

# **Life Settlements Industry Primer**

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# Life Settlements Industry Primer

## Investment Characteristics and Considerations

*Portfolios are valued  
based on several variables*

- Life settlements are seen as zero correlation assets, making them particularly valuable to large institutional investors, hedge funds, and other investment firms.
  - Most financial assets are tied in some way to overlying market trends; i.e. equities in consumer companies perform better when the economy performs well and vice versa.
    - Hedge funds and other financial institutions devote significant effort and resources to manage this correlation and hedge or otherwise diversify risk out of their portfolios.
  - Since life settlements are derivatives of the lives of the underlying insureds and are not tied to any overlying economic indicator, life settlements are particularly useful in mitigating portfolio risk and provide the same returns regardless of market conditions.
- The assets are effectively AAA assets regardless of the rating of the underlying insurance company due to the policies' structurally senior position on the balance sheets of highly regulated insurance companies.
- Returns are dependent on several factors relating to the characteristics of the life settlements in a portfolio, including the age and average life expectancy of the insureds in the portfolio, whether policies were acquired during or after the “contestability” period and other policy-specific items.
- Portfolios are structured to spread risk among several insureds in order to accurately predict the probable cash flows of a given portfolio of life settlements.
  - In most cases, portfolios are tailored to keep exposure to any single given insured at a minimum.
  - Other considerations include geographic distribution of insureds, gender, smoking status, and other factors.

# Life Settlements Industry Primer

## Key Advantages of Life Settlements

*Life settlements offer several advantages not found in traditional investment vehicles*

- **Alternative asset class with little to no correlation to overlying market trends**
  - Life settlements are valuable hedging instruments used to diversify investors' portfolios and reduce volatility.
  - Investment risks are largely systemic and include increased longevity in the population versus actuarial estimates and tables and industry-wide increases in the cost of insurance.
- **Attractive yields**
  - While historical data is minimal, anecdotal returns on settlements portfolios have been estimated in the 8-12% range, obviously dependent on assumed risk and portfolio quality.
- **Low volatility**
  - Portfolios are generally constructed from multiple policies to minimize exposure to any single insured and make returns more stable and predictable through diversification.
  - Life expectancies are not exposed to the same factors that make traditional investment vehicles volatile.
- **Leveragable**
  - Settlements are an established asset class, with numerous loan programs having already been established with major lending institutions.
- **Increasing liquidity in secondary markets**
  - Cantor Fitzgerald and other institutions are creating electronic trading platforms for life settlements.

# Life Settlements Industry Primer

## Recent Corporate Transactions and Entry into Life Settlements Space

- A significant amount of new capital is flowing into the market, particularly from bulge-bracket investment banks, private equity firms and hedge funds, in anticipation of achieving uncorrelated returns and eventually accessing the securitization market.
- A number of Wall Street firms currently provide debt and equity financing to fund life settlements origination platforms and the acquisition of life settlements through managed funds.
- Other firms have made minority or control investments in origination platforms, and additional transactions are rumored to be in process.
  - Reservoir Capital acquired Maple Life Financial Inc., one of the largest originators of life settlements, in March 2006. The terms of the transaction were not disclosed.
  - DLJ Merchant Banking Partners acquired Peach Holdings, a large structured and life settlements originator that was listed on the London Stock Exchange's AIM market, in November 2006.
    - Peach Holdings derives the majority of its revenue from the purchase of structured legal settlements payments and life insurance policies.
    - The \$763 million transaction value provides a valuation of 11.2x the expected, normalized pre-tax operating income for FY 2006.
  - Formation of joint venture Institutional Life Services between Genworth Financial, Goldman Sachs and National Financial Partners created an institutional marketplace for the settlement of life insurance policies in late 2007.
  - J.G. Wentworth entered the life settlement business and had been granted provider licenses in 22 states as of March 2008.
  - Phoenix Companies announced in early April 2008 that it would enter the life settlements market and form partnerships with four brokerage general agencies.

