

ISI Insurance Concepts Forum – April 22-24, 2009

The ISI Insurance Concepts Forum focused on the broad issue of “Institutionalization of the Life Insurance Secondary Market.” Its participants totaled 27 leaders from academia, government, investment sectors, and the life settlement industry.

Day One Discussion Sessions - Working Notes

Government Intervention in the Financial System

There is much support for the notion that the financial system is heading towards a train wreck, and that government intervention is only delaying the inevitable. Discussion at the ISI Insurance Concepts Forum attempted to tackle this issue and it was generally agreed that a healthier course of action would be to allow the train wreck to occur, and then forge an orderly clearing of the tracks and a fresh “restart” process.

While bankruptcy can create carnage in the short-run, it offers full transparency, avoids issues of moral hazard, starts the recovery process sooner, and has a proven track record of over 400 years. Bankruptcy also facilitates the ending of obsolete business models and allows more efficient economic models to flourish. The alternative of government intervention, while seemingly quicker in response to catastrophic events, brings risks of market manipulation, interference with free economic infrastructures, and bureaucratic overhead – plus it risks burdening taxpayers with costs that are unrelated to them.

GM is a perfect example of a company on course for financial ruin (a spectacular train wreck). It has failed to adapt its business model in a changing industry lifecycle. Simply put, static business models cannot succeed over a long period of time. While a restructuring of GM may disrupt many feeder businesses and jobs, it would be more efficient for the government to let GM follow the natural course of changing its business model and then provide retraining to laid-off workers and provide incentives for other businesses to relocate into the affected markets.

A capitalist system should allow for the failure of an institution that does not adjust its business model to the current economic climate, but there has been extreme political pressure to provide aid to Detroit because of the amount of federal funds Wall Street has received and the political distrust that could result in the affected communities. This brings to the forefront the question of the viability of large institutions and bailouts. Are some companies truly “too big to fail?” Many feel that “large” equals “inefficient,” that “big” equals “bad,” and that we should let the behemoths die out; essentially, these companies are “too big to succeed.” However, “big” buys government influence (consider oil, auto, tobacco, etc.), even if it is to the detriment of the common good.

We currently find ourselves in a middle ground. We don't want to throw good money after bad, but we can't bear the thought of 3 million workers being suddenly unemployed. If the big businesses are allowed to fail, then we must ask: "Will new industry or innovation be able to absorb these losses?" and "Will it happen quickly enough?" The example of the Seattle, Washington area was cited. As Boeing declined as the state's industrial giant, Starbucks and Microsoft emerged to pick up the slack and revive the economy. Will Michigan, Ohio, and Indiana be able to do the same?

Many of the auto industry's troubles have played out in newspapers all across America, but one point that has gone largely unnoticed is the impact on the credit markets. The government is funneling trillions of dollars to prop up the banks and increase lending, but what will the impact be when one-third of all auto dealers vanish in response to depressed auto sales?

Despite all the arguments that support government intervention, most in attendance agreed that capitalism cannot exist without failure, and by intervening, the government is only kicking the can down the road to be dealt with later, and many fear the problem will only worsen over time. What exactly is the role of government in a financial crisis? Is the perception that the government is picking the "winners" and "losers" further harming the American psyche?

Collateralized-Debt Obligations and Credit Default Swaps

Everyone agreed that there should be regulation in the CDO and CDS markets, but there was no consensus on what type of regulation should be put in place, or how the rules should be enforced. There was agreement that any regulation needs to come from the federal level, as fragmented state-based regulation would be confusing and ineffective.

Insurer Capitalization

Because there is little transparency to the assets insurers are holding, no one can be certain which insurers are truly facing crisis and are in need of federal assistance through the Troubled Asset Recovery Program (TARP). This has put insurers in a precarious position: accepting federal funds signals to the market that they are in financial trouble; but refusing funds may put policyholders in serious jeopardy.

Policy lapses, once considered to add greatly to the insurers' profitability, now represent a double-edged sword. Current premiums paid on policies provide much needed liquidity in a market where capital is tight. During normal financial times, insurers benefit from policy lapses because the accumulated funds received from premiums and reserves set aside for these policies can be transferred into the insurers' general funds, i.e., a windfall profit. Generally speaking, the net present value of a lapsed policy to the insurer typically exceeds that of a policy kept in force. However, depressed credit ratings and congested credit markets have limited insurers' ability to access capital, and now cash flow from premiums on in-force policies is a crucial source of liquidity to insurers.

