

# LIFE SETTLEMENT ECONOMICS AND RISKS

## CHAPTER 10

Life insurance policy face values transacted in life settlements in the U.S. have increased from \$1.1 billion in 2000<sup>1</sup> to an estimated \$15 billion in 2007. While this has drawn noticeable attention among insurers, legislators, regulators, and the media, it pales when compared to the \$20+ trillion of in-force life insurance in the U.S. as of 2007.<sup>2</sup> Nevertheless, the economic dynamics of the U.S. life settlement industry is significant, complex, and touching on numerous economic strata. In 2007, Conning Research & Consulting, Inc. estimated in its *Strategic Study Series on the Life Settlement Market* that by 2016 the annual transactions could reach \$140 billion.

The focus of this chapter is to establish an understanding of the economic strata and dynamics of the U.S. life settlement industry. This translates to over \$8.2 billion of value to policyholders and other industry participants in 2007, projecting to increase to over \$80 billion in 2014. In terms of tax revenues, this translates to over \$2.8 billion in 2007 and projects to over \$30 billion in 2014.

### ANSWER THE QUESTION

Before considering the economics of life settlements, the question is: "Should seniors own life insurance?" The answer is: "Yes and no!"

The answer is "yes" if:

- There is a continuing and/or reasonably anticipated future need for life insurance.
- There are debts or economic obligations and burdens that the senior does not want to thrust on survivors and the senior needs or wants to provide from his or her own assets.
- A surviving spouse or dependants, such as children, need funding for food, clothing, shelter, other living expenses, or medical care (e.g., retirement funding ceases upon the senior's death, or spouse or dependant impairments require special and costly medical treatment or nursing services).
- The estate is large, essentially illiquid (or there are significant assets (e.g., an art collection, business interest, family home or compound) the client does not want sold at the client's death), and funds are needed to settle state or federal estate taxes.
- The senior is sufficiently wealthy to afford the insurance and desires to invest after tax capital in insurance to create a tax free transfer of estate assets to children or other beneficiaries in order to secure their financial future and assure a meaningful legacy.
- Life insurance is needed to fund a buy-sell agreement, death benefit only, or nonqualified deferred compensation agreement or to serve as an economic shock absorber to help a business survive the senior's death.
- The senior has a desire to make a meaningful and significant gift to charity at the senior's death.
- It is important to the senior to "even things up" among children, particularly where one child will receive a business interest and the other, absent life insurance, would receive nothing.
- A business or practice owned in part by the senior requires life insurance collateral to assure a lender of repayment should a need to borrow a substantial amount of money arise.
- Insurance is required by a divorce decree or separation agreement.

The answer is “no” if:

- The insurance premiums create a cost burden such that basic living needs have to be curtailed, i.e., health care is sacrificed, quality of food reduced, normal home maintenance deferred, etc.
- There is no need for the insurance and quality and enjoyment of life are diminished in order to pay the premiums, i.e., insurance premiums must be cut out or the senior must significantly diminish travel, cultural involvement, socializing, hobbies, and other activities that provide wholeness of life in retirement.
- The insurance has been held as a savings plan, the savings are not related to any specific compelling need, and alternative more efficient and profitable savings plans are available.
- Retirement income is sufficient to fund a more than adequate standard of living for both spouses for life and the death benefits are not needed for the surviving spouse, dependents, or charitable purposes (i.e., the insurance only adds money after death).
- The answer to the following question is (b): “(a) Would you (senior spouse) rather have \$1 million upon your spouse’s death, or (b) enjoy spending \$20,000 more per year traveling with your spouse or doing something special with your spouse each year from now to his or her death?”
- Needed income received from social security is being used to fund life insurance.

Any senior who purchased life insurance years earlier for good economic reasons needs to re-examine those reasons upon entering retirement. Based on the above considerations, the senior should determine if insurance death benefits should be continued – or continued at the present level – since the choice is clearly not a black and white “either or.”

If “yes,” then the senior should seek the most economical means of arranging for the amount of insurance that is needed. Such means may be: (a) simply continue the existing policy; (b) reduce the death benefit and costs to match the need; (c) determine if a loan from the carrier against the death benefit is available and makes economic

sense; (c) exchange the policy under IRC Section 1035; (d) try to sell the policy as a life settlement and use the proceeds to purchase a more economical policy; or (e) surrender the policy or allow it to lapse and then purchase a more economical policy.

However, if the answer is “no,” then the only course of action is to execute the most economical or profitable method of disposing of the policy, i.e., surrender it, let it lapse, or sell it as a life settlement.

There are many “side arrangements” that insurance carriers and agents make available to policyholders in order to discourage the surrender, lapse, or sale of a life insurance policy. These side arrangements may include (a) policy loans, (b) reduction of death benefits and premiums, (c) consideration of accelerated death benefits, (d) reprioritizing of the policyholder’s personal cash flows and living considerations, or (e) shifting ownership and premium costs of the policy to children. While some of these may make economic sense or have some intrinsic value, most are designed to keep the policy in force. And then the question is: “Does keeping the policy in force primarily benefit the policyholder?” Again, the answer should be found in the above “yes” and “no” considerations.

In the final analysis, a life settlement is a diversion of what might be the single most valuable financial asset a client’s family or business might receive at an insured’s death. It is therefore critical that all parties to the potential transaction follow a recognized set of “best practices” to assure that a professional’s “green-light” or suggestion to proceed with a life settlement is appropriate and the best possible choice. A professional involved in life settlements must always put the interest of the client first and provide advice that results in a decision in the client’s best interests. It is therefore essential that a documented and justifiable hold-fold “needs-affordability” process (see Chapter 5) be used in every case.

## **ECONOMIC BASIS FOR LIFE SETTLEMENTS**

Life insurance was originally sold as pure risk protection. A principal person was responsible for another person’s welfare or for payment of debts and, in the event of the principal person’s early death, life insurance provided funds to pay these obligations. At some later time, life insurance was marketed in many forms as savings, investment, or estate planning tools, in addition to pure risk protection. For purposes of this

discussion, such a later policy is referred to as a cash value policy (CVP).

CVPs are complex contracts that provide numerous economic values for policy owners, beneficiaries, insurers, agents, and advisors, plus various tax values to federal and state governments. CVPs create value for the policyholder in several ways: (1) the death benefit to the beneficiaries (this can be a subjective value since it pays after the insured dies); (2) policy earnings paid as interest or dividends by the insurer; (3) accrual of premiums paid by the policyholder in excess of the insurer's cost of insurance and expenses; (4) the ability to convert the policy to another policy; and (5) in the case of variable investment policies, the expected value of the returns on the invested excess premiums.

CVPs are typically issued as convertible term, whole life, universal life, or variable life. They may be also found in certain group life insurance plans, key person programs, (company owned life insurance) (COLI), bank owned life insurance (BOLI), and other similar programs.

At any time after a CVP is issued, the policy typically enables the policyholder to surrender the policy for its net cash surrender value, or the policy may be converted to another policy type having a comparable or lesser value. However, at the time of such surrender or conversion, the secondary insurance market (i.e., life settlement investors) determines a market investment value for the policy. This is generally equal to the present value of the future death benefit less the present value of the premiums required to keep the policy in force until the death benefits are paid. If the market investment value is greater than the net cash surrender value and the conversion value, the policyholder should always consider the pros and cons of selling it to the highest bidding investor rather than surrendering it to the insurer or converting it. Of course, the policyholder should also consider the intrinsic value of the future death benefit to his or her estate, business, or beneficiaries in relation to the policy's current market investment value.

The amount by which the market investment value exceeds the net cash surrender value or the conversion value is the "gross arbitrage" that creates economic basis for life settlements. The gross arbitrage is made up of four specific arbitrages. When aggregated together, these, typically but not always, provide sufficient value differential to enable the life settlement market to provide attractive offers to policyholders seeking to surrender, lapse, or convert their policies. They also provide attrac-

tive commissions and fees to life settlement intermediaries and profits to the investors.

### Expense Reserve Arbitrage

Expense reserve arbitrage is created by the practice of insurers holding back some portion of a policy account value at the time of a policy surrender. Universal life, variable universal life, and whole life policies include investment returns. These are based on interest rates set by the insurers, dividends declared by the insurers, or investment returns from funds in which the policy account values are invested. These investment returns accumulate in the policy account value, representing the asset value of the policy belonging to the policyholder.

However, insurers typically retain an "expense reserve." This results in a reduction of the account value available to policyholders upon a policy surrender. The net amount is referred to as the policy "surrender value." For example, a \$500,000 policy may have an account value of \$50,000 with a reserve or surrender charge of \$10,000 leaving only \$40,000 available to the policyholder.

Life settlement investors plan to hold policies to maturity. Thus, the expense charge becomes irrelevant to their investment decisions. However, the expense charge is real and current to the policyholder upon surrender. This results in an arbitrage in favor of the policyholder when a policy is sold as a life settlement.

### Mortality Arbitrage

Mortality arbitrage is created by the differences between mortality tables used by insurers versus mortality tables used by life settlement investors. Basically, insurers bet that an insured will live longer, while life settlement investors bet that an insured will die sooner.

When pricing a policy, insurers typically begin with reinsurance manuals, based on populations with ages of 40 to 60, and then add debits and credits representing the insured's medical conditions. In addition, insurers and agents aggressively compete for business and tend to favor data that qualify insurance applicants for "preferred" ratings to offer competitively lower premiums.

On the other hand, investors in life settlements obtain specific reviews of insured medical records by professional life expectancy estimators based on tables

specifically fitting people at ages 65 and older. The result is the life expectancies used by settlement investors will generally be shorter than the life expectancies used by the insurers to set premiums. This difference results in an arbitrage in favor of the policyholder when a policy is sold as a life settlement.

### **Policy Lapse Arbitrage**

Policy lapse arbitrage results because of assumptions made by life insurance companies. Policies were priced lower by insurance companies on the assumption that a given number of policies would lapse. In recent years, insurers have used lapse assumptions as a marketing technique to set lower and more competitive prices on policies.

However, the development of the life settlement market means that policies purchased by investors generally will not lapse. Life settled policies remain in force to maturity causing insurers to live with full term policy economics rather than lapse term economics. This results in an arbitrage in favor of the policyholder when a policy is sold as a life settlement.

### **Capital Cost Arbitrage**

Capital cost arbitrage occurs when capital markets enable investors to operate with lower yield requirements and greater efficiency than insurers built into their life products. When a policy is issued, its economics are in part set by the insurer's cost of capital at that time. This in turn affects the policy premiums paid by the policy owner.

Except for interest paid on account values, insurers cannot change the economics built into a policy without concurrently applying the change to an entire class of policies. However, in lower capital markets, investors can target lower yields and thus create higher policy value. The result is an arbitrage that often can be used in favor of the policyholder when a policy is sold as a life settlement.

## **TAX ISSUES AFFECTING ECONOMICS OF LIFE SETTLEMENTS**

Taxation of life insurance transactions and computation of a life insurance policy tax basis is complex and not clear. With the advancement of life settlements,

the need for clear tax rules and guidelines has become increasingly important. See Chapter 13 for additional discussion of taxation.

The secondary market is offering to purchase life insurance policies from seniors for amounts often many times greater than: (a) the cash surrender values of the policy, and (b) the premiums paid. The result is new infusions into the U.S. economy and substantial tax revenues to federal and state governments.

Further, in direct response to the growing life settlement industry, legitimate premium financing has emerged as an estate planning tool (premium financing, as considered here, does not include STOLI). As premium financing transactions are being scrutinized and approved by insurance carriers, life settlement firms, investors, regulators, and legislators, third party sale of life insurance policies is becoming more common. The tax community needs to focus its attention on the unfolding questions concerning the proper computation of gain and tax basis for sellers of life insurance policies.

Taxation of death benefits payouts, policy lapse, and policy surrender to carriers has been well settled. But the IRS has yet to provide formal guidance on the subject of policy sales under life settlements. For example, the proposed reduction of cost basis by the cost of insurance (COI) conceivably changes the well settled basis calculation of policies surrendered to carriers.

Existing case law suggests that a trifurcated approach for the sale proceeds of a life settlement is the proper tax treatment, even if the policy was premium financed. Under such an approach, tax basis is recovered tax-free. Gains recognized to the extent the cash surrender value in the policy exceeds the tax basis would be deemed ordinary income. Gains recognized above the cash surrender value (or, if the policy has no cash surrender value, above the tax basis of the policy) would be given either capital gains or ordinary income treatment.

In the matter of complete nonrecourse premium finance, the transfer of a policy to a lender in discharge of the note might constitute gain (or it might be considered "cancellation of debt" income). Gain recognized through the discharge of a nonrecourse premium finance loan should be treated as ordinary taxable income as no part of the loan debt represents an increase in the market value of the policy. There is, as yet, no definitive case or ruling on point and so the exact nature of taxation is uncertain.

The Internal Revenue Code is not clear on the proper tax basis calculation for policies sold as life settlements in the secondary market. In its guidance, the IRS has provided conflicting views, having applied an approach similar to that mandated under the IRC for policy surrenders, i.e., basis determined by the aggregate of premiums paid. However, while not formally overruling this approach, the IRS has in private letter rulings argued for an approach under which a policy's basis is reduced by the cost of insurance.

Under the IRS private letter ruling approach, one who sells a policy or surrenders a policy in satisfaction of a premium finance loan would be accountable for taxation on the portion of the debt balance discharged that exceeds the aggregate of premiums paid reduced by the cost of insurance. The IRS argument of reducing policy tax basis by the cost of insurance conceivably opens questions to well settled basis calculation methodologies of policies surrendered to carriers. But in advocating the tax basis be reduced by the cost of insurance, the IRS has not addressed the corresponding issue of expensing the cost basis as incurred against other taxable income.

It is without question this multi-billion dollar marketplace represents a significant new economy and an important tax revenue source that continues to grow for federal and state governments.

## LIFE SETTLEMENT INDUSTRY ECONOMIC AND TAX STRUCTURES

The economic structure for life settlements is complex, having numerous interlaced substructures. The substructures are identified in Figure 10.1, which in total represent the macroeconomic and tax structure for the life settlement industry.

