Institutional Life Markets Association

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Statement

Of

The Institutional Life Markets Association (ILMA)

Presented by

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Committee on Financial Services
United States House of Representatives

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Mr. Chairman, my name is Jack Kelly. I serve as the Director of Government Affairs for the Institutional Life Markets Association (ILMA).

ILMA is a trade association comprised of a number of the world's leading institutional investors and intermediaries in the longevity marketplace. We welcome the subcommittee's interest in exploring the emerging secondary market for life insurance, known as life settlements. ILMA's members include Credit Suisse, EFG Bank, Goldman Sachs, JP Morgan Chase, Mizuho International and WestLB. ILMA's members are highly regulated entities that are subject to the rules and regulations of federal and state regulators including the U. S. Securities and Exchange Commission, Federal Reserve Board, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency or by substantially similar regulations of other appropriate authorities. As such, we are committed to appropriate regulation and oversight of the life settlement industry.

ILMA was formed two years ago to promulgate best practices, encourage transparency and standardization of documentation, and to educate consumers, investors, and policy makers about the benefits of the longevity related marketplace. ILMA has been and continues to be an advocate for appropriate regulation of the evolving life settlements marketplace. Life settlements provide seniors with choices designed to enable them to maximize the economic values of their life insurance policies. ILMA members, through lending or by direct purchase, have provided consumers in excess of $ 2.9 billion through the purchase of life insurance policies no longer needed by the owners.

The cornerstone of ILMA's Guiding Principles (which I have attached to my testimony) is the promotion of transactional transparency, best practices, protecting the identity of insureds, supporting longstanding insurable interest principles and advancing public understanding of the life markets. To that end, the first action by ILMA was the creation of the Life Settlement Transaction Disclosure Statement.

This document was the first uniform document created that clearly and concisely discloses the amount of money consumers will receive when they sell their interest in a life insurance policy; unlike the lack of disclosure for fees and commissions associated with the original purchase of a life insurance policy from an insurance carrier. Included in the disclosure statement is a policy's face value amount, estimated cash surrender value (CSV), gross sales price, the amount of the broker's compensation and the net amount a consumer will receive for the sale. The form allows consumers to know exactly how much money they will receive for their policy and exactly how much their broker will receive in compensation for the transaction.

ILMA has advocated in every state that has considered legislation or regulation governing life settlements to incorporate the contents of the ILMA disclosure statement in their respective laws and regulations. ILMA has appeared before the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL) for inclusion of the ILMA disclosure statement in their model life settlements acts.

Shortly after the adoption of the ILMA disclosure form, we created the first set of uniform HIPAA-compliant release forms to ensure that participants in the markets have access to the sample forms designed to adequately protect the privacy of the records of individuals who are participating in a life settlement transaction. The transaction disclosure form and HIPAA forms are available free of charge on ILMA's website at www.lifemarketsassociation.org.

In its invitation to appear today, the committee has asked us to discuss the history, purpose, size and recent growth of the life insurance settlement markets. As stated by the committee, this market has been the topic of discussion by commentators and journalists, specifically the New York Times article of September 6, 2009, entitled "Wall Street Pursues Profit in Bundles of Life Insurance."

The History of Life Settlements

Life settlements are not a new phenomenon. The notion of transferring ones life insurance policy for value was the topic of a 1911 decision by the U.S. Supreme Court in the case of Grigsby v. Russell. This case established a legal basis that the owners of life insurance policies have the right to transfer an insurance policy like any other asset they own.

The practice of selling one's interest in a life insurance policy expanded in the 1980's, when individuals diagnosed with acquired immune deficiency syndrome (AIDS) needed access to funds to pay for their medical treatments and healthcare. Many of these individuals were denied medical coverage by their insurance carriers or the coverage they had was so limited that it failed to provide for their treatment or their healthcare. Subsequently, an option developed called viatical settlements which allowed individuals to sell their interest in their life insurance in order to receive money to assist in paying for their healthcare. The business of viatical settlements was loosely regulated resulting in certain abuses. In response, the NAIC developed a model viatical settlements act which numerous states adopted. As medical solutions developed to combat AIDS and effectively prolong the lives of those infected, the demand for viatical settlements dissipated.

