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Our Take on the Secondary Market for Life Insurance

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Imagine a world where we had to sell our car back to the original dealer, or our house back to the developer, or even stocks to the original seller. This would be a world without secondary markets. It's the world that most life-insurance policyholders have faced historically. But the life settlement market is becoming increasingly fashionable as investors attempt to capitalize on what they deem to be a "mispriced" niche in the life insurance market.

Brief History

The viatical industry emerged in the late 1980s as the AIDS epidemic took hold and patients needed to finance expensive medical treatments. Terminally ill policyholders sold their life insurance policies to viatical firms for more than their cash surrender value but less than their death benefit. The viatical market morphed into the life settlement market in the late 1990s when AIDS/HIV patients began living longer. In the past several years, an influx of institutional sources of capital has expanded the life settlement market considerably.

Though the size of the life settlement market is unknown, best estimates illustrate a budding trend. According to A.M. Best Co., life settlement purchases have climbed from approximately $2.5 billion in 2003 to more than $10 billion in 2005 based on face amounts. This industry remains largely unregulated.

Life settlement firms target policyholders with impaired health but not terminal illnesses. This typically includes seniors 70 years or older with no-lapse universal life insurance policies with face values of $250,000 or higher.

An Example

Joe, 70 years old, decides he no longer wants his $1 million universal life insurance policy. His health may have worsened, his beneficiaries may have died, or he simply can no longer afford the premiums. Prior to the emergence of the life settlements market, Joe would have had two choices: 1) accept the insurer's contractually agreed upon surrender value, which is well below the policy's fair market value, or 2) let the policy lapse and receive nothing. That's an easy decision!

With a life settlements market, Joe could sell his policy to a life settlement company for up to 3 times its cash surrender value. The life settlement firm will pay future premiums on the policy and receive the $1 million death benefit upon Joe's death.

Effect on Life Insurers

There are a number of actuarial-based assumptions used to price life insurance policies, one of which is expected lapse rates. Life insurers price various policies with the supposition that some policyholders will lapse (discontinue paying premiums) rather than retaining the policy until death. Life settlements make

estimating lapse assumptions more difficult because policyholders are opting to sell their policies rather than allowing them to lapse. If insurers price policies based on significantly lower lapse assumptions than are realized, insurers lose. Furthermore, the insurer cannot raise rates on guaranteed premium policies to make up the shortfall. Consequently, they could be compelled to hoard more reserves to pay claims.

We don't think this will have a materially adverse effect on insurers. Like many industry professionals, we think an active secondary market increases the value of insurance policies to policyholders. This should increase demand, which could drive higher premiums. Also, life insurers aren't sitting still.

What Insurers Are Doing About It

Most insurance companies offer accelerated death benefits for policyholders with impaired health as long as their life expectancy is one year or less. This competes well with viaticals but is not a close substitute for life settlements due to the limitation on life expectancy. This gap creates an opportunity for life settlement firms to capitalize on policyholders with impaired health and a life expectancy longer than one year. The fair market value of insurance policies exceeds its surrender value when the insured experiences health impairment because the death benefit is greatly accelerated. Life settlement firms currently offer policyholders fair market value; however, this gap would narrow considerably if insurance companies began offering surrender values adjusted for health impairments.

Insurance companies are taking several steps to thwart competition by life settlement firms. They are attempting to identify potential targets through the application process and cease offering policies in which premiums are financed. Insurers are also modifying underwriting assumptions and altering agents' commission structure to emphasize retention. We think solid management teams will continue to take the appropriate steps to preserve profitability while others will sacrifice future profits for near-term growth by continuing to sell into this market. MetLife MET and Protective Life PL are taking measures to reduce exposure to this market. Meanwhile, John Hancock (a unit of Manulife MFC) and Lincoln National LNC have experienced tremendous sales growth in universal life policies during the first quarter, a prime target for life settlements.

Our Take

Some insurers support life settlements as a tool to assist consumers whose financial protection needs have changed. However, insurers specifically oppose investor-initiated life insurance transactions that are intended to circumvent insurable interest laws--in other words, life settlement firms that contact prospective policyholders to purchase an insurance policy with the intention of subsequently selling it to the life settlement firm. As long as potential profit-making opportunities are available, investors will attempt to exploit them just as in any "arbitrage" situation, whether real or perceived.

We believe that the development of the secondary market for life insurance helps consumers by providing additional alternatives. Naturally, there are inherent risks to having a third party owner with no insurable interest in the insured's life because the investors benefit upon the insured's demise. However, some life settlement firms withhold certain personal information when policies are sold to investor groups. Conversely, all information is disclosed when policies are sold to other life settlement companies. To the extent that policyholders perform the necessary due diligence to select a reputable life settlement firm--just as they would when selecting an insurance company--we think this market is a win-win for consumers.

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