### Policyholder Economics

Policyholders typically purchase life insurance policies to insure a risk, facilitate estate planning, or pay future estate taxes, or as an investment. These all represent some form of economic value, present or future, to the policyholder. Typically, the causes giving initial motivation for purchasing a policy change over time. Often, the policy needs to be replaced, is no longer needed, or can no longer be afforded. Other circumstances can create a need to borrow from the policy or from other lenders using the policy as collateral. Or, it may be in the policyholder's best interest to surrender the policy, let the

policy lapse, or sell it. The economics of life insurance policies for policyholders are numerous and can be plus and minus. Figure 10.2 illustrates economic impacts for the most typical policyholder situations, based on most typical life insurance policies. Of course there are numerous variations to the economic impacts based on individual circumstances and on specific policies and insurers. Thus, independent advice should be sought by any individual considering purchasing or changing life insurance policies.

Calculating the economic values for the policyholder, the investor, and the insurer of a life settlement transaction can be fraught with numerous conflicting phenomena. Consider the following realities:

- If a policy is continued, the policyholder expects to receive greater economic benefit if the insured dies early. Conversely, the insurer expects to receive greater economic benefit if the insured lives longer, say to age 100 or longer.
- When a policy is sold, the policyholder wants to demonstrate to the buyer that the insured will die sooner (to justify the highest possible policy price). In reality, the policyholder expects the insured will live longer. If the insured were expected to die earlier and the policy were not sold, the policyholder would expect to receive greater economic benefit by continuing the policy. Once the policy is sold, the policyholder's economics are no longer influenced by when the insured dies.
- As between the insurer and the investor, the investor expects to receive greater economic benefit if the insured dies early, and the insurer expects to receive greater economic return if the insured lives longer.
- From the insurer's perspective, if a policyholder is not expecting to continue the policy, the insurer is hoping the policyholder will surrender or lapse the policy, or create a policy loan, rather than sell it. This has greater economic value to the insurer.

The question is, "Which course of action has the greater economic value to the policyholder?"

A 2002 study by Wharton Financial Institutions Center<sup>3</sup> reported that when a life insurance policy becomes impaired (i.e., the insured's health becomes impaired),

Figure 10.1

LIFE SETTLEMENT INDUSTRY MACROECONOMIC AND TAX STRUCTURE								
Scenario	Policy Owner	Policyholder advisors	Insurance Agent	Insurer	Beneficiary	Policy seller agents: Insurance Agent Broker	Life settlement transaction services: Provider Escrow Trustee Servicer Legal Counsel	Investor
Issue new life insurance policy	Pay premiums	May receive fees	Receive Commissions	Accumulate premiums accrue reserves				
	Tax Impact	Cost basis accrual	Taxable Income	Taxable Income	Taxable profit less reserve charge			
Borrow from policy	Receive loan proceeds Pay interest and reduce surrender value	May receive fees	Continue Commissions	Pay out loan Secured by account value	Future death benefit reduced			
	Tax Impact	Interest expense generally not deductible	Taxable Income	Taxable Income	Taxable interest income	None		
Borrow from policy	Receive loan proceeds Pay interest and reduce death benefit	May receive fees	Continue Commissions	Pay out loan Reduction of death benefit liability	Future death benefit reduced			
	Tax Impact	Interest expense generally not deductible	Taxable Income	Taxable Income	Taxable interest income	None		
Surrender policy	Receive net surrender	May receive fees	Continue Commissions	Pay surrender value Retain surplus	Future death benefit reduced			
	Tax Impact	Taxable in excess of cost basis	Taxable Income	None	Taxable surplus and reserve recovery	None		
Policy lapse	Forfeit all premiums		Continue Commissions	Retain all reserves and surplus	Future death benefit lost			
	Tax Impact	No tax recovery		None	Taxable surplus and reserve recovery	None		
Insured dies		May receive fees		Pay death benefits	Receive death benefits			
	Tax Impact		Taxable income	Charge to reserves with excess tax deductible	Tax free			

Figure 10.1 (cont'd)

Scenario	Policy Owner	Policyholder advisors	Insurance Agent	Insurer	Beneficiary	Policy seller agents: Insurance Agent Broker	Life settlement transaction services: Provider Escrow Trustee Servicer Legal Counsel	Investor
Policy sold as life settlement	Receive payment greater than net surrender value	May receive fees	Continue renewal commissions			Receive transaction commissions	Receive transaction fees	Pay premiums Receive death benefits
	Tax Impact	Taxable in excess of cost basis	Taxable Income	Taxable Income	Taxable profit less reserve charge. . . Ultimate death benefit charge to reserves with excess tax deductible	Taxable Income	Taxable Income	Taxable in excess of cost basis

Color Code:	Scenario	Positive Impact	Negative Impact	Tax Impact
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Source: Insurance Studies Institute.

the present value of the death benefit increases because death will occur *sooner* than originally projected. Concurrently, the present value of premium payments *decreases*, because premiums will not have to be continued for as long as originally projected. Both effects cause an increase in the actuarial value of a policy for an individual with a shortened lifespan. A 2005 study reported by Deloitte Consulting LLP and the University of Connecticut<sup>4</sup> stated that the present value of maintaining a typical life insurance policy to death has a greater present value than the typical amount paid to the policyholder by a life settlement investor. Are these statements both valid?

The Wharton statement is correct in all cases. But, the Deloitte statement depends on a variety of assumptions: (a) the risk free interest rate versus the policyholder’s real alternative investment earnings rate; (b) the insured’s mortality rating used to underwrite and price the policy; (c) whether or not the premiums paid by the policyholder are at the minimum amounts required to keep the policy in force or at some level amount that may or may not build an account value in the policy; and (d) the capital market interest rate and IRR target used by the policy investor to value the policy in the secondary market.

Investors are well aware of the above phenomena, as their pricing of policies follows the exact same consider-

ations. And it is these phenomena that have to provide economic profit opportunity to the investor or the investor will not purchase the policy. So, in this regard, the Deloitte statement will most often, if not always, be correct (i.e., if the present value of maintaining the policy for the insured’s life expectancy is not greater than the price the investor pays to purchase the policy, the purchase will not occur). But a key difference is that the investor is basing its returns on the mortality probabilities of a comprehensive portfolio, while the individual seller is looking only at him or herself.

The Deloitte report focused on the intrinsic value of continuing the policy. In reality, a typical policyholder considers the economic opportunity cost (EOC) and the personal value cost (PVC) of the life settlement. Since people do not have the resources to satisfy all needs or wants, they must make choices and these involve costs. EOC is the incremental value or profit of the highest-valued forgone alternative (e.g., using the life settlement proceeds to invest in gold, oil, or general market securities, or to settle a debt, or purchase a house, etc). PVC is the incremental value or satisfaction of the highest-desired or most satisfying forgone alternative (e.g., pleasure of a new car, fulfillment of a life time dream, happiness, health, education, security, etc.). The policyholder weights both EOC and PVC when considering whether to continue a life insurance policy or sell it.

Figure 10.2

<b>POLICYHOLDER ECONOMICS</b>		
<b>Scenario</b>	<b>Direct economic impacts</b>	<b>Tax impacts*</b>
New life insurance policy	<ul style="list-style-type: none"> <li>• Premiums typically range from 2 to 8% of the policy death benefit, depending on the insurer, policy type and terms, age, and health impairments.</li> <li>• Commonly issued renewable convertible term insurance has a low level premium for typically 10 years, but then jumps substantially at renewal.</li> <li>• If the policy is universal, variable, or whole life, the amount by which premiums exceed the policy cost of insurance and fees will accumulate in the policy's account value until withdrawn or used to purchase additional insurance.</li> </ul>	<ul style="list-style-type: none"> <li>• Premiums are not tax deductible to individual policy holders. Some unique tax rules apply to group, key-man, COLI and BOLI plans.</li> <li>• Additions to account values by insurers are generally not taxed until withdrawn.</li> </ul>
Borrow from policy	<ul style="list-style-type: none"> <li>• Some or all of the account value can be borrowed and the loan proceeds are unrestricted.</li> <li>• The interest rate is typically low and fixed in the policy.</li> <li>• The loan is always due until paid by policyholder.</li> </ul>	<ul style="list-style-type: none"> <li>• Loan proceeds are generally tax free.</li> </ul>
Borrow from insurer	<ul style="list-style-type: none"> <li>• Some insurers are beginning to offer loans against future death benefits to policyholders.</li> <li>• Use of the loan proceeds may be restricted, e.g., payment of premiums, purchase of additional insurance or an annuity.</li> <li>• Interest rates are typically at market rates and may be paid annually or allowed to add to the loan balance.</li> <li>• The loan becomes due and payable from death benefits when the insured dies and the loan may never exceed the policy death benefits.</li> </ul>	<ul style="list-style-type: none"> <li>• Tax treatment may depend on how loan is characterized.</li> </ul>
Surrender policy	<ul style="list-style-type: none"> <li>• Most policies enable the policyholder to surrender it at anytime for the net surrender value.</li> <li>• The net surrender value is the accrued account value less the amount the insurer holds back to cover the costs incurred to issue and service the policy. The amount held back ranges from all of the account value in the first several years and eventually decreasing to zero held back.</li> <li>• For most of the years of the policy, the net surrender value available to the policyholder is less than the premiums paid; however, if all full premiums are paid and earnings are allowed to accrue in the policy, the entire account value will become available for withdrawal and, in the policy later years, may even exceed the total of all premiums paid.</li> </ul>	<ul style="list-style-type: none"> <li>• Premiums paid add to the policy tax basis.</li> <li>• Amounts withdrawn are taxable as ordinary income, but only to the extent they exceed the policy tax basis.</li> <li>• The amount by which the tax basis exceeds the amount withdrawn is not deductible against other taxable income.</li> </ul>
Convert or renew policy	Policy economics are similar to those for new policies above, except that premiums may be higher or lower, and some policy terms may change.	Same as for a new policy above.
Let policy lapse	All premiums that have been paid on the policy are forfeited to the insurer.	No amount of the premiums lost is deductible from taxable incomes.
Insured dies	All policy benefits are paid to the insured's estate or beneficiaries.	Tax free

**Figure 10.2 (cont'd)**

Scenario	Direct economic impacts	Tax impacts*
Insured dies	All policy benefits are paid to the insured’s estate or beneficiaries.	Tax free
Policy sold as a life settlement	<ul style="list-style-type: none"> <li>• Receives a cash payment greater than the policy cash surrender value.</li> <li>• The excess of the cash payment over the cash surrender value may be .5 to 2 times surrender value, sometimes more.</li> <li>• If the policy has no cash surrender value, and cash payment is worth more than letting the policy lapse.</li> </ul>	<ul style="list-style-type: none"> <li>• The amount by which the cash surrender value exceeds the policy tax basis should be taxed as ordinary income.</li> <li>• The amount between the life settlement amount and the cash surrender value should be taxed as capital gain.*</li> <li>• If the policy has no cash surrender value, or if the cash surrender value is lower than the policy tax basis, the entire difference between the sale proceeds and the policy tax basis should be taxed as capital gain.*</li> </ul> <p>*Note: This result is uncertain.</p>

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\* Numerous tax nuances exist in the tax code, regulations, and rulings, and specific independent tax advice should be used when reporting tax matters resulting from insurance transactions.

The above considerations are illustrated in Graphs 1 to 4 in Figure 10.3. These graphs provide a simple hypothetical illustration of a \$1 million death benefit life insurance policy on a male with attained age of 76 having a level annual premium of \$42,338 based on a policy illustration that projects a zero account value at age 100. The insured has a life expectancy of 112.25 months as determined by professional life expectancy estimators. This scenario is common in life settlement markets. The Net Life Settlement Payment (NLSP) to the policyholder is calculated at a 12% IRR to the investor and is net of all transaction costs. For this purpose, only the net proceeds paid to the policy seller from a life settlement transaction is of interest. The graphs compare present values (PV) assuming the insured dies in any of the years from current to when essentially 100% of the cohorts representing the insured’s applicable mortality table should have died, using alternative discount rates: (a) a risk-free earnings rate of 5% which is representative of insurers’ guaranteed rates; (b) a five year rate of 6.92% as might be found in a variable life policy; and (c) a long-term rate of 9.58% as might be found in a variable life policy.

