1 Life Insurance: Primary and Secondary Markets

INTRODUCTION

This chapter explores the background to the development of the market for life settlements – the sale of life insurance policies to financial investors. It describes the parties involved in a typical life settlement transaction and the associated process. It concludes with a review of some of the legal and practical issues associated with life settlements.

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1.1 HISTORY, APPLICATION AND TERMINATION OF LIFE INSURANCE POLICIES

1.1.1 History: Early Life Insurance

Risk protection has been a primary goal of humans and institutions throughout history. Protecting against risk is the reason for insurance. One of the first records of life insurance was in Rome, where burial clubs were formed, known as *Fratres*. These clubs were set up by the poor to pay for the funerals of their members and to help the surviving family members financially.

Following the fall of Rome most types of insurance were abandoned. Around 450 AD, guilds began to be established for the various types of highly skilled trades. Accounts from that date suggest that these guilds helped their members with various types of insurance, including life and disability.

Insurance in Asia can be traced back to the Vedas, the oldest sacred texts of Hinduism. For instance, Yogakshema, the name of Life Insurance Corporation of India's corporate headquarters, is derived from references within the Rigveda, one of the texts. It is suggested that a form of "community insurance" was prevalent in India around 1000 BC, practised by the Aryans.

1.1.2 Modern Insurance

Illegal almost everywhere else in Europe, life insurance came into its own in England, where it was vigorously promoted in the late seventeenth century. During this time, insurance began to be transacted at Edward Lloyd's Coffee House in Tower Street, London, where ship owners and underwriters (known as "backers") met to put together insurance contracts and other shipping and merchant-related business.

While serving as a means of risk avoidance, life insurance also appealed strongly to the gambling instincts of England's burgeoning middle class. Gambling was so rampant that when newspapers published names of prominent people who were seriously ill, bets were placed at Lloyd's Coffee House on their anticipated dates of death. Reacting against such practices, 79 merchant underwriters broke away in 1769 and two years later formed a "New Lloyd's Coffee House" that became known as the "real Lloyd's". Making wagers on people's deaths ceased in 1774 when Parliament forbade the practice in the Life Insurance Act of that same year.

Slightly more tolerably – as one assumes they had at least some vested interest in the survival of the individuals in question – those same gamblers had made use of mortality information drawn from John Graunt's *Observations on the Bills of Mortality*[1] (published in 1662) to bet on the survival rates of those captains to whom they entrusted their ships. The tables published in Graunt's book are often cited as the first recorded example of a population mortality table and his work led to his election as a Fellow of the Royal Society – no mean feat for a haberdasher, at a time when those engaged in trade were largely ignored by this august body.

Life insurance is not gambling, but its development has spurred the growth of the mathematical science of probability. Today this science has been refined through actuarial studies and has become the foundation of pricing technology for credit default swaps (CDSs).

1.1.3 Insurance Moves to America

The US insurance industry was built on the British model. The year 1732 saw the birth of the first insurance company in the American colonies in Charleston, South Carolina, providing fire insurance. In 1759, the Presbyterian Synods in Philadelphia and New York sponsored the creation of the Corporation for Relief of Poor and Distressed Widows and Children of Presbyterian Ministers – the first life insurance corporation in America established for the benefit of ministers and their dependents. The first recorded issue of a life insurance policy for the general public in the United States occurred in Philadelphia, on 22 May 1761.

1.1.4 Summary

Life insurance was originally dominated by the mutual life insurance companies – companies owned by their policyholders, who therefore received a pro rata share of the company's profits from underwriting life insurance. Similar to the mutual life insurance companies were fraternal life insurance companies, which were started by the various trade associations and fraternal orders to assist their members, the first example being the Ancient Order of United Workmen, organized in 1868 in Meadville, Pennsylvania (Zelizer, 1983). These should be distinguished from stock life insurance companies where the profits are made for the benefit of the stockholders.

Today life insurance has become a major industry across the globe, with many different types of policies available for the consumer and offered by a multitude of insurance carriers. However, most development of structured life insurance products has been driven by the US market, primarily owing to its size. By the end of 2007, total life insurance coverage in the USA reached US$19.5 trillion, including corporate and individual cover (ACLI, 2008).

Companies such as Lloyd's have been keeping statistics on life expectancies since the late nineteenth century. Actuarial estimation of life expectancies in the general population has therefore become a very exact science. The challenge for an investor is to apply this science to the much smaller populations involved in life settlements.

[1] The full title being "Natural and Political OBSERVATIONS Mentioned in a following INDEX, and made upon the Bills of Mortality". The Bills of Mortality published a list of deaths in London and surrounding areas, including cause of death. They were created by Charles II and his civil servants to provide an early warning system for the onset and spread of bubonic plague – Graunt used them to generate a statistically based estimation of the population of London.

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1.1.5 Applications of Life Insurance

An individual might have several reasons for taking out a life insurance policy on his or her life. Examples of these reasons include:

(1) to provide financial support to dependents in the event of the early death of the breadwinner;
(2) to pay for funeral expenses, death and/or inheritance taxes;
(3) to facilitate other financial contracts – for example, many mortgage lenders require that a life insurance policy be taken out as a precondition to a mortgage loan;
(4) to provide compensation for the disruption to a business in the event of the death of a senior employee or director (known as "key man" insurance); and
(5) as a means of saving (often tied to retirement).

The reason for taking out life insurance will often drive the selection of the type of policy. Some policy types will be appropriate for one situation but not for another. For example, a policy that pays out only on death is appropriate for (2) above whereas a policy that pays out at a certain age, if the insured survives to that age, is appropriate for (5) above. Similarly, a term life policy (under which the policy terminates with no payment if the insured lives longer than the specified term) might be appropriate for (3) above but is unlikely to provide appropriate cover for (1) or (4).

With the spread of company-sponsored and private pension schemes, insurance to provide coverage for dependents (item (1) above) is now often part of a pension scheme and may also be included in the benefits package offered by some employers.

1.1.6 The Parties Involved in a Life Insurance Policy

Several parties are involved in the issue and maintenance of a life insurance policy and each has different roles, responsibilities and interests in the process.

The *owner* of a life insurance policy (also described as the *policyholder*) is the person responsible for making premium payments under that policy. This person is often – but not always – the same as the *insured*, the individual whose life is the subject of the life insurance policy. On occasion, the owner of a life insurance policy may be a trust or a corporation (a so-called "non-natural person"), which is typically the case in policies issued for retirement or tax planning and, of course, for "key man" policies which are usually owned by the employer company.

