

## Life Settlements

*The Concept Catches On*

2006



**CONNING**  
RESEARCH & CONSULTING, INC.

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# Life Settlements

## *The Concept Catches On*

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## 1. Introduction

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With roots in the viatical settlements market during the 1990s, life settlements have grown substantially. They provide seniors with a secondary market for existing life insurance policies, and an alternative to lapse and/or surrender for policies no longer needed or wanted. However, some have a less rosy view of the current life settlements marketplace. They see aggressive marketing and lack of transparency, and question whether a life settlement is the best option in many situations.

In what follows, Conning will examine these and other aspects of life settlements. This is the latest in a series of Strategic Studies that Conning has published on this subject. Beginning in 1999, with a study entitled *Viatical Settlements—The Emerging Secondary Market for Life Insurance Policies*, Conning has chronicled the evolution of a market that began as a way for terminal AIDS patients to raise funds to help them through what many expected would be the last few months of life. Medical breakthroughs provided a welcome alternative outcome to many of the insureds, but created problems for the investors that had purchased these policies, many of them unsophisticated individuals.

By 1999, the viatical market was in decline and life settlements had come on the scene. Rather than purchases of policies from terminally ill insureds, with life expectancies of 24 months or less, life settlements focused on seniors. In relation to the terminally ill, these were healthy individuals, although those whose underwriting status had declined since their policies were issued were favored.

In 2003, Conning reported on the progress of the life settlement market in a Strategic Study entitled *Life Settlements—Additional Pressure on Life Profits*. Picking up the threads of the 1999 study, Conning examined the growth that had occurred and chronicled the emerging infrastructure that was coming on line to support the life settlement business. Using data from a survey of life settlement providers, Conning described the characteristics of the policies purchased in 2002.

In that study, Conning examined the benefits of life settlements to both insureds and insurers. A number of problems were identified, not the least of which was the financial impact on an insurer of converting a current policy surrender into a future death claim. Using a model developed with the assistance of Milliman USA, Conning provided

insurers with a way to estimate the financial impact on their company. While it was expected the impact would be relatively small, it would be coming at a time when insurers were under financial pressure from a number of other causes as well, and therefore should not be ignored. In concluding the 2003 study, Conning opined that, if sufficient investment capital could be found, significant growth in life settlements was likely.

Now in 2005, we find a market that has grown substantially, and is currently characterized by an excess of capital chasing a limited number of policies available for purchase. The infrastructure has matured, and well-capitalized providers are working to develop networks of life settlement brokers to provide them access to additional policies available for settlement.

Life settlements remain an emerging market, one that has established some traction but is clearly not yet mature. In what follows, Conning will address the growth in life settlements that has occurred and point out several problem areas that need to be addressed. We will try to point to a middle ground between the “always better” and “never better” positions established by insurers and settlement providers, respectively, when comparing keeping an existing policy to a life settlement of that policy.

Several other types of policy transactions have emerged, which share some of the same characteristics of life settlements, and are often included when settlements are discussed. While lapse and/or mortality arbitrage is a characteristic shared with settlements, Conning will point out several items that differentiate them from true life settlements, and suggest that a separate solution for these problems is needed. In many cases, insurers have the tools needed to defend from these programs, but may lack the will to take the necessary actions.

## 2. Executive Summary

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### ***Financial Performance***

The financial performance of a life settlement is driven by the relationship of the actual future lifetime of the insured after policy purchase and the expected future lifetime upon which the life settlement offer was calculated. The purchaser balances the present value of the death benefit, at an interest rate that provides it with an acceptable return for the risk being assumed, against the up-front payment for the policy, the amount of commissions, fees, and expenses required by the transaction, and the sum needed to fund continuing premium payments. Given that there is a reasonable distribution of the actual future lifespan of the insureds around what was expected at policy purchase, the life settlement investor will realize a return from the transactions that is at least close to what was targeted. On some of the policies that were purchased, returns greater than what was assumed will be achieved, which balance out lower-than-expected returns on others.

However, when individuals seek to evaluate a life settlement offer against the ultimate value to be found from keeping the policy, they do not know the length of their future lifetime. For some of them, keeping the policy will provide a greater financial reward. For others, accepting the life settlement will produce a better outcome. This suggests that the position adopted by some industry observers that it is always better to retain the policy is not correct.

### ***Market Size***

No good source of market size statistics exists for life settlements. Several entities, including Conning, have made estimates. After analyzing the current market from several perspectives, Conning estimates that approximately \$3.3 billion in face amount was transferred in 2004, a figure that should increase in 2005 to about \$5.5 billion.

### ***Producer Compensation***

As with many life insurance product trends, the financial interest of producers is a powerful factor. Sales trends develop as agents and brokers learn new ways to serve

clients, and generate income for themselves in the process. Life settlement transactions supply life agents and brokers with a new tool to serve clients, and provide additional sources of income for themselves. These include fees generated from the settlement itself, which can be substantial, and new commission streams that result from additional policies funded with the proceeds of the life settlement transaction.

There are no externally imposed compensation standards that control what a life settlement broker, who arranges the sale of a policy, and the life agent or financial advisor, who brings the particular client to the transaction, might receive. However, a competitive market generally brings its own discipline, and typical compensation levels are evolving. Our research suggests that a typical current standard would allocate the lesser of 6% of the face amount of the policy or one-third of the increased value provided to the policy owner (increased value equals the excess of the settlement offer to the policyholder over the cash surrender value of the contract).

#### Compensation Illustration

Death Benefit	\$1,500,000
Surrender Value	225,000
Settlement Payment	450,000
6% of Death Benefit (a)	90,000
33.3% of Excess of Settlement Payment over Surrender Value (b)	74,925
<b>Commission (Minimum of (a) or (b))</b>	<b>\$74,925</b>

Source: Conning Research & Consulting, Inc.

Putting numbers around this formula reveals that significant amounts of compensation can flow from these transactions. The current average face amount of life settlement transactions is \$1.5 million. As can be seen in the accompanying table, this would produce almost \$75 thousand of compensation, based on the assumed values in the table that are representative of typical transactions.

### ***Availability of Business***

Promoters touting the life settlement business call attention to the overall size of the in-force block of life insurance. According to the *2004 Life Insurers Fact Book*, compiled by the ACLI (American Council of Life Insurers), there is \$9.4 trillion of life insurance in force on 167 million policies. This would seem to suggest that there is a large potential marketplace.