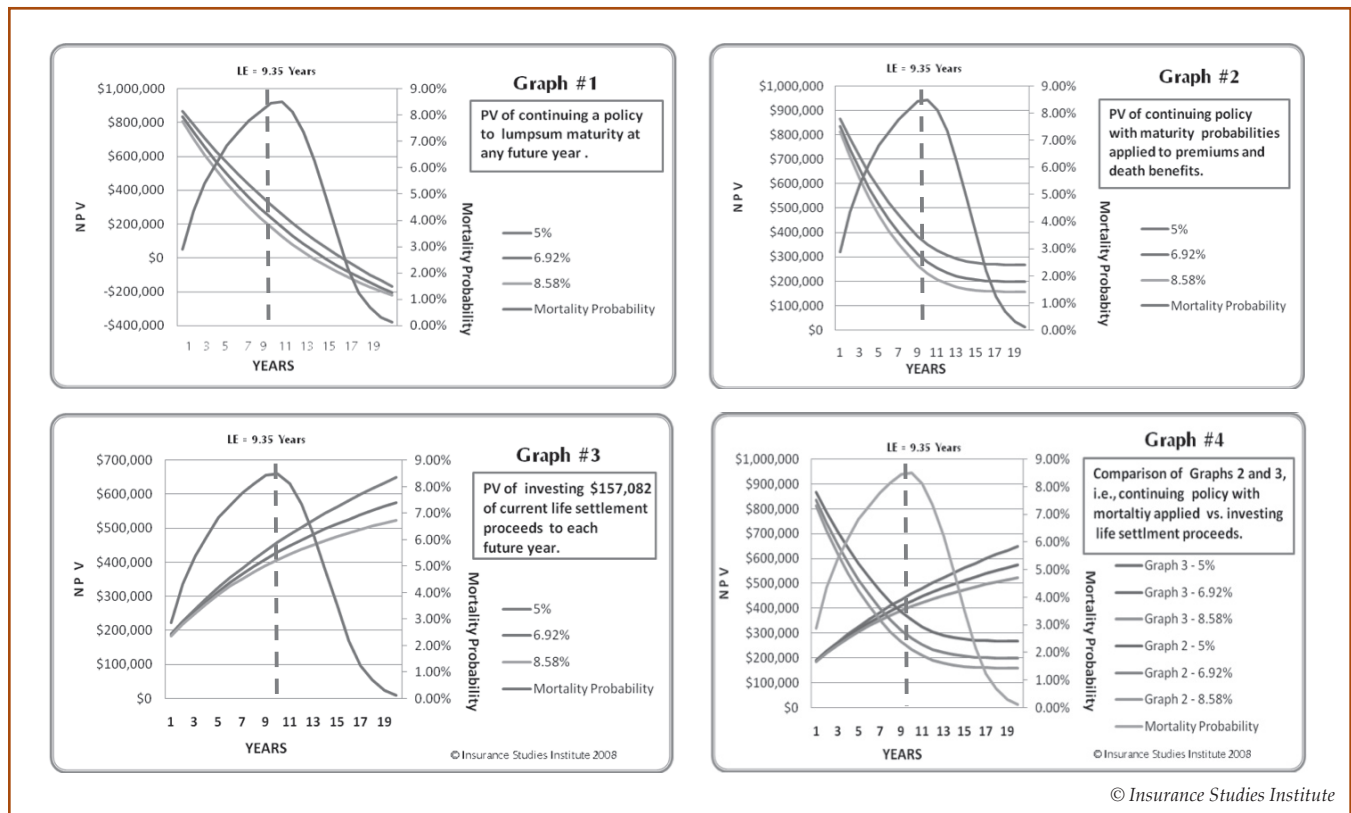
Graph 1 shows the risk-free rate returning PVs that are greater than the NLSP if the insured dies anytime

within the next 15 years. If the insured lives longer, the PVs turn negative. Graph 1 also shows the other rates returning lower PVs, which are greater than the NLSP if the insured dies within 12 or 13 years, and turning negative thereafter.

But the question is: “When will the insured die?” The insured looks into the mirror, feels the aches and pains, practices or does not practice healthy living, considers inherited genes, and makes his or her own judgment as to the likelihood of dying sooner or later. The life settlement investor looks at the mortality table for this answer, as does the insured as a practical matter. To put the graphs in Figure 10.3 into realistic perspective, the PVs must be adjusted by the applicable mortality probabilities to determine the Probable Present Values (PPV). The results are illustrated in Graph 2.

When considering the economic value of continuing a policy or selling it, one must look at the “future probability of living or dying.” The premiums on a life insurance policy are due only if the insured is living. Thus, when considering the present value of future obligations that are based on a probability of living, the future obligations should be weighted by the probability

Figure 10.3



of having to pay them. The same rationale applies to benefits. Future death benefits should be weighted by the probability of dying.

Looking at the curves in Graph 2, the insured sees that the PPVs are as large as or larger than the PVs in Graph 1. This is because probable portions of the future death benefit in each future year reduce the probable annual premium payments. The effect of moving probable portions of the death benefit into earlier years is an increase in PPVs. In all years, the PPV is greater than the PV and greater than the NLSP. This relationships hold for scenarios having either shorter or longer life expectancies.

However, Graphs 1 and 2 in Table II do not take into consideration the after-tax investment of the NLSP plus investment of the annual premiums that would have been invested in the insurance policy had the policy not been sold. This scenario is illustrated in Graph 3. The same investment rates are used for calculating the present values, but in this scenario the risk free return of 5% may not be risk free because it is not being paid as a guaranteed minimum rate by the insurer. To make Graph 3 comparable to Graph 2, the future annual pre-

miums are multiplied by the mortality probability of being alive at the beginning of each year.

Clearly, the result of investing the NLSP and investing probable future premiums are PVs that increase rapidly to substantial values. But are these values greater than the PVs of continuing the policy? This question is answered in Graph 4, where Graphs 2 and 3 are compared. It is evident that the PPVs for continuing the policy are greater if the insured dies early (i.e., within seven years). But if the insured dies after seven years (e.g., 2.25 years earlier than the insured's life expectancy), the PPVs of selling the policy are materially greater. So, if the insured expects to die early and the insured's PVCs support continuation of the policy, this would be the more economical choice. But if the insured expects to live a long life, selling the policy is the wiser economic choice.

A competitive secondary market for life insurance policies enhances the economic welfare of both new and existing policyholders. By allowing companies to compete for underperforming or unneeded policies, the secondary market generates increased consumer choice and favorable valuations for consumers. Because the life settlement industry expands the economy, and because

participation and investment in life settlements is pro-competitive and pro-consumer, regulations are needed that encourage such participation or investment and protect the interests of consumers and investors in the secondary life insurance market.

### **Policyholder Advisors' Economics**

It is common for policyholders and insureds to seek independent advice as to the appropriateness of life settlement transactions. This includes advice from lawyers, trust officers, financial planners, and tax advisors, apart from their life insurance agent. All of these advisors charge fees for such services, ranging from a few hours up to numerous hours for large and complex structures.

Figure 10.4 provides an estimate of professional advisory time for each scenario, but this is not intended to be a guide as to the amount of such time that is needed, reasonable, or appropriate. Each person engaging such professional services must determine the appropriate time for such services based on the scope of services retained.

### **Life Insurance "Agent-of-Record" Economics**

The insurance "agent of record" has an economic interest in a policyholder's life insurance policy. Whenever activity occurs on a life insurance policy by the policyholder, the insurer typically notifies the agent of such activity. No other agents or advisors are entitled to compensation from an insurer unless the agent of record approves such and the other party is a licensed insurance agent. As a result, it behooves the agent of record to pay attention to all life insurance policies in the agent's book of business.

Most agents stay in contact with policyholders and make themselves available when advised by the insurer or others that the policyholder is asking questions. It is common for policyholders and insured to seek advice from the life insurance agent who sold the policy because such agent is expected to be the most knowledgeable of the policy, its terms, and options.

The table below describes the economic interests to life insurance agents from policies for which they are "agent of record" and for which they represent the policyholder when selling the policy in the secondary insurance markets.

### **Insurer Economics**

As of 2006, ACLI reported a total of \$10.06 trillion individual life insurance in force, an increase of \$86.1 billion over 2005.<sup>6</sup> The life settlement industry in 2007 estimated a total of \$12 to 15 billion of death benefits transacted in life settlements, about .15% to .18% of the total life insurance in force. Insurers have voiced material concern that life settlements cause economic losses resulting from reduction in lapsed policies as some insurers admit inclusion of assumed policy lapses when pricing policies, i.e. "lapse based pricing."<sup>7</sup> Cumulative industry data on lapse rates is difficult to obtain as the NAIC reports lapse data in annualized rates for various issue ages and product types. The 2006 U.S. Individual Life Persistency Report, prepared by LIMRA (Life Insurance Management Research Association) and SOA (Society of Actuaries), reported that lapse rates for whole life, universal life, and term life all declined in 2003 to 2004 and from 2001 to 2002. This same report shows that lapse rates decreased for all age groups, except those under age 20. The ACLI 2007 Facts Book reports declining lapse and surrender rates for all individual policy types, with the exceptions of years 2000 and 2002, from 1997 through 2006, with a total 6.3% termination rate in 2006. Based on total individual in force insurance and the 6.3% termination rate, approximately \$633 billion of in force terminated in 2006 of which the 2006 total life settlement industry estimated at \$6.1 billion<sup>8</sup> represented only .96%. While life settlements do in fact prevent settled policies from lapsing and certainly do have greater impact among seniors, the long term decreasing trend for all age groups and the total magnitude of lapses and surrenders versus total life settlement transactions suggests that something other than life settlements, e.g., alternative policy options or social-economic considerations, is having greater influence on decreasing lapse rates.

Apart from the foregoing issue of lapse rates, the following Special Comments from Moody's Investor Services, February 2006, seem to put the economic impact of the life settlement industry on life insurers into perspective:

Moody's believes that the life settlement market is here to stay, but not likely to have a substantial financial impact on the life insurance industry. It might lower the profitability of some insurers' blocks of business, affect the pricing of some products over time, offer incremental value to qualifying policyholders that have a need to surrender their policies prematurely, and add some additional controversy to the industry

Figure 10.4

<b>POLICYHOLDER ADVISORS' ECONOMICS</b>		
<b>Scenario</b>	<b>Direct economic impacts</b>	<b>Tax impacts</b>
New life insurance policy	<ul style="list-style-type: none"> <li>• Many policy purchasers do not use professional advisors and rely on the advice provided by the insurance agent.</li> <li>• 2 to 8 hours for general advice as how to best structure ownership and beneficiaries of the policy.</li> <li>• 6 to 20 hours to integrate the policy into estate plans and wills.</li> <li>• 16 to 32 hours to structure ownership of the policy into a trust or other entity for estate planning or business planning purposes.</li> </ul>	<ul style="list-style-type: none"> <li>• All fee income to the advisors is ordinary taxable income.</li> <li>• Fees paid by the policyholder may be tax deductible.</li> </ul>
Borrow from policy	<ul style="list-style-type: none"> <li>• Many policy purchasers do not use professional advisors and rely on the advice provided by the insurance agent.</li> <li>• .5 to 1 hour for general advice regarding tax planning.</li> </ul>	<ul style="list-style-type: none"> <li>• All fee income to the advisors is ordinary taxable income.</li> <li>• Fees paid by the policyholder may be tax deductible.</li> </ul>
Borrow from insurer	<ul style="list-style-type: none"> <li>• Borrowing from an insurer against the policy death benefit is a relatively new resource and most individuals and insurance agents are not adequately informed of all related ramifications. Independent professional advice is strongly recommended.</li> <li>• 2 to 10 hours for general advice regarding financial and tax planning.</li> </ul>	<ul style="list-style-type: none"> <li>• All fee income to the advisors is ordinary taxable income.</li> <li>• Fees paid by the policyholder may be tax deductible.</li> </ul>
Surrender policy	<ul style="list-style-type: none"> <li>• Many policy purchasers do not use professional advisors and rely on the advice provided by the insurance agent.</li> <li>• .5 to 1 hour for general advice regarding estate and tax planning.</li> </ul>	<ul style="list-style-type: none"> <li>• All fee income to the advisors is ordinary taxable income.</li> <li>• Fees paid by the policyholder may be tax deductible.</li> </ul>
Convert or renew policy	<ul style="list-style-type: none"> <li>• Many policy purchasers do not use professional advisors and rely on the advice provided by the insurance agent.</li> <li>• .5 to 1 hour for general advice regarding estate and tax planning.</li> </ul>	<ul style="list-style-type: none"> <li>• All fee income to the advisors is ordinary taxable income.</li> <li>• Fees paid by the policyholder may be tax deductible.</li> </ul>
Let policy lapse	<ul style="list-style-type: none"> <li>• Most policy purchasers do not use professional advisors and rely on the advice provided by the insurance agent.</li> <li>• .5 to 1 hour for general advice regarding estate and tax planning.</li> </ul>	<ul style="list-style-type: none"> <li>• All fee income to the advisors is ordinary taxable income.</li> <li>• Fees paid by the policyholder may be tax deductible.</li> </ul>
Insured dies	<ul style="list-style-type: none"> <li>• Most policy purchasers do use professional advisors to assure estate administration and taxes are handled properly.</li> <li>• 4 to 32 hours, and up to hundreds of hours for large complex estates, for general advice.</li> </ul>	<ul style="list-style-type: none"> <li>• All fee income to the advisors is ordinary taxable income.</li> <li>• Fees paid by the policyholder may be tax deductible.</li> </ul>
Policy sold as a life settlement	<ul style="list-style-type: none"> <li>• Most policy purchasers do, or should, use professional advisors in addition to the life insurance agent to assure all aspects of such sale are understood, legal, fair, and appropriate.</li> <li>• 4 to 16 hours and up to 32 hours for large policies held in complex trusts and entities.</li> </ul>	<ul style="list-style-type: none"> <li>• All fee income to advisors is ordinary taxable income.</li> <li>• Fees paid by the policyholder may be tax deductible.</li> </ul>

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Figure 10.5

AGENT OF RECORD ECONOMICS		
Scenario	Direct economic impacts	Tax impacts
New life insurance policy	<ul style="list-style-type: none"> <li>Receives compensation (commissions) from the insurance company that typically ranges from 90% to 110% of the policy first year target premium.</li> <li>Receives renewal commissions each year thereafter that the policy remains in good standing with premiums paid.</li> </ul>	All compensation paid by insurer to agent is ordinary taxable income.
Borrow from policy	No economic value to agent, except that such borrowing may help keep the policy in good standing, rather than let it lapse or be surrendered.	No tax impact.
Borrow from insurer	No economic value to agent, except that such borrowing may help keep the policy in good standing, rather than let it lapse or be surrendered.	No tax impact.
Surrender policy	Agent loses all future renewal commissions.	No tax impact.
Convert policy	<ul style="list-style-type: none"> <li>Paid a conversion bonus from insurer.</li> <li>Retains renewal commissions on converted policy.</li> </ul>	All compensation paid by insurer to agent is ordinary taxable income.
Let policy lapse	Agent loses all future renewal commissions.	No tax impact.
Insured dies	Agent loses all future renewal commissions.	No tax impact.
Policy sold as a life settlement	<ul style="list-style-type: none"> <li>If agent is continued as Agent of Record, retains all future annual renewal commission until insured dies.</li> <li>If agent of record is changed to another party, original agent loses all future renewal commissions, but renewal commissions are then paid to a new agent of record.</li> </ul>	<ul style="list-style-type: none"> <li>All compensation paid by insurer to agent is ordinary taxable income.</li> <li>Commissions from policy sale are ordinary taxable income.</li> </ul>

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regarding the appropriateness of these transactions. The life insurance industry and capital markets are increasingly intersecting in new and non-traditional ways. Life insurance products purchased in the secondary markets as investments are but one part of this trend. Moody's believes that the development of the life settlement market is but one manifestation of the increasing level of efficiency by which insurance policyholders are exercising their policy options. While policyholders are typically still far from exercising these options with perfect efficiency, it is clear that the marketplace has become more efficient and will likely continue to do so for the foreseeable future. Any (insurance) company that thinks that it can ignore this fact does so at

its own long run peril. The capital markets have further facilitated this process by permitting these options to be transferred to purchasers who have an interest in more efficient option exercise and have the ability to do so. The problem is that many policy and product designs in the market today are not fully self supporting. This is especially true with many long-dated term contracts and many of the NLUL policies currently being sold. In addition, there might be anti-selection against the company through the life settlement process. Those insured in poor health are less likely to lapse their policies if they have access to a favorable bid for the policy that reflects their poor health and relatively shorter expected remaining lifespan.

