To date, the life settlement market has focused on purchasing older age, high face amount, non-term policies from those whose health has deteriorated significantly since original issue. Still, the secondary market has already begun to make some impact on the older age UL and VUL market.

Here we review the attractiveness of the preferred term market from the perspective of a life settlement investor. Based on the modeling highlighted below, it appears that a majority of this market will likely be unattractive for life settlements, from both the consumer's and investor's perspectives.

I’ve chosen to focus on the financial aspects of feasibility; that is, whether a sufficient cash value can be offered relative to the alternatives (lapsing, retention) and whether potential demand can justify the initial development investment.

**The Policyholder’s Perspective**

Assuming all policyholders are economically rational and can assess their own life expectancy with some accuracy, the decision to sell an existing term policy to a life settlement investor will depend on whether the cash offer made exceeds the expected value of the alternatives.

In order to illustrate the process, a simple model can be constructed. Table 1 contains the model results for four issue ages ranging from 35 to 80. Some observations:

- Over the level period projection, the value of the policy is positive after 5 durations in force for three of the ages. This reflects the combination of increasing benefit payment probability and a level premium. The crossover point for age 80 is a little later.
Policy value is highly negative over the projection period including the end of the level period. Healthy policyholders generally are expected to exercise conversion options or lapse at duration 11 to avoid the significant premium increases. However, this value is relevant when health status changes, particularly severely.

Under this scenario, a positive life settlement offer (LSO) can only be offered for policyholders who are now severely impaired. Payout increases significantly for older issue ages but remains relatively stable around 70-80 percent of the value to the policyholder of retaining the policy.

**The Alternatives**

The first alternative to the LSO is easy to define. Let’s assume the carrier offers zero as a cash value. This is a key value with which to compare the LSO but is not the only one.

The second alternative is the value of future benefits less premiums after considering the current health status of the policyholder. It can be seen that this is greater than the LSO for all ages.

The niche emerging then for the investor would seem to be highly impaired risks over age 60 with large face amounts. Table 2 shows the impact of changing health on the profile of LSO estimated payouts.

### Males, Pref + NT

<table>
<thead>
<tr>
<th>Age at issue</th>
<th>35</th>
<th>50</th>
<th>65</th>
<th>80</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face amount</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Annual premium</td>
<td>175</td>
<td>525</td>
<td>2,530</td>
<td>17,925</td>
</tr>
</tbody>
</table>

**Health status:**

**Policyholder viewpoint: Expected value of claims less premiums**

<table>
<thead>
<tr>
<th>Health status</th>
<th>Preferred health (level premium period only)</th>
<th>Preferred health (payment horizon = 25 years)</th>
<th>Residual standard health (2 table mortality loading)</th>
<th>Severe ill health (15 table mortality loading)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred plus</td>
<td>(18,533)</td>
<td>(72,152)</td>
<td>(10,316)</td>
<td>(37,660)</td>
</tr>
<tr>
<td>Residual standard</td>
<td>(10,316)</td>
<td>(141,445)</td>
<td>(8,021)</td>
<td>(128,954)</td>
</tr>
<tr>
<td>Severe ill health</td>
<td>(37,660)</td>
<td>(175,891)</td>
<td>(27,066)</td>
<td>(261,993)</td>
</tr>
</tbody>
</table>

**Health status:**

**Estimated max payout available from Life Settlement**

<table>
<thead>
<tr>
<th>Health status</th>
<th>Preferred health</th>
<th>Residual standard (2 tables)</th>
<th>Severe ill health (15 tables)</th>
<th>Severe ill health payout as % of face amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred plus</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>5%</td>
</tr>
<tr>
<td>Residual standard</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>16%</td>
</tr>
<tr>
<td>Severe ill health</td>
<td>27,066</td>
<td>80,821</td>
<td>128,954</td>
<td>26%</td>
</tr>
<tr>
<td>Severe ill health payout</td>
<td>5%</td>
<td>16%</td>
<td>26%</td>
<td>52%</td>
</tr>
</tbody>
</table>

**Table 1: Prognosis after 5 durations in force**

### Table 2: Estimated LSO Payouts
Potential Market Size

Let’s assume the current portfolio of inforce term (issued say since 2000) is $10 trillion face amount. The niche identified in the first section of this article is estimated as 0.006 percent of the total. This is equivalent to $580 million of face amount. Table 3 highlights the assumptions used to derive this estimate.

The above assumes LSOs are only sold at one moment in time, and ignores future sales in the primary market acting to grow the inforce risk pool. The accusation of piling assumption on assumption in deriving the end result is fairly made. Clearly, a wide confidence interval should be applied to the market size estimate above.

Conclusions

The term life niche is probably not attractive as a standalone venture but may be attractive as an incremental source of new business to existing life settlement houses as growth in their current target markets begins to slow.

