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AND DEATH SHALL HAVE NO DOMINION

Life settlements and the ethics of profiting from mortality

A Pensions Institute Report for Buyers and Sellers of Life
Settlements, Financial Advisors, Regulators and Policymakers

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And death shall have no dominion

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Foreword

This is the sixth¹ of our series of reports that focus on issues of direct relevance to practitioners, in this case buyers and sellers of US life settlements, buyers and sellers of US older-age longevity risks, financial advisors, regulators and policymakers.

Is it ethical to profit from an investment that relies on the successful prediction of an individual's date of death, and if so, how can investors be sure that such a market operates within a robust regulatory framework that protects both the policyholder and the ultimate investor? These are important questions for institutional and private investors considering a comparatively new asset class, based on trading mortality, often in the form of US life settlements (also known as traded life policies or TLPs) sold by the policyholder to an intermediary (a broker or a dedicated life settlement company) who sells on to investors. The price paid to the policyholder is greater than the surrender value, but is negotiated at a deep discount to the face value of the policy, which would otherwise be received by the policyholder's beneficiaries on death.

The potential for diversification associated with this alternative asset class – which is not correlated with traditional equity and bond markets – appears to have attracted interest from institutional investors around the world, including major investment banks, insurance companies, asset managers, hedge funds, and pension funds. Financial institutions have also established a synthetic life settlement market, which offers institutional investors products that replicate the investment in a portfolio of life settlements. Clearly there are important differences between direct investment and investment in synthetic products. One effect of the development of a synthetic market is a new emerging terminology that differentiates between 'policy-linked exposures' and 'life-linked exposures'.

Mortality projections are a critical feature of life insurance,² defined benefit (DB) pension plans, annuities (individual and bulk), and equity release plans, among other financial products. Pension plan sponsors gain from the early deaths of plan members and pensioners, as do annuity providers. In contrast, providers of term insurance gain when individuals live longer than the age at which their cover ends. Mortality projections are also a key feature of the new market in mortality-linked bonds and derivatives, where cash flows are linked to realised mortality of specified populations or indices, where sellers can hedge mortality or longevity risk and traders can make a profit by exploiting the differential between expected and realised future mortality experience.

Of the various categories of financial contracts and products where mortality plays a key role, arguably the most sensitive and potentially controversial are those involving 'distress' sales in the retail market, where individuals sell an asset or policy at a deep discount to its face value because they are in urgent need

1. The previous reports were: 'Delivering DC? Barriers to participation in the company-sponsored pensions market', by Debbie Harrison, Alistair Byrne, and David Blake, October 2004; 'Pyrrhic Victory? The unintended consequences of the Pensions Act 2004', by Debbie Harrison, Alistair Byrne, Bill Rhodes and David Blake, October 2005; 'Annuities and Accessibility: How the industry can empower consumers to make rational choices', by Debbie Harrison, Alistair Byrne and David Blake, March 2006; 'Dealing with the reluctant investor: Innovation and governance in DC pension investment', by Alistair Byrne, Debbie Harrison and David Blake, April 2007; and 'An unreal number: How company pension accounting fosters an illusion of certainty', by David Blake, Zaki Khorasane, John Pickles and David Tyrrell, January 2008.

2. In the UK, it is conventional to differentiate between an 'insurance' policy, which protects against an adverse event that *might* occur in the future, and an 'assurance' policy, which protects against an adverse event that *will* happen in the future but where the timing of the event is uncertain. This distinction is not known in the US and elsewhere. Throughout this report we adopt US terminology and use the term 'life insurance' rather than 'life assurance'; on occasions we also shorten 'life insurance policy' to 'life policy'.

of capital. Such individuals are usually in retirement and might have a life-shortening medical condition; therefore they are identified by financial services regulators as particularly vulnerable to high-pressure sales tactics that profit the buyer and not the seller of the asset or policy.

However, where policyholders have life expectancies greater than four years and policy sizes range from \$1m to \$20m, it might not be accurate to describe these as 'distress' sales. For such policyholders, life settlements are more commonly viewed as a further tool in prudent financial or estate planning. Also, in this section of the market, as the average policy size sold is well above \$1m, life settlements have been referred to as a high net worth product.

Apart from the sales process, which in itself poses questions about fair treatment of policyholders, this type of market might also raise concerns about data protection, as the organisation that buys policies acquires considerable information about an insured's age, state of health, and financial circumstances.

Since the turn of the century, a number of reports have been published offering a sober analysis of the issues involved in the life settlement market. They note the benefits of the creation of a secondary market in life policies in terms of increased competition and improved liquidity for policyholders with a lower than average life expectancy, who otherwise might get a comparatively poor deal if they surrender a policy through their existing provider. However, the reports also note concerns about the regulatory inconsistencies in the life settlement market and the potential scope for market abuse.

In this Pensions Institute report, we explain how the life settlement market works and consider the ethical issues raised by an alternative asset class whose returns are linked to the mortality of life insurance policyholders or to older-age individuals in life-linked transactions. In so doing, we reach a range of conclusions that might help parties involved in the market to identify issues that need to be addressed to ensure greater efficiency and transparency. We also stress that there might be the potential for unintended or unforeseen consequences that can arise when a new market develops very rapidly, particularly where market growth appears to be one step ahead of regulation and legislation.

Desk research for this study was funded by Deutsche Bank, EFG International, Goldman Sachs, and The Royal Bank of Scotland. The sponsors have not sought to influence the conclusions of the report and they might not share the views expressed here. Finally, we should stress that the views expressed in this report are those of the authors and not those of the Pensions Institute, which itself takes no policy position.

Professor David Blake (Director, Pensions Institute) and
Debbie Harrison (Senior Visiting Fellow, Pensions Institute), *July 2008*

Executive Summary

Market size and growth

- The secondary (traded) market in US whole life policies (i.e., life settlements or traded life policies or TLPs) has grown from zero in the mid-1990s to about \$13bn in 2005. It is expected to grow to about \$160bn over the next few years, although the precise time frame for this cannot be predicted with certainty.
- The primary market in US whole life policies is worth about \$9trn, which indicates a life settlement market penetration of well below 1% at present. As the proportion of over-65s increases by an estimated 90% over the next 25 years, the number of policyholders willing to sell might also increase significantly.

Potential benefits for policyholders

- The liquidity provided by the secondary market benefits policyholders, who no longer want or need the life insurance, as they might get a higher cash sum in the secondary market than the surrender value offered by the issuing insurance company.
- The ability to sell unwanted policies at a later date might encourage people to take out life insurance in the first place.
- The ability to cash in a portion of their 'insurable capacity', which is no longer required, provides additional financial planning and estate planning opportunities for retired policyholders

Potential benefits for investors

- As an alternative asset class, portfolios of life settlements or of longevity risk linked to groups of older-age individuals, whether owned directly or via pooled funds, claim to offer an attractive and comparatively low risk-return trade-off compared with equities, and also to provide diversification of investment risk, since life expectancy is not correlated with returns in equity and bond markets.
- The appeal of the asset class appears to be widespread and diverse. The main institutional investors in life settlements include global investment banks, insurance companies, private banks, and hedge funds; with a growing interest on the part of DB pension funds and also wealthy private investors. Moreover, retail funds are thought to be available in almost all of the 10 largest OECD countries, although accurate data are lacking.
- There is growing interest in synthetic structures that replicate direct investment in life settlement portfolios, since synthetic transactions appear to remove some of the risks and concerns related to cash policies.
- The move to more consistent and rigorous regulation across US states should enhance policyholder protection, improve market transparency and reputation, and provide better data on market size and potential growth.