It is in all parties' interest to assure that life settlements are entered into for good reason. In 2002, the Wharton Financial Institutions Center published a comprehensive evaluation of the benefits of the secondary market for life insurance policies,<sup>9</sup> which reported the following as regards arguments of the insurers:

These anticompetitive arguments rest on the notion that the introduction of a secondary market will increase the cost of providing coverage for a given premium and surrender value. Although some increase in cost can be expected, the issue of cost is tangential to the issue of consumer welfare, and an increase in cost does not imply any negative effect on consumer welfare. The incumbent carriers' argument ignores (1) the demand effects of an active secondary market for life insurance policies, and (2) the distribution of a portion of the previous deadweight loss to policyholders.

If there is no external market for reselling policies, insurers have no incentive to adjust their surrender values for impaired policies to competitive levels because they wield monopsony power over the repurchase of "impaired" policies. Viatical and life settlement firms erode this monopsony power. The magnitude of the benefits of a secondary market for life insurance policies to policyholders and incumbent insurers in the primary market is positively correlated to the quantity of coverage sold to life settlement firms and to the improvement in the terms of accelerated death benefits offered by incumbent carriers. We conclude that the incumbent life insurance carriers' efforts to deter entry by life settlement firms are motivated by the anticompetitive desire to maintain monopsony power over policyholders.

Although life insurers will lose monopsony power and therefore lose economic rent from the termination of policies, the life insurance industry would benefit in the long term from the stronger demand created by the secondary market. Furthermore, by standing as ready purchasers of policies, firms in the secondary market could discourage the repeal of nonforfeiture laws and keep incumbent insurers from the unfair and ultimately unworkable practice of using high lapse expectations to under price certain policies.

In 2007, Paul Rutledge, President of Transamerica Reinsurance, expressed his views on the economics of life settlements to the insurance industry:<sup>10</sup>

Rutledge envisions long term advantages for the development of a secondary market for life insurance products – advantages for both the insurance buying public and for life companies.

Rutledge indicated that life settlements are a natural evolution of life insurance products, noting that a life insurance policy is a financial instrument to be treated like any other asset in a consumer's financial plan, with access to its market value. He further noted that newer policy designs have created larger gaps between surrender value and economic value, causing the surrender value to not reflect the policy's economic value.

Rutledge further noted: Life insurers are in a good position to boost efficiency by streamlining the transaction (*life settlements*) and removing distribution and administration redundancies that they are already performing within the existing life insurance product. In doing so, the life insurer, independently or in partnership with a life settlement company, can provide its customers with a settlement option that should be at least as competitive as other offers. However, current regulations are unclear as to what role life insurers could play in repurchasing their own issued policies. Establishing new regulations enabling insurers to do so would be beneficial. Not only should this be an advantage to the policyholder, it should benefit the insurer as well. Rather than having a policy mature to the benefit of an outside investor, the insurer would have the option of paying an amount less than the death benefit and erasing the corresponding death benefit liability off the books. There is a middle ground where the policyholder reaps a better value and the insurer can come out with value at the same time.

To compete with life settlements, insurers are beginning to offer loans against the policy death benefit, similar to reverse mortgages. The economics (see Figure 10.6) and legal issues of this new practice are still unfolding. What are the economic advantages of an insurer issuing loans against a future death benefit they will pay, versus encouraging the policyholder to sell to a life settlement investor?

- The economic effect of keeping the policy in force via a loan to the policyholder is no different from looking to a life settlement investor to keep the policy in force.

Figure 10.6

POLICY LOAN ECONOMICS	
Loan from Insurer	Life Settlement
Tax treatment may depend on how loan is characterized.	Proceeds from life settlement greater than policy tax basis are taxable.
Interest incurred on the loan, not tax deductible.	After-tax sale proceeds can be invested for income, used to purchase other insurance such as long-term care, or to purchase an annuity.
Death benefit continues in force consuming some portion of insured's insurable capacity.	Death benefit continues in force consuming some portion of insured's insurable capacity.
Policy premiums continue to be paid by policyholder, may be paid with additional loan advances.	Policy premiums cease as to policyholder
Loan reduces death benefit to beneficiaries.	Beneficiaries' interest in death benefit is terminated.
Policyholder retains option to pay off loan and retain the policy.	The policy is gone and cannot be recovered.

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- Because the loan sustains the policy, the insurer does not realize the gains that occur with a policy lapse or surrender.
- The insurer is betting against itself, i.e., when issuing the policy the insurer bet the death benefit would not be paid until many years later, but when making the loan, the insurer is betting the insured will die before the loan balance exceeds the death benefit.
- Insurer earns interest profit on the rate it charges the policy borrower versus its cost of money.
- The policyholder realizes several economic dynamics from a loan versus selling the policy as a life settlement.

Another substantial economic consideration of life settlements to insurers is the reinvestment of life settlement proceeds into new life insurance policies, annuities, and related investment funds. These all create new economics, along with continuation of the original policy.

This section of this chapter focuses on life settlement economics affecting insurers, and it focuses on life in-

surance policies most prevalent in life settlements, i.e., universal life, variable universal life, convertible term life, whole life, and convertible group life. While these several policy types are manifested in numerous unique products offered by insurers, the specific details of which are too complex to expand in this section or chapter, the economics generally follow similar patterns. Thus the economic structure described in Figure 10.7 is intended to be generally inclusive of the more typical structures found in life settlement policies.

### Beneficiary Economics

Most life insurance policy “non-owner” beneficiaries have no current economic value in a life insurance policy until the insured dies. The few exceptions are lenders, businesses, partners, and employers who consider the death benefit as collateral to cover contractual obligations. Any such contractual beneficiaries will typically have contractual rights to approve a sale of the policy. Non-owner beneficiaries, e.g., spouses, children, etc. typically have no rights to the policy until the insured dies. They rarely have any right to approve or disapprove a sale of the policy. Figure 10.8 focuses only on non-owner and non-contractual beneficiaries, which represent the vast majority of all life insurance beneficiaries.

Figure 10.7

<b>INSURER ECONOMICS</b>		
<b>Scenario</b>	<b>Direct economic impacts</b>	<b>Tax impacts*</b>
New life insurance policy	<ul style="list-style-type: none"> <li>• Receive premiums, typically equal 2 to 8% of policy death benefit.</li> <li>• Pay commissions to agent, typically 90 to 110% of first year target premium.</li> <li>• Establish policy structure for cost of insurance (COI), fees, account value accrual, cost recoveries, interest earnings, and death benefit reserves.</li> <li>• Apply and accrue charges for fees, COI, reserves, and cost recoveries to policy.</li> <li>• Pay agent renewal commissions.</li> </ul>	<ul style="list-style-type: none"> <li>• All income is taxable less expenses.</li> <li>• Allocations to reserves are deducted from taxable income.</li> </ul>
Borrow from policy account value	<ul style="list-style-type: none"> <li>• Loan funds advanced from insurer.</li> <li>• Earns interest on loans, typically 5 to 8% APR, flows to insurer.</li> <li>• Becomes liability on insurer's books with no affect on the policy and its reserves.</li> </ul>	Annual interest earned on loan is taxable income.
Borrow from insurer against death benefits	<ul style="list-style-type: none"> <li>• Loan funds charged to policy account accrual.</li> <li>• Interest accrual, typically 5 to 8% APR, reduces death benefits.</li> <li>• Death benefit liability is reduced by loan amount.</li> </ul>	
Surrender policy	<ul style="list-style-type: none"> <li>• Reserves are charged an amount equal to the policy account value.</li> <li>• Difference between account value and net surrender value is retained by insurer.</li> <li>• Amount previously allocated to reserves for death benefit is taken into earnings.</li> </ul>	<ul style="list-style-type: none"> <li>• Difference between account value and net surrender value is taxable income.</li> <li>• Reserve recovery is taxable income.</li> </ul>
Convert or renew policy	Policy economics are similar to those for new policies above, except that COI, reserves, expenses, etc, may be higher or lower, and some policy terms may change.	Same as for a new policy above.
Let policy lapse	<ul style="list-style-type: none"> <li>• All premiums that have been paid on the policy are retained by insurer.</li> <li>• Reserves are released to income.</li> </ul>	Reserves released are taxable income to the extent they were previously deducted from taxable income.
Insured dies	<ul style="list-style-type: none"> <li>• Death benefit is paid out.</li> <li>• Reserves are charged for the death benefit after adjustments for account value reserves.</li> <li>• Amount of death benefit in excess of reserves, if any, is paid from insurer cash flows.</li> </ul>	<ul style="list-style-type: none"> <li>• Charge of death benefit to reserves has no impact on taxable income because the reserves were previously deducted.</li> <li>• Amount of death benefit in excess of reserves is tax deductible.</li> </ul>
Policy sold as a life settlement	<ul style="list-style-type: none"> <li>• Premiums continue to be received and reserves accrued.</li> <li>• All economic aspects of original policy are continued.</li> </ul>	<ul style="list-style-type: none"> <li>• All income is taxable less expenses.</li> <li>• Allocations to reserves are deducted from taxable income</li> </ul>

\* Numerous tax nuances exist in the tax code, regulations, and rulings, and specific independent tax advice should be used when reporting tax matters resulting from insurance transactions. Many tax results in the life settlement area are at present time uncertain. © Insurance Studies Institute

**Figure 10.8**

<b>BENEFICIARY ECONOMICS</b>		
<b>Scenario</b>	<b>Direct economic impacts</b>	<b>Tax impacts</b>
New life insurance policy	<ul style="list-style-type: none"> <li>• Only a future interest in the death benefit</li> <li>• Typically, no guarantee that policyholder will not change beneficiaries</li> </ul>	None
Borrow from policy	Future death benefits reduced by amount of loan and unpaid interest	None
Borrow from insurer	Future death benefits reduced by amount of loan and unpaid interest	None
Convert or renew policy	<ul style="list-style-type: none"> <li>• Only a future interest in the death benefit</li> <li>• Typically, no guarantee that policyholder will not change beneficiaries</li> </ul>	None
Let policy lapse	Future death benefits terminated	None
Insured dies	Receive death benefits, minus all liens on the policy	Tax free
Policy sold as a life settlement	Beneficial interest in future death benefits are lost	None

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**Economics of Agents and Brokers  
Representing Policy Sellers**

Most sellers of life insurance policies use agents and brokers to represent the policy and the seller in the secondary markets. Frequently, the agent is the agent of record for the policy, but this cannot be assumed. The agents and brokers help the seller understand all the ramifications and alternatives to selling, help arrange for information required for buyers, solicit bids to get the highest market price, help the seller evaluate offers, and help the seller complete the closing. Figure 10.9 shows the economics for such agents and brokers.

**Investor Economics**

Investors undertake longevity risks and are committed to paying premiums until the insured dies. If the insured lives longer than the estimated life expectancy, the investor may pay out more for the policy than it will get back in death benefits. However, if the insured dies early or at about the estimated life expectancy, the investor stands to realize its target investment return. Further, there are risks that insurers may refuse payment of death benefits on the basis the policy application contained fraudulent information or that there was a lack of insurable interest and that the contract was void ab initio (from inception),

**Figure 10.9**

<b>ECONOMICS OF AGENTS AND BROKERS REPRESENTING THE POLICY SELLER</b>		
<b>Scenario</b>	<b>Direct economic impacts</b>	<b>Tax impacts</b>
Policy sold as a life settlement	Receive sales commissions ranging from 10% up to 50% from seller's gross proceeds. Typical commission is 20 to 30%.	Taxable as ordinary income.

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Figure 10.10

INVESTOR ECONOMICS		
Scenario	Direct economic impacts	Tax impacts*
Policy sold as a life settlement	<ul style="list-style-type: none"> <li>• Pays a purchase price determined by the discounted present value of the death benefit at the estimated life expectancy.</li> <li>• Purchase price typically ranges from 10% to 60% of the policy death benefit, depending on the life expectancy, projected costs to maintain the policy, and cost of capital. Average cost approximates 20 to 22% of the policy death benefit.</li> <li>• Pays premiums and costs to maintain the policy until the insured dies.</li> <li>• Incurs cost of capital on all amounts invested until policy matures.</li> <li>• Receives death benefit when insured dies, less debts allocable to policy.</li> </ul>	<ul style="list-style-type: none"> <li>• Purchase price goes to policy tax basis</li> <li>• Premiums paid add to policy tax basis.</li> <li>• Death benefits in excess of tax basis is taxable as ordinary income.</li> </ul> <p style="text-align: right;">© Insurance Studies Institute</p>
<p>* Numerous tax nuances exist in the tax code, regulations, and rulings, and specific independent tax advice should be used when reporting tax matters resulting from insurance transactions. Many tax results in the life settlement area are at present time uncertain.</p>		

beneficiaries may claim the life settlement transaction was not valid, or contact with the insured is lost and collection of death benefits is materially delayed. The returns to investors from life settlements have almost no correlation to typical market factors making mortality and eventual policy benefit payments certain. The timing of benefit payments is uncertain. For these reasons, the discount rate (e.g., expected internal rate of return) used to value a life settlement is higher than comparable capital market yields with corresponding credit risk profiles. Figure 10.10 shows the economics for investors.

The economic cornerstone for valuing an investment is determining the net present value (NPV) and the internal rate of return (IRR) of the future cash flows, which include many variables. This holds true for life settlements. The NPV of the future cash flows of a life insurance policy are defined as the discounted cash outflows of the policy (i.e., the policy purchase price, plus future costs of maintaining the policy) compared to the discounted cash inflows of the policy (i.e., the death benefit). The internal rate of return projected is the rate that produces a net present value equal to zero.