However, the amount of this business that is in, or even near, the sweet spot for life settlement transactions is significantly lower than \$9.4 trillion. Conning estimates that 5% to 6% of in-force policies are attractive to life settlement providers (policies at ages 65 and higher and for amounts of \$1 million or more). The size of this group of policies would need to be adjusted to reflect several factors: first, to eliminate those not interested in selling their insurance coverage; then, from those that remain, to exclude those whose life expectancy has not been sufficiently impaired to make them attractive to a life settlement provider; and finally, after eliminating those two groups, to exclude people who would not be convinced that the economics of a life settlement make sense to them. Assuming these three factors eliminate two-thirds of the target population, about 2%, or about \$188 billion of insurance in force, would remain in the target population. While this is significantly smaller than \$9.4 trillion, it does appear to be sufficient to support continued growth of life settlements, at least at a pace consistent with growth to date.

### ***Transparency***

A lack of transparency on the transaction is an inhibitor of growth of life settlements. Three separate forces are working to address transparency. Several states have mandated disclosures at the time of settlement. While there is current concern that many of the rules are too broad, and their enforcement too spotty, to be truly effective, their presence represents a step toward a much more fully disclosed marketplace. Also, an increasing number of settlements are being negotiated with more than one broker, increasing the likelihood that the insured is presented with a more competitive offer. Several online auction sites have sprung up to assist in this effort. Finally, some institutional investors are forcing increased transparency on the market. Unwilling to expose themselves to negative publicity that might result from a transaction deemed abusive, they mandate the commission and expense levels on the cases where they participate and disclosure of these amounts to the seller.

### ***Industry Reaction***

To date, the life industry reaction to life settlements has been somewhat limited. At the industry level, attention has been paid to issues involving insurable interest, and lobbying for programs that appear to be focused on impeding the growth of this market segment.

While concerns with insurable interest are valid, they have limited applicability to true life settlements. The U.S. Supreme Court decision (*Grigsby v. Russell*, 222 U.S. 149 (1911)) established that life insurance policies could be sold. Most life settlement transactions do not involve transfer of policy ownership to an individual with an insurable interest in the life or death of the insured, but neither regulation nor public policy requires one. That is not to say that there are not valid insurable interest concerns with some other types of insurance transactions often lumped in with life settlements.

The industry and many life companies supported special licensing for agents and brokers involved in life settlement transactions, which the life settlement industry characterized as an obstructionist move. While several states have established special licensing requirements, the additional rules have not significantly impeded the growth of life settlements. Some companies have restricted their captive field forces from participating in life settlements.

### ***Value of the Death Benefit***

The strongest industry reaction has been to focus the attention of policy owners who might be considering a life settlement on the value of the policy death benefit. Their argument suggests that the life policy is likely one of the insured's most valuable assets. If a current need for capital or a concern for the cash flow necessary to maintain premium payments is motivating the settlement, they would suggest selling other assets before the life policy, or working out an arrangement with the beneficiary or another interested party to assist with premium payments.

In any analysis of a life settlement, factors particular to the current situation of the individual insured provide the foundation for the discussion. One key issue is balancing current wants/needs and future considerations. It can be as simple as deciding if the insured wants to take advantage of the policy values or is willing to let them accrue to a third party following his/her death. Risk tolerance is an issue, as is the factor used to equate a current settlement offer versus future policy values.

Using a simple model, Conning demonstrates that the value received by holding the policy will vary relative to the settlement offer made on the policy. Keeping the policy

may be better, or it may provide less than the settlement offer. Unfortunately, at the time the offer is made, the insured does not know which alternative will apply.

### ***Other Insurable Interest Issues***

Other programs, often with insurable interest issues or arbitrage opportunities similar to life settlements, are included in a discussion of life settlements. These include LILAC (life insurance life annuity contracts) programs, non-recourse premium financing, and blocks of new policies purchased with a settlement transfer in mind. Each is likely to erode profitability for the insurers involved.

By notifying their distributors they are not interested in issuing such policies, and by establishing appropriate underwriting techniques to avoid issuing such policies, insurers should be able to minimize the negative impact.

### ***Outlook***

Information arbitrage is one driver of life settlements, as the life settlement investor has much more current information regarding the life expectancy of a potential policy seller than the insurer that issued the policy in the first place. In addition to lack of information, current regulation limits what an insurer can pay in surrender value. To change these rules would require the development of a new infrastructure to support the evaluation of current life expectancies. Insurers are not likely to welcome the opportunity to do that.

Life settlements seem to be an appropriate additional tool to help insureds with financial planning. However, aggressive marketing of settlements, especially in the absence of full disclosure of all available options, is not likely to be in the best interests of either insureds or insurers. Techniques need to be developed to structure this marketplace, something that will require cooperation between insurers and life settlement professionals.

Several types of programs have grown up around the fringes of true life settlements that use life policies in a way that was not intended and take advantage of discontinuities in product pricing. The industry will be well served to do what it can to eliminate these opportunities for arbitrage, even if lower sales are a result.

### 3. Current Characteristics

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#### *Discussion Parameters*

Life settlements, defined below, are receiving significant attention; from the insurers whose policies are being transferred, from an ever-expanding network of brokers and providers seeking financial gain from these transactions, and from investors, mostly institutional, seeking to enhance their return by investing in this new, and largely uncorrelated, asset class. As they are discussed around the industry, several different types of transactions often are lumped together with life settlements. In what follows, Conning will take a broad view of life settlements, while separating the discussion into several pieces, each addressing a particular segment of the broader topic.

A key issue, addressed in Chapter 4, looks at who truly benefits from life settlements. Life settlement providers offer a valuable service to insureds, by creating a secondary marketplace for life insurance policies that are no longer needed. However, perception of the potential benefit to insureds is undercut by several aspects of the current marketplace, including the lack of transparency on many transactions and the concern that policy owners are not being presented with information on their full range of options, especially the potential gains from keeping the policy. Observers do not deny that life settlements may benefit insureds in a limited number of cases. However, they express concern with the broad marketing of these programs.

To establish what a life settlement is, we will quote from the definition used by Peter Katz, a life settlement broker, in a presentation he made at the October 2005 LIMRA Annual Meeting. A life settlement is:

- ◆ the sale of an existing life insurance policy
- ◆ on an insured whose life expectancy is greater than two years (not terminally ill)
- ◆ to a third party for an amount greater than the cash surrender value

Using this definition, we can distinguish actual life settlements from several other types of transactions that are sometimes, and mistakenly, included in the same category.

First, true life settlements involve existing life insurance policies. Later in this study, we will discuss several other transaction types that are often included in a discussion of life settlements. These generally involve the purchase of new policies, with the expectation that some of them may be the subject of a future life settlement. These transactions share the characteristic of concern regarding insurable interest with life settlements. Examples include LILACs, especially those sold to groups of insureds, often in connection with charities, and non-recourse premium financing. Within these programs, promoters are able to take advantage of mortality and lapsation arbitrage, by assembling groups of insureds and managing their behavior in ways not anticipated at the time the purchased policies were designed or priced.