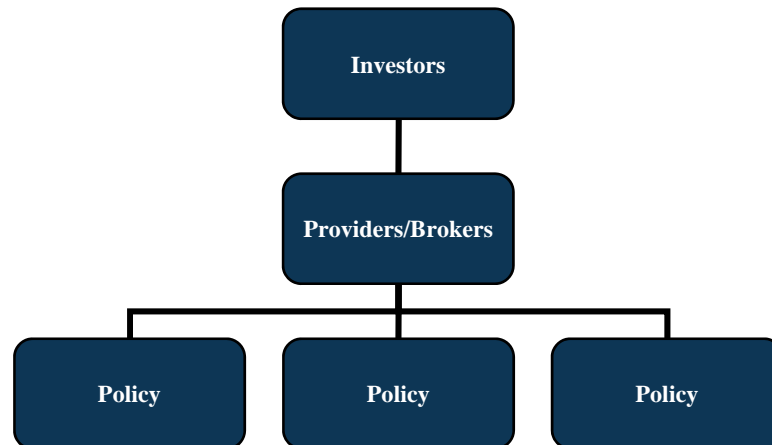
# Life Settlements Industry Primer

## Acquiring a Life Settlements Portfolio – Direct Purchase vs. Securitization

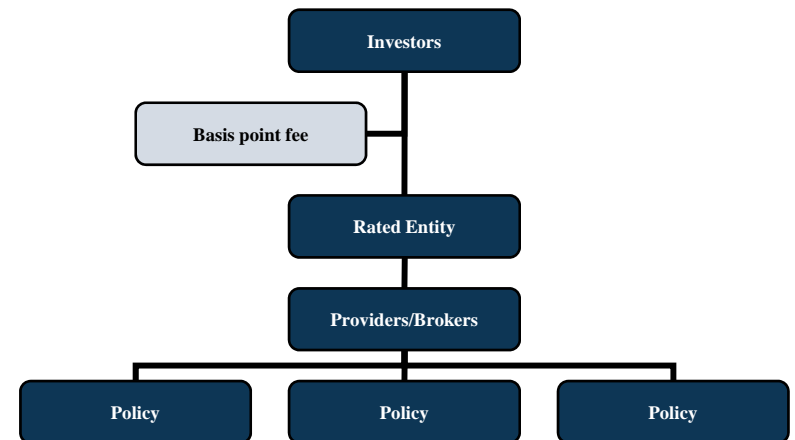
*There are two primary ways to acquire positions in life settlements*

- Investors traditionally have had two basic options to invest in life settlements.
  - The investor may directly contact brokers or providers and aggregate life contracts into a portfolio.
    - This is an involved process that requires a high level of diligence and industry expertise, but provides the investor the most flexibility in customizing a portfolio.
  - An investor may also purchase a structured product from a rated third party who has already purchased a portfolio of life settlements and designed structured securities against the portfolio.
    - There may be fees associated with this approach, but the level of diligence and involvement required is much lower.
    - The current state of the financial markets has materially reduced the amount of structured life settlements product coming to market.
    - Structured product is generally a traditional bond/note.

### Direct Purchase



### Purchase of Structured Product



# Life Settlements Industry Primer


## Fundamentals of Life Settlements Valuation


*The economics of a life insurance policy are similar to those of a discount bond*

- In many ways, the economics of a life settlement transaction are similar to those of a discount bond.
  - Investor pays a discounted price up front for an asset that will deliver a large pay-out at maturity.
  - With discount bonds, no payments are made to the investor between the time of purchase and maturity.
  - The investor's return (yield) is based on the discounted price paid to purchase the asset and the face value received at maturity.
  - Underlying credit quality of the bond issuer is of critical importance to ensure the maturity payment is received.