- There would appear to be no particular ethical issues from investing in this asset class, *provided that* products and processes are fully transparent to all parties. Private investors can choose whether or not to invest in life settlements in accordance with their personal views and beliefs. Institutional investors should, however, consider the ethics of the asset class in relation to any socially responsible investment strategy that is in place. In Section 2 of this report, we consider other examples where economic profits are derived from realized mortality.
- The ‘cash-based’ longevity risk instruments that currently predominate (i.e. life settlements) may be expanded over time by the trading of exposure to pools of similarly medically underwritten older-age persons, without direct reference to policies. This trend will accelerate if major investors become more discriminating about the non-longevity risks of policies (or policy-linked exposures).

Potential risks for individuals

- Some investors with specific ethical concerns about mortality-related products might inadvertently invest in life settlements due to lack of transparency, for example, in the case of hedge funds. This issue might also arise where individuals are beneficiaries of institutional funds, or funds of funds, that use life settlements to diversify risk, for example, pension funds and charities.
- The secondary market could reduce the percentage of policies that lapse and therefore affect insurers’ profits. This might have the knock-on effect of increasing life insurance premiums for older ages.

Potential risks for the market

- Regulation is inconsistent at present. The life settlement market is regulated at US state rather than federal level (as is the case with the US insurance industry as a whole) and is undergoing review and reform in many cases. However, not all states regulate the market and those that do tend not to adopt common rules.
- Regulators and end investors might also be concerned that if overly optimistic mortality assumptions are used to price policies, this will inflate the cash sums paid to policyholders (and, importantly, the intermediaries’ sales commission) and reduce the potential return on life settlement portfolios and funds.
- Regulators are also considering the potential market distortions associated with ‘stranger-originated life insurance’ (STOLI) practices. This is where seniors are persuaded to take out insurance through a ‘premium financing’ arrangement, whereby an investor provides a loan or pays cash to cover the cost of premiums, with the intention of buying the policy in due course. US life insurers are concerned that such practices could distort the primary purpose of life insurance, which is based on an insurable interest between an insurer, a policyholder, and a beneficiary, and is not intended for speculative investment purposes. Moreover, STOLI cases could be contested and the benefits paid to the family rather than the investor. An accurate analysis of such risks would require a detailed examination of the laws in different states on insurable interest, which is beyond the scope of this paper.

Overview and objectives

The life settlement market

A 2005 report, published by the insurance company equity analyst Sanford C. Bernstein, estimated that the secondary market for life policies had grown from zero in the mid-1990s to about \$13bn in 2005, compared with a primary market worth about \$9trn.³ The company expects the secondary market to grow to about \$160bn over the 'next several years' and confirmed that it was still of this opinion as at April 2008, when this Pensions Institute report was being written. Separately, the insurance company consultant, Conning Research & Consulting, estimates that US life policies worth \$19.5bn were traded between 2002 and 2006.⁴

As life expectancy increases, it is likely that the number of 'redundant' policies will also increase, fuelling demand for the life settlement companies' offers of higher payouts than insurance company surrender values.⁵ Bernstein notes that the target market for life settlements – the over-65s – could grow by 90% over the next 25 years, which is more than three times the growth rate of the US population as a whole. Moreover, it is possible that regulation might require advisors and insurers to promote the availability of settlements that offer a higher cash-in value than surrenders.

The roots of the life settlement market lie in the 1990s when AIDS victims with an estimated life expectancy of less than two years sold or were persuaded to sell – an important difference – their life insurance policies in order to have access to the capital to fund expensive medical care. Investments based on these 'viatical' settlements – the term used for the secondary market where insureds have a life expectancy of less than two years – were not generally successful due to aggressive sales practices, inaccuracies in estimating policyholder life times, and unanticipated medical advances that prolonged the lives of AIDS patients.

By the late-1990s, the life settlement market had changed, with a new emphasis on life policies sold by 'seniors' (the over-65s) who had a medical impairment but who were expected to live typically between three and 15 more years (although policies where the individual is expected to live 20 more years are also traded). Apart from the home market in the US, this new asset class has attracted the attention of a wide range of institutional investors around the world, including investment banks, insurance companies, hedge funds and pension funds, as well as wealthy private investors.

One of the earliest non-US markets to demonstrate an interest in life settlements was Germany, where there is a demand for asset classes that can support investment products, which provide a minimum guaranteed annual return – considered a desirable feature by German investors. Initial growth was encouraged by the tax-free status conferred on life settlement investments, although this tax break was repealed in 2004.

3. Suneet Kamath and Timothy Sledge, 'Life Insurance Long View: Life Settlements Need Not Be Unsettling' Bernstein Research Call, March 2005. Hereafter referred to as 'Bernstein', www.bernsteinresearch.com.

4. www.conning.com

5. A life settlement company is a company that buys individual life insurance policies and sells them on to investors.

The trade publication *Pensions & Investments*, in a 2007 report, noted that in the Netherlands some of the large pension plans were now investing in life settlements, although interestingly the same report indicated that US pension plans were holding back from investing in this new asset class until the market became better regulated and more transparent in the way policies are sourced.⁶

In the UK, DB pension plans might consider life settlements as an alternative asset class that can aid diversification and form part of a liability driven investment (LDI) strategy. New funds have also been launched into the UK's mainstream retail market over the past few years, extending the potential target to regular savers, as well as wealthy private investors.⁷

The Life Settlements Report (LSR),⁸ a US trade publication, reports a growing market in synthetic structures⁹ that replicate an investment in life settlement portfolios. LSR names Bear Stearns,¹⁰ Credit Suisse, Deutsche Bank, and Goldman Sachs as key companies in this market, while, separately, Goldman Sachs has launched a tradeable index for longevity and mortality risks (QxX.LS)¹¹ that aims to reflect the mortality experience of a representative sample of the US senior insured population. Such structures can provide more straightforward investor exposure to older-age US longevity risk, while eliminating exposure to policy-related risks, including reputational risks surrounding how policies are sourced, and cross-border tax risks, among others.

US life settlement funds claim to offer an attractive and comparatively low risk-return trade-off compared with equities, and also to provide diversification of investment risk, as life expectancy is not correlated with returns in equity and bond markets. However, the regulation of life settlements in the US is patchy and inconsistent and concerns are already emerging in the light of evidence of aggressive pricing that incorporates unrealistically low life expectations of policyholders. Going forward, the success of this asset class, irrespective of any ethical investment concerns, will depend on the purchasers' expertise in portfolio construction, the accuracy of life expectancy (LE) reports, and robust standards in the regulation of purchase and resale processes.

Clearly, regulation is a key issue and *LSR* reports particular concern over 'stranger-originated life insurance' (STOLI) practices, where seniors are offered a loan or even paid to take out whole life policies with the intention of selling them to investors. Such third-party funding arrangements are known as 'premium financing'. STOLI practices are a concern to the US insurers because they might be seen to distort the primary purpose of life insurance, which is based on an insurable interest between an insurer, a policyholder, and a beneficiary. Regulators are considering banning STOLI practices. However, regulation of life settlements is at state rather than federal level in the US and, while many states

6. *Pensions & Investments*, April 17, 2007, www.plonline.com.

