

## The Life Settlement Market is an Opportunity

The Life Settlement Market is an opportunity that ought to be operated as a business. It is not a get-rich-quick scheme. Many life settlement “experts” and opportunists have cast a shadow on the market and called into question many of their activities.

The life settlement market has been developing during the past few years into a secondary insurance market that can have great value and provide a valuable service to current insurance policyholders as an alternative to cash surrender. Investors have recognized its potential very quickly. Unfortunately most insurers and reinsurers have ignored the market assuming it to be some sort of attack on the legitimate insurance industry and, in doing so have done their policyholders a great disservice – leaving them to fend for themselves against unjustified profit takers.

Many early entrant investors, who have captured a large part of the market, have not fully understood the inner workings of life insurance products, the terminologies used, or the applicability of the actuarial assumptions they have used. It has been feared many would resort to desperate measures when they finally discovered the errors of their ways.

In this article we highlight and explain some of these misunderstandings and point to missed opportunities. We believe that if the life settlement market is run like a business with attention paid to consumer needs, a technically correct understanding of the risks, responsible pricing, and maintenance of high ethical standards, then this new insurance secondary market will thrive and every participant will be well served.

### General Misunderstandings

#### Life Expectancy

The traditional actuarial definition of life expectancy is the *average* number of years expected to be lived by a group or cohort of lives based on some mortality assumption. As a result, half of the group can be expected to die before life expectancy is reached and the other half can be expected to die after life expectancy. This makes the probability of living to traditional actuarial life expectancy about 50%. When this traditional *median* life expectancy is used in life settlement market calculations there is, clearly a very serious understatement, since maximum life expectancy is what is probably intended.

Lately we see investors focusing more realistically on a modified life expectancy with an 85% or higher chance of dying by the end of a specified period instead of the 50% implied by median life expectancy. However, basing life settlement price calculations on this life expectancy statistic alone ignores the distribution of deaths. This, indirectly, assumes that the timing of deaths within the life expectancy duration and beyond is unimportant.

The price of the life settlement and the internal rate of return can be calculated most accurately by using the probability of death each year taken from an appropriate, underlying mortality table. This mortality table should be one provided by a competent life settlement underwriter such that it accurately reflects the expected mortality involved in the life settlement transaction.

### The Pricing of a Life Settlement

The value of a life insurance policy at any given time is simply the present value of future death benefits less the present value of the future premiums as of that time. These present values should be calculated based on appropriate interest rates and mortality rates. The appropriate mortality rates in a life settlement pricing calculation, of course, should be determined through an underwriting process applied to the individual whose policy is being sold. An interest rate appropriate to the needs of the buyer would be used.

However, life settlement policy purchasers typically determine a price (value of the policy plus applicable expenses) by utilizing methods that on the surface appear to have a sound technical footing, but in reality are rather vague. For example:

One approach is to calculate a life settlement purchase price that provides an acceptable internal rate of return by discounting the following future cash flows using interest only:

- the death benefit payable at median life expectancy plus N years, where N is generally between 0 and 2; less
- agent commission and other relevant expenses paid at life settlement; less,
- estimated ongoing premiums payable to the original life insurer each year during the period of median life expectancy plus N years.

In general the life settlement purchase price would be calculated either in a trial and error process using an internal rate of return chosen to satisfy the purchaser's expected hurdle rate or utilizing an equivalent method. However, the mortality assumption reflected in the median life expectancy used in the above calculation is a rather rudimentary approach to incorporating mortality risk. Although mortality is, clearly, an essential component of a life settlement's value, we are reasonably certain that many in the life settlement industry do not use durational probability of death and/or survival (i.e. mortality rates that vary by policy year and age) in their calculations.

In addition, in the above calculation, the estimated premiums required to keep the original life insurance policy in force are typically obtained from illustration systems (for Universal Life or UL insurance products) that show the level premium required to support the policy up to median life expectancy plus N years. The naiveté of many current life settlement investors causes them to calculate this premium based on current assumptions including the current declared net crediting rate. The declared net crediting rate is the current interest rate set by the insurer that issued the UL policy and is not guaranteed. In other words, they make the same mistake many policyholders

make in interpreting a current assumption illustration to be tantamount to a guarantee. They are unaware that the premium may need to be increased due to a future decline in crediting rates or a future increase in mortality rates or even because expenses have increased.

To hedge their life insurance policy purchases, some current investors in life settlements purchase single premium immediate life annuities to pay the ongoing premium. This single premium immediate annuity would provide, in exchange for the single premium payment, periodic payments equal to the presumed ongoing premium on the policy purchased in the life settlement transaction. They think that this will somehow guarantee no additional out-of-pocket cost. What they don't realize is that there is no real link between the UL premium required under current assumptions to keep the life insurance policy in force and the payout annuity.