### Traditional Discount Bond – \$1,000,000 Face Value, 10 Year Maturity

Traditional Discount Bond Illustration - \$1,000,000 Face Value Bond											
Time	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Cash Flows	\$ (300,000)	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1,000,000

*Investor purchases bond for \$300,000*  


*Investor receives face amount upon maturity*  


**Yield: 12.8%**

# Life Settlements Industry Primer

## Fundamentals of Life Settlements Valuation

*The valuation of a life insurance policy is similar to that of a discount bond, but with some important modifications*

- There are a number of key differences between a discount bond and a life settlement contract.
  - The discount to face is generally much steeper for a life settlement contract versus a discount bond (generally somewhere between 70% to 90%).
  - The investor is obligated to pay the premiums associated with policy to keep it “in-force” until maturity.
  - There is no set maturity date for a life settlement. Instead, investors rely on life expectancy reports (“LEs”) from accredited medical underwriters to estimate a maturity date.
    - LEs are a critical element in every life settlement transaction, and is a topic we will discuss in more detail later in this presentation.
  - As the issuers of the policies are large, regulated insurance carriers with high ratings and capital requirements, there is little uncertainty regarding payment at maturity.

### Life Settlement - \$1,000,000 Face Value, 10 Year Life Expectancy\*

Life Settlement Illustration - \$1,000,000 Face Value Policy												
Time	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	
Cash Flows	\$ (200,000)	\$ (19,285)	\$ (19,285)	\$ (19,285)	\$ (19,285)	\$ (19,285)	\$ (19,285)	\$ (19,285)	\$ (19,285)	\$ (19,285)	\$ (19,285)	\$ 1,000,000
	<p>Investor purchases life settlement for a steep discount, 20% of face value</p> <p>Investor assumes principal payments for the policy until maturity</p> <p>Investor receives face amount upon maturity</p> <p style="text-align: right;"><b>Yield: 12.8%</b></p>											

\* It is important to note that there is no fixed maturity in life settlements as it depends on the mortality of the insured; this may be sooner or later than expected, which affects returns

# Life Settlements Industry Primer

## Fundamentals of Life Settlements Valuation (continued)

- Pricing for a settlement contract is generally quoted as a percentage of the death benefit paid at maturity or the yield at which the policy was priced.
  - On a death benefit basis, pricing generally ranges between 10-30% of face, while yield based pricing has historically been between 8% to 12%.
  - Where a policy is priced in these ranges is heavily dependent on:
    - The length of the LE.
    - Premium or carrying costs.
    - Quality of the policy (how it was originated, rights conveyed by purchase documents, etc.).
- The size and level of insured diversification provided by a portfolio is also a factor in pricing an investment.
  - Generally, larger and more diversified portfolios are considered better investment vehicles.

# Life Settlements Industry Primer

## Key Assumptions in Pricing Life Settlements – Quantitative

*The four key factors that determine the price of a life settlement are life expectancy, targeted yield, carrying cost and account value*

The four key factors in pricing a life settlement are 1) Life Expectancy, 2) Targeted Yield, 3) Carrying cost and 4) Account Value.

- **Life Expectancy** – A life expectancy report from one or more medical underwriters will be used to determine the maturity date of a life settlement, and is probably the most important assumption for pricing a policy.
  - Life expectancy reports are generated by reviewing the medical records of the underlying insured, and then fitting the insured's age, medical condition, and gender to a standard mortality table (VBT, AVS, etc.). The table is then used to derive a life expectancy for the insured.
  - The resulting LE is a best estimate by the medical underwriter. Given the host of factors that go into deriving an LE, and the inherent complexities of such an analysis, most investors will request multiple LEs from different medical underwriters to construct a range of potential Les.
  - A maturity before or after the LE figure that was used in pricing the policy can have a dramatic impact on the value of the life settlement. For this reason, many investors seek to compile a portfolio (a strategy common to any financial asset class) of life settlements to reduce return volatility, and to create an asset that can potentially be leveraged.