There may be more than one person insured under a life insurance policy (see "Life Insurance Products and Underwriting" below for a discussion of "first-to-die" and "second-to-die" policies). There will also be at least one (and potentially more than one) *beneficiary*. The beneficiary receives the payout on the policy if it matures through the death of the insured(s) during the prescribed term. The owner has the right to designate the beneficiary of the policy and to change the beneficiary at any time. The company that has issued the life insurance policy is referred to as the *carrier* or the *insurer*. As life insurance is heavily regulated in most jurisdictions, the carrier will need to be licensed to issue life insurance in the relevant territory. In the United States, a carrier wishing to underwrite life insurance throughout the nation will require licensing in each of the fifty states and Washington DC as well as territories such as Puerto Rico.

In many cases – certainly in the case of "traditional" life insurance policies – the owner and the insured will be the same person and the beneficiary or beneficiaries will be dependents of the owner/insured. It is also possible for the owner and the beneficiary to be the same

person – for example, where the dependent son takes out a life insurance policy on his parent in order to meet funeral expenses or where a company takes out a life insurance policy on several of its key employees. It is theoretically possible for the same person to be owner, insured and beneficiary under a life insurance policy, but this is rarely seen. It is, however, important to remember that the same person may play two roles in respect of a life insurance policy, as will be seen when considering the process involved in a life settlement.

1.1.7 Life Insurance and Life Assurance

In the United Kingdom, insurance market participants may refer to "life assurance" – not a term that exists in the United States. *Assurance* policies are designed to provide a payout upon the occurrence of an event which is certain, but where the timing is uncertain – hence the term "life assurance", as death is a certainty but the timing of death is uncertain. By contrast, *insurance* policies are designed to provide a payout upon the occurrence of an event which is uncertain, for example, buildings insurance or contents insurance where it is not certain that your house will collapse or that you will suffer a loss as a result of fire, flood or burglary. In this book we will refer to insurance policies throughout – the distinction between assurance and insurance being irrelevant to life settlements, securitization and/or derivatives.

1.1.8 Termination and Surrender of Life Insurance Policies

There are many reasons why the owner of a life insurance policy may find that policy surplus to requirements. The owner may have taken out insurance in relation to a house purchase or his or her own business. At a later date the policy may no longer be required: the house may have been sold, or the related mortgage loan paid down as the owner's income rose; dependents may have grown up or the insured's marriage may have broken down; a company may have evolved to a point where "key man" insurance is no longer appropriate; or the owner may be seriously ill and may need to realize investments to pay for medical expenses. A variety of reasons can exist for selling an asset and – except to the extent that the insured's state of health affects the value – these reasons should be irrelevant to the calculation of that sale price.

Until recently (the late 1980s), the only option was to surrender the policy to the life insurance company. This involves returning the policy to the carrier – literally, surrendering the right to receive payments under the policy – in exchange for a cash payment, known as the *cash surrender value*. Calculation of this cash surrender value is based upon the specific terms of the policy, but it will certainly depend upon the total amount of premiums paid into that policy since inception (among other factors). The cash surrender value may, in some cases, be zero (if, for example, the policy has only recently been issued and it is therefore subject to high surrender penalties). The cash surrender value will **not** take account of the health status of the insured; its calculation is prescribed in the policy document and the carrier is required to treat all owners of the same policy equally. This goes some way towards explaining why cash surrender values are low. Because the carrier cannot take into account the health status of the insured in calculating the cash surrender value, it must be conservative and therefore assume that it has given up a significant asset – the right to receive ongoing premium payments for many years to come – in exchange for being released from an insignificant liability such as the obligation to pay out the net death benefit at some date, potentially many years in the future. Simply discounting the respective asset and liability flows will show why it is rational for the carrier to be reluctant to surrender the right to receive those ongoing premium payments.

While the carrier is proscribed from incorporating current insured health status in the calculation of its cash surrender values, third parties are not so proscribed. Accordingly, in the late 1980s early 1990s, investors began to consider the risks and rewards of owning life insurance policies and found the returns to be highly significant, even on a risk-adjusted basis – as we will see when we look at the development of the viatical and life settlements markets later.

1.2 LIFE INSURANCE POLICY TYPES AND UNDERWRITING

There are several types of life insurance products that may feature in a secondary market transaction. The type of product is usually more relevant to physical transactions (such as the sale of legal and beneficial interest in a policy through a life settlement) rather than a derivative transaction (such as the assumption of longevity risk through an index swap, of which more later). The purchase of a physical policy exposes the buyer to all of the terms and conditions of ownership of that policy (including, for example, the risk that the carrier defaults upon its obligations under the policy), whereas the majority of derivative contracts focus more on the transfer of longevity risk as we will see in later chapters. It is important to note that very rarely are any two life insurance products created equally. Carriers have a vast range of policy options available, and as the design of a life insurance product is not usually based upon ease of access to the secondary market, it is vital to review the terms of each policy in detail before making a buying decision.

Policies can be divided into *permanent insurance* and *term insurance*. Permanent insurance policies continue for the duration of the insured's life (subject to a contractual maturity date, generally after what would be the insured's 100th birthday). Permanent insurance policies generally accrue a cash value. Payout of the accumulated cash value is assured at the end of the policy, and as long as the policy is kept in force the carrier pays out the contractual death benefit upon the death of the insured and retains the accumulated cash value. Term insurance, by contrast, only pays out the death benefit in the event that the insured dies during the specified term of the policy, and no cash value accrues to the owner. It is often possible to convert term insurance into permanent insurance, by following a procedure laid out in the policy document.

Policies can also be divided into *participating* and *non-participating*. A participating policy allows the policyholder to share in the carrier's surplus – the policy owner receives a dividend representing that portion of the carrier's premium income that is not needed to cover death benefit payments, additions to reserves or administrative expenses. It is very similar to participating in the carrier's investment returns. The vast majority of individual life policies purchased today are non-participating policies.[2]

1.2.1 Universal Life

Universal life policies are a type of permanent life insurance and are usually, but not always, non-participating. Universal life policies account for over 95% of the life insurance policies transacted in the life settlements markets and represent the majority of in-force life insurance policies in the United States (ACLI, 2008). Universal life policies can be described as combining a savings account (which we refer to here as the *cash account*) with a life insurance policy.

[2] 79% of individual life policies purchased in 2007 were non-participating (see Life Insurers Fact Book, 2008).