In the 1990's, seniors, who were faced with paying premiums for unwanted or unneeded life insurance policies, sought an alternative to surrendering the policies for the cash surrender value. The result was the development of a life insurance settlement where owners' receive a sum greater than the CSV for their interest in the insurance policy and the purchaser continues paying the premium. When a third party purchases the rights to the benefits of a policy it is referred to as a life settlement.

The reasons for selling one's interest in a life insurance policy vary from not needing the policy because the beneficiary pre-deceased the insured, the children have grown and are now self-supporting, wanting cash to fund retirement or to fund a policy that more appropriately meets the current needs of the policy holder. With the option for a life settlement, the owner could achieve a greater financial benefit than simply allowing their policy to lapse or receiving the CSV upon the surrender of the policy.

The Size of the Industry

It is difficult to determine the actual size of the life settlements markets as there has been limited validated data as to the number of transactions that have been completed. According the Conning Research & Consulting, Inc., <u>Life Settlements: New Challenges</u>

to Growth, 2008, the annual face value of life insurance policies settled in the secondary market is expected to average $21 billion over the next ten years, reaching $31 billion by 2017. Conning predicted a growth at 11.5 % annually in the next five years slowing to 8.2% in the following years.

In the next few weeks, Conning will issue its 2009 report on the life settlement markets. It is their conclusion that the annual face value of life insurance policies settled in the secondary market in 2008 was $12 billion. At the end of 2008, there were approximately $31 billion annual face value policies in force in the life settlement market. They conclude that growth in the life settlement market was flat from 2007 to 2008. They further report that prospective growth will remain strong due to increased consumer awareness, but by 2011 and 2012 the market will reach a saturation point with an annual growth of two to three percent.

It must be noted that the recent developments in the capital markets that created the so called "credit crunch" have had a significant impact on this marketplace. During the past year, many participants in the secondary market have been unable to renew their credit lines and overall interest for policies in the secondary market has dramatically declined. However, even against this backdrop, there is continued interest in this market because of its low-correlated returns, risk diversification and the ability to understand and measure the risks associated with life settlements.

According to the Insurance Studies Institute, "the secondary market of life insurance provides a great social and economic value to seniors." The 2008 publication by the National Underwriter Company, Tools and Techniques for Life Settlements, provides an example that a policy with the face value of $1,000,000 sold as a life settlement was over three times greater than the cash surrender value. In addition, the present value of premiums saved (by the consumer) from not continuing to make premium payments was over two and a half times the cash surrender value at the settlement. ILMA members believe that actual purchase prices paid to consumers represent multiple times greater than the values used in the National Underwriter example. Thus, when suitable to a consumer, a life settlement can afford a significant financial benefit for their financial planning.

ILMA and other participants in this marketplace think that the development of consistent and verified data on transactions should and needs to be developed.

ILMA'S Role in Regulatory and Legislative Developments

ILMA has from its inception promoted the development of law and regulation surrounding life settlements. We have been an active participant and supported the adoption of model acts created by both the NAIC and NCOIL. Throughout the development of those model acts, ILMA submitted both oral and written testimony and has worked with regulators and legislators throughout the United States to adopt appropriate and comprehensive laws and regulations. We have been the single strongest advocate for the adoption of requirements that life settlement transaction documents include complete disclosure of all fees and commissions associated with the transactions so that consumers can know exactly how much they will receive when they participate in life settlements and how much is being paid to those associated with the transaction.

Since the adoption of the NAIC and NCOIL Life Settlements Model Acts, ILMA has worked towards the adoption of life settlement laws and regulations in over 16 states. To date, laws governing the conduct of life settlements have been adopted in 35 states and Puerto Rico. Presently, ILMA is an active advocate in supporting legislation drafted by the New York Department of Insurance to regulate this marketplace and legislation in California that is pending the signature of the Governor.

