Michelle Moloney: In general, how do you view the development of the life settlement business?

Paul Rutledge: Conceptually, I think life settlements are a natural evolution of life insurance products. If you consider a life insurance policy to be a financial instrument like any other asset in a consumer’s financial plan you would expect to be able to access its market value. Until recently, the only option that consumers had to liquidate their insurance assets was to collect the cash surrender value. This value is governed by regulations and does not consider the insured individual’s health, which the policy is based on. Additionally, newer policy designs have created larger gaps between surrender value and economic value. As a result, the surrender value does not reflect its economic value. Today the life settlements business has evolved to better serve this market need.

However, like any new market, the life settlement business has its challenges. Market inefficiency is perhaps the most significant issue as consumers still get only a fraction of their policy’s economic value. I think life insurers, given their infrastructure and existing role as the insurance carrier, have an opportunity to address some of this shortcoming and deliver consumers more value and at the same
time enhance their earnings. Unfortunately, the life settlements business and the insurance industry also need to address market abuses such as speculative uses of life insurance. The NAIC is making some progress towards curtailing these abuses, but the next step is to introduce regulation that enables insurers to play a greater role in providing competitive alternatives to their customers.

The life settlements industry is still young, and I believe that as the market matures these issues will be resolved. If we take the long view, we see that life settlements are consistent with where other financial services and the life insurance industry itself are headed, which is towards market valuation or its true economic value. We see this with Solvency II, the move to fair-value accounting and the use of economic capital and principles-based reserves.

At the end of the day, consumers should be able to access their policy’s economic value – and it also makes sense to have these values set in the marketplace rather than by regulations that generally don’t offer the needed flexibility to address market changes.

**MM: What do you think is driving the emergence of secondary markets?**

PR: Two factors probably are driving life settlement growth today. The first piece is what I would call the speculative use of life settlements, whereby sales are induced to arbitrage one insurer’s set of assumptions against another insurer’s. This has raised concern with regards to public policy and insurable interest. I believe this is receiving regulators’ primary attention.

Additionally, life insurance receives certain tax benefits because it is generally seen as a product that helps promote the public good. There is some concern that such abuses will blur the line between insurance as a risk management tool and as a third-party investment, and, as a result, put this favorable tax treatment in increased jeopardy.

The second driver really started back in the 1980s with AIDS, where people were looking at ways to extract value out of their policies before they died. I believe this is borne out of a real public need; that is, some people are better served to have access to the value embedded in their policy. The insurance industry responded to this market need by adding accelerated death benefits, but this was limited and, over time, grew increasingly disconnected to the underlying value of the policy. I view life settlements as just an extension of this in many ways.

**MM: What role do you see life insurers playing in the life settlement market?**

PR: As I mentioned earlier, the settlement business as it exists today is very inefficient. Besides the policyholder and settlement provider, transactions involve investors, intermediaries for both the settlement company and the policyholder, an underwriting consulting group (in some instances multiple groups), and TPAs to administer the life settlement policy and monitor the insured’s status. Too little of the value is delivered to the owner after everyone in the food chain has taken its cut.

Life insurers are in a good position to boost efficiency by streamlining the transaction 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.
**M M : What does a life insurer need to consider with regard to product development and a secondary market?**

**PR:** The life insurance industry did not anticipate the development of this market and, as such their pricing did not contemplate the resulting experience, primarily as it relates to persistency and persistency-related mortality antiselection. Lapse assumptions usually drive the price down on most products – especially on newer product designs – and if a product is resold in the secondary market, it will remain inforce. While policyholders have the option to lapse, insurers have some latitude to change assumptions once a product has gone to market, but only on an entire class of business. If a product is used in a very different way than anticipated at the time pricing assumptions were set, it exposes an insurer to arbitrage. Going forward, insurers have the ability to recognize the use of life settlements and its implications with respect to persistency.

If an insurer were to offer a liquidity option directly to their policyholder, the investment duration would shorten considerably. In a sense, it’s analogous to a bond with a liquidity call option. A call option has a cost to it, and a bond with this feature has a lower yield in an efficient marketplace.

