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North America
Financial Services
Insurance/Life

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Market Commentary\Strategy

2ndary Life Mkt: A Problem for Carriers?

Eric N. Berg, CPA, CFA
1.212.526.2805
eberg@lehman.com

Michael J. Levy
1.212.526.5211
mjlevy@lehman.com

Sector View:

New: 2-Neutral
Old: 2-Neutral

Investment conclusion

- A recent presentation by one of the country's leading experts on the secondary market for life insurance – namely, life settlements, viaticals, Investor-Owned Life Insurance (IOLI), Stranger-Owned Life Insurance (SOLI) and Life Insurance Life Annuities Combination (LILACs) – provided an in-depth look at a series of products that have raised many questions about lapsation and insurer profitability.

Summary

- During a 'Digging In With the Experts' conference call titled 'The Growing Secondary Market for Life Insurance – Why Are Insurers' So Concerned?' Brian Smith, the head of the Life Settlements Institute, a secondary market trade organization, talked about some of the positive impacts that the rapidly growing life settlements market can have on major life insurance writers like MetLife, Lincoln National, Prudential Financial, Protective Life, Jefferson Pilot, and Hartford Financial.

The comments could not have come at a better time: Investors have been craving to learn more about a corner of the industry that has been in the headlines. Industry executives from major North American life insurers like Manulife Financial (MFC), Lincoln National, MetLife, and Nationwide Financial have all talked about the development of the secondary market and how they've taken steps to address changes in the market owing to this development. At the same time, stories about the secondary market have appeared in major publications such as the New York Times, the Wall Street Journal and BusinessWeek in recent months.

At the heart of Mr. Smith's comments was the point that the secondary market has the potential to help spur sales of life insurance products that have struggled to grow in recent years without hurting insurers' bottom line. And we believe that he has a point. The growth of the life settlements market means that potential life insurance customers can be enticed to purchase coverage, knowing that if they ever feel that the coverage is no longer necessary, the policy can be sold with relative ease on the life settlements market. As well, sales could get a lift if, as Mr. Smith and some life insurers have noted, policyholders take the proceeds from the life settlement and purchase other products from life insurers.

But we're not convinced that the settlement market is a net positive for the major sellers of life insurance. While it's too early for us to have a strongly held view, we find the argument offered by opponents of the settlement market undeniably persuasive. Life insurers from Maine to California have been pricing business for years with the expectations that a certain percentage of the business would lapse. Now, these companies may see their returns hurt by lower-than-expected lapsation on the policies that are being settled instead of lapsed.

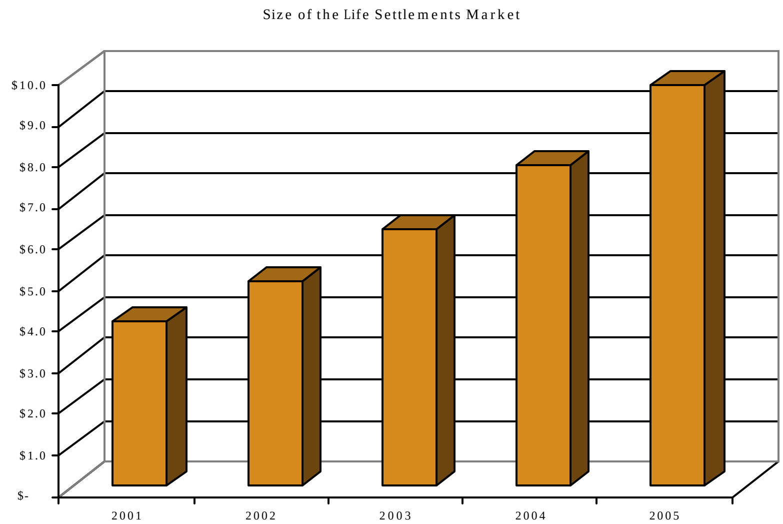
Another one of Mr. Smith's messages was that investors need not be terribly concerned about the future of the life settlement industry and its impact on the broader life insurance market compared with other secondary market products. It's important to compartmentalize the secondary market in two major pieces: life settlements and IOLI/SOLI. Each of these businesses has its own risks and impact on the life insurance market in general. For example, legislators have a different tone in dealing with each of the products, with government seemingly more concerned with IOLI/SOLI than life settlements because of its tax advantages.