7. The UK has its own domestic market in whole life policies, but this has declined in recent years with advisors now generally recommending separate life and savings policies because of the greater transparency and flexibility this confers. UK whole life policies still play an important role in estate planning, however, where they are written in trust and provide a fund on death to help beneficiaries meet any inheritance tax arising on the insured's estate.

8. *Life Settlements Report*, February 21, 2008, www.dealflowmedia.com.

9. Synthetic exposure to policies via a total return swap or a structured note might permit investors to eliminate certain risks inherent in life insurance policies such as carrier credit risk, regulatory risks etc. Some dealers apparently have begun to issue transactions linked to the realized longevity of older-age people without reference to policies at all.

10. This investment bank was taken over by JP Morgan Chase on 16 March 2008.

11. www.qxx-index.com

have introduced or revised legislation, some states have yet to act, including California, New York and Illinois (although these states do regulate the viatical market).¹² One of the issues for regulators is that certain investment structures and vehicles – trusts, for example – might not be transparent and might make the detection of STOLI practices difficult.

In the UK, the regulatory authority for financial services, the Financial Services Authority (FSA), does not regulate funds directly, but rather it regulates the advisory and sales processes. This means that it is not generally concerned with the underlying assets, but it is concerned to ensure transparency and accountability in relation to the underlying asset classes in which institutions invest.

The FSA is also concerned to ensure that funds and products are promoted in a way that does not mislead consumers. This suggests a need for caution in the promotion of life settlement funds in the mainstream retail market, as there are potentially significant risks associated with life settlements that might not be obvious to private investors, particularly less sophisticated investors seeking to exit the troubled with-profits market, for example.

Since the mid-1990s, the market has been the subject of a growing body of research by independent organisations, including the Wharton Business School, the analyst Sanford C. Bernstein, and the insurance company rating firm A. M. Best. The market has also been the subject of press reports, which have ranged in tone and quality of research.¹³ We would expect more research and press interest to follow, as the market grows in size, complexity, and reputation.

Ethical issues

The opinions of individuals, institutions, regulators, and governments naturally vary in their definitions of what is ethical. In this report, we do not aim to make recommendations but rather we endeavour to explore and clarify the ethical questions that we feel the market might wish to address. Certain questions are for the conscience of the individual investor or for the socially responsible investment strategy of an institutional investor. However, there are also issues that might not be resolved until improved and consistent regulation has eradicated anomalies in the market. While we cannot answer these questions or address these issues conclusively, in the following sections we endeavour to assess the current situation and draw conclusions on the following points:

- Is it ethical to invest in an asset class that relies for its return on the deaths (or the prediction of the deaths) of policyholders?
- What constitutes the fair treatment of policyholders, in terms of the benefits of the availability of a secondary market – which enhances liquidity – balanced against the avoidance of unreasonable sales practices and unfair pricing? The age of policyholders and the potential distress nature of sales will be relevant here.

¹² *Life Settlement Report*, February 21, 2008.

¹³ Examples include: 'Investors Seek Profit in Strangers' Deaths' (by Liam Pleven and Rachel Emma Silverman, *Wall Street Journal*, 2 May 2006), 'A Lively Market in "Death Bonds"' (Liam Pleven, Associated Press, 21 February 2007), 'Profiting from Mortality: Death Bonds May be the Most Macabre Investment Scheme Ever Devised by Wall Street' (Matthew Goldstein, *Business Week*, 30 July 2007), and 'An Insurance Man Builds a Lively Business in Death: As Life Settlements Boom, Banks, Regulators Circle; Betting on Larry King' (by Liam Pleven and Rachel Emma Silverman, *Wall Street Journal*, 26 November 2007).

- What constitutes standards of best practice among intermediaries, for example, with reference to general sales practices and STOLI arrangements? Intermediaries include the intermediaries and life settlement companies that purchase policies, and also the medical practitioners who provide the LE reports upon which purchases (and the purchase price) are based.
- What protection do institutional and retail investors require when they purchase policies directly or invest in funds of policies? Such investor protection would seem to require transparency at all stages of the process: in the 'audit trail' from the original policyholder ('origination') to the end investor; in pricing; and in quantifying mortality risks. For retail investors, in particular, there is a danger that collective funds might be promoted as 'low risk' in the mass market where investors might not understand (or be told about) the mortality risks that could affect returns.
- What constitutes clear and consistent regulation in the US, in relation to all of the above points and what difficulties arise where regulation is at state, rather than federal level?

Section 1: The life settlement market

1.1 What is a US life policy?

The most common type of US life insurance policy in the life settlement market is a whole life insurance policy and within this market the most commonly sold product is called universal life. Unlike term insurance, which covers only a predetermined number of years, a whole life policy lasts a lifetime, providing a capital sum on death, which generally forms part of the policyholder's estate. Most policies are taken out by individuals who wish to insure their own lives, but it is also possible to buy policies that insure the life of a third party. This might be a family member, or, in the case of corporate 'key man' insurance, it might be the case that a company or partnership wishes to insure the life of an important individual whose death might have financial repercussions for the business.

A whole life policy has two components, a life insurance component and an investment component: periodic premiums (monthly, quarterly, annual, single, for example) cover the cost of the life insurance, with the surplus going into an investment fund. In the US market, the insurance company typically invests the surplus premium in fixed-income securities to build up a 'cash value'. The cash value is separate from the 'face value' of the policy, which is the guaranteed insurance value. The policyholder may be able to draw on the investment fund and may also be able to borrow against it, depending on the policy terms. The policy would also usually include a withdrawal clause, which allows the policyholder to cash it in, in return for a 'surrender value'.

The insurance value is fixed and guaranteed provided the premiums are maintained. However, this insurance value, in most cases, is not inflation linked and so its real value erodes over time. The cash value of the policy depends on the size of the premium after deducting the charge for life insurance. It will also depend on how long the policy has been in operation, on the returns generated in the investment fund, and on the provider's investment charges. While perceived as comparatively low risk as an investment (compared with, say, equities), fixed-income securities do expose the policyholder to inflation and interest rate risk. Moreover, as the premiums are often fixed at the outset, the proportion of this used to pay for the insurance element might rise over time and so the surplus available for investment might reduce accordingly. However, with a universal life policy the premium is flexible.

On death, the policyholder's beneficiaries receive the guaranteed insurance value. The tax treatment of the payout will depend on local tax rules. Writing a policy in trust would have an impact on the tax treatment of the proceeds.

If premiums cease, for whatever reason, the policy will lapse. Moreover, if the individual dies within the first two years of the policy, the carrier may only return the premiums paid to date, plus interest at a nominal rate. This 'moratorium' or 'contestability period' feature is designed to protect insurers against two risks: first, the self-inflicted death of the insured and second, fraud or omission of material information on the policy application. Many whole life policies insuring seniors are for substantial sums of \$1m or more and in these cases a medical examination is usually required.

