Securities Backed by Life Settlements: Considerations for Institutional Investors

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Introduction

A life settlement is a financial transaction in which the owner of a life insurance policy sells his or her policy for an amount that is higher than the policy's cash value, but lower than the policy's face amount. The purchaser of the life insurance policy, usually a life settlement provider, becomes the beneficiary and assumes responsibility for the premium payments. The life settlement provider may subsequently sell the policy to an investor who, in turn, becomes the beneficiary, and hopes to earn a positive investment return after accounting for the purchase price of the settlement, the future premiums payable, and the ultimate timing of the receipt of the death benefit. Life settlements in force at the end of 2009 had a face value of about $35 billion.[1] Certain financial institutions or other entities securitize life settlements by purchasing large numbers of settlements from life settlement providers and/or other intermediaries, and issuing securities backed by these settlements.

Institutional investors, such as defined benefit pension plans, may be interested in investing in securities backed by life settlements for the opportunity to earn attractive yields, particularly in today's low interest rate environment. Life settlement securities may also be attractive as a portfolio diversifier, because the returns on such securities may exhibit little correlation to the returns on other asset classes, such as stocks or corporate bonds.

However, investing in life settlements poses certain risks and challenges to institutional investors. The objective of this paper is to outline the issues that institutional investors should consider before investing in securities backed by life settlements.

The Evolution of Life Settlements

In the late 1980s, the first settlements, called viatical settlements, were introduced to help terminally ill AIDS patients obtain an advance on an imminent death benefit from their life insurance policies. Viatical companies bought existing policies from AIDS patients at a discount to the policies' face values. However, when new medications became effective in prolonging the lives of AIDS patients, viatical settlements evolved into life settlements, with a focus not only on terminally ill patients, but also on elderly individuals with serious, but not necessarily life threatening, medical conditions.

The most attractive policies for life settlement providers to buy were high face amount policies covering elderly individuals with serious medical issues. Consequently, life settlement policies have an average face value of $2.2 million,

[1] Doss, Natalie, "U.S. Life-Settlement Market Declines 36% in 2009 Amid 'Economic Turmoil'," Bloomberg, October 28, 2010. Conning & Company cited as original source.

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far higher than the average face value of about $50,000 for a 25-year-old life insurance policy.[2] However, because of the reasonably limited number of high face amount policies owned by ill, elderly individuals, some life settlement providers, through their brokers, began seeking out senior citizens and convincing these individuals to apply for new life insurance policies, which the providers, in turn, could buy.

In these transactions, known as Stranger Owned Life Insurance (STOLI), brokers offer senior citizens up-front cash or gifts as an inducement for the senior citizens to apply for a life insurance policy; the broker arranges for premium financing, frequently from the life settlement provider, to pay the premiums on the policy. To enable seniors to meet underwriting requirements, some brokers may collude with the applicants to submit incomplete or inaccurate underwriting information. The premium financing loans often carry high interest rates, and extend for a term just beyond the life insurance contestability period of two years. When the loans are due, the insured individuals often have little choice but to sell their policies to the life settlement provider. In exchange, the premium financing loan is forgiven.

STOLI policies violate the insurable interest concept that is embedded in the laws of many states; insurable interest means that the owner and/or beneficiary of a policy will suffer an emotional or financial loss if the insured-against event occurs.[3] Family relationships and certain business relationships are generally considered to meet the standard of insurable interest. Since STOLI transactions are originated with the intent to sell or transfer the policy to a person or entity without insurable interest, they are prohibited, or a sale/transfer before five years from issuance is restricted, in 29 states. Both the National Association of Insurance Regulators and the National Conference of Insurance Legislators have adopted model laws that restrict or prohibit STOLI.

STOLI transactions pose risks to the senior citizens participating in these transactions because the seniors themselves may be liable for committing insurance fraud or misrepresentation. In addition, seniors may find themselves owing taxes on the forgiveness of the loan that was used to finance the premium payments. Moreover, if an insured senior’s health improves after the policy is written, thereby postponing the payment of a death benefit that had been presumed to be imminent, the life settlement provider may no longer want the policy, and therefore, the loan may not be forgiven, leaving the senior saddled with debt.