At the federal level, ILMA worked with the Senate Aging Committee in its review of the life settlement markets and publicly commended the committee for its work in this area to ensure that senior's rights are protected when they choose to consider a life settlement. In furthering its efforts, ILMA is working with the Congress' Government Accountability Office in the examination of the life settlements market.

Securitization

Recent news reports have advanced the story that the capital markets have initiated an effort to issue rated securitization of life settlements. I think it is important to distinguish between facts and speculation in this reporting.

First, the securitization of insurance products is not a new concept. On September 1, 2009, A.M. Best Company, the rating agency that since 1899 has reported on the financial conditions of insurance companies, issued a Best Review on the insurance marketplace. Included on its report were different categories of insurance linked securities and transactions that they have rated.

Second, securitization plays an important role in bridging insurance markets with capital markets. The College of Insurance defines Insurance Securitization as the transferring of underwriting risks to the capital markets through the creation and issuance of financial securities. In particular, the insurance securitization process involves two elements:

- The transformation of underwriting cash flows into tradable financial securities

- The transfer of underwriting risks to the capital markets through the trading of those securities

In general, securitization can have a number of economic benefits. These include i) lowering the cost of borrowing; ii) giving consumers choices and creating liquidity; iii) providing risk transfer from entities that no longer want a risk to investors who are prepared to bear the risk; iv) separating credit quality from the owner of an asset and the asset itself; and, v) professionalizing the asset management and servicing of the asset.

The insurance linked securities rated by A.M. Best include[1]:

1. Natural Catastrophe Bonds: An alternative to reinsurance, these securities are used by insurers to protect themselves from natural catastrophic events. Typically, they pay high yields because investors could lose their entire stake in the event of a disaster.

[1] A.M. Best – Best Reviews; September 1, 2009

2. Securitization of Surplus Notes and Insurance: Securitization of surplus notes provides another funding source for small and midsized insurance companies that find it very costly to issue capital on their own due to Financial Strength Ratings (FSR's). The securities in these pools are issued by a stand alone special purpose vehicle (SPV) and sold to investors. The proceeds of these notes are used to purchase the transaction's collateral, which consist of surplus notes.

3. Embedded Value (Closed Block) Securitizations: An insurer can close a block of policies to new business, and receive immediate cash from investors in exchange for some or all of the future earnings on that block of business. The pledged assets remain with the insurer and are potentially available in the event of insolvency.

4. Regulation XXX Securitizations: In 1999, the NAIC stated a change to the Valuation of Life Insurance Policies Model Regulation, commonly referred to as "XXX". This change, which increased statutory reserve requirements for newly issued level term policies, created a strain on surpluses for insurers. In addition, the closely related Guideline AXXX mandated additional reserve requirements for universal life policies with secondary "no lapse" guarantees, adding to that strain. As a result, many life insurers employed securitizations and surplus notes to fund a portion of the reserve requirements.

5. Mortality Catastrophe Bonds: A derivative of natural cat bonds, investors in these bonds lose money only if the level of deaths linked to a catastrophic event exceeds the threshold. The event that can bring about the trigger is extreme, such as a pandemic.

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6. Securitization of Structured Settlements: This is a popular method of settling personal injury, product liability, medical malpractice and wrongful death cases. The defendant (typically an insurance carrier) discharges the obligation by purchasing an annuity from a highly rated life insurance company. Securitization of annuity cash flow is achieved through the use of a bankruptcy-remote SPV. The issuer of the securities, the SPV, raise funds from investors that are used to purchase annuity cash flows from the insurance companies or annuitants. The most important risks associated with these transactions are the credit risks ascribed to insurance companies involved in the transaction and mortality risks.

7. Sidecars: Separate, limited purpose companies, generally formed and funded by investors, usually hedge funds, which work in tandem with insurance companies. The reinsurance sidecar purchases certain insurance policies from an insurer and shares in the profits and risks. It is a way for an insurer to share risks, and if the policies have low claim rates while in possession of the sidecar, the investor will make higher returns.

8. Securitization of Reinsurance Recoverables: Insurance and reinsurance companies have been finding alternative ways to reduce their exposure to uncollectible recoverables and reduce the concentration risks associated with ceded exposures. One approach is the securitization of reinsurance

recoverables, which involves a structured debt instrument that transfers risk associated with the uncollectible reinsurance to the capital markets.