It was once believed that credit-rating agencies had greater insight to the credit-worthiness of insurers. Investors have relied heavily on these agencies to provide an assessment of risk which, in retrospect, may have been misguided. The credibility of the rating agencies regarding insurers has been severely tarnished and as a result, many investors are performing their own due diligence.

Regulation and Legislation

Regulation, standardization, and full disclosure will ultimately benefit the life insurance secondary market (“LISM”), but these directives must come from a governing body that has the respect and authority to enforce such rules. To the detriment of these efforts, certain entities in the LISM have been working against industry attempts to provide full disclosure, both on the broker and insurer levels.

At the time of the ISI Forum, the Senate Special Committee on Aging was scheduled to meet on Thursday, April 30 to conduct the “Betting on Death in Life Settlements” hearing. At this brief hearing, three questions were expected to be asked:

- Are life settlements good or bad?
- What should seniors know?
- What should be disclosed?

This hearing was seen as an exciting opportunity for the LISM to educate government officials on the value and social utility that life settlements provide to consumers. But the hearing would also give life settlement detractors a forum to disseminate common misperceptions. Many in the industry welcome the invitation to discuss better oversight, regulation, and how to better protect consumers from market participants who may engage in abusive or fraudulent actions.

Next Steps

Plans are underway to draft a proposal to create a LISM standards board comprised of representatives of all industry stakeholders: investors, regulators, consumers, providers, and brokers. Its initial thrust will be to establish data gathering practices with an independent organization such as the Center for Retirement Research at Boston College, and thereafter expand and refine standards and practices and work toward their enforcement.

Evening Discussions - Working Notes

Group 1: Social value of life settlements

Discussion focused on “Next Steps” described above.

Group 2: Income/asset recovery for seniors

Discussion debated the merits of not only utilizing life settlements to provide critical retirement funding for seniors, but also the options of reverse mortgages, returning to the workplace, and harnessing pension benefits.

Group 3: Longer lives and decreased savings for retirement

Baby boomers have taken a laid-back approach to retirement planning, and given the state of the current economy, the senior community could find itself in a precarious financial position. Complicating matters further, the life expectancy of today's seniors far exceeds that of any previous generation. Undoubtedly, the model for life after 50 will have to evolve in order to provide employment and supplemental savings for retirees. Fortunately, today's seniors possess talents and experience that are still relevant in the workplace, and their willingness to stay on the job will help offset the anticipated "Gen X" worker shortage. Savvy employers will create individualized incentives to keep vital senior workers on board.

Group 4: Funding for long-term care

Much of the discussion on this topic centered on ethics and integrity in the insurance industry, and the fact that seniors must be able to trust their agent/advisor. One question raised was: "What might motivate an agent/advisor to act in the consumer's best interest, besides commissions, and hold them to a higher ethical standard?" There was a general consensus in that a "special designation" or additional qualification process be required for agents/advisors who plan to specialize in working with seniors.

Funding for long term care will be an ever-growing issue as life expectancies increase, but it is the middle third of the socio-economic scale that is most concerned about preserving assets (the lower third will qualify for Medicaid, and the upper third will have enough assets in place to pay outright for long term care.) It was suggested that those people in the middle-third plan to use their homes as collateral for long term care funding.

Group 5: The financial needs of retirees vs. insurer profits

Regarding the issue of life settlement regulation, the government may be working against itself as it struggles to juggle dueling mandates. On one hand, the government has invested trillions of dollars to prop up ailing financial institutions and some legislators see life settlements as a threat to life insurers' profits, especially now that many insurers may be in desperate need of capital. On the other hand, life settlements present consumers with a valuable option to sell an unwanted, unneeded, or unaffordable life insurance policy. As seniors struggle with declining retirement savings and rising

health care costs, life settlements can give seniors the opportunity to enhance their liquidity needs.

