

By Heather Lane

The Waiting Game ~ An esoteric matter of *life and death*

Investors seek diversification and want to avoid market risk. As traditional securities lose their appeal, esoteric asset classes are becoming more alluring. Life settlements, based on reselling life insurance policies, are one such product that could benefit. But the securitization markets, despite their deathly pallor, might not quite be ready to be revived by products whose risk is so hard to measure.



"Is that a better haul than you got from selling your life insurance policy, Edna?"

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The dramatic fall-off in demand for traditional vanilla asset-backed securities (ABS) such as consumer loans, credit cards and auto loans makes one lawyer's quip a fair one: "All asset-backed securities these days seem esoteric."

ABS issuance in the U.S. in the first three months of this year, at just \$50.5 billion, was a mere quarter of that issued in the same period in 2007.

The waning appeal of traditional asset-backed securities, however, is spurring interest in the so-called esoteric sector. Not that investors are jumping in. One could argue that investors are keen to get back to basics and avoid anything that includes the words esoteric or ABS, let alone a combination of the two.

But banks and ratings agencies both claim to be fielding more calls of enquiry about esoteric asset classes as investors seek diversification and investments that do not have market risk. What better than life settlements? People do not die faster or slower with market movements. But can life settlements truly be securitized?

Life settlements are life policies sold by their owners to a third party in return for a lump sum payment. That payment is lower than the face value but more than the insurance company would pay to cash it in. The sellers tend to be 75 years' old or more who are expected to live for at least

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another two years. The buyer continues to pay the premiums but collects the benefits upon the death of the insured. Typically, sellers are high net worth individuals who thus no longer need to worry about using life insurance to provide for loved ones after they pass away. Until relatively recently, though, there was hardly a market for them to sell into. The life insurance business was for a long time a monopsony: the only potential buyer was the one who sold it to you in the first place, leaving policyholders with a poor choice: accept the one and only bidder's price, or stop paying the premiums. A well-functioning life settlements market ought to improve those options.

To date securitized pools of life settlements have been minimal, unrated and carried out as private placements. In 2006, though, it seemed as if a securitized market was about to take off. Coventry First, the largest buyer of retirees' insurance policies in the U.S. teamed up with hedge fund Ritchie Capital Management to create a \$300 million securitized deal that would issue bonds off the underlying assets.

The pool reportedly had a face value of around \$1.6 billion. Several investors including large mutual funds were said to be interested. Barclays, ABN Amro, UBS and Lehman Brothers were involved in putting together the deal, and Moody's issued an indicative rating on the senior notes of A3. But a simultaneous filing against Coventry by New York State attorney general Eliot Spitzer alleg-

ing the firm had acquired insurance policies inappropriately, and the emergence of Ritchie's financial difficulties, caused Moody's to pull its rating and the deal was dropped. Coventry has since been cleared of any wrong-doing, although it does not intend to re-enter discussions on a securitized deal.

Nonetheless, the groundwork put in place for the deal has encouraged bankers that a public securitized market for life settlements is possible. "No one thought a securitization of life settlements could be done, and the fact that it came so close has offered encouragement. Almost every investment bank feels they know how to do it," says one life settlements originator. Moody's is also positive. Giyor Eiger, vice president with Moody's ABS group, says the ratings agency expects to rate one securitized life settlements-backed transaction within the next 12 months. Wishful thinking? One has to wonder.

For a securitized market to take place, the underlying pools need to be large and diversified enough to support several tranches. No one touches Coventry's size with its \$14 billion in some 6,000 life insurance policies.

Wide variation

Some market participants are convinced the secondary market is growing at a rate that will enable other originators to gather a significant enough pool of settlements, however. While it is generally agreed that about three years ago just \$5 billion in face amount of life policies were sold into life settlement pools, estimates for the annual amount changing hands now vary considerably.