As practiced, this method of pricing a life settlement policy has the fundamental flaw of ignoring the timing of death benefit payments. However, in addition, investors also usually lack the sophistication to validate and verify the underlying mortality rates used in the calculation.

A competent and knowledgeable life settlement underwriter may be able to determine appropriate mortality for use in determining the purchase price of life settlements. However, mortality expertise provided by life insurance companies, life reinsurance companies, or pricing experts can be of valuable assistance in calculating life settlement values consistent with the underlying mortality experience.

### Suicide Contestability

Most investors do not understand the suicide contestability provision contained in most life insurance policies or the statistics related to the number of suicides. As a result, investors generally shy away from purchasing policies during the first two policy years even if the seller agrees to retain a reasonable portion of the purchase price in an escrow account.

However, there can be other reasons to shy away from purchasing policies that are less than two years old. For example, underwriting arbitrage (i.e., playing on differences between insurer underwriting and life settlement underwriting) may result in a situation that a cautious life settlement investor would want to avoid. As a general rule, the risk characteristics of an insured are not likely to change much during the first two policy years. Arbitrage, a term borrowed from economics, as applied to the insurance underwriting process means the investor is playing on some presumed state of imbalance between his/her underwriting evaluation and the insurer's.

## **Unjustified Lapse Dependency and Other Issues**

### Lapse prevention

There is a widespread belief among insurers that investors in the life settlement market will prevent policies from lapsing that otherwise would have lapsed prior to death. While it is true that investors in life settlements have a vested interest in keeping the policies

they purchase in force until they terminate as deaths, this should not be a concern to insurers for the following reasons:

- a) Generally, it takes many years for a life insurance product to get to a breakeven point with respect to insurer profitability. Therefore, any encouragement to keep policies in force for longer periods should benefit an insurer.
- b) In any event, it would be foolish to think that an insured, savvy enough to recognize that his insurance policy was worth more than its cash value, wouldn't be smart enough to keep it in force even if he or she did not sell it into the life settlement market.

An insurance company should not depend on the lapse of impaired risk policies to meet its profit targets. Lapse-supported pricing, in general, is frowned on and discouraged to the extent possible in the insurance industry. Using lapse support as an argument against life settlements just seems wrong.

### Economic Value

A recent report by Deloitte Consulting, LLP and the University of Connecticut<sup>1</sup> concludes, generally, that life settlements are a bad deal and that "the greatest economic value results from retaining the contract until death." It is certainly true that when beneficiary needs are of the utmost importance, life insurance policies should be kept in force so that death proceeds can work as intended. This will, no doubt, result in the greatest estate value as indicated in the report.

However, the insured cannot benefit from death proceeds. When it is the insured's financial interests that are prevalent, a cash-out of the policy is typically considered. In truth, the greatest economic value available to an impaired insured will often be the life settlement value which, for an impaired life, is likely to be well in excess of the cash surrender value provided by the life insurance company.

If it were run like a business, the life settlement market would be recognized and marketed as an alternative to cash surrender, not death. And, consumers in the market would recognize that there is a cost for the benefits and services that the life settlement market provides.

Of course, in a life settlement market that is not run like a business, there are other moral hazards related to dealing fairly with customers and the public at large. But, just as the insurance industry has managed various moral risks as it has developed, so too can and should the life settlement industry.

### **Short Window of Opportunity**

A life settlement market will probably continue to grow and become an important addition to the insurance market. Although a significant boom in the market began in

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<sup>1</sup> The Life Settlements Market, An Actuarial Perspective on Consumer Economic Value, Copyright © 2005 Deloitte Development LLC

2004, it is expected that the market will eventually mature, level out, and follow the general life insurance market in terms of future growth.

### **How Can an Insurer Capitalize on the Life Settlement Market?**

Insurance companies cannot prevent life settlements nor, it can be reasoned, should they. Instead, insurers and reinsurers ought to find a way to participate, using their expertise to ensure that the life settlement market develops in an orderly and reasonable way for the benefit of all involved and in particular the insurers and reinsurers themselves.

One way that insurers might participate would be to purchase policies on impaired lives in the life settlement market as a hedge against the increased mortality risk they will experience from impaired lives among their own insureds.

Rather than ignoring life settlements insurers and reinsurers might step in to educate participants in the life settlement market.

While there may be a place for investors in the life settlement market, it is probably, unreasonable to expect that they alone can create a disciplined and orderly secondary market for life insurance policies. Investors must either rely on experts who understand the technical principles that rule the market or rely on entities that are capable of absorbing the new survival risk created by such a market.

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