an "insurance" element will be regulated by the New York Insurance Commissioner, it should be expected that the New York Insurance Commissioner will set out to regulate synthetic life settlements and related hedges.

Conclusion

The issues confronting the further development of the secondary market of life insurance provide a host of challenges and opportunities for senior policyholders, investors, regulators, and market participants.

The economic challenges facing seniors have made the further development and stability of the secondary market of life insurance increasingly important. The financial devastation of 2008 has left seniors with fewer options for successful retirement. The secondary market is a bright spot for many seniors who are often surprised to discover the significant market value of their life insurance policy compared to its surrender value. Further consumer awareness of the secondary market is needed as seniors seek financial options in order to maintain dignified lives in retirement.

For investors, despite the 2008 credit crisis, interest in the life insurance secondary market remains high for reasons of: (a) non-correlated returns except for market influence on costs of capital; (b) stability of returns; (c) predictable liquidity; and (c) understandable and measureable risks. However, investors will demand greater accuracy and consistency in life expectancy reports; more transparency into both life expectancy methodologies and underlying assets collateralizing investments; and continued regulatory framework development. Sustained investor interest is certain to generate new product innovations, such as Policy Value Loans and Synthetic Life Settlements. These products will continue to transform the secondary market landscape for

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consumers, investors, regulators and insurance carrier alike. Ultimately, the most successful product developments will be those that advance and support the secondary market of life insurance and that provide consumers with further options with respect to monetizing the full market value of their life insurance.

As states continue to adopt and amend regulatory frameworks, the focus will remain on STOLI related transactions and insurable interest issues. The implementers of these regulatory frameworks will be challenged to balance consumer protection and property rights against public policy issues related to insurable interests. With high economic stakes for consumers, government taxation, and insurance companies, legislators and regulators will be asked to make difficult but fair decisions facing the industry.

The life insurance industry will have to deal with continued pressure and concerns over federal oversight, reserve requirements, capital adequacy and external credit ratings. Providing the life industry can adequately navigate these troubled waters, the industry is likely to emerge stronger and better regulated. Moreover, with new stability of the life insurance industry, continued development of the secondary market, and enhanced options for liquidity, consumers will develop a greater appreciation for the financial significance of life insurance.

Thus, the expectation that an average $21 billion of annual face amount of life insurance policies will be settled in the secondary market in the near future is dependent upon investors continued interest and acceptance of the asset class. This interest and acceptance will be driven by investor transparency, established regulatory frameworks, stability of medical underwriting, and the continued financial health of life insurance carriers. The secondary market can help itself significantly in this regard by further adoption and adherence to consistency to best practices and standards.

Finally, while the market continues to struggle with ongoing regulatory and structural issues, investor appetite for products driven by the secondary market of life insurance continues to expand as seniors seek needed liquidity, and investors seek stable and predictable assets. As we progress into 2009, all of the complexities facing the life insurance industry and secondary markets make one thing very clear: these industries will have to be nimble, thoughtful, and adaptive in their responses to challenges. But the end goal – to provide beneficial products to seniors, investors, market participants, and shareholders – remains compelling.

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