9. Life Settlement Securitization: A life settlement contract is a way for a policy holder to liquidate a life insurance policy. A portfolio of the contracts may be securitized to provide a source of capital. However, certain variables, such as the uncertainties associated with life expectancies, and regulatory issues can create obstacles that may slow their path to the marketplace.

There have only been two rated life settlement securitizations reported. Each of these is somewhat unique, as the market is in its early stages, particularly when compared with other insurance linked securities. The most recent securitization, reported in April 2009, was an internal company transaction for AIG (that involved no outside investors) and resulted in the largest securitization of life settlements to date—well over $2 billion. This capital relief transaction was a securitization of a substantial portion of AIG's life settlements portfolio. In 2008, AIG valued its life settlements portfolio, which included the death benefits on 4,000 life insurance policies, at $2.58 billion.

This securitization was done, in part, to reduce some of AIG's ongoing borrowing from the Federal Reserve by $1.2 billion. The securitization notes, which were privately rated by AM Best, are being held by AIG's commercial insurance group. Following the transaction, AIG told Business Week that the "securitization notes are an attractive asset class (for AIG) because their performance is not correlated to credit or real estate markets and the notes pay an attractive coupon."[2]

The only other known securitization of a portfolio that included both life settlements and annuity policies occurred in March of 2004, when Legacy Benefits Corporation became the first life settlement company to successfully conclude a rated securitization of life insurance settlement and annuity assets. This transaction was underwritten by Merrill Lynch and was rated by Moody's. The notes were sold in two tranches: the Class A notes were rated A1 and pay a coupon of 5.35% and the Class B notes were rated Baa2 and pay a coupon of 6.05%.[3]

Since these are the only known transactions, it brings to question why suddenly there is such increased attention to the "securitization of life settlements." As I have stated, the use of securitization by the life insurance industry is widespread. In fact, immediately following the New York Times article on this subject, Frank Keating, President of the American Council on Life Insurance stated, "securitization of life insurance policies transferred to third-parties is not necessarily a bad thing."[4] In light of the long and well established history of securitization in the life insurance industry, it is only reasonable that such a tool would be explored for life settlements.

Insurance carriers have utilized securitization to access increased capital in order to provide products to their customers. Increased access to capital funding sources will result in more competition which will benefit consumers in obtaining the maximum price

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[2] Business Week , April 7, 2009
[3] Press Release, Legacy Benefits, March 16, 2004
[4] Letter to the Editor, NY Times, September 9, 2009

for life insurance policies they wish to sell. Life settlement securitization also has the potential to create additional choices and liquidity for life insurance owners.

It is also worth pointing out that there are a number of reasons why only such a limited number of life settlement securitizations have been completed. The life settlement industry is a relatively new. It typically takes a number of years for an asset class to mature to make securitization possible. In addition, life settlements do not have scheduled payments (creating challenges for those developing a model of cash flows), do not have uniform documentation, and each life insurance policy in a portfolio is unique from the others.

Some commentators argue that if the market for life settlement securitization were to grow, it could force insurance companies to increase life insurance premium costs. The argument rests on the assumption that life settlements will reduce the number of policies lapsing and the decrease in profits to the insurance company will be transferred to and borne by other insureds. There are a number of reasons why ILMA does not agree with this argument:

1) The life settlements market is available for seniors. The elderly and those with health problems both tend to lapse their policies less frequently in any event, so there is no, or limited, adverse effect from the policy being settled in the secondary market.[5]

2) Reduced lapse rates may in fact have a positive impact on life insurance companies. The issuance of life insurance policies typically entails large underwriting and upfront origination costs (such as sales commissions). This cost structure provides insurance companies an incentive to move towards lower lapse rates.[6]

3) The limited size of the overall life settlement market compared to the amount of life insurance in-force undercuts one argument against life settlements, the concern that an active life settlement market will result in increased premium costs. According to the American Council of Life Insurers (ACLI), Life Insurers Factbook 2008, there is approximately $25 trillion of life insurance in force today and according to the Conning Report, $31 billion in life settlements. By comparison, the life settlement market is simply not large enough to have any recognizable effect on pricing, and it is not clear that it will ever grow to the point where it would have a real effect on policy premium costs. In fact, over the past decade, according to the Insurance Information Institute, life insurance premium costs have decreased despite the growth in the life settlement market.