### Prominent Medical Underwriters



FASANO ASSOCIATES



# Life Settlements Industry Primer

## Key Assumptions in Pricing Life Settlements – Quantitative (Continued)

- **Targeted Yield** – the required rate of return used by an investor used to discount the face value at maturity. Depending on the quality of the underlying policy and the buyer’s cost of capital, the yield generally ranges between 8% and 12% for “plain vanilla” type policies, and higher for policies within the contestability period, etc.
- **Carrying Cost** – Cash cost to the investor to keep the policy in force until maturity. Generally includes cost of insurance for the policy (premium payments), financing costs associated with a policy loan (if one is outstanding), monthly fee to the servicer of the policy (tracks premium payments and ensures that the policy doesn’t lapse), and financial intermediary fees (applicable if the policy is in a beneficial interest trust or other structure that includes a financial intermediary).
- **Account Value** – Value accumulated in a universal life policy can be used as collateral for loans taken against the policy and be drawn on in lieu of paying premiums on the policy.
  - Account value also is relevant in pricing Option B policies, which stipulate that the beneficiary receives both the account value and death benefit at maturity.
    - Option A policies pay the greater of the death benefit or account value at maturity.

# Life Settlements Industry Primer

## Key Assumptions in Pricing Life Settlements - Qualitative

*Qualitative factors are extremely important in life settlements as many legal concepts can affect the enforceability of a policy*

There are a number of qualitative factors to consider when purchasing a life settlement. Of particular importance are 1) insurable interest, 2) contestability, and 3) documentation.

- **Insurable Interest** – In order to collect on a policy at maturity, there must be a bona fide insurable interest when the policy was originally taken out by the underlying insured. Broadly speaking, this means that the person purchasing the policy must have an economic interest in the continued life of the insured.
  - Insurable interest can be an issue when a policy is originated using premium financing. Premium financing is when the underlying insured uses a loan from a third party to pay for the premiums that are due on the policy.
  - If structured correctly, premium financing can be used to help an individual purchase a life insurance policy without impacting insurable interest.
- **Contestability** – For a period of two years after a policy is purchased, the insurance company is not obligated to pay the face amount of the policy (assuming a maturity during this time) if there were material misrepresentations in the insured’s application. After the two years has passed, the policy is “incontestable”, and the insurance company is obligated to pay the face amount at maturity (assuming there is an insurable interest).

# Life Settlements Industry Primer

## Key Assumptions in Pricing Life Settlements – Qualitative (Continued)

*Sufficient documentation  
is critical in life  
settlements transactions*

- **Documentation** – This is a broad category that covers all of the legal and business documents related to a life settlement. Examples include the sale contract between the insured and the purchaser of a policy (generally a broker), HIPPA forms and releases, limited powers of attorney to monitor the policy and update information, medical records, life expectancy reports, loan documents if the policy was premium financed, etc. Policies that have all of the needed documentation in good order, with the appropriate disclosures and legal opinions are easier to transfer between beneficiaries.
- All of these qualitative factors are measured when an investor is evaluating a policy for purchase. “Cleaner” policies with no insurable interest or contestability risk and proper documentation will generally sell for a higher percentage of face (implying a lower calculated yield). Policies that are viewed to be “non-conforming” in one or more of these categories will be deemed to be “riskier”, and require a higher rate of return to be built into the pricing model.

### Documents typically needed in a life settlements transaction

- Policy
- Purchase documents
- HIPPA forms and releases
- Limited powers of attorney for monitoring/updating medical records
- Life expectancy reports
- Medical records
- Policy statements (usually annual)
- Illustrations
- Verification of coverage
- Loan documents if applicable

# Life Settlements Industry Primer

## Sample Life Settlements Portfolio Valuations

The following is a hypothetical valuation of a two policy portfolio valued by two different firms. This is strictly for illustrative purposes and all names are fictional. The calculations were performed using proprietary Lewis & Ellis actuarial models.