Here are some more take-aways from Mr. Smith's talk:

The Market is Big – And it's Getting Bigger

The life settlements business is getting bigger by the day. It has been estimated by Conning & Co. and others that the size of the settlement business has grown from about $50 million in 1991 to $1 billion in 1999 to $5 - $10 billion at present. And the market is continuing to grow as baby boomers age and investment firms "discover" what has generally been a market with stable, steady returns. According to Mr. Smith, the market could continue to grow annually at 20 % - 40 % clip in the future.

Figure 1: Estimated Growth in the Life Settlements Market – 2001 to 2005



Source: Conning & Co., LSI, and Lehman Brothers estimates

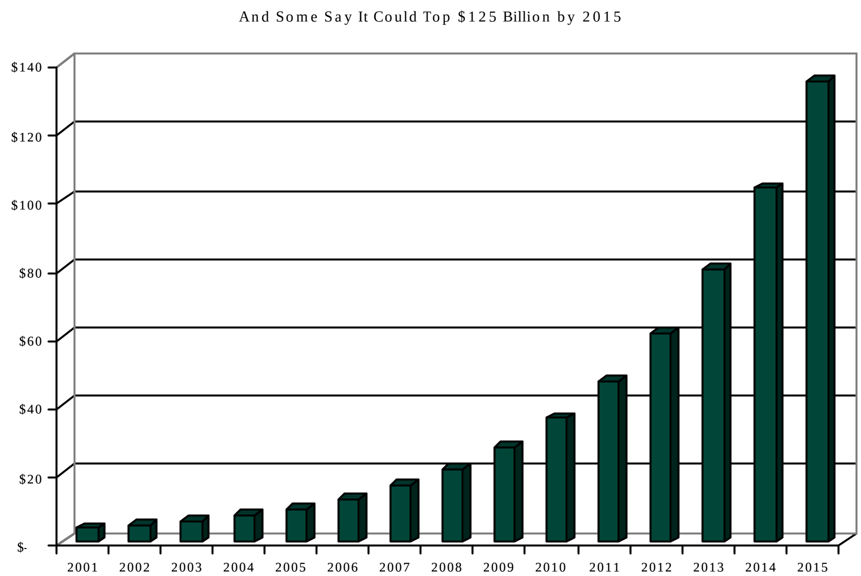
At the same time, the players in the market are becoming increasingly sophisticated and diverse, coming from the largest institutions on Wall Street all the way down to the individual wealthy investors. Most noteworthy among these firms are two insurers, Berkshire Hathaway and American International Group, which has an investment in one of the largest life settlement firms, Coventry First. According to Life Settlement Solutions, a life settlement firm, other influential investors in the market include hedge funds and multinational banks such as Citigroup, Morgan Stanley, Credit Suisse, Abbey National, and Deutsche Bank.

The Future Looks Rosy for Policyholders Who Could See Higher Settlement Amounts In an Increasingly Competitive Market

The future prospects for the settlement market look strong too, according to Mr. Smith. With only about 2 % of seniors having settled their life insurance policies, it's clear that there's more room for growth. Given the current size of the market and Mr. Smith's estimates of how quickly the market can grow, it's entirely possible that, within the next decade, the size of the life settlements market will exceed $125 billion.

And this growth could help aging Americans holding life insurance contracts. With all the new financial institutions eager to participate in the market, it's likely that the market will get more and more competitive, with higher payments being made for polices than is the case today. This is obviously good news for policyholders.

Figure 2: Estimated Growth in the Life Settlements Market – 2005 to 2015



Source: Conning & Co., LSI, and Lehman Brothers estimates

… But Should Lower Lapsation Be A Concern For Investors? Answer: It Depends on Whom You Ask

Ultimately, what do these developments mean to the primary life insurance companies? Will the increased number of participants, higher degree of sophistication, increased market size, and higher payouts to policyholders help or hurt life insurers' bottom lines?

While Mr. Smith obvious has his biases as the LSI, of which he is president, represents life settlement firms, he conveyed the message that the life settlement market poses minimal risk for the life insurance industry. While it is certainly true that every life settlement arrangement equals one death claim that would have lapsed and will now have to be paid by the life insurer, Mr. Smith argued that lapsation assumptions of life insurers are so low that if the results turn out slightly lower-than-expected, it would not be that big of a deal in terms of the hit to earnings. Further, Mr. Smith pointed out that proceeds from life settlement arrangements are often reinvested with the same company in the form of a new policy or some other investment-type product, helping the growth of these insurers.