At this time, we should introduce a concept that may be new to those not experienced with life insurance terms – the *cost of insurance*, or "COI". Generally, the owner of a life insurance policy will describe the cost of that policy in terms of the amount of premium that he or she pays to the carrier, be it annual, semi-annual, quarterly or monthly. The uninitiated might assume, with some justification, that this premium is to compensate the carrier for agreeing to pay the net death benefit upon the death of the insured – indeed, the amount of the first year's premium payment is often the deciding factor when it comes to selecting the carrier for a new life insurance policy. In the case of a universal life policy, however, the premium is paid into the cash account and that cash account balance (the *account value*) then attracts interest at a given rate (the *current crediting rate*). The current crediting rate is set by the carrier based upon the performance of its investments, which, in the case of universal life policies, are usually long-term fixed interest assets, e.g., higher rated corporate and government debt instruments. The carrier then debits the cash account to meet expenses, typically an administrative charge on each premium payment and further monthly charges to meet the cost of maintaining and administering the policy. The carrier also debits the cash account with the COI – a specified amount of money that reflects the mortality risk assumed by the carrier (i.e. the risk that the insured dies earlier than the carrier expected, causing the carrier to lose money on the policy). For this reason, in calculating required premium payments, the carrier will apply the COI to the *net amount at risk* – the amount by which the contractual death benefit payment exceeds the account value that has been built up in the policy. The higher the account value, the less the carrier has at risk (as the carrier retains all of the account value upon the death of the insured). The distinction between premium payments and the cost of insurance is critical to the correct evaluation and pricing of a policy for a prospective life settlement, for reasons that will be explained in subsequent chapters.

We referred earlier to the cash surrender value of the policy, being the amount that a carrier will typically pay out were the owner to surrender the policy. The cash surrender value of a universal life policy is always less than or equal to the account value (it may be reduced by the amount of any *surrender charges* that are applied to the policy). Carriers typically impose surrender charges on newly issued policies during the first few years of issue (potentially as long as 15 years, depending upon the product). These surrender charges are imposed to offset the costs incurred by the carrier in issuing the policy – processing the application, underwriting the insured(s) and paying commission to the *producer* (the life insurance agent who introduced the new owner/insured to the carrier).

Universal life policies typically have a *policy maturity date*, which is defined by reference to the date on which the policy was first issued (the *policy issue date*). The policy maturity date is typically the first anniversary of the policy issue date (a *policy anniversary*) after the insured's 100th birthday. Policies issued before 2001 will occasionally have an earlier maturity date – for example, the policy anniversary after the insured's 99th, 97th, 95th or even 90th birthday.[3] If the insured survives beyond the policy maturity date, coverage under a universal life policy typically ceases, and after this time the carrier may be obliged to make no payment on the death of the insured, or may only pay out the cash surrender value.

The amount paid by the carrier upon the death of the insured depends on the terms of the policy. It may be a fixed amount (referred to as *level death benefit*) or a variable amount. If

[3] Insurance carriers have gradually migrated from the 1956 mortality tables to the 2001 mortality tables. The 1956 tables have much higher levels of expected mortality in earlier durations than the 2001 tables, so policies issued before the introduction of the 2001 tables generally set a maturity date well before the insured's 100th birthday as the tables assumed that the probability of living to age 100 was statistically insignificant.

variable, it may be described as *increasing death benefit* (in which case it usually equals the fixed amount stated on the policy plus the then current account value) or in the case of policies issued recently, as *return of premium* (ROP), in which case the death benefit payable at any time is a function of a stated amount plus the total amount of premium payments made up to that date. Policies with a ROP component typically have a limit on the total amount to be paid out, such that the ROP component stops within a few years of issue, with the policy usually reverting to a level death benefit payout.

Accrual of interest on the account value for a universal life policy is generally tax free in the United States, making this a good policy for estate planning.

1.2.2 Variable Universal Life

Variable universal life policies – also a type of permanent life insurance – have many of the same characteristics as universal life policies. The difference arises in the management of money in the cash account. As mentioned, cash account balances in universal life policies are typically invested by the carrier in long-term, fixed rate instruments with minimal credit risk. Accordingly, the current crediting rate on those policies tends to be reasonably low albeit – it is to be hoped – relatively stable. Variable universal life policies introduce an element of discretion for the owner as it is possible to invest the balance in the cash account across a number of different sub-accounts, managed by the carrier. These sub-accounts will have exposure to different investment strategies and asset classes, potentially including short-, medium- and long-term fixed rate instruments, equities, commodities and corporate credit. The opportunity to vary the mix of investments creates a greater potential rate of return, albeit with higher volatility.

Universal life and variable universal life policies have flexible premiums and for that reason are often described as *flexible premium adjustable life policies*.

1.2.3 Term Insurance

Term insurance is frequently used for “key man” policies and for policies purchased to support a fixed term mortgage loan. The phrase describes a policy with a fixed term, which pays out a prescribed amount to the beneficiary following the death of the insured within that term. There is no accumulated account value for term insurance and the insurance coverage is terminated at a specific date with no further payment if the insured survives beyond this date. Owners of term policies pay premiums based solely on what the carrier determines is required to cover the risk of the insured’s death during the term, given the insured’s age and medical history (as underwritten just prior to issue of the policy) based upon a fixed death benefit amount. As a result, younger persons and shorter terms will generally attract lower insurance premiums.

1.2.4 Endowment Insurance

An endowment policy has a fixed term, like a term policy, but unlike a term policy it pays a defined amount in the event that the insured survives to the end of the fixed term. Premiums are higher – often substantially higher – than term insurance contracts, as there is certainty that an amount will be paid out by the carrier. However, the amount to be paid is frequently uncertain, as it is usually dependent upon the performance of investments made by the carrier.

Endowment policies were commonly issued in the UK to support interest-only mortgage loans. Such policies were often sold to UK homeowners during the 1990s on the basis that the endowment would increase in value over the term of 15, 20 or 25 years such that it would repay the principal amount due on the mortgage loan at its maturity. Poor performance of the underlying investments and a litany of mis-selling complaints, as well as a change in the tax treatment, caused endowment policies to fall out of fashion and very few have been issued in the UK in the last five years (ABI, 2008).

The widespread use of endowment policies in the UK created one of the first secondary markets for insurance instruments – the traded endowment policies, or "TEPs" market. TEPs were bought and sold at auctions conducted by specialist endowment brokers. Such auctions continue today, although compared to the US life settlements market, the value and number of the endowment policies traded is very low.

1.2.5 Whole Life

Whole life insurance is the generic name for a policy that continues until the death of the life assured. Such policies have increasing accumulated value as the insured ages. The premium payments are structured to "overpay", such that the account value will build up to the contractual death benefit amount by a defined age (usually 100), progressively reducing the carrier's net amount at risk.

The most common type of policy sold in the USA is the whole life policy. Here the policy holder pays a fixed annual premium over his or her life in exchange for a whole life policy with specific death benefits or face amount as stated on the policy. The beneficiary of the policy receives full benefit from the policy regardless of the date of death. Premiums are usually constant, based upon the average actuarial premium amount needed to cover claims for the policy holder's entire life – as a result premiums are larger than needed to cover the mortality risk in the early years. The excess premium is invested at a pre-stated rate and as this cash surrender value grows it can be used for other possibilities.

Whole life insurance combines features of both term insurance (where the premiums are fixed) and permanent life insurance (where a cash value accrues within the policy and payout of the cash value is assured at expiration of the policy). In the life settlements market, participating policies are most often whole life policies rather than universal life policies.