1.2 *What is a 'life settlement'?*

We discuss how the market works below: here we simply define the terminology. Whole life policies can be assigned, which means that the insured individual – or policyholder if this is a different individual or entity – can sell a policy and assign the interest in the death benefit¹⁴ to the purchaser. When a third party buys the rights to the benefits of a life insurance policy, the arrangement is known as a 'life settlement' or 'traded life policy' (TLP).

Under 'non-contestability' provisions that govern US life insurance, life insurers cannot usually contest the payment of death benefits after the end of the contestability period, provided premiums have been fully paid up to the date of the policyholder's death.

1.3 *The reasons for the original purchase and the subsequent sale*

To understand how the secondary market works, it is important to appreciate why whole life policies are purchased in the first instance and why they might be sold at a later date.

The most common reason for the original purchase is to secure life cover, so that dependants (or businesses) receive a capital sum in the event of the policyholder's death. However, this need can be met through the purchase of term insurance, which is considered to be a simpler and, in many cases, cheaper product than whole life. So, why buy the more complex and expensive alternative? It might be because of customer preferences (the buy side), but it might also be due to insurance company and intermediary marketing (the sell side). From a behavioural perspective, whole life looks more attractive than term insurance to consumers who are not comfortable with buying pure insurance products – that is, policies that only pay out if a claim arises (in this case on death). Motor and home insurance fall into this category, as does term insurance, which only pays out if the policyholder dies within the term covered. Whole life insurance might, therefore, be perceived as an easier 'sell' because the investment element of the policy provides an additional cash value that can be used in various ways, as already noted, while the insurance value will be paid on the insured's death, whenever this occurs. There is a further potential distortion due to the large sales commissions paid to life insurance agents on whole life and universal life, which are not available on term products.

Whole life policies are sold by policyholders for a range of reasons. Typically the policyholder's circumstances have changed so that they no longer need the life cover and would like to gain access to the embedded capital value rather than simply to let the policy lapse. In a period of comparatively low interest rates, the growth of the investment element (linked to deposit and fixed-interest bond rates) might be limited, and this might provide an additional reason for a sale.

The Bernstein study, which reports the findings of the 'Hartford 2003 Consumer Survey', lists four main reasons for the purchase of life settlements. Here we reproduce the headline percentages (that is, the percentage of policies purchased for the stated reason) and then for each we consider briefly why the purchaser might subsequently wish to sell.

¹⁴ That is, the face value of the policy.

- **Income protection (79%):** This is by far the most common reason for purchase, with the objective of replacing the income of an individual who dies and who has financial dependants, for example, a working parent with children still in education. Once the dependants become independent financially, the insurance might be considered redundant and the sale of the policy might appeal if this would secure a capital sum and remove the need to continue paying monthly premiums, which in retirement, for example, might become unaffordable. Where ill health is an issue, the capital secured on surrender or on sale in the secondary market could help fund medical care and other needs.
- **Estate planning (9%):** Estate planning refers to the use of the policy by individuals who would like to provide a lump sum on their death to their beneficiaries, for example, to cover any tax bills that might arise on the value of their estate. Changes in family arrangements – for example a divorce or the death of a dependant – might make the policy redundant, as might a significant reduction in the estate’s value. A change to estate tax legislation in the US in future could also reduce the need for this type of protection.
- **Retirement planning (8%):** Retirement planning is likely to be a reason for purchase on the part of those who are seeking a combination of insurance and investment, with the ability to borrow against the cash value or to use it for drawdown purposes, where this is possible.¹⁵ Reasons for the sale might reflect age and also the desire to consolidate retirement financing vehicles.
- **Business planning (4%):** This is the smallest component and refers to the purchase of policies by businesses that would suffer if an important employee or partner were to die. Key-man insurance pays the policyholder (the employer or partnership) on the death of the named individual, which might otherwise destabilise the business in some way. It might also be used by a partnership to assist with succession planning, so that the remaining partners have sufficient capital to buy out the rights of the family of a deceased partner’s share in the business. Such needs might change if an insured employee/partner leaves the business or a partnership dissolves, for example.

Of these four reasons for a policy sale, we suggest that the last is the least contentious from an ethical perspective, as the third-party nature of the arrangement avoids the potential for distress sales. However, the potential for market abuses still remain.

1.4 The life settlement or traded life policies market explained

The Wharton report observes that, generally speaking, life policies are assignable, which means they can be taken over by a third party who purchases the rights to the benefits.¹⁶ When a policy is genuinely no longer wanted, or the need for capital is more urgent than the need for life cover, the policyholder has three options: to let the policy lapse, which occurs when premiums stop, in which case there is no return to the policyholder; to sell back to the insurer and receive in return a surrender value; or to sell in the secondary market in the hope of receiving a larger sum than the surrender value.

¹⁵ Having said that, whole life policies are not particularly flexible and tax-efficient in this respect compared with private pension arrangements.

¹⁶ Neil A. Doherty and Hal J. Singer, ‘The Benefits of a Secondary Market for Life Insurance Policies’, Wharton School, October 2002 www.coventry.com/pdfs/wharton.pdf. Hereafter referred to as ‘Wharton’.

Surrender values tend to be based on normal health assumptions – indeed there might be complex regulatory issues for insurers that offer explicit health-dependent surrender values – and so for those with impaired lives, they are not generally attractive.¹⁷ The life settlement market focuses on senior ‘impaired’ lives – that is policyholders over age 65, who have a reduced life expectancy. Opinion varies as to the length of life expectancy that investors consider acceptable: it can start as low as three years and is generally capped at between 15 and 20 years. As mentioned, the sale of a policy where the insured is expected to live less than two years is classed as a viatical settlement, and such policies are excluded from the life settlement market.

A. M. Best describes the secondary market in this way:

*The life settlement market is an outgrowth of the viatical settlement market in which policies of the terminally ill – normally those insureds expected to die within two years – are bought and sold. In the life settlement market, however, insureds generally are 65 years or older, with medical impairments resulting in life expectancies of about three to 15 years. [...] The more severe the chronic illness of an insured, the lower the life expectancy and, hence, the higher the price paid for the life settlement.*¹⁸

As the Wharton report notes, the availability of a secondary market introduces liquidity to an otherwise illiquid market. It provides a potentially better deal for policyholders who want to sell (or are forced to sell) policies and it also stimulates competition among insurers, which otherwise would be under no pressure to improve surrender values or to offer other arrangements, such as a loan against the policy, which would be repaid on the death of the policyholder:

*If there is no external market for reselling policies, insurers have no incentive to adjust their surrender values for impaired policies to competitive levels because they wield monopsony power over the repurchase of ‘impaired’ policies. Viatical and life settlement firms erode this monopsony power.*¹⁹

It could also be argued that the secondary market might have a beneficial effect on the primary market. Where customers see that they are not locked in for life, they might be more willing to take out life insurance in the first place. In these two respects – greater competition and a more positive consumer attitude to life insurance – the secondary market would seem to offer, in principle, ethically sound consumer benefits, provided it is well regulated and customers fully understand the nature of the transactions in which they are involved.

Life settlement companies have sprung up over the past decade to buy unwanted policies in the hope of making an attractive return on the capital employed. They offer a larger capital sum to policyholders than the provider’s surrender value, but still purchase policies at a deep discount to the face value.