The second set of transactions to be removed from under the life settlement umbrella is viaticals. Viaticals usually involve an insured with a life expectancy of less than two years. Other differences between life settlements and viaticals can be found in the following section.

### ***“It’s Not Your Father’s Viaticals Anymore”***

While many people still associate the current life settlement phenomenon with the viaticals settlement marketplace of the late 1990s, things have changed dramatically. Yes, we are still talking about “selling” an existing life insurance policy to an unrelated investor, but that is one of a very few similarities. Where viaticals involved younger to middle-aged males, most of whom had been diagnosed with AIDS, life settlements focuses on seniors, with a minimum age of 65 but with members of the 70-80 age band the typical target. Males are overrepresented in the target population for viaticals and life settlements: viaticals because that is where the AIDS virus initially flourished; and life settlements because that is where most large life insurance policies can be found. For viaticals, life expectancies were quite short, two years or less. While life settlement clients generally have experienced some deterioration in life expectancy since their policies were issued, survival for up to an additional 15 years is normal, with the bulk of them enjoying a five- to ten- or twelve-year life expectancy. Viatical policies were quite small (generally less than \$50,000 in face amount) compared to the \$250,000 or \$500,000 minimum size required today to even be considered by most life settlement

providers, and the \$1 million to \$1.5 million average size of the policies actually transferred. Much of the funding for viaticals purchases came from individuals. Institutional investors, including hedge funds and life insurance companies, supply the bulk of the assets being invested in life settlements.

Medical breakthroughs that significantly extended the life expectancy of AIDS sufferers were a major cause for the decline of viaticals sales. Living benefits, which accelerated benefit payments from life insurance policies, was another. Neither came fast enough to help viaticals providers avoid the negative publicity that came from various investment scams, such as failing to continue premium payments when reserves ran out because the AIDS sufferers were outliving their life expectancy, or submitting fraudulent applications to life insurance companies that did not fully disclose the health status of the applicant. Since the life settlement market is perceived to have its roots in viaticals, the mistakes and the fraud of some less-than-ethical viaticals practitioners have been carried forward to taint the life settlement marketplace. In today's financial services world, viatical transfers do not occur with significant frequency.

### ***Life Settlement Financials***

To facilitate understanding of those transactions Conning considers to be true life settlements, we have developed the following model of the financial aspects of a life settlement. It uses the characteristics of a typical transaction to illustrate the financials of life settlements. While not nearly as precise as the tools used by investors and life settlement providers, this model does provide illustrative information, and permits us to illustrate the effect of changes in various assumptions on the overall transaction.

### Illustrative Life Settlement Calculation

(\$ in thousands)

Assumptions		Settlement Financials		
Policy Data		Time Zero Policy Purchase	Each Year Thereafter	At Life Expectancy
Death Benefit	\$1,000	Settlement Payment	\$300	
Surrender Value	150	Commissions	50	
Tax Basis	100	Fees & Expenses	25	
Annual Premium	15	Investor Offer	\$375	
Settlement Data		Policy Premium		\$15
Target Rate of Return	12%	Present Value of Premiums	77	
Assumed Life Expectancy	7 yrs.	Total Cost	\$452	
Settlement Rate (% of DB)	30%	Death Benefit		\$1,000
Commissions-Minimum of:		Present Value of DB	452	
% of Death Benefit	6%	Variance from Target Return	(\$0)	
% of (Sett. Payment - SV)	33%			
Fees & Exp. Rate (% of DB)	2.5%	Ratio: Costs to Sett. Payment	25%	

Source: Conning Research & Consulting, Inc.

In this illustration, an insured, assumed to be 70 years old, with a \$1 million policy seeks a life settlement. The policy has a cash surrender value of \$150 thousand, a tax basis of \$100 thousand, and an annual premium of \$15 thousand.

When applying for a life settlement, the insured is required to provide the life settlement investor with access to medical records. An insured whose life expectancy has deteriorated since policy issue is more attractive to a life settlement investor who is looking to minimize the wait to receive the policy death benefit. As a result of reviewing the insured's medical records, the life settlement investor will have much more current information regarding the insured's life expectancy than the insurer, which likely last reviewed the medical information when the policy was issued. However, at the present time, nonforfeiture regulations do not permit insurers to differentiate cash surrender values based on current life expectancy, creating the opportunity for life settlement providers to offer more for a policy, on a selective basis, than the insurer is able to pay.

Getting back to the financial example, after evaluating the insured's underwriting status, an institutional investor estimates the insured's life expectancy, assumed here to be seven years. This is approximately the current average for life settlements, and is somewhat lower than would be typical for a group of 70-year-olds. The life settlement investor is

able to achieve the lower average life expectancy by being selective in the policies it is offering to purchase.

In this example, the life settlement investor has determined that it needs a 12% return to justify the investment considering the risks involved. Estimating the cost of future premium payments for the insured's life expectancy to be \$77 thousand, the investor makes an offer of \$375 thousand for the policy. After commissions, fees, and expenses, \$300 thousand is paid to the insured, a portion of which is likely taxable.

The investor will receive the \$1 million policy proceeds upon the death of the insured. We are assuming that the underwriting analysis was accurate and that the insured dies at the estimated life expectancy. The present value of the death benefit at the time the policy was purchased is \$452 thousand. This is sufficient to cover the total cost of the settlement transaction, and provide the investor with the desired 12% return.

The insured's actual future lifetime relative to the estimated life expectancy is a major determinant of investor return, which underscores the need for an accurate assessment of the insured's life expectancy. Having purchased the policy with the expectation of a 12% return on investment, the investor's return would increase to almost 15% if the insured died one year earlier. It would drop to about 10% if the actual future lifetime exceeded the life expectancy by one year.

The assumed life expectancy is one of the critical factors in calculating the settlement payment to the insured. With all other assumptions remaining equal to the earlier values, if the insured's estimated life expectancy was only six years, one year less than illustrated above, the investor could earn the same return (12%) after investing approximately \$505 thousand, \$350 thousand of which would be paid to the insured. However, if the life expectancy was one year longer (eight years), the insured's payout would have to drop to about \$260 thousand, 26% of the face amount of the policy, in order to maintain the 12% return.

Investor return is the other key determinant. With all other factors remaining the same, if a 15% return was needed to justify the investment, an insured with a seven-year life expectancy would receive only \$247 thousand as a settlement payout. This would increase to \$350 thousand if the investor required only a 10% return.