Of course, this assumes that consumers will behave in a rational manner. As mentioned earlier, while the expected value of an LSO may be less than the expected benefits of the alternatives, some individuals may still opt for the settlement to have access to cash today. However, it does appear that the risk life settlements poses to term writers’ assumptions should be minor.

A Dedicated Full-Service Underwriter

In the 1970s facultative underwriting was generally considered by the reinsurance community to be a necessary – if not necessarily profitable – exercise of providing clients a second, third or even fourth opinion and quote for their impaired risk cases. The early 1980s brought us the “Term Wars,” a time when both direct and reinsurance companies sought to capture market share. This involved hundreds of thousands of dollars spent underwriting thousands of cases and ultimately tens of highly substandard cases actually issued and placed.

While it’s fun to wax nostalgic, the truth of the matter is the facultative paradigm has changed. Thirty years on, we are looked upon by today’s senior management to be both a profit center using consistently sound facultative underwriting practices and an integral member of the organizational team to help achieve our strategic goals.

The underwriting team at Transamerica Reinsurance remains committed to providing our customers with the best services possible. As one of the few remaining full service reinsurance companies, we fully realize the opportunities presented to us and the benefit of weaving facultative underwriting into our organizational fiber. However, with opportunities come responsibilities. Continued next page

Table 3: Market Profile

<table>
<thead>
<tr>
<th>Face Amount &gt; $500,000</th>
<th>67%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issued at Preferred or Preferred Plus</td>
<td>59%</td>
</tr>
<tr>
<td>Issue Age &gt; 60</td>
<td>2%</td>
</tr>
<tr>
<td>% no longer preferred after 5 years inforce</td>
<td>5%</td>
</tr>
<tr>
<td>% highly substandard in non-preferred cohort</td>
<td>25%</td>
</tr>
<tr>
<td>% eligible for LSO electing to keep policy in force</td>
<td>50%</td>
</tr>
</tbody>
</table>

For more information, you may contact the author at 704.330.5166 or david.o'brien@transamerica.com

By Glenn W. Hoffman,
Second Vice President,
Chief Reinsurance Underwriter
O ur primary responsibility remains the processing of facultative submissions on a timely and competitive basis. We also contribute through:

- Deal teams. O ur regional underwriting directors serve on teams working with the Sales, Pricing and O perations departments to provide underwriting expertise and drive opportunities to mutually successful completion. O ur ultimate goal in this area is to understand our clients’ needs as well as they do.

- Enhanced client focus. O nce a new business treaty is executed, our underwriting directors work with client company management on underwriting-related issues, supporting their risk selection programs and helping to ensure continued product profitability. O ur underwriting program serves as an important communication tool for helping clients identify and maximize their areas of strength and fortify their areas of weakness.

We appreciate the confidence that our facultative clients have shown in Transamerica Reinsurance as illustrated in the 2005 Flaspohler Survey, but we recognize that there is always room for improvement. While there may only be a small fraternity of full-service reinsurers left standing, competition will likely remain as staunch as ever.

With that challenge in mind, we have made the commitment to maintain our position as one of the top companies in the facultative underwriting arena. We stand ready to help with your questions and listen to your comments.

**Middle Market - Untapped and Worth Billions**

As we know, the life insurance industry is facing some serious challenges. While premium growth has been positive in real numbers since before 1985, when adjusted for inflation they have posted a decline. A big reason for the decline is the reduction in the number of policies sold. Policy count declined 39 percent from 17.1 million in 1985 to 10.5 million in 2003. In addition to this, we have seen agent attrition at a record rate.

In spite of this, the opportunity to make new sales is out there, especially in the middle market. LIM RA reports twice as much demand for life insurance by people earning less than $75,000 per year than those earning more (see Figure 1). Demand is also high for those under the age of 45 (see Figure 2).

There is clearly opportunity to sell insurance to younger, middle market clients, a market LIM RA estimates is worth about $17 billion. Even a one percent market share equates to $170 million of new premium.

The problem is that the shrinking agency population has migrated to the more affluent markets. So how do insurers reach the middle class? By using three channels: (1) banks, (2) multiple line agents and (3) direct mail.
Using these channels is a win-win for all involved. Consumers get the coverage they need. Distributors are able to garner additional revenue without significantly increasing sales costs. And the insurance industry captures a market that rounds out its pool of applicants in a very risk sensitive way, producing potentially substantial returns.

Simplified underwriting is the key to reaching the middle market. Not only does it improve the sales experience for the customer, but it’s an easier process for the sales person. This in turn can provide effective access to a new distribution channel. Expanded distribution is the true value proposition of simplified underwriting.

Simplified underwriting has historically involved a short application with fewer than 10 underwriting questions. By eliminating more invasive procedures or APSs, policies can be issued more rapidly.