1.2.6 Policy Riders

Carriers will frequently offer extra options with their insurance products, to be added at issue. These are commonly known as "riders", such as:

- *Extended Death Benefit Rider:* In this case, if the insured lives past a certain date (typically the first policy anniversary after he or she has attained the age of 100), no further premium payments are due but the carrier remains obliged to pay the net death benefit (or some other amount, depending on the terms of the rider) if the insured dies before a later policy anniversary date, e.g. age 105, 100, 115 or 125.
- *Term Rider:* If the insured dies within a short time after issue of the policy (say 5 or 10 years), the death benefit payment is increased by a fixed amount, equivalent to owning a separate term life insurance policy on the insured.

	Insurance Type	Premium	Death Benefit	Cash Accumulation	Investment Choice
Term	Level Term Insurance	Relatively low, fixed	Fixed during the term, then zero	No	No
	Renewable Term Insurance	Relatively low, increasing	Fixed	No	No
	Decreasing Term Insurance	Relatively low, decreasing	Decreasing during the term, then zero	No	No
Permanent	Whole Life Insurance	Relatively high, fixed	Fixed minimum amount, some upside	Yes	No
	Universal Life Insurance	Relatively high, flexible	Variable	Yes	No
	Variable Whole Life Insurance	Relatively high, fixed	Fluctuates with the performance of the investment	Yes	Yes
	Variable Universal Life Insurance	Relatively high, flexible	Fluctuates with the performance of the investment	Yes	Yes
Endowments	Level Term Insurance	Relatively high, fixed	Fixed during the term, then zero	Yes	No

Figure 1.1 A comparison of insurance products

Riders may be offered as incentives to purchase insurance from a particular carrier or offered as a "bolt-on" to a policy when first issued. We will look in later chapters at how riders can affect policy pricing. Figure 1.1 compares some characteristics of the different policy types.

1.3 DEVELOPMENT OF THE VIATICAL SETTLEMENT AND LIFE SETTLEMENT MARKETS

1.3.1 History and Inception

Although the secondary market for life insurance is relatively new, the judicial ruling in the Supreme Court case of Grigsby v. Russell in 1911 declared the policy owner's right to transfer legal ownership and beneficial interest to a third party at his or her own discretion.

The first of such transactions occurred amidst the devastating impact of the AIDS epidemic in the mid-to-late 1980s, when life insurance policies were purchased from terminally ill individuals, for an amount made up of a percentage of the policy face value. A key driver for this change was the requirement of vast sums of capital by terminally ill AIDS patients to primarily finance expensive health care fees. Subsequently, this type of transaction was given the term "viatical" and the viatical settlements industry was born.

However, it was only after the Health Insurance Portability and Accountability Act (HIPAA) was signed into law in 1996 that the life settlements market emerged. Aside from imposing a series of administrative, physical and technical safeguards on the storage and use of protected health information, HIPAA essentially confirmed the right of the owner of the life policy to transfer ownership/beneficial interest to a third party having no insurable interest in the life of the originally insured party, while determining the tax treatment of the corresponding gain. This effectively allows third party investors to freely purchase life insurance policies at the discretion of the policy owner and beneficiary, hence, creating a market for life settlements.

1.3.2 Negative Sentiments

The life settlements industry has had more than its fair share of negative sentiment. Early transactions in viatical settlements involved the sale of policies insuring the lives of AIDS patients to some retail investors, with the promise that the returns would be extremely high and realized in a very short period as long as the investors continued to pay the required premiums over this period. The "magic bullet" effect caused by the availability of highly active antiretroviral therapy (Palella *et al.,* 1998) to combat AIDS resulted in the insured individuals living much longer than the investors had been led to expect, leading to losses and the inevitable lawsuits from state and federal regulators.[4] Increasing regulation – as insurance is regulated at state level in the USA one is transacting in 50 separate markets rather than one – and the cross-over of insurance methodologies and experience has led to most of the bad apples being weeded out. However, the "headline risk" continues, with an enforcement action against a significant market participant brought by Eliot Spitzer[5] in 2006, resulted in a claim for $2.1 billion in triple damages under the federal RICO statute (Racketeer Influenced and Corrupt Organizations Act of 1970).[6]

The life insurance lobby has used these "bad apples" in support of its campaign to promote regulation that will effectively eliminate the life settlements industry, through the implementation of legislation at state level and via the National Association of Insurance Commissioners (NAIC) Model Act drafting process.[7] The life settlements industry has responded to this pressure through lobbying for appropriate regulation at state level – supporting consumer choice through maintaining the availability of life settlements in as many markets as possible.

[4] SEC v. Mutual Benefits Corp *et al*., Case No. 04-60573-CIV-MORENO: a widely reported lawsuit against Mutual Benefits Corp., its directors and affiliates over the mis-selling of viatical settlements to investors.

[5] The People of the State of New York by Eliot Spitzer v. Coventry First LLC, Montgomery Capital Inc. *et al*., index no. 404620/06 (New York State Supreme Court).

[6] Ritchie Capital Management, LLC *et al*. v. Coventry First LLC *et al*., ECF Case 07 Civ. 3493 (DLC) (USDC Southern District of New York).

[7] See the press release at: http://www.naic.org/Releases/2007_docs/viatical_settlements_model.htm. The NAIC treats the Model Act as under continuing development.

1.3.3 Market Size

Two recent surveys have estimated that the available market size will grow from an estimated $13 billion in 2004 to $161 billion over the next few decades; through a combination of population ageing and increasing market penetration (penetration is currently estimated at around 3% – see Bernstein Research (2005, 2006)). The face amount that cleared through the market grew from around $10 billion in 2005 to $12 billion in 2007.[8] In common with other asset classes, the life settlements market contracted significantly during 2008, as institutional investors fight to repair the damage to their balance sheets. However, life settlements is attracting a much wider audience within the investor community than was the case even two years ago, and once investor activity picks up again, growth in life settlements activity should be much more rapid than in other, more traditional, asset classes.

1.3.4 Institutional Involvement

The bad press dealt to the life settlements industry might explain the historical lack of capital markets interest in what should be an attractive asset class – after all, credit derivative swap (CDS) pricing was derived from life insurance underwriting methodologies, so credit traders should feel that they understand the risks extremely well. Intensive regulatory and compliance requirements, the lack of market transparency and efficiency and extremely high barriers to entry have historically tended to turn most investors away from the product. In March 2007, the Institutional Life Markets Association (ILMA) was formed by six leading investment banks (Bear Stearns, Credit Suisse, Goldman Sachs, Mizuho International, UBS and West LB) to promote legislative initiatives and best practices in the life settlements and premium finance industry. ILMA is endeavouring to develop and agree higher standards of market practice and to enhance transparency in the industry through fee disclosure and standardized documents.