## **Sources of Life Settlements**

### **Policy Types**

Minimally funded UL (universal life) contracts are the primary target of life settlement providers. The low funding level generates only small cash surrender values, making it easier for the settlement offer to look attractive to the insured. In addition, the flexible funding aspect of a UL contract allows the provider to adjust its premium-payment pattern to take future interest rates into consideration, optimizing the provider's return. Aggressively priced UL contracts provide additional potential gain, in that lower required premium payments allow the life settlement provider to take advantage of the lower mortality and/or higher lapse assumptions used in policy pricing, maximizing the arbitrage. One drawback of minimally funded UL contracts is that they have little cash value available for paying ongoing mortality charges, which increase sharply as the insured ages.

Whole life contracts are not as attractive, although they are subject to some life settlements. They generally have a much higher cash surrender value, increasing the amount the investor must pay and/or reducing the excess value that a life settlement broker is able to provide. They also have much less flexibility in the amount and timing of future premium payments.

VUL (variable universal life), to the extent that the policy has a fixed income option that produces returns comparable to what can be achieved with UL, can be attractive to life settlement providers. However, expense charges are normally higher than on UL, and, as a registered product, there is concern for the additional regulatory oversight. The VUL contract has the same flexibility in future premium payments that help to make UL the current product of choice. More settlements involving VUL are likely as fewer of the easier-to-settle UL policies remain available.

There is some life settlement activity on level-premium term products as well, although there are some additional hurdles that need to be addressed. Generally speaking, in order to avoid insureds who might live beyond the guaranteed period, life settlement providers will not be interested unless the remaining guarantee period on the term contract is at least twice as long as the estimated life expectancy of the insured. Convertible term policies, where policy provisions permit the term contract to be exchanged for a

permanent policy, can be sold. However, the life settlement provider will need to examine the policy form to which the term policy can be converted, the future premium stream on that policy, and the control the insurer has in approving the conversion.

Finally, convertible group products, where the insured is allowed to convert the group insurance to an individual policy, may be available for life settlement, assuming the insured has control of the election to convert the coverage and the transfer to a third party. The life settlement provider will need to be comfortable with the same list of things as with convertible term.

### Coverage Types

Individually sold life policies are the primary source of life settlement transactions. The initial purpose of the insurance was often to provide financial protection from a premature death. In some cases, the children are now grown and need less protection. In others, the initial beneficiary, often the spouse, has predeceased the insured. Absent a secondary purpose for the insurance, a life settlement may seem like a logical alternative.

Business insurance policies (buy-sell, keyman, etc.) can provide additional life settlement opportunities. Policies purchased to fund buy-sell programs may no longer be needed after one or more of the original owners have left the firm. Policies used to provide keyman coverage may become superfluous after the insured has retired or otherwise dropped out of active participation in the business.

Small and mid-sized executive benefit plans funded with life insurance contracts may be another group of likely targets for life settlement providers. This becomes more likely in situations where corporate operations are being restructured, such as following a sale or a bankruptcy, or where an infusion of cash is needed to address a pressing business issue. Self-administered plans, using individual rather than aggregate funding, that do not maintain an ongoing relationship with the life agent or broker that sold the plan are more likely to be targets.

The potential reduction in the estate tax might make insurance purchased with that purpose in mind a likely target were it not for the fact that much of the life insurance purchased to fund estate taxes is owned by trusts. Working with a trustee is likely to introduce sufficient extra complication to the transaction to deter some life settlement

providers. Others try to distinguish themselves by touting their ability to work with trustees.

Other business insurance programs where regulations, such as tax laws, have changed since the policies were purchased may also be likely candidates for life settlements. For example, many insureds are unsure of how to handle policies purchased under the old split-dollar rules, now that some of those rules have changed.

### ***Other Options***

The life settlement industry is often criticized for not disclosing alternatives to a life settlement. For many, this is not a valid concern, because providers of a particular service should not be expected to suggest alternatives to potential clients.

The situations where policy surrender is a better alternative to a settlement are rare, and lack of appropriate disclosure of this option receives little criticism. However, many feel that keeping the policy in force is often a more appropriate alternative than a life settlement, but that this option is usually not presented to the insured. Several life insurers, led by Massachusetts Mutual, sponsored a joint study by Deloitte Consulting, LLP and UConn (University of Connecticut). The Deloitte study supports the industry position that keeping the policy is better, but it has been challenged in the trade press and by other academic analysis.

The responsibility of a life agent or broker to his/her client suggests that the life settlement option should be presented when confronted with a policy surrender request, as the insured will often be better off with the settlement than with accepting the surrender value. Extending that logic to the retention of the policy suggests that, in those situations where the insured's life agent is involved in a life settlement decision, this alternative should be better explored as well, to determine which of the three alternatives (surrender, settlement, or retention) is superior. However, at the time that they are considering a life settlement, many insureds no longer have a relationship to the agent or broker who sold them their policy. It is not clear that a life settlement broker has any fiduciary responsibility to the insured beyond getting them the best settlement offer, and therefore may not have any obligation to explore other alternatives.

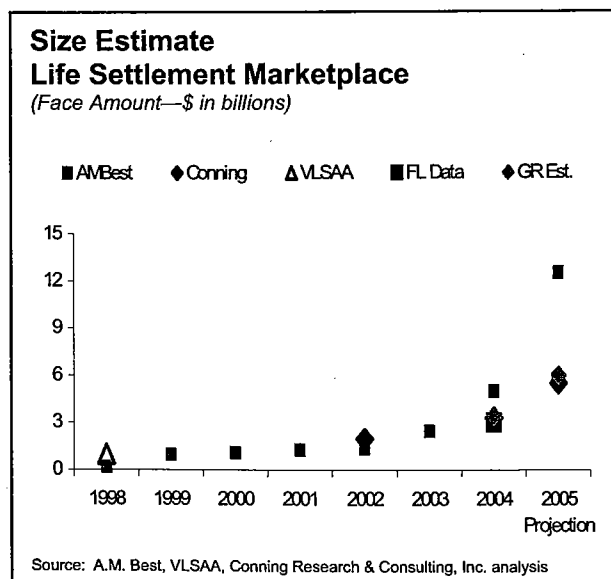
## Market Size

Questions regarding the size of the life settlement market are among the most frequent queries we receive at Conning. This is a difficult figure to quantify, but one of great importance to investors considering participation in the market. There is no official source of the information and no independent third party to which life settlement providers report the volume of policies purchased.