Hence, if an insurer offers a liquidity call option, they would need to lower their investment yield; however, the reverse should also hold true. If an insurer doesn’t offer a settlement option, they should offer a higher yield. When you couple this dynamic with an alternative secondary market, there is a potential for arbitrage. That is, the consumer could purchase the life insurance product without the settlement option “price” and obtain liquidity via the secondary market. Technically, in a completely efficient market, the price for the settlement option should be discounted from the economic value passed on to the consumer within a life settlement contract or the issuing company could retire the contract. This potential for arbitrage may be the ultimate driving force towards true market efficiency.

Of course, one of the largest impediments towards an efficient market is regulation. For insurers to be able to compete in the marketplace, regulations need to be updated on numerous structural issues such as accounting, non-forfeiture regulation and reserving to support mark-to-market of assets and liabilities.

**M M : Some life insurers view the settlement market as a threat to the insurance business model and advocate limiting the development of settlements to preserve the concept of insurance and the public good. What are your thoughts on this?**

**PR:** Quite frankly, I don’t think it’s a bad thing if you could facilitate the development of an efficient secondary market. Again, while liquidity may be provided by the insurance company, the life settlement business or both, insurance companies will need to have the mark-to-market capability to reflect a policy resale or settlement. Ultimately there will be, in a sense, a new traded financial security, however complex. And, while we struggle currently with other impediments such as regulations and the value chain, the truly hard part of this longer term market evolution will be protecting privacy and public interest. You don’t want to have a marketplace where someone speculates on an individual’s death.

**M M : What do you think about the concerns that many life insurers have voiced with regard to abuses in the settlement business?**

**PR:** These concerns are well-founded. The biggest area of abuses that I see involves the speculative use of life insurance. Here, life insurance products are used for purposes that life insurers and regulators never anticipated, essentially a mortality and persistency arbitrage play. We have seen many of our clients take measures to reduce their exposure to such speculative sales. Some have barred their agents from non-recourse premium financing deals, while others have added questions about the sources of funds for premiums or required agents and applicants to sign statements attesting to the intended use of the coverage being sought. At least one company has included policy language...
that gives it the right of first refusal to repurchase a policy. These are good front-line efforts. The industry is also working together effectively to enact tighter controls around these abuses. The new draft of the NAIC’s Viatical Settlements Model Act has been revised to extend the two-year moratorium on the sale of a life policy to five years. It also provides a broader definition of life settlements in an attempt to include certain premium financing arrangements; many of these deals, while structured differently, still exhibit the same cash flow and disposition as life settlement business. This is a complex issue because there are some legitimate uses of premium financing. How do you protect the legitimate uses while preventing these structures from evolving into something with the same potential for abuse? The industry is making progress but there is still work to be done.

**MM: What in your view do life insurers have to gain from life settlements?**

PR: I really see this development as another step in the modernization of our business model. Over the past few decades we have seen the life insurance industry slowly converge with other financial services sectors. The life settlement evolution is another small step towards this and is indicative of things to come.

For life insurers, this marks an occasion to refine and enhance our value proposition. We issue long term contracts to consumers whose needs change over the life of the contract. Yet, largely because of our regulatory structure, the life insurer and policyholder are essentially locked into the framework once the policy is issued.

Life settlements present insurers with another opportunity to meet customer needs. After all, we’re in business to meet the needs of our customers, and if these needs change, we should be willing to change with them.

Finally, from a purely defensive perspective, the consumer need driving life settlements is not going to go away. It is best for life insurers to actively engage the life settlements market and capitalize on their own strengths to provide an even better alternative to their customers and themselves.

The emergence of life settlement groups will likely require some give and take on the part of life insurers, but this new market also provides the industry an opportunity to demonstrate its commitment to meet changing consumer needs. We at Transamerica Reinsurance look forward to working with our clients to assess their positioning and address ways to improve value to their customers.