The Life Settlements Association (LISA) estimates at present around \$15 to \$18 billion changes hands annually. In a 2005 report research firm Sanford Bernstein projected a \$160 billion market well before 2030, with the life settlements market growing eight times faster than the life insurance market. Such growth was attributed to several factors. First, individuals in the U.S. are living longer and may outlive the usefulness of their life insurance policies. Second, the decline in interest rates could result in lower cash values within existing poli-

cies relative to prior expectations. "These trends, coupled with low current penetration of the target market (i.e., 3%), suggest the life settlement market has ample room to grow," say Bernstein analysts Suneet Kamath and Timothy Sledge.

LISA executive director Douglas Head attributes growth to the increase in the number of baby boomers taking out life policies. Life settlements tend to be from seniors over 65 with some negative change in health. With this demographic growing, the sale of life policies, and consequent resale of these policies into the secondary life settlement market, is increasing at around 30% a year, says Head. "That age group is regarded by life insurance companies as a sweet spot for policy sales, and we are going to see a greater pace in sales and in a secondary market." A market of \$160 billion would certainly lend itself to securitization in terms of size, although it is worth noting that other studies indicate a much more muted rate of growth. Conning Research, a research and asset management firm, estimates the face amount to be around \$7 billion, with growth averaging about \$1 billion a year for the foreseeable future.

They are not alone in these estimates. While the number of companies now offering a secondary market for life settlements is increasing, their growth forecasts are impressive but still relatively conservative. Last year Cantor Fitzgerald launched LexNet, its life settlements

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trading platform, where life settlements are auctioned or bought and sold on a bid/offer basis. Stuart Hersch, president and CEO of Cantor LifeMarkets, says volume on LexNet has grown dramatically and that he expects the platform to facilitate trading of \$1 billion to \$2 billion in face value of policies this year.

There are several factors that hinder

the growth of the secondary market. The first is simply supply of policies. Life settlements originators argue that they are providing a service by offering seniors a competitive price for life policies they no longer want.

Says Larry Simon, CEO and president of Life Settlements Solutions, an originator of policies: "Consumers are recognizing the value of life settlements. For seniors that feel their family will be sufficiently looked after upon death without the \$3 million life policy pay-out, it may make sense to stop paying the premiums. The choice is to let the policy lapse, surrender it back to the insurance company or sell it on to a buyer who will pay more than the insurance company which in many cases will be three to four times the amount the seller would receive by surrendering the policy."



"What do you mean he left his life insurance to himself?"

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Middleman wins?

The majority of life policies sold is in the \$3 million to \$5 million range where this scenario is most likely to occur. Not everyone is convinced the insured are getting a good deal, however. "As yet, the life settlements market is not efficient. The sale of a policy, when you factor in commissions and costs, does not generate the appropriate value," says Mark Charron, Deloitte's national leader for actuarial insurance solutions.

A Deloitte study carried out between 2000 and 2003 showed that the average policy seller was paid just 20% of the face amount. "The intrinsic value (that is what it is really worth to the buyer) is about 64% of the face amount. That 44% of lost value goes to origination fees, underwriting fees and commissions. Yes, there certainly is value — but for the middle man," says Charron. "Furthermore, it is argued that selling on a policy is an alternative to letting a policy lapse, but these policies tend to be bought off people who are in impaired health. If you are in

impaired health and may soon die, you are unlikely to want your policy to lapse, but neither is it in your interest for your policy to be sold on."

Charron does, however, believe that efficiency will improve and that sellers will gradually be paid more for their policies as the market matures and more buyers enter. If the consumer starts to receive fair value for a policy, more may be encouraged to sell into a secondary market.

Regulation is a second hindrance to growth. The industry has been plagued by controversy. It is a fact of the asset class that returns increase when the insured person dies earlier than forecast. One esoteric ABS banker admits that while encouraging his father to sell

his life insurance policy into a life settlements pool, he refrained from telling him that "basically, there is now an incentive out there for someone to bump him off."