Life settlement providers compete with one another and, therefore, there is a tendency to be optimistic when reporting results. In addition, there is an additional segment of the market that operates below the radar screen, dealing in private transactions that are rarely noticed. Complete and accurate historical data were not available when earlier estimates of market size were made and that data is still not easy to come by. At the November 2005 VLSAA (Viatical and Life Settlement Association of America) meeting, there was significant discussion of the concern for sizing the market, but no concrete proposal for a solution was forthcoming.

In developing the life settlement Strategic Study published in 2003, *Life Settlements—Additional Pressure on Life Profits*, Conning surveyed many life settlement providers to gather data on their sales. Using that as a base, we extrapolated to establish the estimated \$2 billion of volume (face amount) in life settlements in 2002 for the whole industry. This was double the \$1 billion of estimated market size for 1998 that was attributed to the VLSAA.

During a presentation in October 2005, A.M. Best, using data from a March 2005 *Bernstein Research Call*, presented its estimate of the size and growth pattern of the life settlement market. As can be seen in the accompanying graph, the historical VLSAA and Conning estimates of the market are slightly higher but are otherwise in line with the data reported by A.M. Best.



Looking forward, the A.M. Best data illustrate the explosive growth they expect in life settlement. A.M. Best projected that transfers would be within a \$10 billion to \$15 billion range for 2005. Conning has illustrated that on the graph as \$12.5 billion. In the Bernstein report, projections were not as specific as to either amount or timeframe, but they did forecast substantial growth.

The amount of insurance transferred as life settlements, estimated by A.M. Best to be \$10 billion to \$15 billion in 2005, is an impressive statistic in its own right. Looking at the amount of capital needed to fund that level of transactions reveals the size of the investment required. Again, there are no hard statistics available, but it is estimated that the average life settlement offer approximates between 25% and 30% of face amount. (This ratio has been rising, and Conning used 30% in its financial analysis of a typical transaction.) To cover the commissions and expenses associated with the transaction, and because of the need to allocate funds to cover future premiums, Conning has added an additional 15%, 50% of the amount received by the seller of the policy, raising the needed investment to 45% of the face amount. At that rate, somewhere between \$4.5 billion and \$6.8 billion would need to be invested in life settlements in 2005 to support the purchase of \$10 billion to \$15 billion in face amount. This equates to between 4.0% to 6.0% of the total net premiums for individual life insurance policies expected to be collected in 2005 by the industry. While Conning expects continued growth in life settlements, we view this level in 2005 as a bit optimistic.

Conning has tried two additional approaches to help quantify the current life settlement market. The State of Florida requires life settlement providers licensed in the state to disclose annually the volume of business they have purchased. It is supposed to include all the policies the provider has acquired, not just those from Florida. The requirement is new, and both providers and regulators are working to develop an appropriate compliance process. When questioned, members of the staff in Florida commented that they were not sure exactly what data had been supplied. Several examinations of life settlement providers had started, but were not yet complete; as a result, they were not in a position to provide any additional information.

The Florida data indicate that \$1.52 billion in face value was purchased in 2004 by the nine companies that reported to Florida. Most of the major life settlement providers are on the Florida list. Conning estimates they represent half of the total for the U.S., which would put the total U.S. market for 2004 at about \$3.04 billion. The largest U.S. life

settlement provider, Coventry First, is considered to represent about 30% of the U.S. market. It reported \$880 million of face amount to Florida, suggesting that the U.S. total in 2004 was \$2.93 billion. If our analysis of the Florida data is correct, it suggests that the life settlement market is somewhat smaller than others have estimated.

Another attempt at quantifying the U.S. life settlement market uses the experience of some German investors. Several closed-end German investment funds are major investors in U.S. life settlements. Discussions with several people knowledgeable with this capital source reveal that during 2004 approximately \$800 million to \$1 billion was used to purchase U.S. life settlements. This was thought to represent about 60% of the total, suggesting that the total amount invested was between \$1.3 billion and \$1.7 billion. Using the 45% rule of thumb for the relationship of capital to face amount would suggest, face amount purchases of between \$2.9 billion and \$3.8 billion. The rough average of these figures suggests a \$3.4 billion market size in 2004, on the high side of the other estimates. Employing a similar technique and updated data regarding German investment suggests a 2005 market size of between \$5.3 billion and \$6.7 billion. This shows significant growth over 2004, but falls well short of the \$10 billion to \$15 billion A.M. Best estimate.

In Conning's view, the Florida data support a low estimate, while the German estimates are slightly higher. For 2004, \$3.0 billion to \$3.5 billion appears to be a reasonable estimate for the amount of insurance purchased, increasing to \$5.0 billion to \$6.0 billion in 2005.

## **Investors**

Observers of the current situation in the life settlement market characterize it as investor capital chasing available policies—i.e., that there is more money currently available to fund policy purchases than there are available policies to be purchased. As such, and keeping the magnitude of the capital being invested in mind, it suggests just how far things have come since the late 1990s. Institutional investors, using a broad definition of that term that includes hedge funds, have replaced individuals and are a major factor of this evolution. Investment bankers are involved, including Deutsche Bank and UBS, making investments from their own funds and facilitating the process for groups of other investors. Several major U.S. life insurers are also significant investors in life

settlements, providing them with an opportunity to offset potential underwriting losses if their own policies are purchased with investment gains from the business they purchase.

Insured mortality, the driver of life settlement profitability, is perceived to be uncorrelated to other major drivers of investment return, such as economic conditions, interest rates, or equity market performance. Historically, the high and uncorrelated returns that have been available have attracted a surfeit of capital. Closed-end German investment funds are reported to be the largest group of investors in U.S. life settlements. German interest has been driven, in large part, by the favorable tax treatment participants receive on life insurance investments. The tax regulations changed in midyear 2005 and, even though the German funds have tried to use leverage to offset the higher taxes, the volume of new investment has dropped off.

In October 2005, the Financial Accounting Standards Board clarified the accounting treatment of life settlement transactions. Historically, life settlement investors had been required to value policies purchased using their cash surrender value. Because the policies are purchased for amounts in excess of surrender value, often several times the surrender value, this caused the purchaser to report a loss at the time of purchase. New accounting guidance permits the use of either an investment method or the fair value of the purchased policy. This is likely to open the market to additional institutions (trusts and pension funds, for example) that have been kept on the sidelines by internal investment restrictions.

Institutional investors and the more rigid management routines they bring are perceived to be good for the life settlement market. Because the identity of insureds is often not revealed to the investor, participants can have less concern for their own privacy and that some individual may profit from their death.