Finally, trade organizations such as the Life Settlement Institute have made argued that the growth of their industry has resulted in higher sales of life insurance policies. Potential customers who would not have wanted to tie up funds in life insurance products are more likely to buy life insurance if there's a healthy life settlement market. Customers will no longer be scared that they would be locked into holding the policy with no financial recourse should they decide they no longer need the policy other than the small cash surrender value paid by the life insurer.

But not everyone agree with the position of life settlement firms.

Some would argue with Mr. Smith, saying that the life settlement market can be detrimental to the life insurers in our coverage universe. As noted earlier, some companies have claimed that the settlement business has the potential to wreak havoc on life insurers' lapse experience. Even if the original lapse assumption was low, critics of the industry argue, it is still potentially meaningful to an insurer's profitability. And while sales may improve with the further development of the market, there's no guarantee that the settlement amounts will go back into the life insurer. Indeed, if the life insurance policy is being settled for cash, these critics say, why would the policyholder reinvest the proceeds?

Finally, there's the moral hazard involved with the life settlement market. Some companies have expressed concern that some policy holders will inappropriately be encouraged by their agents to sell their policies instead of keeping it for the advantage of their beneficiaries.

The Number One Reason Why The Life Settlements Market is Growing So Rapidly: Policyholders Get Paid More

Aside from the aggressive marketing being done by the life settlements industry, a central reason why the growth has been so solid in the market is because customers are getting a better deal from the settlement companies than they are from the life insurance companies. Policies that once lapsed are now being sold to life settlement companies. Mr. Smith pointed to an internet-based magazine for seniors which gave four examples of instances where an individual was able to settle a life insurance policy for significantly more than the cash surrender value that would have been paid had the policyholder surrendered the policy.

Figure 3: Examples of How Policyholders Have Benefited By Turn to the Settlements Market

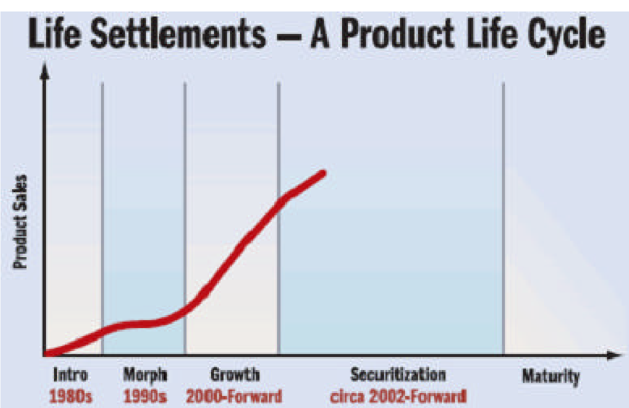
Examples of Life Settlements				
Face Value	Cash Surrender Value	Age	Settlement	
$ 500,000	$ -	70	$ 116,340	
$ 75,000	$ 142,000	76	$ 225,000	
$ 4,000,000	$ 90,000	82	$ 1,430,000	
$ *10,000,000	$ 800,000	varied	$ 3,500,000	
*Aggregate of key man policies				

Source: SeniorJournal.com

The Settlement Market is Getting More Sophisticated

It appears, too, that the strong growth trend is unlikely to change anytime soon. According to the Viatical & Life Settlement Association of America, another life settlements trade organization, the number of new participants has doubled over the past five years. At the same time, the life settlement market has become increasingly sophisticated. A National Underwriter report on life settlements published recently pointed out that the market has moved past the 'Growth' stage and entered the 'Securitization' stage. Whereas in the past, the individual settlement firms used their own capital to invest in the market, now, traditional financing methods for blocks of settlement contracts have been introduced. The reason for this: to encourage the participation of more money managers.

Figure 4: The Life Cycle of the Life Settlements Product



Source: National Underwriter

Differences between Life Settlements & IOLI/SOLI: More Important than You Might Think

Mr. Smith was careful to point out that while the different areas of the secondary market – life settlements, viaticals, IOLI, and SOLI (see appendix for complete definitions - are usually grouped together, the issues and implications of each products are quite unique. Laws governing life settlements are more developed than the laws governing IOLI/SOLI. Also, life insurers have come down hard on IOLI/SOLI policies, voicing in no uncertain terms the belief that the practice is not insurance as it's commonly defined and may skirt insurable interest and tax laws. The bottom line: while legislators may attempt to tax and more heavily regulate the IOLI/SOLI products, it's unlikely that the life settlements will face the same regulatory hurdles.