However, while speed to issue is nice, limited underwriting information introduces greater risk uncertainty. This requires higher premiums than fully underwritten products. In the extreme, this higher premium may be up to twice as much, an obvious impediment to sales.

Transamerica Reinsurance has developed a new underwriting engine that addresses the shortcomings of simplified issue business. In-depth discussions with experts in the direct mail, bank and multi-line channels have led to the creation of a better balance between simplified underwriting and competitive rates when compared to the traditional simplified underwritten approach.

Our system uses a reflexive application with a limited number of drill-down questions combined with information from MIB, MVR and pharmaceutical databases. This results in a fusion of underwriting simplicity and speed to issue with pricing improvements and enhanced sales opportunities. In fact, rates can be as much as 15-30 percent less than rates offered by traditional simplified term products.

By utilizing our underwriting engine, associated product development and a reinsurance program, a direct writer may be able to tap a heretofore elusive market, while simultaneously accessing new forms of distribution.

For more information, you may contact the author at 704.344.2805 or bruce.wing@transamerica.com.
Understanding Reinsurance Expenses

The life insurance industry has traditionally used conservative mortality pricing to help compensate for expense costs, especially on the front end. As we continue to see margins pressured, direct companies should reexamine their cost structure to correctly identify and allocate expenses. As you rely on your reinsurers for risk and capital relief, it is important for us to understand more about your cost structure and vice versa.

To achieve adequate and equitable expense assumptions, a reinsurer must consider the various types and levels of services it provides to both internal and external clients. Expenses that a reinsurance company incurs differ in both their nature and magnitude from those of the direct-writing company. This article examines the reinsurance side of expenses and discusses some of the factors influencing these differences. The underlying expense types are grouped within the larger categories of acquisition versus maintenance expense.

Acquisition Expense

- Deal pricing and setup: These expenses reflect the costs associated with pricing deals and setting up the documentation and administrative network for won deals. While these costs are mostly fixed, larger more complex deals require more time and resources and therefore generate higher expense.
- Facultative underwriting: Expenses are per underwritten case, but total costs do not necessarily relate to the size of the deal. Depending upon the client’s underwriting needs, a small deal can generate more facultative submissions than a large deal.
- Marketing: A reinsurer’s marketing effort is generally a fixed cost that is not related to the size of any particular deal.

Maintenance Expense

- Claims administration: While expenses are incurred on a per claim basis, claims administration costs vary based on the level of reinsurer participation in the ceding company’s claims process.
- Treaty administration: Reinsurance is usually on a “self-administered” basis, where the ceding company creates its own cession data and submits it to the reinsurer in an electronic format. This data includes all the transactional records needed for accounting, financial reporting and valuation. Hence, the magnitude of reinsurance administration expense is related more to the reporting capabilities of the ceding company rather than the size of the deal. A large deal from a client with excellent reporting can be less expensive to administer than a small deal from a client with problematic reporting.
- Actuarial functions: Expenses are generally fixed, but the extra due diligence required for the financial reporting and valuation of a large complex deal often generates additional expense.
Private Label Helps Solve IT Crunch

It seems that compliance issues become more complicated every day for life insurers. Greater financial transparency called for in Sarbanes-Oxley as well as the continued challenge of product complexity have certainly been a driving force for much of this. To a large degree, technology is the glue that holds an insurer’s compliance together.

As demand for technology resources increases, some insurers have discovered that planned product and/or system upgrades will need to be postponed in order to focus on more pressing compliance needs.

Through our private label solutions, Transamerica Reinsurance can help alleviate at least a part of that IT crunch. Our private label products have at their core a sophisticated technology platform, built in conjunction with Vector Insurance Services, LLC. By using our private label solutions, our clients can focus internal resources on their more profitable permanent products and meet regulatory demands while we focus on their term products and services.

But our systems do more than provide access to a customized term life solution. Our systems provide a turnaround time that can greatly increase speed to market. For the producer, this can translate into faster service and a higher close rate on term life sales, which should increase producer satisfaction.

Realizing that many companies have invested time and resources into updating

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By Mary Barrett,
Second Vice President, PC&D Operations
their own systems, we designed our technology platform to be modular. This allows clients to select only those services that complement their own technology capabilities. This “plug and play” flexibility allows clients to maximize the return on their own IT investments without reinventing the wheel for their other technology needs.

Real-time data access also allows clients to assess underwriting performance quickly. This provides immediate access to up-to-date information or adherence to criteria and time-service standards. This should help alleviate the cost and disruption associated with in-depth onsite audits. All of this translates into easier business processes for our clients and for us.

Our IT investment is just one facet of our private label services. Our solution is wrapped in a term life reinsurance treaty with up to 100 percent coinsurance available and provides generous marketing allowances.

We welcome you to contact Transamerica Reinsurance to discuss these and other features that your company may find advantageous in our private label solutions.

For more information, you may contact the author at 704.344.7957 or mary.barrett@transamerica.com.