The moral issues have encouraged regulators to focus on the industry. Cases of fraudulent or unethical behavior have aggravated the issue. A handful of cases have been filed in U.S.

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Anonymous Life Settlements Expert

courts by seniors who claim to be the victims of clever, potentially deceptive, sales tactics, having sold their policies at a mere fraction of the face value. The most controversial topic being investigated by state regulators at present is that of stranger-originated life insurance (STOLI) schemes.

Such arrangements involve investors approaching a stranger, encouraging them to take out a life policy scheme in a trust to transfer immediately to the investor in return for a one-off payment of cash. By establishing the policy in a trust name, the required regulation of holding the policy for a minimum of two years before on-sale is avoided.

In the case of Linda Angel versus Life Product Clearing, Leon Lobel, the plaintiff's father, agreed to purchase a \$10 million insurance policy after being approached by an agent for

Lincoln Life & Annuity Company of New York. The 77-year old purchased the policy through a life insurance trust which was immediately transferred to LPC for \$300,000. Lobel died five days after receiving this payment and his daughter is contesting the rightful ownership of the benefit.

According to some originators of life settlements, a handful of Wall Street banks have been investing in such schemes.

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One ABS banker believes that the negative publicity that life settlements generate is reason enough to argue against a securitized market. “The reputation of the ABS market at present is under scrutiny, the last thing it needs is to get tied up in life settlements.”

As regulators clamp down on STOLI schemes, they may be forced to insist that policies be held for as much as five years with solid proof of an insurable interest that is not a stranger before being sold into a secondary market. There are also noises being made by some states to restrict who can have access to an insured’s personal information. This would deter investors who need to know who they are buying policies from.

Having a large number of underlying settlements, while important to being able to offer a securitized deal, is not the be all and end all, however. One source close to the Coventry/Ritchie deal says that the ratings agencies may prefer 1,200 policies over 2,000, and will want certain policies over others. “Tranching these policies off to be rated can be very complicated,” he says. “They can be split on life expectancy or size of policy and naturally some are deemed less risky than others.”

Inexact science?

Despite some marketing claims that all life settlements are Triple As because everyone dies eventually, measuring the risk of life settlements is not an exact science. This has led some to conclude that life settlements do not lend themselves to a rated securitized market. One hedge fund manager says his firm attempted to put a deal together with an investment bank in 2005. “We were going to issue 15-year bonds,” he says. “Firstly, we had to have it wrapped by an insurance company, but it decided against it as rating the product was proving impossible. The longevity risk factor just could not be firmly established.”

Essentially, the life settlement owner has to continue to pay premiums until the named insured dies. If the insured dies later than expected, the premiums being paid in will begin to eat into the profit that comes from the final benefit. The risk of forecasting incorrect life expectancy was demonstrated in

the case of viaticals. Many investors were burned when medical advancements increased life expectancies from less than two years to, in some cases, more than 10. Investors were forced to continue to pay premiums on policies that were based on inaccurate life expectancies, and ended up losing money.

Establishing when policyholders are going to die is therefore essential. But data on mortality rates and life expectancy are not entirely accurate. The most commonly used guide in the life settlement industry to predict life expectancy in the U.S. is the Valuation Basic Table (VBT) that was developed by the Society of Actuaries. The 2001 table was being used up until March this year when a study released by Milliman and Phoenix Life Solutions found the data to be flawed.

“We note that even though this is the most recent ... published mortality table of insured lives, the actual mortality data for issue ages 65 and over was limited [and] actual mortality data for issue ages 75 and over was nonexistent,” the report said. The VBT 2008 table released mid-March has a lot more information, says Andrew Kaplan managing director at JPMorgan. “The data is accurate, but the data necessary and the tools available to express the uncertainty of the results is limited, but it is getting better. Those that do best in predicting life expectancy evaluate the quality of the data they use, understand the strengths of the third party that assesses that data and manage new information as it becomes available properly.”