Typically, life settlement investors establish a minimum IRR that is required for the firm to achieve its target profit. Investors may have different minimum IRRs due to differences in factors such as their capital structure, weighted average cost of capital, and tax structure. Like other fixed income securities, the investor minimum IRR

hurdles are often based upon the London Inter-Bank Offer Rate (LIBOR) to which basis points are added. (This is similar to how individual mortgage rates are priced and quoted.) The price the investor is willing to pay for the policy is then quantified by the spread between the policy’s expected IRR and the investor’s required minimum IRR.

Typically, if the policy IRR is *higher* than the minimum IRR hurdle rate, the policy should be purchased (assuming all other purchase criteria have been met). If the policy IRR is *lower* than the minimum IRR hurdle rate, the policy should be avoided. Because different life settlement investors use different pricing methodologies and have different minimum IRR hurdle rates, market prices offered for a life settlement policy can vary significantly.

While life settlements will mature with certainty, the maturity date is not certain as with a bond or mortgage. Thus, the actual policy IRR will not be known until the date the policy death benefits are actually paid. To further account for processing time after mortality, some investors add up to three months to the probable death benefit curve for collection delays. In addition, life settlement investors typically test the sensitivity of the policy IRRs by testing variations of the life expectancy results when aggregating large portfolios. For example, by what amount will the policy IRR be affected if an insured’s actual life expectancy is one year longer? See Figure 10.11 for illustration of IRR sensitivity to life expectancy error

Figure 10.11

IMPACT ON IRR OF LIFE EXPECTANCY EXTENSION							
Pricing based on John Doe, 70 Year old Male, non-smoker, \$2,000,000 face amount							
5 Year LE				15 Year LE			
Understated by:	LE (Yrs)	Price @ 10% IRR	Adjusted IRR	Understated by:	LE (Yrs)	Price @ 10% IRR	Adjusted IRR
Base = 0%	5.0	\$ 1,174,902	10.00%	Base = 0%	15.0	\$ 206,109	10.00%
10%	4.5	1,241,928	8.66%	10%	13.5	318,753	6.62%
20%	4.0	1,311,401	7.40%	20%	12.0	440,265	4.31%
40%	3.0	1,458,135	5.03%	40%	9.0	714,950	1.11%

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on the insured for a single policy. Note that the impact on IRR differs by the term of the life expectancy.

Figure 10.11 considers the impact of life expectancy extension on a single policy. Institutional investors of life settlement typically seek to acquire hundreds, if not thousands, of life insurance policies. Thus, while the impact of life expectancy extension remains the primary risk for investors, the magnitude of this risk decreases dramatically when additional policies are added to a portfolio.

A research report by Insurance Studies Institute<sup>11</sup> reports: “Life settlements offer institutional investors an asset class that provides diversified returns which are not correlated or dependent on movements of the economy. Life settlements do not share the same types of risk typically associated with most investment assets. The two major risks associated with life settlements are LE underwriter risk and longevity risk. LE underwriter risk is subject to proprietary methodologies and the accuracies of the underwriters and can be managed and reduced by structuring a balanced diversity of LE underwriters for each insured and/or for all insureds in a portfolio, and by evaluating the performance records of the underwriters. Longevity risk, while it cannot be eliminated, can be statistically predicted, managed, and reduced by aggregating 300 or more insured lives in a portfolio. A portfolio of such size provides predictable stability and mitigation of longevity risk, thus increasing the efficiency of other longevity risk management tools (e.g., hedges, swaps, and guarantees) and enhances the potential attractiveness of the portfolio for securitization.”

### Economics of Pricing Life Settlements

One of the major factors affecting the economics of life settlements is policy pricing. Even though new life

settlement pricing models continue to emerge, some being patented and copyrighted, two fundamental methodologies have emerged in most pricing models: (1) Deterministic Pricing, and (2) Probabilistic Pricing.<sup>12</sup> While these two methodologies differ significantly, they share several common economic factors, including but not limited to: (a) an expected internal rate of return (IRR) to the policy investor; (b) utilizing the age and life expectancy (LE) of the insured to determine mortality rates; (c) reverse engineering the policy’s cost of insurance (COI); (d) discounting the death benefit and all costs to maintain the policy until maturity; and (e) optimum utilization of the account and cash values of the policy. Additional economic factors that influence the pricing of a policy typically include the financial rating of the insurer, market interest rates, policy ownership structures, specific health impairments, and mortality improvement factors.

The fundamentals of both the Deterministic and Probabilistic Pricing Model methodologies are applicable to most of the different types of life insurance policies that are attractive to life settlement investors, including, universal life, variable universal life, whole life, and renewable term convertible into universal life. Each policy type has different features that affect their attractiveness to investors. While the internal economics of a life insurance policy are a separate but major component of the policy pricing model, the policy economics do not influence the life expectancies or the mortality curves, and the policy economics play out the same in whichever life settlement pricing model is used.

### Deterministic Pricing Model

According to Zollars, Grossfeld, and Day, the first pricing methodology used to value life insurance policies was the Deterministic Pricing Model, which originated

from the early viatical settlement industry. There, life expectancies of insureds were shorter and theoretically more predictable than the longer senior life settlements that are more common in today's secondary life insurance markets.

The basic pricing premise of the Deterministic Pricing Model assumes that, in addition to the purchase price, the purchaser pays the full policy costs until the insured's estimated life expectancy. This is typically stated in months, at which time the death benefit is calculated to be paid. Some investors add one to two years to the estimated life expectancy as a risk buffer.

The economic value of the policy is determined by calculating the discounted value of the death benefit from the life expectancy (the cash inflow), less the discounted value of the policy costs (premiums) required to maintain the policy (the minimum cash outflows) from date of purchase to the estimated life expectancy. The discount rate applied to this cash flow stream is the expected return the investor seeks over the specified period of time.

In portfolio theory, the Deterministic Pricing Model assumes a large portfolio of policies is purchased with the insured having somewhat homogenous characteristics and the mortality of those insured approximating the mean expected life expectancy of the entire portfolio.

The primary weakness of the Deterministic Pricing methodology is its failure to directly take into account the probability of deaths occurring before or after the estimated life expectancy. In addition, Deterministic Pricing methodology does not consider the mortality curves of the insured.

### Probabilistic Pricing Model

As the secondary life insurance markets have matured with senior life settlements, life settlement investors and financiers have developed a new and more advanced pricing model methodology referred to as the Probabilistic Pricing Model. The Probabilistic Pricing methodology was designed to address the primary weaknesses of the Deterministic Pricing Model. The Probabilistic Pricing Model takes into consideration the mortality curve of the insured, rather than assuming mortality will occur at life expectancy.

Utilizing the inputs of age, gender, and smoking and an appropriate mortality table, the Probabilistic Pricing

Model uses the insured's life expectancy to determine a mortality curve for the insured. This model then calculates two economic curves:

1. *Cash inflow* is the policy death benefit spread over the entire mortality curve in proportion to the insured's probability of not surviving each future year. It is possible for the mortality curve to extend past the policy maturity date and thus cause some probable death benefits to be theoretically lost. This does not occur in the Deterministic Pricing model.
2. *Cash outflow* is the cost (COI) of the policy to maturity over the mortality curve in proportion to the insured's probability of surviving each future year.

These two economic curves are combined to create a "probable cash flow." This is then discounted to a net present value at the investor's expected rate of return to determine an economic value of the life insurance policy. The Probabilistic Pricing Model's portfolio theory also takes into account that a large portfolio will tend to approximate the blended mortality curves of all insured.

This model has one inherent advantage over the Deterministic Pricing model. It takes into account the fact that some individuals will die prior to, and some after, the life expectancy dates of the insured. This is a better reflection of reality. Knowledge of the shapes of individual mortality curves enables the investor to assemble a portfolio of policies on insureds having greater probability of dying before or after the given life expectancy, and thus better match the expected cash flows with target economic returns.

### Actuarial Impact on Life Settlement Economics

Mortality and life expectancy are the most influential variables in the economics of life settlements. Whatever method of pricing is used, pricing life insurance policies includes capital costs, target rates of return, internal policy economics, life expectancy, and mortality curves. Except for life expectancy and mortality curves, all pricing variables are sufficiently predictable to give relatively high confidence to investors.

Life expectancy and mortality curves require special knowledge and actuarial expertise to assess. An eight year life expectancy that is understated by six months

can represent a 10.7% reduction in the economics of the policy to an investor. Use of a mortality table that represents total population rather than the senior population can result in substantially greater economic risk to an investor. Investors devote extensive effort to get these variables tightly managed and within risk tolerances.

### Understanding Mortality and Life Expectancy

In actuarial terms, the mortality for an individual is calculated by determining the “risks” (e.g., age, gender, tobacco use, medical condition, and medical history) of an individual, who is then categorized amongst a cohort group of individuals sharing similar risks – known as a mortality table. The cohort group to which the individual becomes classified has an average life expectancy, which is then assigned to the individual. In other words, the life expectancy given to one individual is based on the “group” of individuals to which they are categorized, who all share the same mortality table.

Using mortality tables as the representative “group,” the actuarial medical underwriting firm sets the time-frame in which half of the individuals in this group are expected to die before the given life expectancy and half of them after. The result of this analysis seeks to provide an estimate of the individual’s 50% probability to live to their particular life expectancy. The 50% mortality rate is used in many facets of both the insurance industry and secondary life insurance markets.

The most common practice used today to determine the mortality estimation for an insured is to acquire life expectancy reports from experienced actuarial medical underwriters. In addition, some providers and investors develop their own internal proprietary actuarial medical underwriting techniques that augment or are used in substitution of third party life expectancy reports.

### Life Expectancy Ratings

Typically, when an actuarial medical underwriter firm provides a life expectancy report, they include a mortality “rating.” The mortality rating indicates the individual’s life expectancy as compared to the entire mortality table of cohorts. For example, a mortality rating of 100% means the mortality of the individual is equal to the median life expectancy of the cohorts in the mortality table used by the underwriter and 100% of the mortality table will be applied. A mortality rating of 200% doubles all the tabular mortality rates of

the mortality table being used, resulting in a shorter life expectancy. But it does not necessarily result in a life expectancy that is half of one represented by 100% mortality rating. And, for example, a mortality rating of 90% utilizes only 90% of the tabular mortality rates, resulting in a longer life expectancy.

Entering 100% as a mortality factor does not imply that the insured is “standard.” In fact, most carriers expect that “standard” rated insured that purchase underwritten policies will have mortality below 100% of the 2001 VBT (Valuation Basic Table). In other words, 100% of VBT is consistent with some level of impairment. (Note: These rating percents are different from the life expectancy 50% probability referred to above.)

Mortality ratings are applicable only to the mortality table from which the life expectancy was generated and cannot be applied to another table. For example, a median (50%) life expectancy of 122 months may represent a 95% rating from one mortality table, but it can represent a 120% rating in another mortality table. Or, a life expectancy of 111 months with a rating of 100% can represent a rating of 133% in a different table. The point is: mortality tables are based on different mortality data of like cohorts and assumptions. The investor must select the table believed to be most fitting to the insured population that is being considered, i.e., the cohort of senior insureds when pricing typical life settlements.

Once the investor selects a mortality table, the life expectancy provided by the actuarial medical underwriter is matched to the selected mortality table and the associated rating for that table is determined. The rating can then be used in the Probabilistic Pricing Model to create a mortality curve applicable to the specific insured. This is further used to calculate the probable cash inflows and the probable cash outflows for the policy. The two cash flows are discounted by the investor’s required internal rate of return to calculate the economic value of a policy.

## ECONOMIC EFFECT OF LIFE INSURANCE POLICY TYPE ON LIFE SETTLEMENTS

Theoretically, the economics of any contract can be reduced to a monetary value, including insurance contracts. But reality is that the terms of some contracts can be excessively complex or insufficiently manageable, resulting in a structure that is not conducive to efficient investment. Investment in life settlements requires a

contract that can be controlled by the investor within its risk tolerances. Some investors want to keep it simple, while some may accept complexities in exchange for higher returns.

Life insurance is issued in many different forms and even more different contracts, with many different terms. Each offers different economics and choices for life settlement investors. Figure 10.12 illustrates the most common policy types found in the secondary insurance markets and describes the more typical considerations applied to such policies in life settlements. But, of course, the secondary market has become sufficiently mature and efficient to offer many variations on the considerations in Figure 10.12 and sellers with unique insurance contracts may find investors willing to consider their policies.

### **Costs, Fees, and Commissions of Life Settlements**

Most costs, fees, and commissions can be negotiated to some extent, but usually not eliminated. While sellers should seek to have all costs, fees, and commissions disclosed before agreeing to sell a life insurance policy, they must be realistic as to fair compensation for services rendered.

Typically, charges for professional services are based on hourly fees, transaction fees, or completion fees. Hourly fees are simple (i.e., \$x per hour worked). Transaction fees are equally clear (i.e., \$x or x% rate per transaction, such as a share of stock sold). Completion fees are more complex and usually relate to the amount of effort and risk the provider undertakes.

A good analogy is the real estate agent who works on a contingency fee set at x% of the closing price versus a lawyer that handles a case on a contingency formula. Real estate listings are shared in large markets and many agents bring buyers to the seller. While the listing agent takes some contingency risk in marketing the property, such marketing is fairly predictable and controllable. Thus real estate fees may range from 3 to 10% of the closing price. However, cases handled by lawyers can take many directions, require extensive unknown amounts of effort, are materially affected by judges and opposing counsel, and cannot be shared with others in the market. Thus, legal contingency fees may range from 25 to 50% of the settled amount, plus expenses incurred.

Life settlement selling services are somewhere between real estate agents and lawyers working on contin-

gency. Figure 10.13 identifies the functions and typical fees for the various parties involved in life settlement transactions.

### **Economics of Life Settlement Portfolios**

The aggregation of individual mortality curves and life insurance policies into a life settlement portfolio creates many economic value added considerations. It is these economic considerations that have motivated billions of dollars to provide the capital needed to create and expand the secondary life insurance markets. Many early efforts to create value added by aggregating portfolios failed because early viatical settlements proved to be unprofitable investments, and many portfolios were poorly constructed and poorly managed.