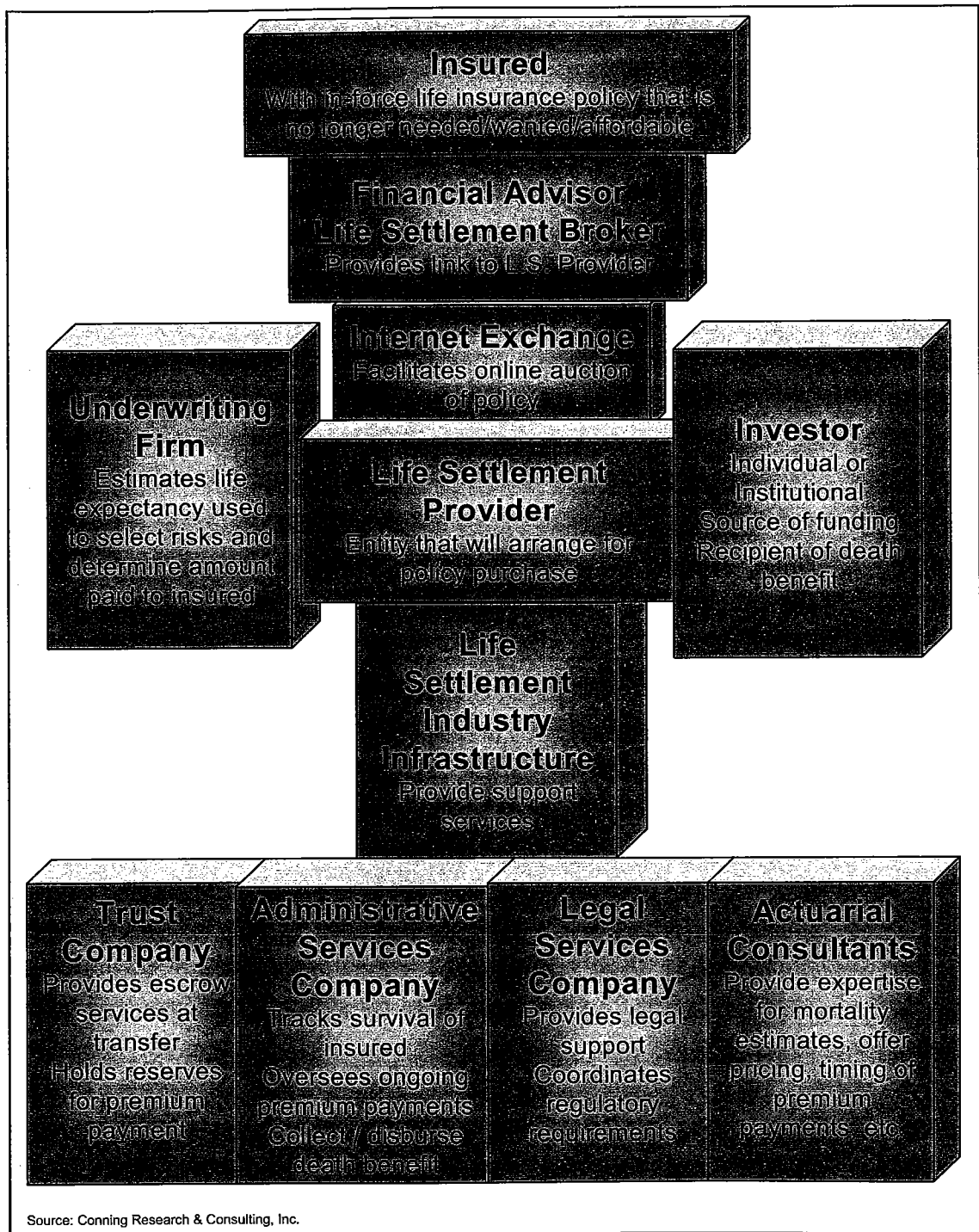
Securitization is a potentially important aspect of institutional investor participation. "Death bonds," as they have been referred to pejoratively, are asset-backed securities, with the death benefit from purchased life insurance policies as the revenue stream. Several securitizations of life settlements have been attempted, with limited success to date. Getting credit reporting agencies to understand these bonds, buy into the underlying underwriting and pricing of the risks, and assign ratings to them is one hurdle. Completing the funding for the transaction on a timely basis is an additional concern. Dignity Partners completed a securitization of viatical policies in 1995. A life settlement

transaction (Tarrytownsecond LLC) had received a aa- indicative debt rating from A.M. Best in January 2004. This was reduced twice, in June 2004 and March 2005, as the program sponsors had trouble raising sufficient capital to complete the transaction, before it was withdrawn in June 2005.

## ***Infrastructure***

This growth in life settlements has not occurred in a vacuum, and a significant support structure has evolved. An earlier version of the accompanying graph was initially printed in Conning's 2003 study. After 30+ months, there are several new types of support organizations that should be added, and one that has been deleted, but the overall picture is quite similar.

- ◆ **Life settlement providers** serve as the point of contact between the life agents and life settlement brokers helping insureds to sell their policies and the investors that fund the settlement offers. While many small firms and individual proprietors struggle to maintain their position as a provider, the vast majority of the life settlements business is now handled by large corporate providers. Access to institutional funding makes needed capital available to them.
- ◆ **Investors.** Institutional investors such as investment banks (U.S. and foreign), insurance companies, and hedge funds have all become involved in life settlement funding, in some cases investing for their own account and, in others, assembling groups of third-party investors.
- ◆ **Underwriting firms** assist in pricing and risk selection. Some provide underwriting expertise in at least two ways: evaluating the current life expectancy of insureds whose policies are being considered for purchase (a key aspect of pricing and risk selection) and determining the quality of the initial policy underwriting (to help reputable investors avoid cleansheeted—policies with a less than complete disclosure on the application of the insured's medical status—or otherwise questionable policies). Four major providers, and a number of smaller firms, provide underwriting support.



Source: Conning Research & Consulting, Inc.

- ◆ **Trust companies** provide escrow services, at time of transfer and on an ongoing basis, to ensure that purchase payments are disbursed after the policy transfer has been recorded and that funds are available to make continuing premium payments.

- ◆ **Administrative services companies** can assist at several stages of a transaction, often tracking the continuing survival of insureds, making actual premium payments, and processing claims at the death of a covered insured.
- ◆ **Internet exchanges** are relatively new participants in the life settlement infrastructure. Two of them began offering their services in 2005. On the graph, they would fit between the Advisor/Broker and the Provider. It is their role to offer an auction-type marketplace for the policies being offered, and seek multiple offers from providers. If successful, the theoretical competition they create between providers should result in a better price being offered to the policy owner.
- ◆ **Legal services companies.** As investors have become more concerned with legal issues surrounding life settlements and the regulatory requirements in various states, legal services firms have stepped up to assist them.
- ◆ **Actuarial consultants.** The technical expertise that actuaries bring is used in several areas. They assist underwriting companies in determining appropriate basic mortality patterns, and the effect that various impairments will have on life expectancy. They assist investors in calculating the appropriate offer to be made and the amount needed to be put in escrow to handle future premium payments. They assist administrative services providers in determining the optimum pattern of premium payment, taking policy features and investment returns into consideration.