1.4 THE PARTIES INVOLVED IN A LIFE SETTLEMENT TRANSACTION

We will review the process associated with a typical life settlement transaction later in this chapter. First, let us introduce the parties involved in the transaction. For this purpose we assume that the transaction is a "traditional" life settlement, i.e. that the life insurance policy has not been originated through a premium finance programme. We divide the parties into *direct* participants (those directly involved with the movement of the policy and the transfer of title) and *indirect* participants (those who provide services that are associated with the transaction).

Direct participants in the transaction include:

- *Policy owner:* Also known as the "policy holder" and in the context of a life settlement transaction as the "seller", this person is the owner of the policy immediately prior to the transaction. The policy owner may be a natural or a non-natural person. Once the policy has been sold, this person has no further interest in the policy.
- *Agent:* This is usually the life insurance agent (often referred to by insurance companies as a "producer") who sold the policy to the policy owner, or with whom the policy owner has

[8] The 2007 figure was taken from Conning Research (October 8, 2008) Life Settlements: New Challenges to Growth; the 2005 figure was estimated on the basis of a poll of market participants.

an existing relationship. The agent's role is to introduce the seller to a broker and then to liaise between the seller and the broker as necessary to ensure successful completion of the transaction.

- *Broker:* A life settlements broker. If the policy owner is located in a state which regulates life settlements and/or viatical settlements, the broker will be required to be licensed in that state in order to participate in the transaction. The broker's role is to represent the interests of the seller in dealing with the provider. This includes soliciting the best offer for the policy by submitting the policy to as many providers as possible, in order to create a wide market for that policy.
- *Provider:* A life settlements provider. As for the broker, the provider may be required to be registered in the state in which the policy owner is located. The provider's role is to act as the buyer of the policy (with respect to the policy owner). It is the provider's responsibility to ensure that sale and transfer documentation conform to relevant state regulations relating to life settlement practice and procedure. The provider may also have an ongoing role in the transaction, as state regulation may require the provider to retain records and to assume responsibility for servicing the policy after completion of the transaction.
- *Investor:* Sometimes referred to as the "funder", the investor is usually the ultimate owner of the policy. The investor usually acquires the policy in a transaction with the provider which, although legally distinct, is often so close in time as to be virtually simultaneous with the acquisition from the seller. The investor may be a natural person, but more commonly is a bank, a large institutional investor, a hedge fund or an established special purpose vehicle (SPV).
- *Escrow agent:* All transactions in regulated states (i.e. transactions where the policy owner is resident or organized in a regulated state) are required to employ an escrow agent. The escrow agent receives the signed change of ownership (CoOwn) and change of beneficiary (COB) forms from the policy owner and releases these forms to the provider or trustee once the agreed purchase price for the policy has been received from the provider. The escrow agent holds the agreed purchase price until the change of ownership and change of beneficiary has been acknowledged by the carrier and then releases the agreed purchase price to the seller. The escrow agent is usually a bank and will often be affiliated with the trustee.
- *Trustee:* Frequently, an investor that is an institution, a fund or a SPV will engage a third party to act as trustee of the policy. The role of the trustee is to safeguard the documents associated with the policy (the policy form and/or policy certificate). In some structures, the trustee also becomes the legal owner of the policy itself, with the investor becoming the beneficial owner. This is usually done to comply with the financing structure of the investor; for example, debt issued by a SPV may be secured on the policies which the SPV acquires, in which case the trustee will function as trustee of the debt and will hold the policies for the benefit of the debt-holders. In this case, the trustee is responsible for completing and filing the change of ownership and beneficiary form with the carrier. The trustee becomes the owner of record of the policy with respect to the carrier and receives all of the policy correspondence (e.g. premium notices, grace notices and annual statements) from the carrier. In this case, the trustee will be required to work with the tracking agent to complete and submit the claim package in the event of the death of the insured (or both insureds, in the case of a "second to die" joint life policy).
- *Collateral manager:* A transaction which uses a SPV or a fund will usually employ a collateral manager (also referred to as the "investment manager" or "asset manager"). The

collateral manager chooses the policies that will be acquired by the SPV or fund. The duties of the collateral manager with respect to any one policy acquisition may include:
– confirming that the policy satisfies the eligibility criteria for inclusion in the portfolio of policies owned by the SPV or fund;
– monitoring performance of the policy over time; and
– undertaking optimization of the policy to minimize premium payments and maximize actual and/or prospective returns to the investors in the SPV or fund.

The collateral manager will have other duties with respect to the portfolio of policies. We will review these in later chapters.

Indirect participants in the transaction include:

- *Insured(s):* The insured or insureds are natural persons whose lives are insured under the policy. Although the insured will be required to sign documents as part of the closing of the transaction, he or she is not a contractual counterparty as – unless the insured is also the policy owner – he or she has no legal or beneficial interest in the policy.
- *Carrier:* The carrier is the insurance company that has issued the policy. The carrier is critical to the transaction, since it pays the sum assured in the event of the death of the policyholder. The investor therefore assumes the credit risk of the carrier as part of the transaction. The carrier's role in the transaction is to register the change of ownership and beneficiary in its books and records – it is the acknowledgement of this registration that usually triggers the payment of the purchase price and/or broker fees, as will be seen when we review the transaction process itself.
- *Medical underwriter:* Sometimes confusingly referred to as the "life expectancy provider", the medical underwriter uses its knowledge of elder mortality and the medical records of the insured to produce a life expectancy report for each insured. The life expectancy report typically includes an estimation of the life expectancy for the insured (usually expressed as a number of months) and may also include a paragraph describing the salient features of the insured's health, ICD9 codes appropriate to the insured and a mortality curve for the insured. Note that a life expectancy report is not necessarily required for a transaction to close – however, the majority of investors require at least one life expectancy report and, more often than not, two or three life expectancy reports (each from a different medical underwriter) in order to proceed with the transaction.
- *Servicer:* The servicer has no direct role in the completion of the transaction, but rather is responsible for the "care and feeding" of the policy after its acquisition. Its responsibilities may include monitoring correspondence on the policy, undertaking health status tracking (see "Tracking Agent" below), updating medical information and monitoring the premium payments on the policy.
- *Tracking agent:* Like the servicer, the tracking agent has no direct role in the completion of the transaction. Once the transaction has closed, the tracking agent is charged with tracking changes in the health of the insured. The tracking agent typically does this using a combination of direct contact with the insured (e.g. telephone calls, postcards) and public record checks (e.g. the US Social Security Administration Death Master File,[9] which tracks the "return" of social security numbers upon the death of an individual). The tracking agent is usually responsible for obtaining copies of death certificates after the death of an insured.

[9] http://www.ntis.gov/products/ssa-dmf.aspx.