Experience, increased knowledge, and research have enabled sophisticated tools and techniques to help prudently manage life settlement portfolios. The results are increased understanding and greater control of longevity risks, better criteria to stylize portfolios to achieve investment objectives, and stronger regulations and industry disciplines that help assure quality transactions. For example, securitization of life settlement portfolios can create financial instruments with payoffs correlated to mortality risk and, by taking positions in such instruments, an incumbent insurer can hedge preexisting mortality risk.

Financing entities seeking to carve out their space in this attractive non-correlated asset class should be aware of the dynamics, impediments, and opportunities as they relate to product supply and demand. The balance between the demand for policies and the number of policies available for purchase has a direct correlation to investors' profit margins. For financing entities, expertise in aggregating policies for assembly into investment portfolios is a given.

As capital for life settlement portfolios continues to expand, opportunities to invest and benefit from portfolio economics will also continue to expand. Figure 10.14 shows the economic synergies that attract investors to life settlement portfolios.

### **Comparing the Life Settlement Economics**

Any attempt to condense and compare the variety of economics stemming from life settlements that operate

**Figure 10.12**

<b>LIFE SETTLEMENT ECONOMICS OF COMMON POLICY TYPES</b>		
<b>Policy Type</b>	<b>Major Economic Characteristics</b>	<b>Typical Life Settlement Considerations</b>
Universal Life	<ul style="list-style-type: none"> <li>• Fixed death benefit to age 100 or, with extenders, age 120.</li> <li>• Premiums may be set by policyholder to any amount, but not less than the amount required to maintain the policy.</li> <li>• Earns interest on account value at rates which can change in relation to market interest rates, but has a minimum guaranteed interest rate.</li> <li>• May be surrendered at any time, subject to surrender charges that assure insurer recovery of its costs.</li> <li>• Account value may be borrowed at a fixed interest rate.</li> <li>• Withdrawal of account value reduces death benefit.</li> <li>• Failure to pay premiums may result in policy lapse, in which case net surrender value, if any, is paid to policyholder if the policy is surrendered or used to maintain the policy until gone.</li> </ul>	<ul style="list-style-type: none"> <li>• IRRs calculated using the policy current interest rate, and at the minimum guaranteed interest rate. Interest rate changes should be tested for IRR sensitivities.</li> <li>• Premiums set to the minimum required to maintain the policy, i.e., build up of account values is generally not economically attractive to investors.</li> <li>• Account values generally stripped out by withdrawal or absorbed to pay premiums.</li> <li>• Prefer policies with death benefits that continue to age 100 or longer, but there may be exceptions.</li> </ul>
Variable Life	<ul style="list-style-type: none"> <li>• Same as Universal Life above.</li> <li>• Offers choice of investment returns in addition to an interest rate. Typical choices include mutual funds in bonds or stocks or other investment classes that the insurer offers.</li> <li>• Variable policies are securities and all transactions involving such policies must be handled through registered securities brokers. This can increase the cost of selling such policies to life settlement investors.</li> </ul>	<ul style="list-style-type: none"> <li>• Same as Universal Life above.</li> <li>• Investors must decide which variable investment to use. Many simply select the interest rate offered by the insurer to minimize risks, while many will select from the more aggressive choices to maximize returns.</li> </ul>
Whole Life	<ul style="list-style-type: none"> <li>• Premiums paid until the policy reaches a paid-up status.</li> <li>• Premiums may be increased by policyholder, but not reduced below the scheduled amounts.</li> <li>• Account value earns interest at a fixed rate or, if in a mutual company, earns dividends.</li> <li>• Can borrow account value at a fixed interest rate.</li> <li>• Cannot withdraw account value, but can surrender the policy for the cash surrender value.</li> <li>• Failure to pay premiums may result in policy lapse, in which case net surrender value, if any, is paid to policyholder if the policy is surrendered or used to maintain the policy until gone.</li> </ul>	<ul style="list-style-type: none"> <li>• IRR calculation factors in the economic cost of increasing and maintaining the account value, which has the effect of reducing the policy economic value.</li> <li>• Premiums cannot be minimized, resulting in greater cash outflow and lower policy economic value.</li> <li>• Cannot allow account value to be absorbed to pay premiums except in the form of loans with interest costs, which reduces the policy economic value.</li> <li>• The above inflexibilities make the policy less attractive to the secondary markets and thus reduce its market value.</li> </ul>

Figure 10.12 (cont'd)

Policy Type	Major Economic Characteristics	Typical Life Settlement Considerations
Term Life	<ul style="list-style-type: none"> <li>To be eligible for life settlements, a term policy must be renewable and convertible to universal life.</li> <li>May have annually increasing premiums or 5 to 10 year level premiums that increase when renewed.</li> <li>No account or surrender values.</li> <li>Renewal right terminates at some age, such as 100.</li> </ul>	<ul style="list-style-type: none"> <li>Most investors will require the policy to be converted to a universal life policy, and then all the above Universal Life considerations apply.</li> <li>Some may continue the policy as term if the insured life expectancy is sufficiently short to avoid risk of the insured surviving past the point that the policy cannot be renewed.</li> </ul>
Group Life (including government life insurance programs)	<ul style="list-style-type: none"> <li>There are too many variations in group life insurance policies to depict here. But for the most part, such policies are similar to term policies</li> <li>Only those programs that allow an individual insured to convert the group policy to an individual policy qualify for life settlements.</li> </ul>	<ul style="list-style-type: none"> <li>The policy must be converted to an individual policy, typically a universal policy.</li> <li>Release may have to be obtained from the group.</li> <li>See Universal Policy above.</li> </ul>
Employer Owned	<ul style="list-style-type: none"> <li>Often called Split Dollar, Key Person, BOLI, or COLI. There are too many variations in employer owned life insurance policies to depict here. These are typically term or some special form of universal life.</li> <li>These policies have numerous special ownership structures and tax ramifications, and some employees have rights to purchase or inherit such policies upon employment termination or retirement.</li> </ul>	<ul style="list-style-type: none"> <li>Each policy will be examined for its ownership and policy characteristics. If required, some policies may have to be converted to universal life.</li> <li>Releases may have to be obtained from the employer.</li> </ul>
Premium Financed	<ul style="list-style-type: none"> <li>Almost always a universal life policy (see Universal Life above.)</li> <li>Subject to a financing agreement that provides funds to pay policy premiums.</li> <li>Loan becomes a lien on the policy death benefits.</li> <li>Owned in a trust or some separate entity.</li> <li>Most financing arrangements retain control over the policy, including marketing of the policy to investors.</li> <li>Most financing arrangements entitle policyholder to pay off the loan and retain the policy.</li> </ul>	<ul style="list-style-type: none"> <li>Will not purchase if it is a STOLI.</li> <li>Operates same as Universal Life.</li> <li>Generally, all financing loans must be paid off before investor will accept policy title and before paying seller, but some investors will close and then pay off the loans, having held back an amount from the closing to assure payment of the loans.</li> <li>Some life settlement providers offer bridge loans to pay the policy loans, thus enabling a clean closing.</li> </ul>

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across the life insurance and life settlement industries, plus those affecting policyholders, advisors, and government, faces major challenges. Not only is adequate data mining difficult, but the many iterations of insurance policy products makes generalizations subject to many assumptions and exceptions. Nevertheless, Insurance Studies Institute (ISI) has undertaken a research project that attempts to quantify life settlements economics such that they can be compared among the various players and transaction choices.

The ISI graphed data is separated by major industry players: policyholders; beneficiaries; life insurance agents and life settlement brokers; professional advisors, providers, and servicers to the transactions; and investors. Graphed data for insurers is not available because their internal GAAP and statutory account practices are too complex to reliably condense based on the limited information that was available to ISI at the time these graphs were released. The graphed data represents only the primary choices when considering sale of a life insur-

Figure 10.13

FUNCTIONS, RISKS, AND FEE STRUCTURES FOR INDUSTRY OPERATORS		
Operator	Function and Risks	Fee Structure
Life Insurance Agent (some states refer to such agents as brokers)	<ul style="list-style-type: none"> <li>Uncover all the policy facts and ownership, educate the seller on life settlements and on alternatives, determine the appropriateness of a life settlement for the seller, determine the best methods to present the policy to the market, seek multiple offers, negotiate the best price and terms, and help the seller through the closing process.</li> <li>Policy may not get offers or seller may not sell.</li> <li>Time, effort, and expenses may be lost.</li> <li>Requires extensive knowledge of seller and insured situations, and substantial effort to educate seller and explain alternatives.</li> <li>Requires extensive effort to get medical records and ownership documents and verify status of policy.</li> <li>Surprises in situational facts can lead to extensive additional work to convert policy, verify and clean ownership structure, update beneficiaries, pay off loans, keep policy in good standing through closing, and get releases from divorcees, etc.</li> <li>May have to interface with seller's legal counsel.</li> </ul>	<ul style="list-style-type: none"> <li>Fees are contingent on closing and typically range from 10 to 30% of the accepted gross policy price.</li> <li>Some agents have sought up to 50%, but investors and other operators in the life settlement industry resist such high fees.</li> <li>Fees are the responsibility of the seller, but are typically paid by the broker.</li> <li>Most states allow a period of time (15 to 30 days) for the seller to rescind the transaction, causing payment of fees to be withheld until after the rescission period.</li> </ul>
Industry Brokers (represent life insurance agents/brokers to buyers)	<ul style="list-style-type: none"> <li>Accept policy packages from life insurance agents and present the policies to multiple life settlement buyers, which are typically represented in the market by life settlement providers.</li> <li>Verify all information presented in the policy package and, if necessary, assure that the policy is properly packaged with all information that is required by the market to make offers for the policy.</li> <li>Determine what state laws regulate the transaction.</li> <li>Seek and negotiate the best price and terms.</li> <li>Present offers to the life insurance agent representing the seller.</li> <li>Assure that the life insurance agent and all other parties to the transaction are in compliance with all applicable laws.</li> <li>Assure that the life insurance agent and seller fulfill all terms and requirements of the buyer.</li> </ul>	<ul style="list-style-type: none"> <li>Fees are contingent on closing and typically range from 3 to 15% of the accepted gross policy price.</li> <li>Fees are typically paid by the life settlement provider/investor to the broker, which in turn divides the fee between the life insurance agent and the broker.</li> <li>Resistance from investors and regulators is felt when the combined fees for the broker and the life insurance agent exceed 35% of the accepted gross purchase price.</li> <li>Most states allow a period of time (15 to 30 days) for the seller to rescind the transaction, causing payment of fees to be withheld until after the rescission period.</li> </ul>
Seller Advisors	Provide advice on taxation, estate planning, retirement funding, appropriateness of a life settlement, and the required closing documents; verify the transaction processes, etc.	<ul style="list-style-type: none"> <li>Typically \$200 to 300 per hour</li> <li>Paid directly by seller</li> </ul>
Medical Providers	Provide copies of medical records and sometimes provide assessment of insured's health conditions.	<ul style="list-style-type: none"> <li>May require numerous additional release forms specific to various clinics.</li> <li>Clinics may add their own fees for record retrieval and photocopying.</li> <li>Fees may be paid by seller, agent, or provider and are not refundable if transaction is rescinded.</li> </ul>

Figure 10.13 (cont'd)

Operator	Function and Risks	Fee Structure
Life Settlement Providers	<ul style="list-style-type: none"> <li>• Represent investors (buyers) of life settlements.</li> <li>• Evaluate policy packages, calculate economic value of policy, and submit and negotiate offers, seeking the lowest price possible for the investor.</li> <li>• Verify all policy facts and assure that policy conforms to investor purchase criteria.</li> <li>• Prepare, submit, and verify completed purchase closing documents.</li> <li>• Assure that all aspects of the transaction are in compliance with applicable laws, including rigorous fraud detection.</li> <li>• Transfer funds to escrow agent.</li> <li>• Arrange for transfer of ownership.</li> <li>• Complete the closing process.</li> </ul>	<ul style="list-style-type: none"> <li>• Typical fees range from .5% to 2% of the policy death benefit.</li> <li>• Fees are negotiated and paid by investors.</li> <li>• Most states allow a period of time (15 to 30 days) for the seller to rescind the transaction, causing payment of fees to be withheld until after the rescission period.</li> </ul>
Verification Agents	<ul style="list-style-type: none"> <li>• Verify all transaction documents.</li> <li>• Verify that all facts and terms conform to the investor's criteria.</li> </ul>	<ul style="list-style-type: none"> <li>• Typically, \$100 to 300 per transaction.</li> <li>• Fees are paid by investors and not refundable upon transaction rescission.</li> </ul>
Escrow Agents	<ul style="list-style-type: none"> <li>• Accept deposits from investors.</li> <li>• Make payments to sellers as per the purchase contract.</li> </ul>	<ul style="list-style-type: none"> <li>• Typically, \$100 to 300 per transaction.</li> <li>• Fees are paid by investors and not refundable upon transaction rescission.</li> </ul>
Trustees	<ul style="list-style-type: none"> <li>• Hold life insurance policies for the benefit of the investor.</li> <li>• Perform all functions as defined in the trust agreement.</li> </ul>	<ul style="list-style-type: none"> <li>• Typically, \$100 to 300 per transaction.</li> <li>• Fees are paid by investors and not refundable upon transaction rescission.</li> </ul>
Policy Servicing	<ul style="list-style-type: none"> <li>• Determine the minimum premium payment due and pay policy premiums in a timely manner to avoid lapse notices.</li> <li>• Advise Trustee and Provider of notices from insurer that may affect the policy status.</li> <li>• Track the insured until death.</li> <li>• Keep Trustee and Provider updated on changes affecting insured, e.g., change of address, health information, etc.</li> <li>• Obtain death certificate.</li> <li>• Obtain updated medical records upon request of Trustee or Provider.</li> </ul>	<ul style="list-style-type: none"> <li>• Typically, \$25 to 40 per policy per year.</li> <li>• Fees are paid by investors and not refundable upon transaction rescission.</li> </ul>

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ance policy and does not include choices of structuring a policy loan with the insurer, reducing the policy death benefits, exchanging the policy for an annuity, utilizing accelerated death benefits, etc. The specific choices included in the graphs include:

a. Continuing the policy to the insured's life expectancy.