### ***Quest for Visibility***

As mentioned above, the current status of the life settlement marketplace could be characterized as investor capital seeking available policies. Life settlements are an expanding phenomenon. Business insiders—i.e., investors seeking to increase returns and life settlement providers seeking to assist them—have come to appreciate their potential

benefits well before the public at large. There is a two-stage campaign going on to remedy that problem and increase the supply of policies available for settlement.

The first stage focuses on agents and other financial advisors. It is not possible to pick up a trade publication serving life insurance producers, such as *Broker World*, *California Broker*, or *Life Insurance Selling*, without finding both advertisements touting the various life settlement providers and articles, often written by representatives of the same organizations, describing life settlements and why life agents and brokers should make their clients aware of their benefits. Online publications aimed at this same audience are liberally laced with pop-up ads. Representatives of life settlement providers are very visible participants at industry conventions and trade shows.

The second target audience includes the general public. Additional articles and advertisements are included in consumer-focused publications, such as the *AARP Magazine*, *The Wall Street Journal*, and *Business Week*. Some of the articles extol the benefits of life settlements, while others warn consumers about pitfalls to be avoided. The Internet teems with websites with pop-up ads stimulated by a broad range of keywords. In addition, life agents and brokers, having been introduced to life settlements, have developed their own promotional programs, focused on their own clients and a broader general audience. In November 2005, one broker announced the rollout of a new service that would provide a free policy analysis to seniors, suggesting that life settlements could be used to replace existing policies with new ones providing enhanced benefits.

### ***Quest for Legitimacy***

Life settlements have received their share of bad press over the years, something that persists as critics point out problem areas with these transactions. Carried over from viatical settlements, the concern for investors profiting at the death of program participants is a continuing cloud that hangs over the industry. There have been innumerable stories of transactions that have gone bad, of individual investors who lost substantial sums to unscrupulous promoters, and of fraudulently obtained policies.

As the life settlement marketplace matures, reputable providers, and the trade associations that they have formed, are working to clean up the poor image. As policy size has increased substantially over viatical transfers, the financial sophistication of

insureds has improved as well. Institutional investors have largely replaced individuals, eliminating unsophisticated investors as a source of problems. Developing a blacklist of unscrupulous participants is an announced, but unrealized, goal of the VLSAA, one of the major life settlement trade associations. An advertising program in publications targeting seniors, featuring Betty White as an industry spokesperson, is intended to provide a more positive image to the public.

### ***Other Concerns***

The privacy of program participants is another issue facing the life settlement industry. When individuals choose to sell their policies to a life settlement provider, not only must they grant access to their current medical history, but also they must consent to ongoing tracking of their survival. While they may feel comfortable in their present dealings with a professional life settlement provider, they lose all control should their policy be resold. There have been some attempts to restrict subsequent sales of settled policies, but investors facing an uncertain future are reluctant to agree to these restrictions.

Several major insurers restrict their distribution systems from participation in life settlements. This raises concerns in two areas. First, to the extent that a life settlement may provide a financial benefit to their client, some would say that they have a fiduciary duty to make the client aware of it. Once they have done that, it may be unreasonable to limit their financial participation in the transaction, if it is elected. In addition, restricting ethical financial services advisors from participating in life settlement transactions makes it easier for the sharp operators to use the system for their own benefit, with the result that consumers may be the losers. This is especially true when an unknown life settlement broker represents the insured in a transaction, rather than an advisor who is familiar with the situation.

### ***Summary***

There are several different types of life insurance transactions, all with the common thread of insurable interest, that tend to be lumped together as life settlements. This clouds a discussion of true life settlements.

A life settlement is the sale of an existing life insurance policy. They differ from viatical settlements in that the insured has a two-year-plus life expectancy, even though the current life settlement market can find its roots among viatical settlements. Concerns with insurable interest issues on policies bought with transfer to a third party in mind also fall outside the scope of life settlements, even though the mortality and/or lapse arbitrage that makes them a potential profit source to a third-party investor is quite similar to several aspects of life settlement transactions.

The financial performance of a life settlement is driven by the relationship of the actual future lifetime of the insured after policy purchase and the expected future lifetime upon which the life settlement offer was calculated. The purchaser balances the present value of the death benefit, at an interest rate that provides it with an acceptable return for the risk being assumed, against the up-front payment for the policy, the amount of commissions, fees, and expenses required by the transaction, and the sum needed fund continuing premium payments. Given that there is a reasonable appropriate distribution of the actual future lifespan of the insureds around what was expected at policy purchase, the life settlement investor will realize a return from the transactions that is at least close to what was targeted. On some of the policies that were purchased, returns greater than what was assumed will be achieved, which balance out lower-than-expected returns on others.

Individually purchased and minimally funded universal life contracts are the policy of choice for life settlement investors. However, whole life, variable universal life, term life (with suitably long guarantee periods), and even group life certificates can be sold. Both personal and business-related policies can be transferred.

No good source of market size statistics exists for life settlements. Several entities, including Conning, have made estimates. After analyzing the current market from several perspectives, Conning estimates that approximately \$3.3 billion in face amount was transferred in 2004, a figure that should increase in 2005 to about \$5.5 billion.

Life settlement investments come from several sources. Institutional investors account for the bulk of current funding, with investment banks, investment funds, and life insurers among the largest investors.

As the life settlement market has grown, an infrastructure to support it has developed, with specialists from many disciplines providing support. Underwriters are key in establishing the expected lifespan of those that offer their policies for sale. Large life settlement providers serve as the point of contact between the life agents and life settlement brokers helping insureds to sell their policies and the investors that fund the settlement offers. The investors and providers are supported by service companies that process the transactions, pay future premiums, and track the continuing survival of those whose policies have been bought. Lawyers and actuaries apply their knowledge and skills to address what has become a very complicated network of issues that must be addressed.

To succeed, life settlement investors and providers have to make consumers aware of the life settlement option. They accomplish this indirectly by raising the awareness of agents and brokers, who can then pass the message to their clients, and directly through advertising. In the process, they have to overcome a poor public image that results from some earlier transactions that have gone bad, and allay the anxiety of insureds who are concerned that a stranger may profit from their death.

## 4. Drivers/Inhibitors of Growth

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### *Drivers*

As discussed in Chapter 3, life settlements appear to have experienced significant growth over the past several years. There have been four recognized drivers of this growth, and an additional demographic issue that has served as a facilitator.