Day Two Discussion Session - Working Notes

The LISM has come a long way since its beginnings in viatical settlements. It has expanded into a highly structured and sophisticated industry, and will become even more complex with the development of the tertiary market. It is clear that the federal government has endorsed life settlements through its asset acceptance of AIG's \$8.5 billion private life settlement securitization. This "positive" government action contrasts with "negative" rumblings coming from some insurance regulators, who have been critical towards life settlements and have created confusion for seniors and interference for agents. On the institutional level, a life settlement is both appealing and mystifying, as it is an uncorrelated investment in what has been a correlated investment world.

Mortality Risk

Much debate has taken place in other forums regarding life settlements and their distinction as *truly uncorrelated* compared to traditional investment assets, or if they simply have a *low correlation* with these assets. Discussions leaned toward the belief that the underlying asset is uncorrelated; but when placed in some sort of investment vehicle or fund structure, a life settlement is exposed to credit market risk. A life settlement is not completely free of risks, and these issues were explored further during the Secondary Market Investing discussion.

The foremost idiosyncratic risk associated with life settlements is mortality risk. When managing a portfolio of life settlements, mortality risk is the chief concern. One way to manage this risk is to diversify. By aggregating a large pool of life settlements, the influence of an individual policy is lessened, a more predictable stream of cash flows is attained, and mortality risk is reduced.

Characteristics of catastrophic risk management may be applicable. This stems from the understanding of mortality tables which are based on large cohort populations. The risk of any one life not conforming to a mortality table is high, but the risk of the entire population changing materially from the table patterns is remote. It is the risk of remote occurrences that concern investors, similar to the risk of remote disasters. Thus, there may be some effort to structure further research to determine the applicability of catastrophic risk management models to life settlements.

Hedging Strategies

Diversification reduces the risk of the portfolio, but does not eliminate it. Another risk management technique is to transfer the risk through hedging or swaps. These are common practices with traditional investment assets but are less developed for

the LISM. Institutions such as Goldman Sachs and Deutsche Bank are attempting to create synthetic hedging platforms but are facing several of the challenges Lloyds of London faced when it attempted such a feat several years ago.

The failure of Lloyd's of London's synthetic platform illustrates the difficulties in creating a viable hedging platform and explains why others might be soured on the whole idea. Most hedging strategies carry some amount of basis risk, i.e., the risk associated with an imperfect or mismatched hedge, but the basis risk involved in a life settlement hedge can be infinite. This is because the characteristics of the portfolio being hedged can be difficult to match to characteristics of the offsetting portfolio pool; additionally, there is the element of negotiating the hedge. Not only must the LEs reasonably match, but applicable mortality curves should also match. Swaps are also a difficult transactional market to cultivate for life settlements because it is difficult to find counter parties willing to take on the other side of the trade. Theoretically, insurers should be attracted to such a platform because their exposure to life insurance mortality risk (excluding annuity risks) is counter to that of life settlement investors, and the platform would allow them to transfer such risk to other parties. The life insurance industry is traditionally slow to change, however, and for now the logic is being disregarded. Furthermore, there is reluctance to enter into financial transactions with life settlement investors. This hesitation may also be attributed to the nature of life insurance, which involves a "long-term" commitment. Life insurers are very protective of their turf – in particular, their preferential tax treatments. The very nature of life settlements (the fact that death benefits from purchased policies are taxable) creates unease for insurers who are fearful of losing this status.

High Fees

As institutional capital begins to flow into the LISM on a greater scale, life settlement providers will need new and innovative ways to mitigate ramp-up risk. A life settlement transaction is a multifaceted process that requires the involvement of many parties. The multitude of participants and competing interests create a process that requires not days, but rather weeks or months to navigate. The hefty fees that brokers charge to pair buyers with sellers is often criticized by other market participants and are perceived to be inflated and unwarranted. The growth of the LISM should allow for other insurance brokers to enter this space, which will allow market forces to drive down compensation fees.

Investing in Life Settlement Vehicles

In today's market, investors want something simple. Wall Street's propensity for over-structuring investment instruments has tainted many investors' views of complex financial securities. The advent of CDSs, CDOs, and other variations of asset-backed securities has eliminated the ability of even sophisticated investors to understand what they are investing in. This has created a huge opportunity for the LISM, because an investment in life settlements is relatively easy to understand. As

an industry, however, the LISM needs to do a better job of reaching out to individual and institutional investors to ask them what they want in an investment product.