[2] Jonathan Nguyen-Phuong, Life Settlement Dynamics, “Life Settlement Market Overview,” November 2009.

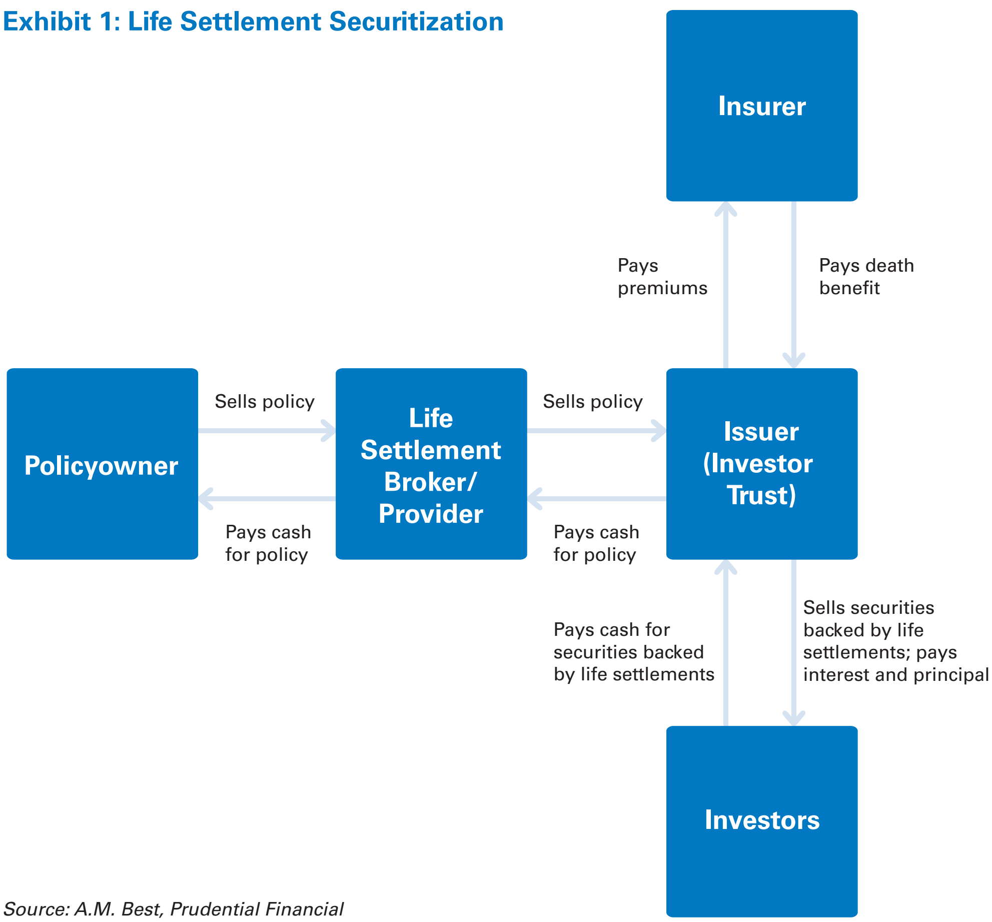
[3] The precise definition of insurable interest varies across states.

How Life Settlement Securitization Works

A typical life settlement securitization begins with brokers suggesting that individual policyholders sell their life insurance policies to a life settlement provider. The brokers collect medical and other information from the insured individuals, and offer or "bid" the policies to life settlement providers. Life settlement providers are specialized intermediaries who purchase large numbers of life settlements for sale to investors or a securities issuer. Providers often employ actuaries and underwriters to evaluate the life settlements being offered by brokers, who in some cases are affiliated with a life settlement provider.