   Furthermore, it is unclear to what extent, if any, life insurance companies assume a certain lapse rate when setting policy premiums, especially policies sold to older consumers who are less likely to let them lapse. Typically seniors, who secure life insurance policies for estate or financial planning purposes, intend and do maintain the policy in force.

[5] "Determinants of the lapse rate in life insurance operating companies", Review of Business, Fall, 2007 by Laurence Mauer, Neil Holden.
[6] ibid

Life settlements benefit the insurance industry through additional policy issuance: concurrent with a sale of a policy many insureds will purchase a new policy more suited to their current circumstances.

Myth v. Truth: Life Settlement Securitization is the Next Subprime Mortgage Crisis

The analogy presented by commentators, journalists and bloggers that life settlement securitization is the next subprime crisis is completely inaccurate.

Mortgage securitizations involve the following participants:

- Borrower (Homeowner)
- Loan originator (Bank)
- Special Purpose Trust
- Underwriter (investment bank)
- Rating agency
- Investor (capital markets)

The most significant participants in this transaction are the Borrower and the Investor. Asset-backed securities linked to subprime mortgages relied on the continued stream of payments by the homeowner to fund the securitization. When the Borrower defaulted or failed to make payments, the asset (the mortgage) did not generate sufficient cash flow to meet the payment obligation under the security, thus resulting in a default of the security. In the case of mortgage backed securities, there were two clear "losers" when the security defaulted: the Borrower who has defaulted on his mortgage and may lose his home and the Investor who will not receive anticipated cash flows from this security.

A life settlement securitization involves the following participants:

- Issuer (bankruptcy remote SPV)
- Pool of life insurance policies (acquired through licensed Providers)
- Underwriter (investment bank)
- Rating agency
- Investor (capital markets)

It is critical to note that the original owner of the insurance policy, who has sold the policy to a state licensed life settlement provider, is paid in full for the policy at the time the ownership is transferred. They have no further financial participation in the process and cannot be adversely impacted as a result of the securitization. This greatly differs from the mortgage backed security, which relies upon continuing payments by the borrower. Rather, the major risk in a life settlement securitization is the uncertainty associated with predicting longevity. Unlike a mortgage-backed securitization that relies on continuing payments from the borrowers, investors in life settlement securitizations would be required to provide sufficient funds in advance to keep the life insurance policies in the pool in force. If the life settlement securitization fails the only loser would be the investor, which is the case in all investments, and there would be no impact on the insured or any original policy owner. Accordingly, such investments would only be suitable for institutional investors, who can analyze and understand the risks.

Regulations Relating to Life Settlements

ILMA's position is that life settlement transactions should be regulated to ensure that the consumer is protected and informed about the impact of such a transaction. To that end, ILMA believes that the persons transacting the life settlement with the policy owner, both the life settlement broker representing the policy owner and the life settlement provider purchasing the policy, should be licensed and regulated. Life settlements may or may not be appropriate transactions for all individuals. ILMA believes that transactional transparency in the documents associated with a life settlements contract should inform the participants of exactly how much money they will receive for their policy and how much money is being paid to the brokers representing the seller from the sale of the policy. Additionally, consumers should, from the onset of the transaction, consult with their financial adviser, their tax adviser and an attorney to review the transaction to evaluate if the transaction is appropriate based upon the tax impact and their financial and future insurance needs.

Presently, due to the fact that life settlements are regulated by state insurance regulators, there is a lack of uniformity in the laws governing these transactions. ILMA seeks the adoption of uniform laws and regulations that will protect consumers that participate in these transactions. Such uniformity would include uniform disclosure requirements, licensure of participants and enforcement procedures.

