Conning Research & Consulting
STRATEGIC STUDY SERIES

Life Settlements

An Asset Class Resets

2011

CONNING

Life Settlements

An Asset Class Resets

2011

This publication has been prepared for and distributed exclusively to specific clients of Conning Research & Consulting ("Conning"). Further distribution, sale, or reproduction, in whole or in part, and by any means, is prohibited. Statements and information in this report were compiled from sources that we consider to be reliable or are expressions of our opinion. The report is not intended to be complete, and we do not guarantee its accuracy. It does not constitute and must not be considered investment advice. With offices in Hartford, New York, Dublin, London, and Cologne, Conning is a portfolio company of the funds managed by Aquiline Capital Partners LLC ("Aquiline"), a New York-based private equity firm.

Annual statement information contained herein was in part based on the NAIC Annual Statement Database, via National Underwriter Insurance Data Services/Highline Data.

Conning Research & Consulting

110927

Conning Research & Consulting publishes a number of insurance industry research publications, including its "Insurance Segment Reports" semi-annual line-of-business reviews; its "Forecast & Analysis," which offers a forward look at the industry; and its well-known "Strategic Study" series on key products and issues of interest. All are available on a subscription basis and through our web-based research archive Conning Library.

For more information regarding Conning's publications and services, please visit www.conningresearch.com.

Life Settlements
An Asset Class Resets

TABLE OF CONTENTS

1. Introduction

After the perfect storm that hit the life settlement market in late 2008 and early 2009, a buyer's market emerged. Annual transaction volume decreased as capital retreated from the life settlement market. Conning wrote in 2010 that a prolonged delay in the return of capital could impact the future size of the life settlement as a viable asset class.

In 2011, the buyer's market continues, at least when it comes to new life settlements. As a result, in 2011, Conning began to examine the affect this is having on the future growth and development of life settlements.

Looking at the development of the life settlement market, we see an asset class that is resetting itself in terms of annual volumes to an earlier era. That said, the fundamental appeal of life settlements for certain policy owners remains. This appeal translates into a continued demand by individuals to settle their policies. The ongoing question remains as to whether enough investors will return to meet that demand.

This study reviews the life settlement market as it resets and looks ahead at the challenges and opportunities it faces.

- We review the current market and provide our forecast of how the life settlement market may develop over the medium-term.
- We analyze how the landscape has changed for policy sellers and buyers from the high-point of 2007/2008
- We examine how insurers have responded to STOLI and the impact those responses may have on future growth opportunities.
- We explore the current and emerging regulatory landscape and consider its impact on life settlement providers, policyholders, and investors.

A History of Life Settlement Research

Conning has followed the development of the life settlement market since 1999 because it represents the convergence of several themes we believe confront the broader life insurance industry. First, policyholders increasingly demand products and services that provide consumer flexibility. The life settlement market response has been to meet these demands. This increasing consumer optionality creates a second theme, an accompanying increase in the level of risk in accurately pricing products. Finally, life settlements represent the continuation of third-party providers assisting and influencing policyholder behavior, without concern for the best interest of the insurer.

Our prior studies include:

1999	*Viatical Settlements—The Emerging Secondary Market for Life Insurance Policies*
2003	*Life Settlements—Additional Pressure on Life Profits*
2006	*Life Settlements—The Concept Catches On*
2007	*Life Settlement Market—Increasing Capital and Investor Demand*
2008	*Life Settlement Market—New Challenges to Growth*
2009	*Life Settlements—A Buyers' Market for Now*
2010	*Life Settlements—The Market Stabilizes as Insurer Impact Grows*

2. Executive Summary

After the perfect storm that hit the life settlement market in late 2008 and early 2009, a buyer's market emerged. In 2010 and into 2011, capital has yet to return to the levels of a few years ago. As the life settlement industry adjusts to a prolonged buyer's market, its participants find themselves operating in a changing landscape in terms of acceptable policy criteria, expected returns, regulation, and competition.