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Any business investing in life settlements will need advice and assistance from professional advisers. Although rarely directly involved in an individual life settlement transaction, maintaining a relationship with experienced professional advisers is critical to the success of the business as a whole. Actuaries help determine the appropriate mortality tables (successors to John Graunt's work in London in the 1660s, now based upon many millions of observations); assess the reasonableness of the mortality schedule provided by medical examiners; perform an underwriting review of the medical examiners used in the transaction; help in the valuation and structuring of the transaction; and may help to determine the liquidation value of a portfolio of policies. Attorneys help to ensure that documentation is complete and has been prepared in compliance with appropriate regulations, and they may also check compliance with "insurable interest"[10] and other insurance axioms. They may help to verify that brokers and providers (and, in some cases, medical underwriters) are licensed in the relevant states; draft medical disclosure forms complying with privacy laws; and, in the case of a SPV, they will ensure that the bankruptcy remote issuing entity has been created in such a way as to protect the interests of the investors. Finally, accountants will assist in structuring a fund or SPV in order to optimize its withholding tax treatment; address the recognition of income and expenses by the fund or SPV; and advise on the tax treatment appropriate to the acquisition, maintenance and disposal of a portfolio of life settlements.

1.5 THE LIFE SETTLEMENT PROCESS

The process for a life settlement transaction is complex and lengthy. Transactions rarely take less than 90 days to complete and frequently take 120 days or longer, particularly if the bidding process is not successful on the first attempt.

The process below assumes that there is a single broker, a single provider and a single investor involved in the transaction and also assumes that the policy owner is the sole insured on the policy. In reality, there are usually multiple brokers, providers and investors involved in the bidding process – such that the flow of information (at least in the stage up to a purchase price being agreed) looks something like Figure 1.2.

In our perfect world of a single broker, a single provider and a single funder (although two or more medical underwriters!), a typical life settlements transaction works as follows:

1. The policy owner decides to sell his or her policy and contacts the agent to initiate the process. The decision may, in some cases, have been prompted by the agent following research which indicates that the policy owner can reduce the cost of ownership by selling a more expensive (in COI terms) "old" policy and replacing it with a less expensive "new" policy.
2. The agent contacts a broker, licensed in the state of residence of the policy owner. The broker sends to the agent some documents for completion by the policy owner – usually an application form and a HIPAA release form. The HIPAA release authorizes the disclosure of personal health information concerning the policy owner by attending physicians, hospitals and other health care providers. The application form will ask the policy owner to set out his or her recent medical history and to supply information on the policy, including the names of all beneficiaries.

[10] The doctrine of insurable interest will be discussed later in this chapter.

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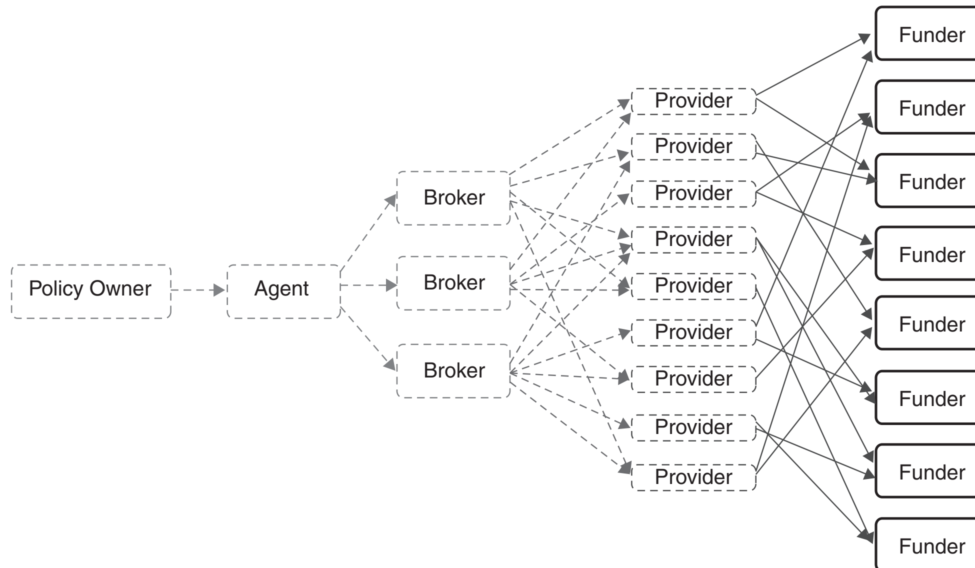

Figure 1.2 Information flow in a typical life settlement transaction

3. The policy owner completes the HIPAA release form and the application form. The agent requests a current policy illustration from the carrier. This illustration usually shows the minimum constant annual premium required to carry the policy to maturity (usually age 100 or later) with a minimal remaining account value at maturity (usually \$1 or \$1000, depending on the face amount of the policy).
4. Once all of the documents have been completed and the policy illustration received, the agent sends them to the broker.
5. The broker sends the signed, completed HIPAA release form on to one of the companies that retrieves medical records for the insured – a process that can take four to six weeks to complete. The retrieval company will request an APS (attending physician statements) from each doctor identified on the application form. It will also request hospital records and, in some cases, prescription records for the policy owner. A full set of medical records can total between 100 and 250 pages.
6. The broker sends the set of medical records to one or more medical underwriters. The broker will select the underwriters based on its knowledge of the target provider's requirements – typically two or more life expectancy reports are required.
7. The medical underwriters generate a life expectancy report for the insured, based upon the information contained in the medical records. The medical underwriter usually constructs a vector of mortality debits and credits for the insured, which may vary with time (as there is evidence to suggest that some illnesses have a greater effect in the short term than the medium to long term). The medical underwriter applies this vector of debits and credits to a mortality curve appropriate for the insured's gender, smoking status and age and calculates a life expectancy for the insured. The life expectancy report will contain this life expectancy and may also contain a specific mortality curve for the insured, an outline of the vector of mortality debits and credits and commentary on the insured's health and

medical history. The process of producing a life expectancy report typically takes between 10 days and four weeks from receipt of the medical records, assuming that the medical records submitted by the broker are complete.