### Portfolio

#### ■ Policy 1: Johannes Doe III of Cleveland, Ohio

- \$1,000,000 face value policy
- 68 year old female non-smoker
- LE Reports:
  - AVS: 120 months
  - FAS: 110 months
  - 21<sup>st</sup>: 140 months
- Universal life policy from MetLife
- Medical records show general good health
- All other factors equal to Policy 2

#### ■ Policy 2: Ana Nimice of New York, NY

- \$1,000,000 face value policy
- 73 year old male smoker
- LE Reports:
  - AVS: 90 months
  - FAS: 80 months
  - 21<sup>st</sup>: 100 months
- Universal life policy from MetLife
- Medical records show family history of heart disease and high blood pressure
- All other factors equal to Policy 1

### Investors

#### ■ Draco Investments LP

- Strategy: Aggressive
- Target IRR: 15%
- Draco values the portfolio at:
  - Policy 1: \$155,277 (15.5% of face)
  - Policy 2: \$271,115 (27.1% of face)
  - TOTAL: \$462,392 (23.1% of face)

#### ■ Galapagos Turtle Growth Fund LLC

- Strategy: Conservative
- Target IRR: 8%
- Galapagos values the policies at:
  - Policy 1: \$297,995 (29.8% of face)
  - Policy 2: \$416,954 (41.7% of face)
  - TOTAL: \$714,949 (35.8% of face)

# Life Settlements Industry Primer

## Life Settlement Securitizations

- The first major securitization sponsored by Ritchie Capital, involving a pool of 598 universal life policies originated by Coventry First, was initially on hold pending the outcome of the New York Attorney General's complaint, but ultimately was aborted when the sponsor filed for bankruptcy.
- Prior to the announcement of the investigation, Moody's issued a preliminary rating for the proposed issuance.
  - The senior tranche was rated A3 with a principal amount equal to 14.26% of the aggregate face value of the portfolio and a coupon of 6.41%.
  - The total LTV of the senior and junior notes was 40.28% with a weighted avg. coupon of 7.83%.
- Additional life settlement securitizations were reportedly coming to market in 2007, but did not materialize due to deteriorating market conditions.

Life Settlements Securitizations				
Issue Date	Issuer	Amount (\$ in millions)	Underwriter	Notes
<b>Completed Transactions</b>				
2003	LILAC Structures*	NA	NA	Multiple issuers and transactions
Feb-04	Legacy Benefits	\$61.5	Merrill Lynch	Private Placement
<b>Canceled Transactions</b>				
NA	Ritchie Capital	\$302.0	Lehman Brothers	Sponsor went bankrupt
NA	Peach Holdings	NA	NA	Pulled due to market deterioration

*\*A number of sponsors executed life insurance and annuity combination ("LILAC" transactions in 2003-2004)*

Source: Moody's Investors Service.

# Life Settlements Industry Primer

## Acquiring a Life Settlements Portfolio – Investment Partnership

*Investing with an experienced industry participant can be an attractive alternative structure*

- In addition to directly purchasing settlements to create a portfolio from an aggregator/broker or investing in structured products, investors can also choose to partner with an experienced industry participant
  - Capital is invested with a life settlements expert that creates a portfolio either through aggregation or origination (if the entity is able to source product from underlying insureds).
  - This approach allows the investor to have more “hands-on” participation in the investment (compared to buying a structured product) without replicating the back-office infrastructure and industry expertise needed to aggregate and service a portfolio (as required in a Direct Purchase structure).
    - Similar to a limited partnership structure with the industry expert acting as a general partner and the investor assuming the role of a limited partner.
    - Investment strategy and purchase criteria for policies are mutually agreed upon in advance by both parties.
  - With the number of industry participants increasing rapidly as the sector begins to mature, the key to this strategy is identifying credible partners that have knowledge of the space.
    - Generally look to past activity within the space along with an overview of the expert’s investment / origination strategy.
  - To align economic interests and reduce initial investment amounts, a structure where the industry participant retains an ongoing interest in the value of the portfolio could be explored.
  - To accelerate the creation of a settlement portfolio, a “forward-purchase” mechanism could be utilized.
    - Essentially the investor would dedicate a specific amount of capital to purchase any life settlement policies sourced by the industry expert.
    - A strong working relationship between the investor and the industry expert, and a full understanding of the industry expert’s business model by the investor would be required to make this a viable strategy.