Market Review and Forecast

Conning estimates life settlement sales decreased for the third consecutive year in 2010. Capital continues to remain skittish about returning to this asset class, and investors are focused on acquiring distressed portfolios rather than purchasing new policies. Given the combination of death claims and lapses on settled policies, the estimated in force amount of life settlements barely increased over 2009. Based on our analysis of the life settlement market, we estimate that in 2010:

- Approximately $3.8 billion worth of U.S. life insurance face values were settled.

- Approximately $36 billion of U.S. life settlements were in force at year-end.

To understand where this asset class is heading, it is important to look back over its first decade. When we look at the period of 2002 through 2010, we see four distinct periods of change in annual volumes. The first period, 2002 through 2004, represents the emergence of this new asset class from the ruins of the viatical settlement market. Annual volumes increased as investors and policy owners began to learn about life settlements. In 2005 and 2006, an influx of capital, primarily from German investors seeking a tax-advantaged investment and the development of STOLI (stranger-originated life insurance), significantly increased annual sales.

In 2007 and 2008, an influx of capital combined with growing awareness of life settlements among brokers and policy owners (and the continued sale of STOLI policies) increased annual volumes to a high point of $12 billion. This created a seller's market as investors sought more policies to build portfolios. Changes in life expectancy and the economic and credit crisis led to a collapse in annual volumes in 2009 and 2010, and the emergence of a buyer's market for policies.

Looking ahead, Conning forecasts that the annual volume of life settlements, in face amounts, will average around $4 billion per year. In essence, the asset class has reset itself to its initial growth period of 2002 through 2004.

Observed then from a distance, life settlements seem to be entering a new phase that may well result in smaller volumes over the short-term. Meanwhile, the fundamental appeal of life settlements remains. Life settlements continue to offer a value added benefit to policyholders as long as insurers are unable to provide cash surrender amounts that reflect a policy's mortality-adjusted economic value. Life settlements also retain their attraction as an alternative asset class for investors due to the low correlation with equity markets and competitive returns.

Given current economic conditions and investor sentiment, life settlements continue to be a small asset class. The number of policies that could be settled will continue to grow as policy owner awareness increases. However, the level of capital needed to meet that demand may not be available. As result, annual volumes will remain relatively flat over the forecast period. This creates a challenge to the in force amount because new settlements may not be sufficient to replace the amount of policies either lapsing or filing death claims, eventually reducing the amount of settled policies.

Over the medium- and long-term, the asset class's largest growth challenge will be attracting more capital to purchase new policies, rather than seek vulture-investing opportunities among distressed portfolios. Meeting that challenge will determine the asset class's ultimate size.

The Investor's Market Landscape

As with all types of assets and the markets where they are traded, life settlements exist in a changing landscape. If the life settlement market is resetting itself, in terms of annual face amount settled, to the 2005/2006 era it is useful to understand how the current landscape is both similar and different from that era. The comparison between these similarities and differences may provide some indication of what challenges have been resolved and which remain. This chapter explores the similarities and differences from the policy seller's point of view.

An Unchanged Opportunity

Have life settlements lost their fundamental appeal? Are life settlements destined to go the way of viaticals? The short answer is no. The appeal of life settlements to policy owners stems from the relatively higher amounts they receive for selling their policies than for surrendering or lapsing. That difference is the result of the low surrender values priced into an insurance policy.

It is this higher payout to policy owners whose cash value policies have not been in force for a significant period that is the appeal of life settlements. In essence, life settlements meet a need that insurers cannot match. Even if nonforfeiture laws allowed for medically underwritten surrenders, the insurers incurs costs associated with acquiring a contract that affect its ability to match the offer. Those costs had not been recouped, and paying the higher surrender value on younger policies creates an immediate loss.

If policy owners of relatively young policies were thinking of either lapsing or surrendering their policies, then it made economic sense for them to seek the highest possible value for those policies. Because nonforfeiture regulations do not permit insurers to differentiate cash surrender values based on current life expectancy, creating the opportunity for life settlement providers to offer more for a policy, on a selective basis, than the insurer is able to pay, the appeal of life settlements remains.

