

## **ISI's Initial Insurance Concepts Forum**

The Insurance Studies Institute (“ISI”) hosted its first Insurance Concepts Forum in April, 2009, and participants included twenty seven leaders from academia, government, investment sectors, and the life settlement industry. This dynamic group spent two days discussing numerous topics, with a focus on the “Institutionalization of the Life Insurance Secondary Market.” Spirited dialogue sparked several initiatives, including a draft proposal for an industry standards board, considerations toward an industry-wide marketing campaign, research of catastrophic risk management, and development of future forums with targeted themes.

The life insurance secondary market (“LISM”) 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.

Forum notes are highlighted below. Full notes are available online at <http://www.insurancestudies.org/events.html>, along with the original discussion topics that set the framework for the Forum.

### **Government Intervention in the Financial System**

There is much support for the notion that the capital markets and credit financial systems are heading towards a train wreck, and that government interventions (bailouts) are only delaying the inevitable. A healthier course of action would be to allow the train wreck (bankruptcies) 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, and starts the recovery process sooner. 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.

If “big” businesses are allowed to fail, then we must ask: “Will new industry or innovation be able to absorb the losses?” and “Will it happen quickly enough?” The example of the Seattle, Washington area was cited. When Boeing declined as the state’s industrial giant, Starbucks and Microsoft emerged to pick up the slack and revive the economy. Would, for example, Michigan, Ohio, and Indiana be able to do the same?

Is the perception that the government is picking the “winners” and “losers” harming the American psyche?

## **Insurer Capitalization**

Because there is little transparency to the assets insurers are holding, no one can be certain which insurers are truly facing a 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. *(Subsequent to the Forum, stress tests released by the Treasury noted that Met Life does not need capital, but the vagueness of the stress tests still leave investors and insured in the dark as to the real financial condition of MetLife, and this one test is not a measure for all life insurers.)*

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 reserves set aside for these policies can be transferred into the insurers' general funds, i.e., windfall money. 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 into 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. Credit-rating business models should be examined for conflicts of interest, insurability of ratings and perhaps stress testing of capital infrastructures.

## **Regulation and Legislation**

Regulation, standardization, and full disclosure will ultimately benefit the LISM, but these directives must come from a governing body that has the respect of both regulators and industry stakeholders. To the detriment of these efforts, some entities in the LISM have been working against attempts to provide full disclosure, on both 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?

Though poorly titled, this hearing was seen as an opportunity for the LISM to educate government officials on the value and social utility of life settlements, and discuss better oversight, regulation, and consumer protections. *(The outcome of the hearing is too comprehensive to note in this brief article, but a general concern is that legislators may be overly influenced by insurers and are not sufficiently addressing the needs of seniors.)*

### **Mortality Risk**

Regarding “correlation” of life settlements to traditional investment assets, discussions leaned toward the belief that the underlying asset is uncorrelated; but when placed in some sort of investment vehicle or fund structure, such an investment is exposed to credit market risk.

The foremost idiosyncratic risk associated with life settlements is mortality risk. By aggregating a large pool of life settlements, however, the influence of an individual policy is lessened, a more predictable stream of cash flows is attained, and mortality risk is reduced. It is hoped that additional research applicable to catastrophic risk management may discover techniques to better identify and manage mortality “tail” risk than is available in Monte Carlo analyses.

### **Hedging Strategies**

Hedging and swaps 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 in its failed attempt to provide longevity risk insurance.

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 difficult 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.

### **Portfolio Ramp-Up and 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 – some with competing interests – and it can take weeks or months to complete. The

robust fees that brokers charge to pair buyers with sellers are often criticized by other market participants and are frequently perceived to be inflated and unwarranted. *(In a recent discussion with Mr. Larry Kosciulek, Director of Investment Company Regulations for FINRA, he indicated that 5% of the transaction amount is FINRA's guideline, but he stated that a fair market fee may be somewhat higher.)* Further expansion of the LISM should cause 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 need in an investment product. A noted example of a new investment product is the GWG LifeNote, which works much like a bank CD, i.e., the investor purchases a note with a fixed yield for a time certain maturity. The notes are backed by a portfolio of life insurance policies from highly rated insurance companies, and investors can choose to receive interest payments either monthly, quarterly, annually, or at maturity.

### **Consumer Awareness**

Public perception of life settlements is often mixed, depending on the source of the information. Many life insurers are sending negative messages, as some see settlements as a threat to their core business. Life insurance is a mature and sophisticated industry that is good at managing demand and fear. Insurance exists because of the fear of loss, but when the insurance industry portrays life settlements as a detriment to consumers, they are able to manage fear on both sides.

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. The cultivation of knowledgeable agents and financial advisors has helped, but has not done enough to educate the general public. Perhaps it is time for industry stakeholders to unite and begin a multi-phased marketing campaign.

### **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 21<sup>st</sup> 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 major LE providers have agreed to create a common mortality table to judge performance, which table is expected sometime in 2009. However, the LE providers will continue to use proprietary methods to create their 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**

All in all, the Forum was deemed highly valuable. The broad issue of "Institutionalization of the Life Insurance Secondary Market" was not resolved, but it was unanimously agreed that institutionalization of the LISM must come from within and is needed for the LISM to mature to the point that it commands respect of government, investors, and consumers. Completion of the several follow-on actions stemming from the Forum will help this cause.