Life settlement companies might purchase policies for their own investment purposes or with the objective of selling the acquired policies on to third parties. In the latter case, they act as an intermediary between the seller (the policyholder) and the ultimate buyer (the end investor). The ultimate buyer could be an institutional investor, such as an investment bank, insurance company, hedge

17. See Wharton, pp. 17-20 for a closer analysis of this issue.

18. ‘Life Settlement Securitization’, A. M. Best, March 2008 www.ambest.com/debt/lifeselement.pdf. Hereafter referred to as A. M. Best.

19. Wharton, p. 1. ‘Monopsony’ refers to a situation where there is only one purchaser of a good or service in a given market.

fund or pension fund, or it could be a retail investor. While a wealthy private investor might buy direct, a typical retail investor would buy units in a pooled fund established by an asset manager, or in a bond issued by an investment bank (a different type of pooled fund that usually has a fixed term – say, five or seven years). The asset manager or investment bank will have bought the underlying policies from a life settlement company and will need to hold cash in addition to the life settlements in order to maintain the premium payments and to pay investors who request a drawdown of cash, where this feature is offered. An investment bank bond might offer a target annual return over the term of the investment and might aim, but not guarantee, to return the investor’s original capital at the end of the term.

When the original policyholder dies, the proceeds from the traded life policy accrue to the life settlement investor. The ‘return’ on a traded policy can be calculated as follows: the difference between the total payout (policy face value) on the policyholder’s death and the sum of the purchase price, maintenance costs and operating costs. Maintenance and operating costs include the periodic premiums, which can be monthly, quarterly, semi-annual, or annual, paid between the date of purchase and date of death, plus any transactional and operational costs, including sales commission to intermediaries. Based on Bernstein’s research, the estimated return on a life policy held for seven or eight years is likely to be in the region of 9-13%. The ultimate return to the investor might be higher or lower, depending on transaction costs and the time of death. A. M. Best’s analysis shows that the typical transaction costs can be between 50-100% of the price paid to the policyholder. Therefore, where the settlement company pays a policyholder 15% of the face value, it might sell the policy to investors for 23-30% of face value. These figures vary significantly, depending on the individual’s age, state of health, and the premiums required to maintain the policy.

There are other important players in the market, including the tracking agents. These agents generally track mortality via database searches, while morbidity tracking is carried out through contact with individuals identified by the insured (rather than with the insured directly). Then there are the financial institutions that lend money to the life settlement companies, so that they can make further purchases: actuaries; legal services; and, importantly, the medical practitioners, on whose LE reports the pricing of a policy depends. As we will discuss later in this report, the accuracy of the LE report is critical to the success of the market, but has already proved to be problematic, with overly-optimistic predictions of early deaths resulting in the underperformance of some of the early life settlement funds.

Where the purchaser of policies constructs a fund for sale in the institutional or retail market, there will also be intermediaries (consultants, private client advisors, and sales representatives), who recommend these products to investors and who receive a fee or commission in return. Finally, there are the fund-rating agencies, which issue ratings for securities backed by life settlements based on a wide range of factors.²⁰ However, we understand that, at the time of writing, there had been no issues of rated life settlement securities with longevity risk.

It can be seen that, although in its infancy, the life settlement market has already developed a comparatively complex infrastructure. Certain processes clearly are critical to the market’s operation, but others are potentially unnecessary and add

²⁰. See A. M. Best report.

to the cost to the ultimate investor. While A. M. Best's research indicates that the transaction costs can add between 50% and 100% to the price the life settlement company pays the insured, in future these costs might be reduced, as a result of the development of auctions, with platforms linking seller and buyer without the need for a fully intermediated purchase and resale. The newer synthetic transactions, which are linked to pools of (anonymous) older-age lives, can also reduce such costs.

In the past few years, there has been considerable activity in this area. In January 2005, the Life Exchange was established. Its stated mission is 'to provide the secondary life insurance market with the most advanced and independent electronic trading platform available by which to conduct life settlement transactions with the highest degree of efficiency, transparency, disclosure, and regulatory compliance' (www.life-exchange.com). In April 2007, the Institutional Life Markets Association started in New York, as the dedicated institutional trade body for the life settlement industry.²¹ In December 2007, Goldman Sachs launched a monthly index suitable for trading life settlements. The index, QxX.LS, is based on a pool of 46,290 anonymised lives over the age of 65 from a database of life policy sellers assessed by the medical underwriter AVS (www.qxx-index.com).²² In July 2008, Institutional Life Services (ILS) and Institutional Life Administration (ILA), a life settlements trading platform and clearing house, were launched by Goldman Sachs, Genworth Financial, and National Financial Partners. ILS/ILA are designed to modernize dealing in life settlements and meet the needs of consumers (by ensuring permanent anonymity of the insured) and of the capital markets (by providing a central clearing house for onward distribution of life settlement assets, whether individually or in structured form).

1.5 Portfolio construction

Building a life settlement portfolio is potentially fraught with uncertainties. The challenge is partly one of regulation: different US states apply different standards of regulation. It is also partly due to the difficulties of ensuring best practice throughout the process in which a number of different intermediaries are involved and where transactions and their costs are not fully transparent. The challenge is to construct an efficient portfolio of a minimum of, say, 300 policies, and to achieve the desired diversification in terms of age and health. Certain bonds sold in the UK also diversify mortality risk across geographical areas, since mortality experience can vary significantly. For obvious reasons, speed in portfolio construction is important, as medical reports on policyholder life expectancy become out of date quite quickly and usually have a shelf life of a maximum of two years.

One of the difficulties in relation to transparency in the life settlement market is that financial institutions selling funds that are based on a proprietary portfolio construction model²³ might be reluctant to disclose details. This is because of

21. The founding members were Bear Stearns, Credit Suisse, Goldman Sachs, Mizuho International, UBS and West LB AG.

22. According to the *Wall Street Journal* (November 26, 2007), Cantor Fitzgerald has set up an Internet-based exchange for those who want to buy or sell policy rights.

23. This is used to ensure an appropriately diversified portfolio of life settlements. There needs to be good diversification across medical condition, life expectancy, and life companies with different credit ratings etc. In some cases portfolio construction takes account of geographical and regional variations in mortality. However, we understand that, unlike in the UK, US carriers do not price life insurance regionally. The authors would like to thank Keydata for providing access to details about their portfolio construction. Debbie Harrison was the author of a product review for intermediaries for a Keydata in 2007 and 2008.

sensitivities concerning intellectual capital and the identification of any third party subcontractors (which could be seen as an endorsement). However, these details might be made available to investors and advisors on request. The success of a life settlement fund will depend on the expertise of the investment manager and the third parties it appoints to construct, monitor, and administer a portfolio of policies.

According to A. M. Best, a portfolio can include different types of policies, such as universal life,²⁴ variable universal life,²⁵ whole life, variable whole life,²⁶ term life, joint survivorship, and group policies, so long as the original policyholder is aged at least 65 and has a life expectancy of between three and 15 years (20 years in some cases). Among other criteria, only policies issued by US insurers on the lives of US residents are permitted. Policies with decreasing death benefits are generally not permitted and there must be no outstanding debt on the policy.

1.6 Comparisons with other markets

Secondary markets are generally considered beneficial for the consumer/policyholder, as they create a more competitive market in what previously might have been a monopsony on the part of the original provider.