The securities issuer, in turn, pools the life settlements into an investor trust to structure securities backed by the life settlements. These securities are then sold to institutional investors. The trust, funded by the securities sold to investors, pays the premiums on the in force policies, and, as the insured individuals covered by the policies pass away, the death benefits fund the interest and principal payments on the securities. Exhibit 1 illustrates the mechanics of a typical life settlement securitization.

Exhibit 1: Life Settlement Securitization



Source: A.M. Best, Prudential Financial

To date, no life settlement securitization has been registered with the SEC. There have been a number of privately offered life settlement securitizations, although only a few of them have been rated.[4] The first rated securitization was completed in 1995 with a face amount of $35 million.[5] Since then, two more rated life settlement securitizations

[4] U.S. Securities and Exchange Commission, "Life Settlements Task Force," July 22, 2010, p. 15.
[5] U.S. Securities and Exchange Commission, "Life Settlements Task Force," July 22, 2010, p. 15. This securitization involved policies purchased from individuals with terminal illnesses, so it was technically a securitization of viatical settlements.

were completed, and a third was attempted but withdrawn when the life settlement provider involved in the transaction was sued by the New York attorney general.[6]

Securitization of life settlements will exacerbate the STOLI problem. Securitization is very effective in encouraging the rapid expansion of a "product," in this case, life settlement contracts. Promoters will use capital generated from securitization to create larger inventories of life settlement contracts which, in turn, will fuel more securitizations and more STOLI.

The percentage of collateral underlying life settlement securitizations that is represented by STOLI policies is not clear. However, there are indications that many life settlements are, in fact, STOLI transactions. For example, more than half of the life settlements completed during 2008 were for policies that had been in force for four years or less.[7] This raises questions because it is not clear why individuals who purchased life insurance legitimately would no longer need the insurance so soon after completing their purchases.

The Risks Associated With Investing in Securities Backed by Life Settlements

Investors in life settlement securities are exposed to a number of risks arising from the STOLI collateral, as well as the inherent structure of life settlement securitizations.[8]

- **Contract enforceability risk.** Investors may lose part of their investment in a life settlement security if one or more of the life insurance policies within the security are rescinded because it is discovered that the policies were originated fraudulently or illegally. For example, if a policy included in a life settlement securitization is actually a STOLI transaction, and was originated in a state where STOLI is illegal, the policy will be rendered void if it is discovered how the policy was originated. Moreover, in most states, the lack of insurable interest at the time of issuance can be challenged even after the two-year contestability period for life insurance policies has passed.
- **Litigation risk.** Today, there are more than 300 pending lawsuits related to STOLI that were filed by investors, estates, insurers, and life settlement intermediaries.[9] Investors face the risk of litigation from insurers, who may challenge a claim for violation of insurance law or fraud. Investors also face the risk of litigation related to the presumed rightful beneficiaries, for example, from a spouse who believes he or she was the rightful beneficiary of the insured. Investors should also consider the risk of brand damage due to negative publicity from litigation challenging STOLI investments.
- **Longevity risk.** The value of a security collateralized by life settlement policies is highly sensitive to the longevity of the individuals insured by the underlying policies. If the insured individuals live much longer than had been originally anticipated, the value of the security backed by life settlements will deteriorate. This risk is growing, because the declining number of terminally ill individuals

[6] U.S. Securities and Exchange Commission, "Life Settlements Task Force," July 22, 2010, p. 15-16.
In 2006, the New York attorney general sued a life settlement provider. The rating agency subsequently withdrew its rating, and the securitization transaction was not completed.
[7] Peter Keating, "The Trade-offs of Selling Your Life Insurance," *SmartMoney,* November 9, 2009.
[8] Standard & Poor's, "Uncovering the Challenges in Rating Life Settlement Securitizations," October 13, 2009.
[9] U.S. Securities and Exchange Commission, "Life Settlements Task Force," July 22, 2010, p. 14.

with policies to sell is causing brokers and providers to buy policies from healthier individuals whose longevity is more difficult to predict. In addition, life settlement providers and the issuers of securities backed by life settlements must possess robust actuarial and underwriting skills to accurately assess longevity and select life settlements for inclusion in a security.