### **Producer Compensation**

As with many life insurance product trends, the financial interest of producers is a powerful factor. Sales trends develop as agents and brokers learn new ways to serve their clients, and generate income for themselves in the process. One needs to look only to the substantial client benefit from wealth-accumulation and/or tax-avoidance programs that have occurred over the past two decades, as life agents and brokers learned new ways to use life products and moved away from protection-focused sales.

Life settlement transactions supply life agents and brokers with a new tool to serve clients, and provide additional sources of income for themselves. These include fees generated from the settlement itself, which can be substantial, and new commission streams that result from additional policies funded with the proceeds of the life settlement transaction. In some situations, clients are able to move to policies with features not available on their old policies, and pocket substantial sums from the settlement proceeds. In other cases, annuities or long-term care programs can be funded that better serve their current needs.

The financial rewards associated with life settlements have been sufficiently attractive to some financial services professionals that they have changed the focus of the services they provide and market life settlements almost exclusively, as life settlement brokers. This change in the focus of their financial services practice comes at a cost. Because settlements are now the majority source of their income, it should not come as a surprise that alternatives to the life settlement are not frequently disclosed.

In some cases, the compensation generated from life settlements has been quite high. Because there is a lack of transparency on these transactions, the amount of money paid to the various parties is generally not disclosed to the seller of the policy. However, as

more sophisticated sellers, and the financial advisors they look to for advice, get involved in life settlements, additional disclosure is being demanded. As transparency improves, the potential for excessive compensation is declining.

There are no externally imposed compensation standards that control what a life settlement broker, who arranges the sale of a policy, and the life agent or financial advisor, who brings the particular client to the transaction, might receive. However, a competitive market generally brings its own discipline, and typical compensation levels are evolving. Our research suggests that a typical current standard would allocate the lesser of 6% of the face amount of the policy or one-third of the increased value provided to the policy owner (increased value equals the excess of the settlement offer to the policyholder over the cash surrender value of the contract). This compensation will usually be split between the life settlement broker and the life agent representing the insured, if there is one, with the broker typically receiving one-third and two-thirds paid to the agent.

#### Compensation Illustration

Death Benefit	\$1,500,000
Surrender Value	225,000
Settlement Payment	450,000
6% of Death Benefit (a)	90,000
33.3% of Excess of Settlement Payment over Surrender Value (b)	74,925
<b>Commission (Minimum of (a) or (b))</b>	<b>\$74,925</b>

Source: Conning Research & Consulting, Inc.

Putting numbers around this formula reveals that significant amounts of compensation can flow from these transactions. The current average face amount of life settlement transactions is \$1.5 million. As can be seen in the accompanying table, this would produce almost \$75 thousand of compensation, based on the assumed values in the table, which are representative of typical transactions. This commission is several times as large as what would be paid on the sale of a similar life insurance policy. And, to the extent the proceeds of the settlement are used to fund the sale of another product, there would be additional compensation available for the life agent and/or settlement broker.

And if the amount of compensation available on life settlements were not sufficient to spark interest on its own, the accompanying advertisement, found in November 2005 on the website of Viatical Settlements, Inc., a life settlement broker, seeks to get the message out that a substantial payday can be the result of a life settlement transaction.

**An Opportunity to Make More Money on One Deal  
Than Many Agents Have Made in a Year**

We'll show you step by step

- o How to help your existing clients get the most money for their policies
- o And at the same time make more money on one deal that you probably have made in a year.

Source: Viatical Settlements, Inc.

One of the more recent financial inducements to get agents and brokers involved in life settlements is a football-themed sales incentive program, sponsored by a major life settlement provider. This program promises more than \$25,000 in cash and prizes for qualifying policies submitted before the end of January 2006.

### **Emergence of Providers**

The emergence of life settlement professionals, both brokers and providers, is a second driver of the explosive growth of this business segment. Well-organized and well-capitalized life settlement providers (such as Coventry First, Peachtree Life Settlements, and Wm. Page & Associates, Inc.), and the brokers they use to interface with the policy owner, are the conduit between investor capital and insureds with policies available for sale.

Providers have stimulated growth on both sides of the market. By introducing investors to the returns available from life settlements, they have increased the available capital. By recruiting brokers to market their services to life agents and brokers, they have been responsible for growing the supply of policies available for settlement.

For some of the major firms, the provider is the focal point of the transaction, actually doing the pricing of the individual settlement transactions, while coordinating the efforts of the various service companies that each bring expertise in one or more areas, as described in Chapter 3. In other situations, the investor will hire its own professionals to do the pricing, while the provider fills the role of coordinating all of the operational and administrative details.

### **Investors Seeking to Increase Returns**

The business model that has emerged, and now controls the majority of life settlement transactions, is characterized by several factors. Key among them is the involvement of

institutional sources of capital, which helps by bringing additional legitimacy to this maturing marketplace.

Life settlements are on the radar screen of many institutional investors. These include major investment banks (including Deutsche Bank and UBS), with a mix of investments for their own account and the coordination of third-party investments. Hedge funds of various sizes and nationalities, and a number of major life insurers (AIG is the largest insurer investing in the U.S. market), are other sources of life settlement capital. Faced with an uncertain economy and low interest rates, at least at the long-term end of the spectrum, investing in life settlements presents an attractive alternative.

The timing of the actual versus expected mortality is the major driver of returns on life settlement investments. This differs from the profitability to the insurer of the product itself, where the investment return on the assets underlying the product is a major determinant. The life settlement investor receives the policy proceeds at the death of the insured, and recovers the amount advanced to fund the life settlement. As discussed in Chapter 5, the return on the amount invested will vary depending on the timing of the actual death relative to what had been assumed in determining the amount to pay for the policy. Because fluctuations in actual versus expected mortality are not related to other measures of economic activity, life settlements provide uncorrelated returns to investors.

Historically, 15% annual returns, or higher, were commonplace on life settlement investments. Increasing competition has caused returns to drop somewhat. Our research suggests that 12% is common as of November 2005, but that some transactions priced to yield less than that. By adjusting the amount of the settlement payment for a given estimated life expectancy, the life settlement investor can select the expected return on its investment, constrained, of course, by current marketplace conditions.

Life settlements, priced to yield 10% or 12% returns, are quite attractive when compared with the 5.25% yields currently available on A-rated 10-year corporate bonds. The likelihood that the actual return on a life settlement would drop to this level is small. For the return on a transaction with a seven-year life expectancy, priced to yield 12%, to drop to 5.25%, the insured would have to live for almost 13 years, which has a probability of approximately 15%.