- b. Allowing the policy to lapse and investing future saved premiums.
- c. Surrendering the policy and investing the after-tax proceeds and future saved premiums.
- d. Selling the policy and investing the proceeds in a 10 year certain lifetime annuity, plus invest the saved future premiums.

Figure 10.14

ECONOMIC DYNAMICS OF LIFE SETTLEMENT PORTFOLIOS		
1	Non-correlated assets	Valuation of life settlements are determined primarily by mortality curves, which have no correlation with investment markets or with the economy as a whole. Life settlement portfolio valuations do not increase or decrease with market changes.
2	Capital markets sensitivity	Life settlement portfolios traded in capital markets increase and decrease in value based on capital market yield requirements and elasticity of capital to enter the secondary insurance markets. If a portfolio is not traded in the capital markets, i.e., it is bought with intention to hold to maturity, the capital markets have no affect on the portfolio valuation.
3	Institutional investor needs	Higher and predictable returns than available in long-term average stock and bond markets, no volatility in valuation, ultimate maturity to a known value, asset quality reflected by credit rating of insurers.
4	International investors	U.S. life settlements offer attractive yields because the underlying policies are not “endowment” or “TIP,” as are common in foreign countries.
6	Cash flows	Life settlement portfolios have dynamic cash flows as demonstrated by actuarial laws monitoring mortality, i.e. in a portfolio of 300 or more lives the probability of one insured dying in a given year is predictable and the resulting cash inflow of death benefits offsets premium outflow. The economic effect is a measurable and probable cash flow which is not available with one or a few policies.
7	Use of leverage	Fixed cost or low marginal cost leverage is available for portfolios in tranches having maturities compatible with portfolio mortality curves.
8	Dynamics of quantity	Research demonstrates that a portfolio of 300 or more insured provides sufficient mortality bandwidth to have predictable longevity risk. Such portfolios gain benefits of mortality strategies, structured life expectancies for liquidity, cash flow scheduling, leveragability, and longevity risk monitoring and management.
9	Mortality aggregation	A portfolio of many short, medium, and longer life expectancies tends toward normalization of mortality resulting in economic considerations and returns based on population statistics. Aggregating mortalities in a large portfolio elevates monitoring of the insured to a discipline of statistical monitoring, much like life insurance companies, and eliminates the stigma of “death watching.”
10	LDI correlated	A portfolio of life settlements, like mortgages and bonds, can be aggregated with appropriate distribution of life expectancies to offer measurable and predictable liquidity to correspond with liability streams. Such predictable yields can be virtually guaranteed with the use of market based mortality swaps and guarantees.
11	Alpha certainty	Unlike alpha risk in stocks, bonds, mortgages, oil/gas, real estate, and other market sensitive investments, life settlement portfolios enjoy structured and predictable yields, making investment alpha predictable and not subject to market risk.
12	Insurer credit quality and failure exposure	Diversification of insurance companies in portfolios essentially eliminates risk of exposure to insurer failure. Most life settlement portfolios are designed for minimum exposure to any one carrier and to carriers having credit ratings lower than A-.

**Figure 10.14 (cont'd)**

13	Syndication and securitization opportunities	Portfolios of life settlements enable the economic benefit of syndication and securitization for investors. Most investors seek investment products that have been washed, scrutinized, and tested by professionals qualified to dig and sort through the nuances of the underlying assets and management. Even large pension, endowment, and other qualified plan investment managers seek the comfort and certainty found in most syndicated and securitized investments.
14	Investment dynamics	Investors can purchase entire portfolios, partial positions, investor notes, guaranteed returns, subordinated tranches, and loans, to mention a few of the many investment vehicles that can be created in and offered from life settlement portfolios. Plus, policies can be resold from a portfolio and entire portfolios can be resold.
16	Policy management efficiencies	Efficient servicing, optimization of premiums, performance measurements, statistical monitoring, and evaluations are all benefits of portfolio disciplines.
17	Certain liquidity	In addition to probable liquidity based on mortality curves of the insured in the portfolio, certain liquidity will occur by holding the portfolio until the insureds have died.

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- e. Selling the policy and investing the proceeds in a new paid-up life insurance policy, plus invest the saved future premiums.
- f. Selling the policy and concurrently apply for a new \$1,000,000 10 year term policy, with the difference between the new premiums and the premiums saved from the sold policy invested.
- g. Selling the policy and investing the proceeds with expectation of consuming them over the life expectancy for personal uses, plus invest the saved future premiums.
- h. Selling the policy and investing the proceeds and saved future premiums.

This section interprets the graphs and provides understanding for applying the information. Economics of the several choices compared in these graphs will vary with specific policy terms, account values, surrender values, assumed discount (investment) rates, tax rates, and life expectancies. Based on understandings of the life settlement industry, it is believed that the sample case is typical.

Figure 10.15 shows assumptions used in the sample case life settlement economics shown in Figures 10.16 to 10.20.

**Figure 10.15**

**Sample Case for Figures 10.16 to 10.20**

A standard case was used to evaluate the primary options available to a senior considering selling a life insurance policy. The case is:

- 76 year old male
- \$1,000,000 universal life policy
- LE = 9.36 years
- Cash surrender value = \$102,998
- Account value = \$146,098
- Policy issued 6 years ago

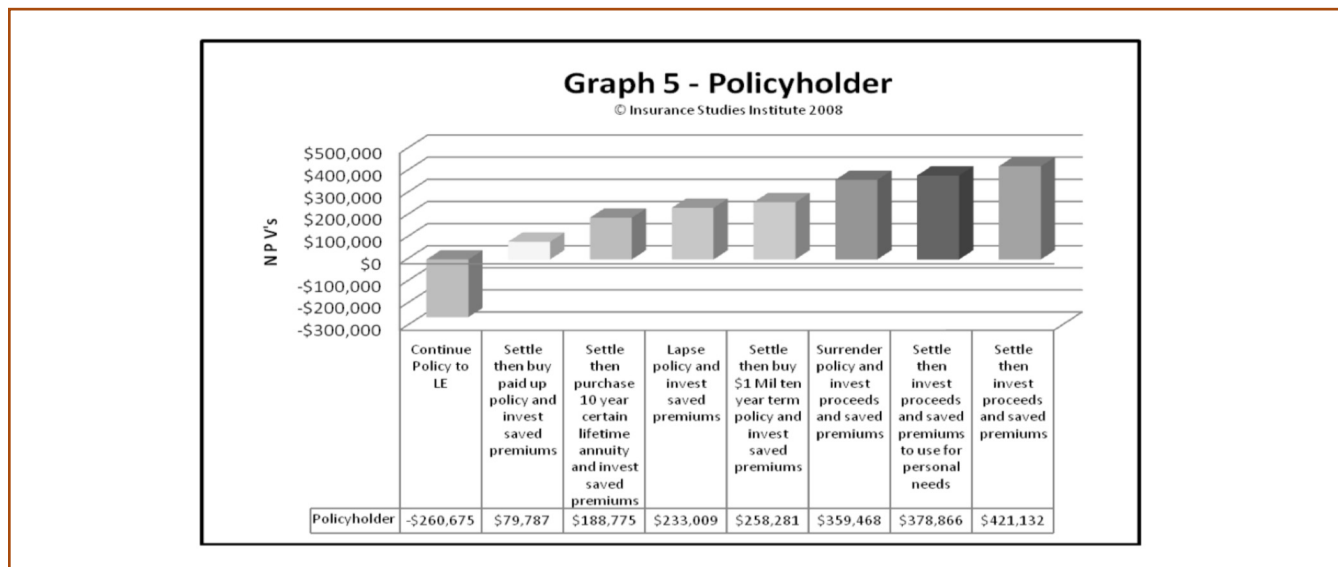
Note that the sample case includes a cash surrender value. However, a policy having no surrender value will look identical to the lapsed choice.

NPV is calculated using a 5% discount rate. All values are after estimated taxes.

**Policyholder Economics**

Figure 10.16 shows that the policyholder will expect to realize negative economics by keeping the policy and paying premiums to his life expectancy. However, any other choice returns better economics, including lapsing or surrendering the policy. Clearly, the most economically attractive choice is to sell the policy and invest the proceeds, including investing the future premiums that are saved by not continuing the policy.

Figure 10.16



One can argue that the above graph excludes the death benefits, and if the PV of the death benefits in Figure 10.17 below were included, the results would be different. If the policyholder’s considerations are best resolved by assuring death benefits to the beneficiaries, then the two graphs can be considered together. However, if the policyholder’s considerations are based on other priorities and not on the values transferred to beneficiaries, then the respective economics are separate.

If the average life settlement death benefit were \$1 million, actual seems to be between \$1 and \$2 million, the aggregate after-tax PV of life settlements to policyholders in the 2007 \$12 to 15 billion life settlement market would exceed \$5 billion if all sellers invested the proceeds and future saved premiums at 5%. The PV of tax revenue on this would approximate over \$225,000,000. This \$5 billion is money that is freed for current reinvestment into the economy versus waiting for the insured to die at some future time.

**Beneficiary Economics**

Figure 10.17 shows that the beneficiaries’ benefit if the policyholder allows death benefits to flow to them, else the policy has no value. Life settlement transactions only retain value for beneficiaries if the policyholder uses proceeds to purchase another policy that name the beneficiaries to receive the death benefit, e.g., a new universal life policy, a term policy, or a paid-up policy. An annuity purchased by the policy seller only

provided potential value to beneficiaries if the annuity has a term certain and the annuitant dies before the end of the term certain.

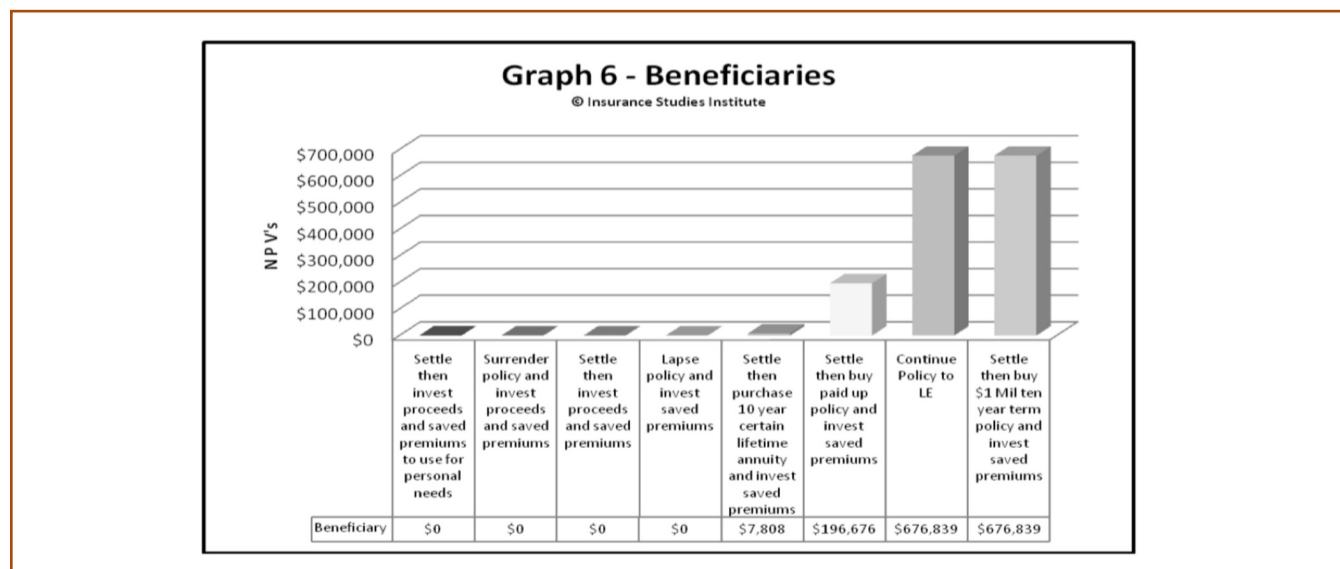
While there is a current PV to future death benefits paid to beneficiaries, there are no current economic values that feed into the economy and no tax revenues resulting from death benefits paid to beneficiaries.

**Agents’ and Brokers’ Economics**

Life insurance agents receive nominal economic value if a policy is continued. However, unless the agent is removed from “agent-of-record,” the life insurance agent continues to receive the same value after the policy becomes a life settlement. But the agents and brokers who represent the policyholder in selling a policy receive material commissions. And, those agents who assist the policy seller purchase new life insurance or annuities stand to gain even more value. Clearly the agents who help policyholders sell policies as life settlements and continue to help the policy seller arrange for placement of the proceeds and investment of the premiums on the sold policy that are now freed up stand to gain substantially, as much as double the life settlement commission and up to 10 times the value of continuing the original policy. Figure 10.18 shows sample NPVs for agents and brokers.

If the average life settlement death benefit were \$1 million, actual seems to be between \$1 and \$2 million,

Figure 10.17



the aggregate after-tax PV of life settlement commissions in the 2007 \$12 to 15 billion life settlement market would approximate over \$281,000,000. The PV of tax revenue on this approximates over \$151,000,000. This \$281,000,000 is new money that fosters multiple economic returns.

assisting in getting them done and tracking them until maturity. The aggregate of these fees over the span of a life settlement are substantial, and clearly impact the pricing of policies. Figure 10.19 shows sample NPVs for advisors, providers, and servicers.

**Advisor, Provider, and Servicer Economics**

Professional advisors, including, legal, tax, estate planning, financial planning, trustees, escrow agents, collateral agents and servicing agents earn fees for advice related to evaluation life settlement transactions,

If the average life settlement death benefit were \$1 million, actual seems to be between \$1 and \$2 million, the aggregate after tax PV of advisor fees in the 2007 \$12 to 15 billion market would approximate over \$200,000,000. The PV tax revenue on this approximates \$110,000,000. This \$200,000,000 is new money that fosters multiple economic returns.