The banks certainly seem to be trying to obtain more accurate and predictive data and come up with ways to manage longevity risk. JPMorgan launched a longevity index in 2007 that investors can use to hedge longevity or mortality exposure. Credit Suisse also has an index that it launched in 2005 that enables longevity risk transfer.

Until there is some standard for measuring longevity risk, the ratings agencies will struggle to assign ratings to life settlement pools. As yet, only A.M. Best has put out a methodology on ratings in the life settlements industry. However, Kaplan

Last year Cantor Fitzgerald launched its life settlements secondary trading platform and expects the platform to facilitate \$1 billion to \$2 billion in sales a year.

notes, that if the mortality rates of a nation were known, then investors would receive considerably less than their 8-10% returns.

The unpredictable cash flows of life settlements cast further doubt over the potential for securitization. “Just what is the cashflow?” questions Gina Hubbell, head of structured products in Cantor Fitzgerald’s Debt Capital Markets group, noting that “an insurance policy isn’t a receivable as the insured has no obligation to pay a specified amount over a defined period of time.”

One banker says securitization is out of the question. “These are negative cash flow assets – you cannot securitize negative cash flow assets. We have seen deals done, and proposed like Coventry, but these are deals where the risk has been transferred so that they are almost guaranteed. You could securitize a basket of rocks and have them guaranteed to pay out by a firm. That does not mean you have created a new market. The underlying assets do not produce a cash flow and therefore cannot be securitized.”

Far more complex?

He has a point. The deals that have been proposed involve tranching pools of life settlements combined with annuities. One source close to the Coventry/Ritchie deal says despite the excitement it generated, it was never going to happen. “It seems a simple concept. You buy an insurance policy and pay the premium on it and collect the benefit at the end. But it is far more complicated than even a mortgage-backed security,” he says.

“You need a liquidity provider to pay the premiums. That provider will be the first to get the money out. Then you need a takeout to pay off the bonds at some point in time which someone has to guarantee. And then you need to lever up the returns to get good enough yield so that is another debt provider needed. The lumpy cash flows need to be smoothed out too. You might just get \$3 million in benefits paid but have to pay out \$4 million one year.”

He says the Coventry/Ritchie deal had a debt provider, a liquidity provider and someone to take out the principal payment at the end of the bond’s life, but one of those already indicated it was dropping out even before the rating was withdrawn. “It required a significant amount of equity, and a large, rated tranche. The bank debt was never going to be repaid in full. It was unlikely it would happen from the word go. I don’t want to say it can’t be done. But I’m doubtful it can be done and make anyone involved money.”

Not only structurally does a securitized market seem

questionable, but commercially is it attractive? Sellers will soon grumble when they see public deals where a policy sold for 10% of face value, is being securitized at 75% of face value.

Second, is the issue of social responsibility. “A securitized



Too exotic a brew for securitization?

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mortgage market creates benefits to homeowners by reducing costs, which tracks the policy of encouraging homeownership. The more the market pays for a mortgage asset, the lower the effective cost to the homeowner. In the life settlement market, however, the higher the present value of the insurance policy, the earlier the expected death of the beneficiary. That increased value does not necessarily lower the cost of insurance to the individual,” says Hubbell. That said, she believes that “given sufficient demand and increased participation, which is rapidly occurring, ratings agencies and banks should be able to come up with a viable securitized product.”

That said, Hubbell believes that ratings agencies and banks will work

around the cash flow streams to come up with a viable product. “Eventually the ratings agencies will get their arms around this. They rate insurance companies after all which have similar cash flow streams.”

Charron is more convinced that the life insurance industry lends itself to loans against policies rather than onsale of entire policies. “Instead of selling my policy to you, I take out a loan from you against my policy. It therefore does not matter how long I live as long as the loan is paid back, and the residual amount will end up with a family member or charity. Not only does it do

away with the incentive to kill me, but it is more tax efficient.”

If ABS investors are hoping that bonds securitized on life settlements will fill the gaps in their portfolio, they might, it seems, be waiting some time. ▼

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