ILMA believes the U.S. Securities and Exchange Commission (SEC) regulates the securitization of life settlements as it regulates all securitizations. To date, the SEC has stated that it regulates any life settlements transactions involving the sale or purchase of a variable life annuity or the offer of an investment in a fractionalized interest in a life insurance policy. The Financial Industry Regulatory Authority (FINRA) has promulgated several advisories to its members concerning the regulation of variable annuity life settlements. ILMA stands ready to work with the SEC and FINRA as they explore this issue.

In closing Mr. Chairman, I would again like to thank the subcommittee for the opportunity to present ILMA's views on life settlements. We look forward to working with the subcommittee and its staff to answer any of your questions and to work towards appropriate law to govern this emerging market.

INSTITUTIONAL LIFE MARKETS ASSOCIATION, INC.

GUIDING PRINCIPLES

The Institutional Life Markets Association, Inc. (ILMA) is a trade association comprised of a number of the world's leading institutional investors and intermediaries in the mortality and longevity marketplace, formed to encourage the prudent and competitive development of a suite of evolving mortality and longevity related financial businesses, including the businesses of life settlements and premium finance.

Life insurance is one of the most important financial assets a consumer owns, and the prudent regulation of the life settlement and premium finance industries is critically important to a consumer's ability to acquire such asset and, during the term thereof, to realize all of the economic opportunities associated therewith.

To help bring consensus among the various life insurance companies, life settlement providers, brokers, banks, premium finance lenders and other participants in the life settlement and premium finance industries, and to facilitate the promulgation of appropriate regulation and the development of industry "best practices," ILMA has formulated the following guiding principles to be considered when conducting business in this marketplace.

- Transparency. Consumers are entitled to transparency when engaging in life settlement and premium finance transactions. Accordingly, a consumer's representative should disclose all bids received and provide full disclosure of all fees and commissions payable to such representative. Industry participants should not engage in premium finance transactions designed to conceal the nature of a transaction from life insurance companies. When a consumer applies for a life settlement or premium finance program, an advisor should emphasize the consumer's obligation to complete the application truthfully and accurately.

- Suitability. Life settlements and premium finance loans are not appropriate for everyone. Industry participants should advise consumers applying for life settlements or premium finance loans to seek competent, professional advice to fully understand the risks involved and to determine whether a transaction is right for them.

- Consumer Choices. Consumers should have the ability to choose how to finance their life insurance policy and whether to hold the policy to maturity, surrender it for cash surrender value or settle it in the secondary market. Regulations that unnecessarily restrict such choices are anti-consumer and should not be supported.

- Fiduciary Duty. Life settlements and premium finance loans are complex financial transactions. Consumer representatives such as agents, brokers, and other advisors should be mindful of the fiduciary duty they owe to consumers who participate in such transactions, including helping consumers understand the value of a policy and how best to realize this value. The nature and scope of this fiduciary duty should be explained and defined at the start of the professional relationship.

- Insurable Interest Principle. Industry participants should support laws designed to deter transactions that seek to evade insurable interest laws and principles.

- Policy Origination. No person should pay, directly or indirectly, an inducement to any prospective policy owner or insured for taking out a life insurance policy. Offers of "rebates," "free insurance" and similar questionable incentives should be prohibited.

- Protection of Insured's Identity. Industry participants should develop and implement procedures designed to appropriately safeguard the identity of insureds engaging in life settlement and premium finance transactions. These participants should make every effort to prevent the inappropriate disclosure of confidential information relating to an insured or to a particular transaction.

- Competition. A well regulated and competitive marketplace best serves the interest of consumers and industry participants. Industry participants should not support or engage in practices that seek to unlawfully restrict competition.

- Marketplace Education. Industry participants should seek to educate consumers, investors and others on legislative and administrative developments affecting the life settlement and premium finance industries. These persons should also seek to provide a forum for interested parties to examine and review such developments.

With these Guiding Principles as a basis, ILMA looks forward to engaging in a dialogue with the leaders of the life settlement and premium finance businesses to promote common interests and objectives and to develop industry "best practices." ILMA also looks forward to working with legislators and regulators to help design appropriate and consumer-oriented regulation.