Conclusion

While there's uncertainty about whether the life insurance companies will be adversely impacted by the life settlements market, a couple of things are clear. The business is already big and it's only going to get bigger. Our call is that the major life insurance companies need to research the topic more, communicating with investors why there lapse assumptions are safe from the potential pitfalls of fewer customers surrendering their policies or letting them lapse. Insurers which don't address the market at all may be setting themselves up for earnings misses in the years ahead.

Appendix A: Definitions

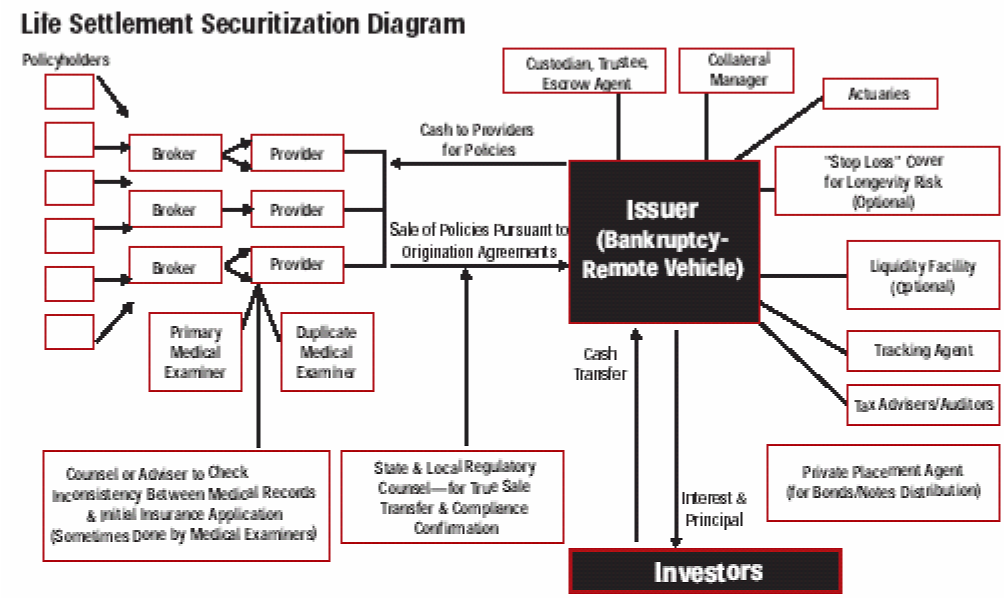
Life Settlement - A Life Settlement is the sale of an existing life insurance policy for a lump sum of cash that is more than the cash surrender value. Through a Life Settlement, a policy owner can realize present value from an asset that is generally thought to only have a benefit when the insured passes away. A *Viatical Settlement* is similar except that the insured has a terminal illness and a life expectancy of under 24 months.

Investor Owned Life Insurance (IOLI) - Refers to life insurance policies that are purchased through non-recourse premium financing. At the end of the loan term, typically 24 to 36 months, the owner can repay the loan and interest, sell the policy into the secondary market, or transfer ownership of the policy to source of financing. If the insured dies during the loan period, the death benefit less the loan balance is paid to the owner/beneficiary.

Life Insurance-Life Annuity Contracts (LILAC) – An arbitrage process in which an income annuity contract and a life insurance contract are purchased with the aim of taking advantage of the difference in mortality pricing and other differences on the two different products. In a LILAC, the annuity contract's income stream is used to fund the life insurance premiums.

Stranger Owned Life Insurance (SOLI) – These are typically life insurance policies purchased by a trust established by a participating charity. The insured is usually a wealthy donor of the charity aged between 75 and 90. The funding is provided by securities issued by an investment bank. Usually these policies are linked to a single-premium immediate annuity to become a LILAC.

Appendix B: Life Settlement Securitization Diagram



Source: A.M. Best

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Other Team Members:

Blinchik, Pavel 1.212.526.1239 pblinchi@lehman.com

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Manulife Financial (MFC)	MetLife Inc (MET)
National Financial Partners (NFP)	Nationwide Financial Svcs (NFS)
Phoenix Companies (PNX)	Principal Financial Group (PFG)
Protective Life (PL)	Prudential Financial Inc (PRU)
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