Insurers Respond to the Impact of STOLI and Life Settlements

The length of time since a life settlement policy was issued has another implication on the future of the life settlement market. If the majority of the policies settled in the past were within a few years of issue, it may be some indication that STOLI sales played a much greater role in the life settlement market than suspected. For example, the life settlement industry has stated that its target audience is a policy owner who no longer wants or needs their policy. However, if 51% of policies were settled within four years of issue, this would appear to challenge that point. Either these policies contain many STOLI sales, or agents are selling policies (especially high face value policies) to older individuals who are either unable to continue premium payments or perhaps never needed the product in the first place.

Insurers are making efforts to monitor policies for STOLI. In some cases, this monitoring has led to rescission of the policy or the contestation of claims. *The Wall Street Journal* reported in 2010 that insurers had filed more than 200 civil law suits in various states over alleged STOLI transactions. This monitoring has also led some insurers to report suspected STOLI cases to legal authorities, which in turn, has led to criminal charges brought against the individuals involved in the STOLI scheme. States are also taking an active role in combating STOLI sales by implementing anti-STOLI legislation as well as filing charges in cases of suspected fraud.

However, the existence of so many STOLI cases may indicate a potential weakness in the underwriting and approval process for high face value policies. In these cases, somehow, the insurer issued policies that it later contested in court. Either the agent committed fraud and it was not detected during underwriting, or it was detected during the underwriting process, yet approved for issue anyway.

Two things are troubling if insurers are issuing high face value policies after being aware of potential STOLI issues. First, these policies, relative to smaller face value policies, have a larger financial impact on the insurer if the insured dies before policy costs are recouped. Second, problems in the underwriting and approval process that allow potential STOLI cases to be issued may hinder later efforts to contest any claims.

What does this mean for policy sellers as the life settlement market reboots? Most importantly, the length of time after policy issue matters. If the policy has been in force for a long period, insurers may be less likely to challenge the death claim or sale. On the other hand, policy owners who want to sell their policies relatively quickly after issue may find their policies contested by insurers.

Mitigating STOLI may also impact the ability of insurers to realize new sales from an emerging market opportunity. The growth in new insurance sales among older individuals is greater than for younger customers. In addition, these older insureds tend to buy high face value policies. However, insurers may well be tightening their underwriting process to identify STOLI during application and protect the insurer's ability to successful sue after issue. This tighter underwriting can lead to delays in policy issuance, which can frustrate the agent and the customer.

The Sell Side Market Reboots

The life settlement market, in 2005, was a wild west for policy owners. It was largely unregulated. Transparency about the fees and commissions taken from the offering price from investors was lacking. As a result, policyholders were at a disadvantage in evaluating the true value of their policy. Both agents and policyholders were largely unaware about the existence of life settlements and the settlement process. Investors were selective in the types of policies they purchased, the face amounts, and health criteria.

The sell-side is no longer the wild west of 2005. Like the old frontier towns, civilization has arrived and tamed the west. Consumer and agent awareness of life settlements has increased. Once the existing pool of settled policies has been repurchased, lapsed, or had death claims filed, those investors that remain will return to buying policies.

As investors return to life settlements, they will find clearer, and more stable, regulation. These returning investors will be dealing with better-educated consumers and agents. At the same time, policyholders will find that the criteria investors used to judge the appeal of a policy has changed. Having focused on high face values and older (and sicker) policy owners when the life settlement market emerged, investors relaxed those criteria when it was at its height in 2007 and 2008. However, the buyer's market has led to the tightening of these criteria. As a result, policyholders may find themselves with less opportunity to sell their policies.

From the perspective of life settlement investors, the events of 2008 and 2009 changed their landscape. The risks of inaccurate life expectancies and dependence on leverage became apparent. Larger institutional investors, especially investment banks, exited the asset class. Taxation changed causing funds to relocate their operations. Investment fraud continued to rear its head, causing some degree of concern among potential new investors. These factors came together to create the current buyer's market. However, for those investors that continue to participate there are several key points that point towards a more positive future.