Consumer Awareness

The public perception of life settlements is often mixed, depending on the source of the information. Reverse mortgages went through a similar phase, where there was confusion and uncertainty towards such an idea. The reverse mortgage industry responded with a massive public relations campaign, which resulted in a better understanding of the reverse mortgage product and general acceptance in the public's eyes. No such campaign has taken place to promote the social utility provided by life settlements in the life insurance secondary market.

Nonetheless, the public opinion towards life settlements has become increasingly positive over the last few years, although it remains largely unknown among seniors. As the industry has matured and more investment capital has flowed into it, society has started to appreciate the value that life settlements provide to seniors who are in need of money, or those who desire to sell an unwanted asset. But this change in public perception has come more from a grassroots level, as the industry has done little to communicate its message to the general public. The cultivation of educated agents and financial advisors has helped the life settlement industry communicate its value to the public, but there are still many who are uninformed about the benefits of a life settlement.

The life settlement industry, by choosing to not proactively advertise to the public, is allowing insurers and other media to promote their view of life settlements, and often the resulting message is negative. Considering that life settlements arose from viaticals, and that there were fraudulent investment schemes in the early years and STOLI issues in the past few years, it is easy to see how those outside the industry might paint it as one that takes advantage of uninformed seniors.

Some assert that negative publicity towards life settlements can still be helpful for promoting the industry, in that it raises general awareness of life settlements (i.e., any press is good press). The thought is that if negative publicity stirs a debate over whether life settlements are good or bad for society, the LISM will win that argument every time. Others stress that being in an ever-defensive position is bad for the industry, and stakeholders should unite and begin a multi-phased marketing campaign immediately, complete with national spokesperson, before it is too late and seniors end up losing access to this valuable market.

Life insurers see life settlements as a threat to their core business and have aggressively tried to thwart the LISM. Life insurance is a mature and sophisticated industry that is good at managing demand and managing fear. Insurance exists because of the fear of loss. And when the insurance industry is able to portray life settlements as a detriment to consumers, they are able to manage fear on both sides. Ironically, life settlements could actually benefit the insurance industry. Perhaps

more life insurance policies would be purchased if consumers were aware that they had the option, down the road, of selling their policies in the secondary market.

Conflict of Interest

Countless industries and companies struggle to manage agency problems and conflicts of interest, and the LISM is no different. Many industry participants argue that fee disclosure and transparency will help the LISM to mature and ultimately benefit consumers. The industry is at odds with itself, though, because brokers are a powerful force in the industry and would be negatively impacted by the disclosure of fees. This has been a major source of contention for the LISM because some market participants have been accused of bid-rigging. (Brokers, bowing to pressure from persuasive agents, agree to not disclose offers from other providers, in exchange for commissions that are a larger percentage of the gross offer.)These tactics have undermined the efforts of other industry participants to provide greater transparency to life settlement transactions.

Measuring Performance of LE Providers

Throughout the short existence of the LISM, there has been much disparity between the performances of the life expectancy (“LE”) providers. The various firms providing such services have all claimed to have LE accuracies of over ninety percent, but analysis of the LE estimates clearly demonstrates a wide variance in the LEs issued. Recent mortality table changes by 21st Services and AVS have brought the three major providers more in line with one another, but there is still disagreement as to the best way to assess LE accuracy. As a group, the different LE providers have agreed to create a common mortality table to judge performance, but they continue to use proprietary methods to create the initial LEs.

If the industry had a longer history, it would be easy to go back and judge performance by using the standard deviation between the LEs issued and the actual dates of death, but even this point comparison methodology would have its flaws because it would not account for changes made in the underwriting process over time and in the mortality curves used. Some medical underwriters argue that it is better to look at the entire population of seniors underwritten and aggregate the probable deaths predicted instead of using the predicted dates of deaths to compare against actual dates of death. Detractors of this methodology argue that this truncates the tails of the medical underwriters’ mortality curves and introduces bias towards healthier individuals or those with shorter LEs.

Conclusion

The forum group did not generate specific conclusions from the discussions, though several action steps were initiated. The overall value of the forum was deemed to be outstanding, and ISI anticipates hosting forum events in the future.