8. The broker receives the life expectancy reports from each medical underwriter and sends them, together with the illustration and a completed application form (which may be the provider's application form, completed by the broker based on information in the broker's application form) to the provider.
9. The provider receives the package from the broker and reviews the contents. If the policy appears suitable for the provider (i.e. it is likely to be purchased by a funder with which the provider is working), then the provider will set the policy up in its systems for evaluation. Evaluation of the policy typically breaks out into a *qualitative evaluation* (for example: is the policy face amount above the minimum and at or below the maximum amount the funder will accept? Is the age of the insured above the funder's minimum attained age?) and a *quantitative evaluation*. The quantitative evaluation involves entering the characteristics of the policy into a pricing model to calculate an assumed gross purchase price at one or more target IRRs (which will be set by the funder). The quantitative evaluation will be developed using a pricing model that has been developed by the provider and/or the investor, or using one of the third-party models that have been developed for use with life settlements.
10. If so required, the provider will forward the package for the investor's direct evaluation. In this case, the investor will usually communicate to the provider a maximum gross purchase price which the investor will pay to acquire the policy.
11. Prior to making a decision on the policy, the provider may communicate with the investor and with the broker. It may ask the broker for information about other bids that the broker has received for the policy and may seek clarification of information submitted by the broker.
12. Once it has completed the policy evaluation, the provider either advises the broker that it is unwilling to consider a bid for the policy (e.g., because it falls outside the provider's "buying box") or it communicates an initial bid to the broker. Often, the gross purchase price communicated to the broker will be accompanied by restrictions on what proportion of that gross purchase price can be paid to the broker and agent as commission and what proportion must be paid to the seller. It may also require that the compensation earned by the broker and agent be fully disclosed to the policy owner at the time of contract.
13. Assuming that a bid is communicated to the broker, the provider may then become involved in an auction for the policy, in which the broker seeks to ensure that it is obtaining the best possible price for the policy owner, who is the broker's client.
14. Ultimately, the agent and the policy owner will identify a bid that they wish to pursue. Although this should be the highest bid in terms of gross purchase price, it is often difficult for the agent and/or broker to compare "apples with apples" when considering bids. Many fail after a price has been agreed because of incomplete or inconsistent information; others fail because the documentation requirement is too onerous for the policy owner to complete. For these reasons and others, the bid ultimately recommended to the policy owner may not be the best bid economically, but rather the most likely to close (in the experience of the broker and/or agent).
15. Once the bid has been selected, the broker informs the provider. The provider then prepares a closing document package, which includes all of the documentation necessary to close

the transaction – a life settlement contract, consent forms for the policy owner's spouse, any dependents and the current beneficiaries under the policy, plus any disclosure forms required by the funder or mandated by regulation in the policy owner's state of residence. Once complete, the closing document package is sent to the broker, who sends it on to the agent.

16. The agent liaises with the policy owner to complete the closing document package. Many of the documents are required to be notarized upon execution by the policy owner, his or her spouse/dependent(s) and the current beneficiaries under the policy. The agent will also request a written verification of coverage (VOC) from the carrier, which sets out updated information concerning the policy – recent premium payments, account value, cash surrender value, current and future COI and details of any outstanding policy loans or recent withdrawals. The agent will also assemble the original documentation for the policy, including the policy form and the policy schedule, as well as a copy of the carrier's application form completed by the policy owner when the policy was originally issued. The agent will also request a copy of the relevant CoOwn and COB forms from the carrier, which will be signed "in blank" by the policy owner (so that the identity of the new owner can be completed later in the process).
17. Completion of the closing document package usually takes some three to four weeks from receipt by the broker. Once completed, the broker sends the original life settlement contract and the signed CoOwn and COB forms directly to the escrow agent, to be retained pending receipt of the *seller compensation*. This is the portion of the gross purchase price that is to be paid to the seller (as distinct from the portion due to be paid to the agent/broker as commission). The balance of the documents in the closing document package (together with copies of the documents sent to the escrow agent) are sent directly to the provider.
18. Once the closing document package is received by the provider, fully completed, the provider usually sends it on to the investor for review. The investor conducts a document verification process, which compares the contents of the closing document package with the information previously received by the funder on the case, to ensure consistency with what has been received before. The investor may outsource this responsibility to a third party with staff experienced in reviewing closing document packages and with systems designed to administer this process effectively.
19. The document verification process can usually be completed in two to three business days, assuming that no further issues present themselves. Examples of issues that can occur at this stage include pricing issues (e.g. the information on the written VOC discloses that the account value, cash surrender value or net death benefit amount differ significantly from what was assumed during policy evaluation) and compliance issues (e.g. a discrepancy between information on the original policy application and the information provided in the broker's application form or the provider's application form).
20. Assuming that no problems arise in the course of document verification, the provider instructs the escrow agent to send the original CoOwn and COB forms to the trustee for signature and onward transmission to the carrier.
21. The trustee completes the CoOwn and COB forms upon receipt, signs them and sends them on to the carrier.
22. The carrier processes the change forms upon receipt and sends back an acknowledgement of the change of ownership and beneficiary to the trustee, at which point the trustee is confirmed as the legal owner of the policy on the books and records of the carrier. The trustee sends this acknowledgement on to the provider and to the investor. The trustee

updates its own books and records to show the provider as the beneficial owner of the policy. Immediately thereafter, the trustee transfers the beneficial interest in the policy to the investor.

23. The escrow agent then releases the seller compensation to the policy owner. The payment to the policy owner starts the clock on the rescission period – the period during which the policy owner is legally entitled to reverse the sale should he or she choose to do so. This period is usually between five and fifteen business days after payment of the seller compensation and it varies from state to state.
24. After the expiration of the rescission period, the investor transfers the balance of the gross purchase price (i.e., the commission due to the agent and/or broker) to the provider. The provider pays this on to the broker, which pays the agent.

A timeline for the transaction process is shown in Figure 1.3.

1.6 LEGAL ISSUES

The legal issues surrounding life settlements are complex and shifting. Prospective investors in life settlements should take steps to ensure that they seek and obtain legal advice from an attorney with experience of life settlements and life insurance. Nothing set out in the following paragraphs, or elsewhere in the book, should be taken as advice – it represents the authors' opinions as to the scope of some of the more critical legal issues affecting the market at the time of writing.

Although the life settlements market as such does not exist in the UK, a lot of the key legal concepts draw their basis from English law and particularly English insurance law. US insurance law has departed significantly from English law over the last century – English law still treats insurance as an inalienable contract, under which the policy cannot be separated from the risk. The US, by contrast, takes exactly the opposite view and holds that the policy owner has the right to transfer legal ownership and beneficial interest in the policy to a third party at his or her discretion.[11]

Both US law and English law draw upon the doctrine of insurable interest to support their respective positions on transfer of ownership. A person taking out a policy of life insurance is required to have an insurable interest in the life so insured, i.e. an interest in the continuing health of the insured. It is assumed that a person has an insurable interest in his or her own life, as well as in the lives of his or her spouse and/or dependents. An insurable interest can exist between business partners and between a company and its key employees (but not necessarily its non-key employees). It may also exist where there is no more than a financial connection between the parties – e.g. where you stand to suffer a financial loss were the insured to die. English law requires that the insurable interest continue throughout the life of the policy[12] – US law requires that an insurable interest exist at issuance only. In the USA, therefore, the absence of an insurable interest on the part of a subsequent assignee or transferee of the policy does not invalidate that assignment or transfer, nor does it render the policy void or unenforceable against the carrier (assuming that the owner has complied with its other terms).[13]

[11] Grigsby v Russell, 222 U.S. 149 (1911) (United States Supreme Court).

[12] Although note that there is currently a proposal before the Law Commission to consider amending the law on insurable interest: Insurance Contract Law Issues Paper 4: Insurable Interest, January 14, 2008.