There is no secondary market with which we can draw direct parallels with the life settlement market, but there are examples from which we can gather useful experience, particularly in relation to the ethical concerns we raised at the outset. There are two UK products, in particular, that base the 'return' on the purchase of an asset from an individual, which is sold at a deep discount to its face value: that is, where the consumer in the primary market becomes a supplier to the secondary market.²⁷

The first example is the UK market for 'traded endowment policies' (TEPs). Endowment policies combine term life insurance and an investment fund and were the most common mortgage repayment vehicle in the UK until the mid-1990s. Sales subsequently declined, mainly due to concerns over the ability of with-profits funds – the most common form of investment fund used – to deliver the capital at maturity required to repay the debt.

In the case of TEPs, the market maker that purchases the policies and the subsequent investor aim to buy policies which have a significantly higher embedded value than the surrender lump sum offered by the issuer, taking account of the cost of maintaining premiums to maturity and the potential for future bonus prospects (annual and 'terminal' allocations paid at the provider's discretion – in effect, the total return). The market for TEPs is mainly involved in individual policy sales rather than pooled funds.

There are, however, important differences between US TLPs and UK TEPs. US TLPs mature on the death of the life insured and so there is a risk in relation to

24. Universal life is a form of permanent life insurance that is more flexible than whole life since the premiums are flexible, the benefits are adjustable and the returns are variable unlike whole life. The flexibility comes partly from being able to switch funds between the life insurance and savings accounts. The life insurance company manages the investments in the savings account.

25. With VUL, the policyholder manages the investments in the savings account and is able to switch between different types of mutual fund.

26. As with VUL, the policyholder chooses the investment strategy.

27. Other examples of secondary markets noted in the Wharton report include catastrophic risk insurance and Nasdaq-listed securities. See pp. 11-15.

mortality assumptions. However, the 'face value' of the policy – the insurance value – is known from the outset. TEPs, by contrast, have a known maturity date but do not have a known maturity value. The final payout on an endowment policy depends on a range of factors, some of which are difficult if not impossible to model accurately. These include guarantees on conventional endowments, the financial strength of the insurer, and the asset allocation selected by the fund. With-profits funds invest in a range of assets and the allocation is at the discretion of the insurer. The performance of with-profits funds has become increasingly varied and, since the equity bear market of 2000-2003, many funds have closed to new business, due to falling profits and the more onerous solvency requirements imposed by the regulator (the Financial Services Authority). In recent years, whole back books of these policies have been sold to third-party insurance companies.

Nevertheless, despite the concerns noted above, the TEP market has been successful in that it has provided a secondary market that offers the policyholder the potential to secure a higher lump sum than the surrender value offered by the insurance company.

A very different market is equity release (also known as home income plans or reverse mortgages). Regulation of this product in the UK has improved in recent years following a mis-selling scandal in the 1980s, when, on the individual's death, the debt (including rolled up interest) often exceeded the equity in the property. Equity release products work in a variety of ways but generally involve the purchase of part or all of the equity in a house in return for a cash lump sum. When the homeowner dies, the property is sold and the proportion owned by the equity release plan provider (usually an insurance company) is paid off. A common arrangement involves a mortgage against the property, where the interest rolls up until the date of death. Modern policies guarantee that the loan will not exceed the equity value, so that there is no debt on death to be paid by the homeowner's estate or family. As yet, there does not appear to be a well-developed secondary market in equity release plans in the UK. However, the fact that equity release is often a 'distress' response to long-term care costs is relevant to the US life settlement market in terms of consumer protection and regulation.

Section 2: Ethical issues

In this section, we review the ethical issues identified in our overview with reference to our own desk research and to the reports that have been published over the past six years on the US life settlement market; in particular the reports from A. M. Best, Bernstein, and Wharton, and also the regular coverage of the market in *LSR*.

2.1 Is it ethical to bet on the mortality of others?

One of the potential barriers to the growth of the life settlement market is the question of whether it is ethical to profit from betting on when someone will die. Clearly those with a religious or personal objection will not want to do this and, provided investor transparency is achieved (see below), it should be possible for such investors to avoid an inadvertent indirect investment.

Religious objections apart, it must be emphasised that since the 18th century, when life insurance began, there has always been a concern about the distinction between insurance and gambling or speculation. Arguably, the life insurance and annuity industries are based on 'gambling on life' through the pooling of mortality and longevity risks. In the case of term life insurance, those who live longer than anticipated cross-subsidise those who die young, while with annuities, the reverse is true. Similar principles apply to general insurance: policyholders whose house burns down are cross-subsidised by policyholders whose house does not. However, general insurance does not seem to raise the same ethical concerns as life insurance and annuities, despite the underlying principle of risk pooling being the same.

As we mentioned earlier in this report, mortality projections are a critical feature of a wide range of financial products: life insurance, defined benefit pension plans, annuities (individual and bulk), and equity release plans, among others. It can be argued that pension plan sponsors gain from the early deaths of plan members and pensioners, as do annuity providers. By contrast, providers of term insurance gain when individuals live longer than the age at which their cover ends. These are well-established markets and concerns over 'betting on mortality' have generally only arisen in very minor cases, where, for example, a specific religious objection arose to compulsory annuity purchase in the UK. Furthermore, it can be argued that there is a significant difference between betting on when a named individual will die and transactions linked to the realized mortality experience of large pools of anonymous individuals.

The US life settlement market began when investors identified and responded to a simple problem: the lack of liquidity in life insurance products. They recognised that the surrender values on life policies offered by monopoly life companies are well below the prices that could be offered in a traded market, while still leaving an attractive, albeit not risk-free, profit for the life settlement company. Without this mutual buy-side and sell-side opportunity, it is very unlikely that the life settlement market would ever have got off the ground. The secondary market, therefore, corrects a market inefficiency. Correcting market inefficiencies is not regarded as an ethical issue in other markets and there is no obvious reason why it should be any different in the case of life settlements, provided the market adheres to recognised standards of best practice (see below). Further, as

mentioned, there is the view that secondary market liquidity might actually help the primary market to grow, since prospective policyholders can see that they do not need to be tied to maintaining a long-term policy that is no longer required if their requirements change.

Importantly, the life settlement market is in the vanguard of the new life market – the global market that is developing to trade mortality- and longevity-linked securities and derivatives.²⁸ Lessons learned in the life settlement market could well help to speed up and improve the development of the wider life market, which might have positive implications for pension plans and their beneficiaries.

2.2 The fair treatment of policyholders

From the ethical point of view, it can be argued that potential sellers of life policies should understand clearly that a third party will benefit from their death. The most sought-after policies appear to be those owned by older people, who have shorter expected life spans of, say, three to four years. However, these are also the individuals whose dependants might have most to lose when a policy is sold. This suggests that the availability of affordable and genuinely independent advice for such policyholders is an important issue for regulators and investors concerned about the ethics of distress sales. In addition, best practice might highlight the importance of gaining the approval of the beneficiaries of the life policies being sold. We understand that this practice is already well established but LSR has reported legal cases where beneficiaries did not appear to have been informed of the transfer of a policy that was held in a trust but which had been taken out under a STOLI arrangement (see 2.3 below).²⁹

For a well-regulated market, it is also necessary that policyholders behave reasonably or ethically when they arrange a sale. For this reason, it is important that the concerns about STOLI and 'premium financing' are more widely understood and disseminated to policyholders. Naturally, life insurance companies will be very concerned if individuals taking out a policy are engaging in what they might regard as some kind of deception, where the insured's intention is to sell the policy to an investor as soon as possible. If, in the meantime, policyholders are receiving funding from the investor in order to cover the cost of premiums, they are implicated, albeit perhaps unwittingly, in STOLI arrangements.