Figure 10.18

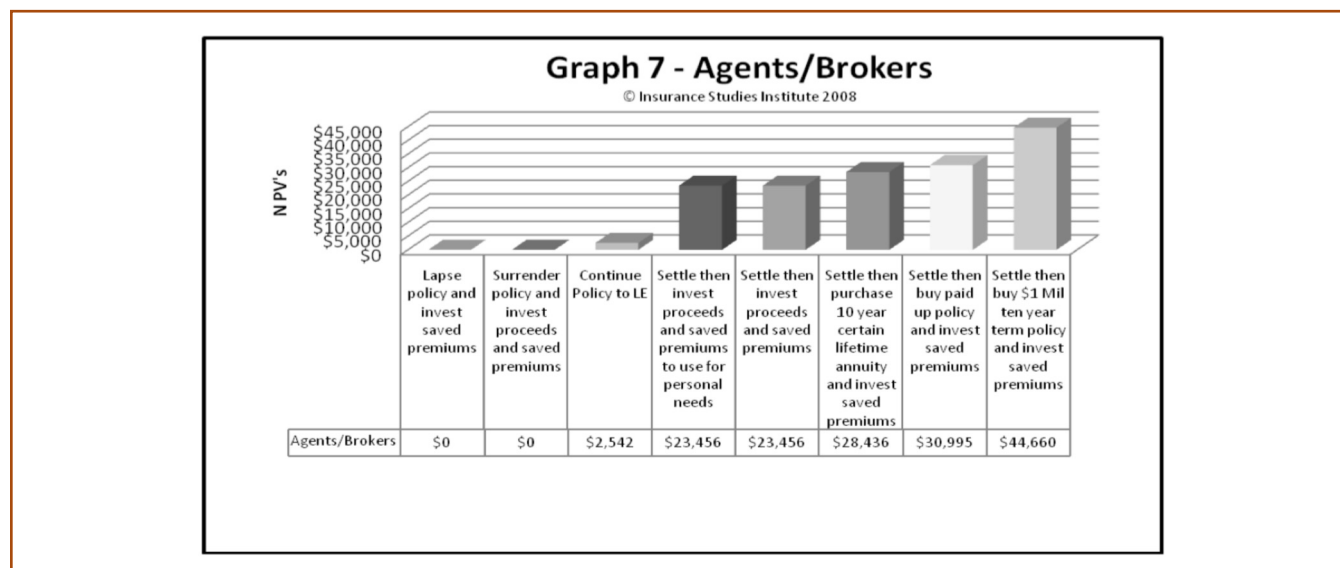
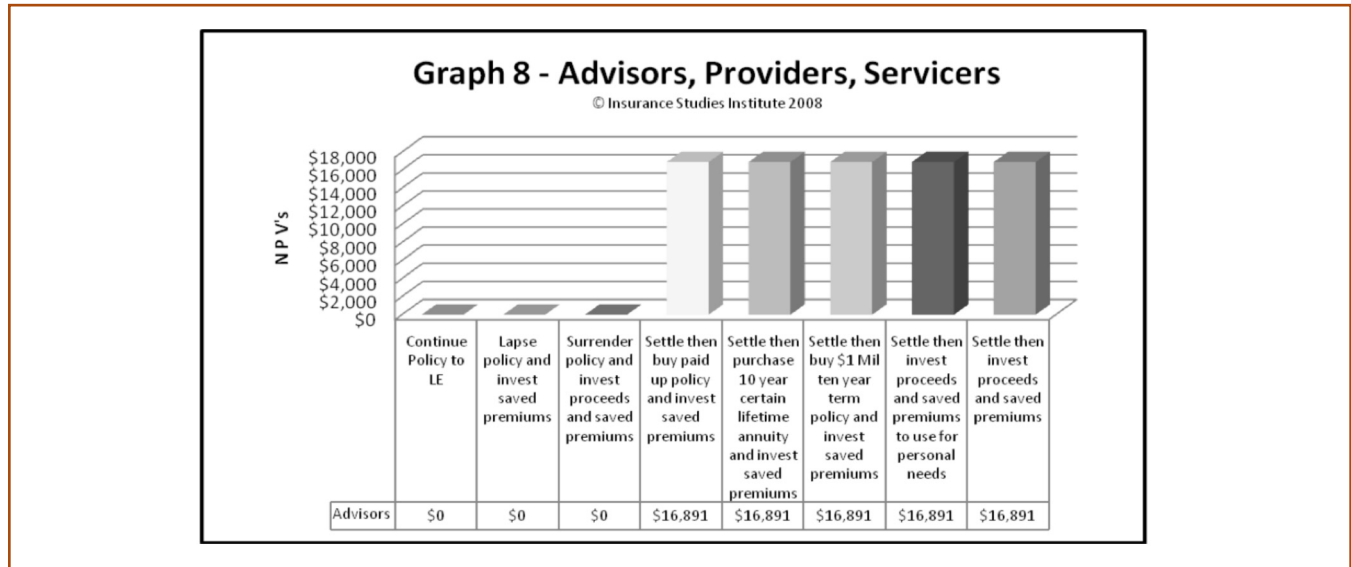


Figure 10.19

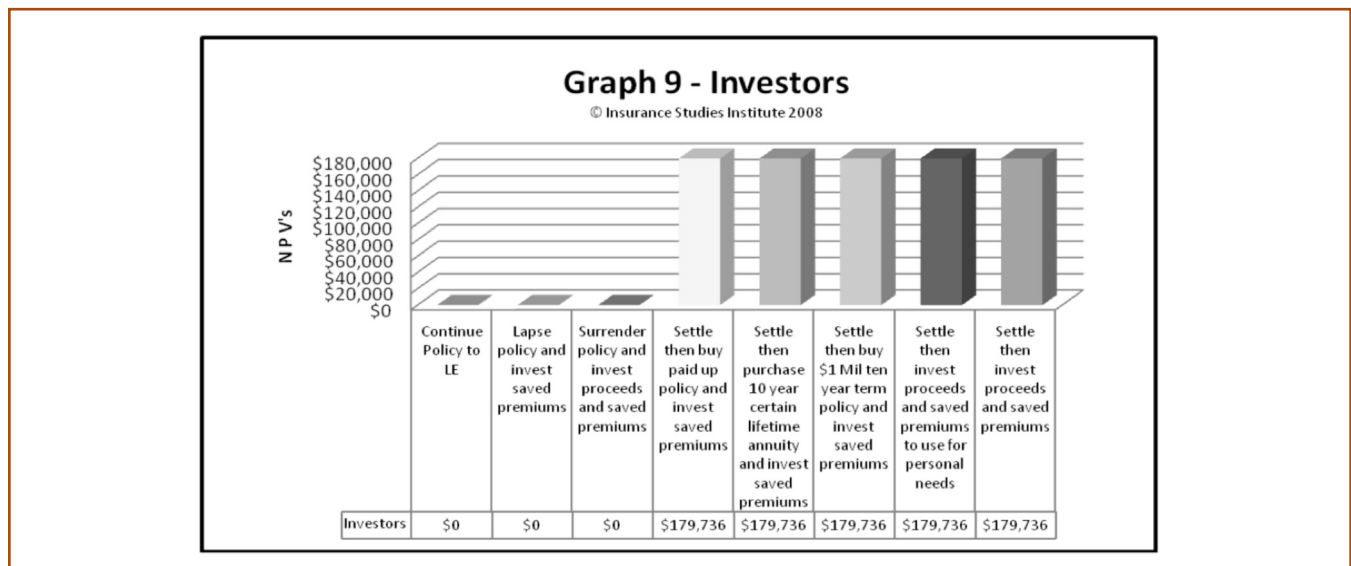


**Investors' Economics**

Investor economics are subject to the discounting used to price life settlements and the ultimate mortality that is realized. Thus the values presented in Figure 10.20 can vary substantially from policy to policy and investor to investor. The values in Figure 10.20 seem consistent with transactions current as of early to mid 2008. The mortality risk to investors has been reviewed elsewhere, so the comments here focus on the PV of the transaction to investors. Investor economics are typically not affected by what the policyholder chooses to do after the transaction.

If the average life settlement death benefit were \$1 million, actual seems to be between \$1 and \$2 million, the aggregate after-tax PV of life settlement transactions to investors in the 2007 \$12 to 15 billion life settlement market would approximate something greater than \$2.8 billion. The PV of tax revenue on this approximates over \$2.5 billion. It is necessary to understand that converting a policy to a life settlement changes the death benefits from non-taxable to taxable, thus the tax revenue from investors is substantial versus none from original beneficiaries. However, the economic impact beyond those created for policyholders, agents, and advisors will not be realized until the insured dies.

Figure 10.20



**Figure 10.21**

Participants	After-tax PV of Transactions	PV of Tax Revenues
Policyholders	\$5,000,000,000	\$225,000,000
Beneficiaries	0	0
Agents and Brokers	281,000,000	151,000,000
Insurers	N/A	N/A
Advisors/Providers/Serviceers	200,000,000	110,000,000
Investors	2,800,000,000	2,500,000,000
<b>Total</b>	<b>\$8,282,000,000</b>	<b>\$2,876,000,000</b>

### Aggregate Economics and Taxation

There is substantial risk at attempting to aggregate the above graphed information to draw conclusions regarding the overall economic impact of the life settlement industry. But with the understanding that there are numerous variables that have not been specifically quantified and that insurer data is absent, summation of the graphed data can provide some relative insight to the aggregate structure of economics within the life settlement industry.

Assuming an average life settlement death benefit of \$1 million, actual seems to be between \$1 and \$2 million and life settlement transactions in the 2007 totalling \$12 to 15 billion, aggregate PVs of all life settlements are shown in Figure 10.21.

### SUMMARY

Life settlements are societally and economically sound, pro-senior, pro-consumer, pro-government, and productive for the economy. The economic structure for life settlements is complex, having numerous interlaced substructures.

If the insured expects to die “early” and the insured’s personal value and goal considerations support continuation of the policy, such would be the more appropriate, as well as economically sound choice. But if the insured expects to live a long life, selling the policy may be the wiser economic choice. The key to the decision is needs.

Any senior who purchased life insurance years earlier for good economic reasons must re-examine those reasons upon entering retirement. Based on the above considerations, the senior must determine if insurance death benefits should be continued based on a new re-evaluation of needs and circumstances at that time. Independent advice should be sought by any individual considering purchasing or changing life insurance policies.

A competitive secondary market for life insurance policies enhances the welfare of both new and existing policyholders. By allowing companies to compete for underperforming or unneeded policies, the secondary market generates increased consumer choice and favorable valuations for consumers. Because the life settlement industry expands the economy and because participation and investment in life settlements is pro-competitive and pro-consumer, regulations are needed that encourage such participation and investing. Conning Research estimates a \$140 billion life settlement industry annually by 2016.

It should be in the interest of lawmakers to develop best practices regulations that prevent abuse, encourage transparency, and protect the opportunity for consumers to become aware of, understand, find, and obtain the highest liquidity possible through a sale of life insurance policies in the secondary life insurance market.

### QUESTIONS AND ANSWERS

**Question** – How should an investor decide how to get into life settlement investments?

*Answer* – Depending upon the medical actuarial assumptions used to calculate the life expectancy, economic investment results will vary widely among life settlement investors, regardless of pricing model used. The pricing of life insurance policies varies greatly due to a plethora of variables outlined above. Market participants cannot assume any one firm will consistently offer better prices than another, and they should be alert to the impact of changing interest rates, economic cycles, and sensitivities to risks. Investors should also be alert to the ability of the settlement firm to complete the transaction in a timely and efficient manner, comply with all applicable laws, and provide prudent and considerate follow-up and policy servicing during the insured's life.

**Question** – How will the life settlement industry impact the life insurance industry?

*Answer* – Not much in reality. It is more likely the insurance industry, given its financial strength and prowess, will create ways to compete with the life settlement industry. It is speculated by some that insurers may acquire life settlement operators and embrace it. There is evidence that some insurers are willing to design new insurance products that will specifically fit into the life settlement industry.

**Question** – Should policyholders pursue policy loans against death benefits?

*Answer* – Only if the policy cannot find value as a life settlement and if the insured expects to die sooner rather than later. A loan against the death benefits reduces the death benefit; meanwhile premiums must generally still be paid. Such a loan works more to the insurer's economic benefit than the policyholder's, except as noted, if the insured expects to die sooner rather than later.

**Question** – How will life settlements affect baby boomers retirement planning?

*Answer* – Baby boomers are just now facing the reality of retirement. All the considerations set forth in this chapter and elsewhere in this book apply to baby boomers. But there are a lot of baby boomers and

their changing needs should be expected to bring numerous policies to market. Baby boomer's issue will be how to maintain their policies until they reach an age at which the policy develops value as a life settlement. And in this regard, with improving health care, baby boomers may have to wait longer for life expectancies that will support policy prices attractive to investors.

**Question** – Can life settlements supplement social security?

*Answer* – Life settlements can supplement social security, more among the small policy holders. As shown above, the PV of selling and using the proceeds and saved future premiums for personal needs may be greater than keeping the policy. Thus, in the proper circumstances, a life settlement can be a supplement to social security.

## CHAPTER ENDNOTES

1. Bernstein Research, 2006.
2. ACLI 2007 Fact Book.
3. "The Benefits of a Secondary Market for Life Insurance Policies," Wharton Financial Institutions Center, 2002.
4. "The Life Settlements Market – An Actuarial Perspective on Consumer Economic Value," Deloitte Consulting, LLC and University of Connecticut, 2005.
5. Tax on the NLSP is estimated at: (NLSP – Premiums paid to date of sale) \* 15% capital gains tax rate, assuming the policy has no cash surrender value and that capital gains are in fact available.
6. ACLI 2007 Fact Book.
7. When a policy is lapsed, all premiums paid to that date for that policy are retained by the insurer and none are paid to the policy holder, unless the policy has an accrued cash surrender value which is paid to the policyholder. By including the insurer's lapse rates and the resulting economic benefit to the insurer, the insurer can place a lower price on the policy making the policy appear more attractive and competitive to consumers.
8. "Life Settlement Market, Increasing Capital and Investor Demand," Conning Research and Consulting, Inc., 2007.
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