  – The prospect of increased longevity is a particularly important risk for sponsors of pension plans to consider before investing in life settlements. Pension plans are by their nature sensitive to increases in longevity, as are life settlements. As medical science advances, there may be increases in the longevity of the overall population; if the individuals covered by the pension plan live longer than expected, the plan faces higher liabilities. If the pension plan invests in life settlement securities, it may experience a decrease in the value of those plan assets at the same time that it is experiencing an increase in liabilities, both due to increased longevity. While life settlements might be considered an attractive investment because they are uncorrelated to other asset classes, they are not uncorrelated to other pension plan risks.

- **Liquidity and lapse risk.** The cash flow generated by the securitization of life settlement policies will be affected by the longevity of the individuals insured by the underlying policies. If the insured individuals live longer than expected, there may be insufficient cash flow to pay the premiums on all the policies. Investors may have to inject additional capital to pay the insurance premiums and prevent policy lapses.

- **Solvency risk.** In the event that a life insurance carrier becomes insolvent or is taken into receivership, most state guaranty associations place a $300,000 cap on death benefits for the carrier's in force policies.[10] This may be an issue for life settlement investors, because the average face value of policies covered by life settlements is $2.2 million, far higher than the cap.

Rating agencies have been reluctant to rate life settlement securitizations. They have cited a number of concerns, including the lack of insurable interest in the policies, the limited track record of life settlement providers, the limited number of policies in each life settlement securitization, the reliability of medical reviews of the insured, and the potential mismatch in the timing of cash flows within a life settlement securitization.[11]

Key Questions to Ask When Considering an Investment in Securities Backed by Life Settlements

Although life settlements may represent a new investment opportunity, they also raise serious concerns for institutional investors. Institutional investors should consider the following issues when evaluating a life settlement security:

- What was the origination process for the life settlements and underlying policies that are backing the security?

  – Has there been sufficient due diligence to ensure that the policies were originated legally?

  – What is the track record of the life settlement provider originating the life settlements? What actuarial and underwriting skills does the provider possess?

[10] A.M. Best, "Life Settlement Securitization," November 24, 2009, p. 20.
[11] U.S. Securities and Exchange Commission, "Life Settlements Task Force," July 22, 2010, p. 17.

– What are the ratings of the insurance companies that sold the policies contained within the securitization?

– Are there outstanding loan balances on the policies that may represent an unexpected source of future costs for investors?

– Does the level of commissions paid to the brokers and life settlement providers involved in a securitization leave sufficient funds from the proceeds of the life settlements to provide an equitable distribution to the insured?

- What actuarial and underwriting skills does the issuer possess?
- Does the life settlement securitization include a large enough number of life settlements to be statistically reliable with respect to longevity assumptions? Do the actuarial assumptions used allow for a margin of error?
- How much risk, if any, is the issuer retaining after selling the securities backed by life settlements?
- Are the investors in a life settlement security willing or able to inject additional capital if longevity assumptions prove to be inaccurate?

Conclusion

Life settlements have rapidly evolved from individual financial transactions designed to assist terminally ill individuals to financial instruments backing complex structured securities. However, these securities pose unique risks to investors resulting from both the securitization structure itself as well as the STOLI policies that may serve as the underlying collateral for the securitization. This paper describes these risks and outlines the issues that investors should consider before investing in life settlement securities.

Note: This paper does not address the purchase by institutional investors of life insurance on their own employees and/or benefit plan participants on whose lives there is an insurable interest. These products, corporate-owned life insurance (COLI) and trust-owned life insurance (TOLI), are insurance-based investments which have been widely used to informally fund various employee benefit liabilities for over 30 years. As with any investment, there are risks which must be considered as well as rules and regulations with which the investor must comply.