2.3 Standards of best practice among intermediaries

Almost without exception, the independent research reports on the life settlement market and the fortnightly LSR publication raise concerns about poor sales practices, which might imply poor policyholder protection and/or misrepresentation to investors. Currently, STOLI practices are under review by insurers and legislators. LSR cites US legal cases where relatives have complained when the proceeds of a policy have been paid to a life settlement company on the death of the policyholder.³⁰ Such cases are made more complex where the policy is held in a trust and where the trust is established by the investor or a related trustee company.

28. David Blake, Andrew Cairns, and Kevin Dowd (2008) 'The Birth of the Life Market', Pensions Institute.

29. See LSR, February 7 2008, pp. 1 and 9.

30. LSR, February 7 2008.

To avoid such practices, it is becoming more common for insurance companies to ask specifically on the policy application form whether the individual intends to sell the policy. This is a difficult point to contest if the policyholder says he or she does not intend to sell, as it is possible that such a change of mind genuinely could have been made after the policy came into force. However, where, prior to the policy being taken out, an investor has made money available to the individual to cover the cost of premiums in return for the right to buy the policy at a later date, then premeditation on the part of the policyholder would seem to be evident. These are complex legal issues for the US courts to determine, and also will depend on a state-by-state view of the specific legal definition of what constitutes insurable interest.

From the end investor's perspective, the outcome of such litigation (and any future changes in regulation), will be important, as this might affect the return on the policies held in a portfolio if, subsequently, an irregularity in the original purchase emerges and the insurance company contests a claim. Bernstein says this is a critical issue for the market, and, if not addressed, could lead to litigation on the part of investors in life settlement funds, who were led to believe they would achieve higher returns than experienced.

Given the immaturity of the market, it is not yet possible to assess the impact of such cases on the investor's return, as consistent long-term performance data are largely unavailable. The synthetic or life-linked markets could potentially provide an alternative solution for investors because they make it possible to avoid direct exposure to life insurance policies.

2.4 Transparency for investors

The maxim 'only invest in products you understand' highlights an important aspect of the life settlement market for end investors. While we can see that the label 'death bond' does not provide positive promotional copy – particularly in the retail market – nevertheless it is critical that investors understand that the death of policyholders creates their return and that a higher than expected return might be a direct result of early deaths.³¹ Therefore, promotional material from the investment manager or insurance company, and also any sales practices on the part of intermediaries, must bear this important point in mind. If they do so, this will help to pre-empt any future claims of ignorance on the part of investors who, with hindsight, might have chosen a different asset class due to ethical concerns.

Equally, it is important that direct investors and also investors in collective funds are able to see process and cost transparency from the origination of the policy – where the rights to the benefits are transferred from the policyholder to the life settlement company or intermediary – through to the point where they invest.

A further critical factor for investors is the reliability of the LE report on which policy purchases are based. When a policy becomes available, the life settlement company frequently requires two independent medical reports to assess life expectancy in order to determine the purchase price offered. The medical reports contain a summary of pertinent health issues, including the primary disease or condition if relevant, and a prediction of life expectancy. It is important for the life settlement company – and the end investor – to know that reliable and up-to-

31. The description 'death bond' appeared in a headline in the *Wall Street Journal* on February 21 2007. However, understandably, the term is not used by the industry.

date mortality tables are used and that the medical examiner's methodology for calculating any adjustments for health conditions are sound. The most common table used by medical practitioners is a version of the 2001 VBT (Valuation Basic Table).³²

Clearly, longevity risk is a major issue for investors in life settlements and this risk is compounded where the medical reports underestimate life expectancy based on known facts about the policyholder's medical history and also where they use overly optimistic mortality assumptions. An underestimate of one or two years in a portfolio based on insureds with an estimated life expectancy of between three and 15 years could significantly alter the potential profits. A. M. Best, in its September 2005 report analysed the problem of the potentially systematic underestimation of mortality. The research showed that 'maturities' (deaths) for a portfolio of insureds constructed five years previously were not in keeping with the medical reports provided at the time. In its March 2008 report A. M. Best notes that in recent years medical examiners appear to have been issuing more conservative mortality estimates, although there are still significant variations where medical reports are issued on the same policy and these range from two to 24 months.

2.5 Clear and consistent regulation

In 1996, following concern over viatical settlements, the US Securities and Exchange Commission (SEC) endeavoured to regulate the viatical market under federal securities law. It was unsuccessful, but nevertheless individual states began to introduce their own regulation. This point is important and worth stressing: *at the time of writing, life settlements were not formally classed as securities and the life settlement market was not regulated at federal level in the US.*

Some, but not all, states have specific life settlement regulation in place. The National Association of Insurance Commissioners (NAIC), which represents all 50 US states, has issued model regulations for life settlements. According to Bernstein, by 2005, 36 states had implemented some form of regulation, including minimum payout levels as a percentage of the policy's face value. A second feature of life settlement regulation, where it is in place, is that policyholders are required to wait two years after taking out the policy before selling on to a third party.

The licensing of sales agents or brokers is less consistent. In about 15 states, agents with standard life insurance licenses can arrange sales of policies in the secondary market. But the absence of this license extension in other states does not prevent transactions taking place. Furthermore, the agents or brokers might or might not be registered with insurance regulators, depending on the state in which they are based.

It is important to note that the regulation of the market is being reviewed by many states. For example, according to a report in February 2008 in *LSR*, Ohio, in a bid to eliminate STOLI practices, has adopted a five-year waiting period before life insurance policies can be 'settled' (sold on) and it has imposed a new requirement for life settlement companies to register with the state insurance department.³³ In the same edition, *LSR* reports that the Indiana State House of

³². This is likely to be replaced by the 2008 VBT.

³³. See *LSR*, February 7 2008.

Representatives had tried to implement similar legislation, but that this appears to have been stalled, partly due to the opposition of the life settlement companies.

The imposition of a five-year waiting period would make STOLI practices, where they are combined with premium financing, far less attractive. There would be a much greater likelihood that the policyholder might die before the investor acquires the policy and can sell it on, in which case the investor will have paid the premiums but the death benefits would go to the deceased's family.

Wharton points out that most of the consumer concerns over life settlements have arisen in the viatical market and that there have been relatively few incidents where fraudulent practices in the life settlement market have affected policyholders. It also reports that reputable life settlement companies are self-regulating and refers to the proactive work in this area of the Life Settlement Institute (LSI), which is a non-profit trade group supported by several major institutionally-funded life settlement providers and financiers.³⁴

In 2002, the LSI began to build an anti-fraud database for companies to share information about suspicious or fraudulent activity by policy sellers, brokers, medical practitioners (see below), and other parties to the transaction process. The LSI has argued that life settlements should be classed as securities to ensure that the market complies with the Federal Securities Act of 1933. In its conclusion, the Wharton report expresses the concern that life insurance companies might be attempting to obstruct the development of the secondary market in various ways that interfere with the policyholder's rights to assign their policies to a third party:

In this paper, we have demonstrated that a competitive secondary market for life insurance policies improves the welfare of both new and existing policyholders. It is therefore in the interests of lawmakers to develop regulations that protect the interests of consumers and investors in the secondary market. Because participation and investment in the secondary market for life insurance policies is pro-competitive, lawmakers should design regulations that encourage, rather than dissuade, such participation or investment. Wharton, p. 38

As a final point about regulation, according to a report in the *Wall Street Journal*, regulators are concerned that certain brokers buying policies for life settlement companies have 'manipulated the bidding process for policies, by submitting fictitious bids in exchange for compensation from other players in the market'.³⁵ Such practice could have a very adverse effect on both sellers and buyers of life policies.