[13] Grigsby v Russell, 222 U.S. 149 (1911) (United States Supreme Court).

Policy Owner
Agent
Broker
Provider
Funder
Trustee
Escrow Agent
Carrier
Time
Policy owner considers selling his/her policy
Agent submits policy to Brokers for consideration
Policy transmitted to one or more Providers
Providers may price the policy or send to one or more Funders for pricing
Agent discusses bid with policy owner
Brokers communicate bid to Agents
Providers place bid with Brokers
Funder communicates price range to Provider
Policy owner identifies preferred bid
Agent relays information to Broker who brokers the deal
Broker informs Provider
Broker sends closing package to seller
Provider sends closing package to Broker
Policy owner completes documents and sends to broker
Broker sends closing package to Provider & sends change of ownership (COO) to Escrow Agent
Provider transfers seller compensation to Escrow Agent (or funder)
Escrow agent releases COO documents to provider
Provider sends COO and change of beneficiary (COB) forms to Trustee
Trustee completes COO and COB forms and sends to Carrier
Carrier registers changes made to policy owner and beneficiary
Transmits acknowledgement to Trustee and CCs new owner
Trustee carries out final checks
Agent is paid commission through broker
Once rescission period passes, Provider pays commission to broker
Escrow agent releases compensation to Seller

Figure 1.3 Timeline of a life settlement transaction

Insurable interest is, perhaps, the single most important legal issue for any prospective investor in life settlements. The problem is compounded by the fact that insurance is regulated at state level in the USA – so that the definition of insurable interest must be considered in the state in which the policy is issued (typically the state in which the first owner of the policy was resident or organized at the time of issue). Instead of operating in a single market, an investor is effectively operating in 51 different markets. The problem is further compounded by the fact that the circumstances surrounding the issue of a life insurance policy may, by the time the policy comes up for sale as a life settlement, be lost in the mists of time. It may be nigh on impossible to satisfy oneself (and one's legal advisers) that the first owner of the policy had a valid insurable interest in the life of the insured at that time. *Caveat emptor*, indeed.

The consequences of having no insurable interest are severe – the policy may be void *ab initio* or it may be unenforceable against the carrier. Other circumstances may also allow the carrier to challenge payment under the policy, e.g. a suicide clause under which the policy becomes void (or, more frequently, subject to challenge by the carrier) if the insured dies within a specified period of time after issue. As this period of time (referred to as the *contestability period*) is set by each state independently, an investor must research this carefully. A general rule is that the contestability period lasts for two years from the date of issue of the policy and the majority of life settlement investors will decline to purchase a policy during its contestability period. State regulation – and the differences between the states – is a headache for any investor used to the level playing field of one federal regulator that operates in the securities markets. The majority of US states have now enacted regulations specifically addressing the life settlements and/or viatical settlements markets.[14] Many states have passed legislation based upon the model legislation developed by the National Association of Insurance Commissioners (NAIC). The model legislation goes through periods of development when a new issue is drawn to the attention of the NAIC – one recent example being STranger-Originated Life Insurance (STOLI), a phrase that essentially describes the origination of life insurance in the absence of an insurable interest. A full exploration of the issues surrounding STOLI is beyond the scope of this section, but prospective investors should closely scrutinize the circumstances surrounding the issue of any policy offered for sale and should consult with professional advisers to satisfy themselves that STOLI is not a concern in any specific case.

Although the majority of investors will not be covered by HIPAA (as it applies to those whose job involves the collection and storage of private medical information), privacy and confidentiality are significant issues for regulators. In order to undertake investment and monitor performance of a life settlements pool, an investor will need access to private information (e.g. name, address, telephone number, Social Security Number) and private medical information (e.g., attending physician statements (APS), hospital inpatient and outpatient treatment records). The receipt and retention of this information is likely to be governed by laws applicable in the country in which the investor is located and these laws should be researched thoroughly to ensure that the investor's workflow complies.

Investors should note that the majority of states (and the SEC) treat variable universal life policies as securities – because the cash account may be invested in securities (e.g., stocks listed on a US exchange). For this reason, investors should ensure that the acquisition of a variable universal life policy (both the purchase by the provider from the seller and the onward sale to the investor) complies with applicable securities legislation.

[14] The list of states with regulations promulgated changes from month to month. The Life Insurance Settlements Association (LISA) maintains a legislative map at its website which is updated frequently: http://www.lisassociation.org.

1.7 OTHER ISSUES

Investing in life settlements is not for the faint of heart. The business and legal issues are significant and the infrastructure required to support a business is complex; but the risk-adjusted returns can be compelling, with little or no correlation to other asset classes and low volatility. An investor wishing to explore participation in the market will have many issues to consider in addition to those already listed above. A few of these issues, and some suggestions as to how to address them, are listed below.

- *Medical underwriting is an inexact science*. A life expectancy report is a statement of opinion, not of fact, and there is no guarantee that the insured dies before, at, or after the number of months specified in the report. Medical underwriters usually draw their life expectancies by reference to an assumed population of 1000 lives, each having the same health characteristics as the insured. The life expectancy is usually expressed as the number of months after which at least 50% of this assumed population has died. By definition, this means that up to 50% of this assumed population has **not** died by this date. Remembering that the insured is as likely to die after the stated life expectancy as before is vital to an appreciation of how longevity risk can affect returns in a pool of life settlements.
- *No two policies are created equal*. When considering acquisitions, it is vital to read the policy form and policy schedule in full, together with the terms of any policy riders. Many policies will have characteristics that may not manifest themselves in the illustration but will be of economic value in the future, even if they cannot easily be factored into the pricing of the policy prior to acquisition.
- *Information has a very short half-life*. Given the speed with which life expectancy underwriters adjust their methodologies, investors should try to refresh medical information and life expectancy assumptions regularly. As this may have an impact on revenue recognition, investors should agree an appropriate policy to address such information updates with senior management, advisers and auditors, when setting up their business.
- *Relationship management is as important as data management*. With so many different parties involved in each transaction, managing all of the associated relationships is a full-time job. Many investors with a banking background will assume that "money talks" and that sellers will not distinguish one offer from another on the basis of anything other than price, but in a market with very limited standardization, nothing could be further from the truth. Life settlements will undoubtedly migrate towards a standardized platform over time, but needing to placate regulators and legislators in 50 different states is a significant time barrier to that process. Soliciting and closing good quality policies therefore depends on having the right relationships and on maintaining those relationships.

In this chapter, we have examined the circumstances that gave rise to the development of the life settlements market. We have discussed the type of policies that an investor might encounter in the life settlements market and identified the direct and indirect participants in a life settlement transaction. We have also outlined the process involved in a typical life settlement transaction and considered some of the legal and practical issues associated with transacting in life settlements. The next two chapters will focus on the pricing of mortality-linked instruments, such as life settlements, before we go on to consider some of the structures in which life settlements can be employed.