We end this section with a list of requirements for a well-regulated market derived from A. M. Best's March 2008 report on the life settlement market, 'Life Settlement Securitization':

- Increased clarity and standardisation of the general methods for predicting life expectancy of the insured, including the release of data on the performance of medical examiners
- Transparency in the pricing of life settlements

34. www.lifesettlementsinsitute.com. Apart from the LSI there is also the Life Insurance Settlement Association, which has a broad-based membership of some 175 companies (www.lisassociation.org).

35. WSJ, May 2 2006.

- Transparency in the fees earned by intermediaries involved in the transactions
- Effective data protection safeguards on the part of the life settlement industry with reference to personal details, including the identities, health conditions, and financial status of the original policyholders
- Effective industry regulation and oversight, including self-policing
- The establishment of credit rating agency standards for assessing the credit risks associated with life settlement transactions

Section 3: Conclusions

In the light of the analysis in this report, we would argue that best practice in the life settlement market in respect of ethical and regulatory considerations should meet the following standards.

The direct consideration of the ethics of mortality-linked assets as part of the investor's ethical or SRI strategy: *Provided that* products and processes are transparent, private investors can choose whether or not to invest in the life settlement market in accordance with their personal views and beliefs. Institutional investors should, however, consider the ethics of the asset class in relation to any socially responsible investment strategy that is in place. Given the 'youth' of this asset class, institutional investors might need to review their existing SRI principles to consider if their principles should include provisions relating to life settlements. Disclosure might be an important issue where the institution invests on behalf of private individuals, such as pension plan members or charities, for example.

The fair treatment of policyholders: Transparency is an important issue in relation to policyholders, who must understand that a third party will benefit from their death. The availability of independent advice, which can explain alternative ways of raising capital, is crucial here, particularly if insurance companies develop alternatives to life settlements, such as loans against the policy, repayable on death. Best practice might indicate that policyholders should be required to inform beneficiaries before arranging a sale.

Policyholders should also behave ethically and this requires them to provide accurate information to insurance companies about any STOLI and premium financing arrangements.

The fair treatment of end investors: The regulation of STOLI practices is also relevant for investors, who might suffer if cases are contested and the expected benefits are paid to the deceased's family rather than to the investor's fund. Additionally, transparency in pricing and in the intermediary processes are important safeguards for investors, as is consistency in the assumptions used for life expectancy reports, on which the purchase price of policies are based. In particular, the LE predictions used in pricing policies should be unbiased estimates of true life expectancy and the providers of LE reports should be regularly assessed for the accuracy of their predictions.

Clear and consistent regulation: The analysis made by A. M. Best in its March 2008 report appears to be very thorough and its recommendations appropriate. The company argues for increased clarity and standardisation of the methods for predicting life expectancy, including the release of data on the performance of medical examiners; transparency in the pricing of life settlements; transparency in the fees earned by intermediaries; policyholder data protection; effective self-regulation; and the establishment of credit rating agency standards for assessing the credit risks associated with life settlement transactions. To this list, we would add the need for consistent regulation and legislation across all 50 US states, which would enhance market efficiency and improve market reputation.

Synthetic life settlements: For the investor, synthetic life settlements avoid the problems and time involved in building portfolios of physical life policies. This has clear advantages in terms of cost reduction. However, as with physical portfolios, great care is (or should be) taken over the assessment of the LE reports. Synthetics might also permit investors to eliminate exposure to some of the non-longevity risks embodied in policy-based transactions. Such risks include: documentation risk, portfolio lumpiness,³⁶ regulatory concerns, administrative burden, cross-border tax risk (for non-US investors), ramp-up risk,³⁷ insufficient numbers of lives, and carrier credit risks.

The impact of the secondary market on insurers' profitability and pricing:

It is too early to predict with any certainty what the impact of the secondary life insurance market will be on the primary market. We note that there might be an adverse impact for certain insurers with a high exposure to the primary market, where the profit margin is eroded due to a reduction in the anticipated percentage of lapses, which currently is about 6% annually, although the rate varies by carrier, product type, age and duration.³⁸ However, it might be the case that interest in life insurance increases as a result of the development of the secondary market, which creates liquidity for policyholders previously trapped by a monopsony. It is also the case that insurance companies are likely to innovate to compete with life settlement companies by improving surrender values and/or offering alternatives, such as a loan against the policy value, which would be repayable on the policyholder's death. In both cases, consumers would benefit indirectly from the existence of the life settlement market, although we note that if insurance companies improve surrender terms this could reduce the availability of policies for sale in the secondary market.

In addition to the prospect of innovation on the part of insurance companies, a consequence of the very public focus on US whole life insurance policies is that prospective policyholders and their advisors, where applicable, might decide that it would be simpler and, possibly, cheaper to meet protection and investment requirements separately through a combination of term insurance policies and investment plans.

Although the secondary market for life settlements is in its infancy and the synthetic products market is barely out of its swaddling clothes, both might grow very rapidly and therefore it is in the interests of legislators, regulators and all participants to keep a very close eye on developments and to work towards standard regulation of the market in all US states. If this can be achieved, then ethical issues should cease to be a significant concern and a well-regulated and transparent life settlement market will provide greater liquidity for life insurance policyholders and a welcome new asset class for investors. It will also provide a firm foundation for the development of the wider life market.

³⁶. Portfolio lumpiness arises when a portfolio consists of a small number of large policies : it can lead to poor portfolio diversification.

³⁷. 'Ramp-up risk' occurs during portfolio or fund construction when life settlements (or indeed any asset) are acquired one-by-one over a period of time. The risk is that the investor does not acquire enough policies (assets) to provide a sufficiently diverse pool of exposure – that is, the portfolio does not 'ramp up' enough.'

³⁸. Source: Insurance Information Institute (www.iii.org).

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The investment management and investment performance of occupational and personal pension schemes.

Pension Funding and Valuations

The actuarial and insurance issues related to pension schemes, including risk management, asset-liability management, funding, scheme design, annuities, and guarantees.

Pension Law and Regulation

The legal aspects of pension schemes and pension fund management.

Pension Accounting, Taxation and Administration

The operational aspects of running pension schemes.

Marketing

The practice and ethics of selling group and individual pension products.

Pension Macroeconomics

The implications of aggregate pension savings and the impact of the size and maturity of pension funds on other sectors of the economy.

Public Policy

Domestic and EU social policy towards pension provision and other employee benefits in the light of factors such as the Social Chapter of the Maastricht Treaty and the demographic developments in Europe and other countries.

Research disseminated by the Pensions Institute might include views on policy but the Pensions Institute itself takes no institutional policy positions.