The Investor's Opportunity Remains

Life settlements attracted investors for two main reasons. First, the asset class has a low correlation to fixed-income and equity securities. Second, life settlements still offer investors the potential to generate a competitive return.

Life settlement investors view insurance as an asset with a low correlation to equity or interest rate changes. For investors who have a large portion of their assets in equity or debt, adding life settlements as an alternative investment is one way to reduce a portfolio's exposure to sudden downturns in the stock or bond markets. Low correlation is not the same, however, as noncorrelation.

Lower interest rates affect the premium optimization used by life settlement investors. Life settlement investors use the premium flexibility of UL (universal life) to increase their return by "optimizing" the premiums they pay to the insurer.

Life settlements continue to offer the potential to generate competitive returns for investors. However, the buyer's market has brought forth two distinct markets for policies. The secondary market involves the purchase of policies from the individuals who initially took the policy out. The tertiary market involves the purchase of already settled policies, either singularly or in portfolios, from other life settlement investors. Both markets command a premium over similar risk-free rates, however, the secondary market appears to offer a higher premium for investing in new policies.

People considering allocating capital to life settlements are aware that they are at some degree of risk of losing their investment. Therefore, life settlement investors either consciously or subconsciously require an investment risk premium over a comparable risk-free investment. Life settlement investors in the secondary market also appear to be commanding a buyer's premium due to the lack of investor capital available to purchase policies in the secondary market.

In the tertiary market, the supply of capital interested in buying already settled policies and portfolios is creating enough competition for already settled policies and portfolios that investors need to reduce their IRRs (internal rates of return) and by extension increase their offer in order to win business. Given that LEs (life expectancies) and face amounts are comparable between the secondary and tertiary markets, any advantage found in bottom fishing for bargains among already settled policies or portfolios may be declining.

The Investment Side Reboots

As the life settlement market reboots, investors will continue to find an opportunity to make returns that are higher than other fixed income investments. Returning life settlement investors will understand life expectancy risk better. They will also face a legal landscape that has seen several recent cases that strengthened their ability to receive death benefits. In addition, if the life settlement market remains small in terms of the number of buyers, then IRRs may remain high.

Investors rely on life expectancies from underwriters, and often from more than one, as a major pricing component. Those life expectancies flow through to portfolios, where fund managers use them to calculate policy values over time. As the life settlement market reboots, investors will continue to remain concerned about the accuracy of life expectancies. However, efforts to standardize life expectancy methodologies should contribute to a reduction of concern among some investors.

Several court rulings in 2010 and 2011 limited the ability of life insurers to contest death claims. The life settlement industry has engaged with life insurers over policy rescission and denial of death claims since it began.

Life insurers have always resisted some death claims. However, with the rise of life settlements, some insurers have been more forceful in resisting suspected STOLI and other life settlement claims. Evidence of this can be seen in comparing the dollar amount of resisted claims for the ten insurers who have been the greatest focus of life settlement investors against the remaining industry. Against this background of an increase in resisted claims, recent court rulings have favored the life settlement industry. These cases are a positive development for investors.

What will be some broad investor themes that might emerge as the life settlement market reboots?

The life settlement market of 2006 through early 2008 saw several large investment banks enter the space. After the credit crisis and recession of late 2008 and early 2009, many left for a variety of reasons. Their withdrawal was a major factor in the reduction in capital to buy policies. As of 2011, the gap created by the withdrawal of those large investors has not been filled.

Investors can purchase settlement portfolios for only so long. At some point, these portfolios will be held until the policies in the portfolio lapse or a death claim is paid on them. This will cause capital to return to buying new policies. As it does, competition for policies will lead to higher offers being made, lowering the return for investors.

Finally, a smaller market, in terms of the number of players and the capital they bring, may benefit life settlement investors already in the market. The less capital available means that life settlement investors can continue to demand a capital premium in addition to their risk premium.

Glossary

Life settlements are an emerging asset class. As a result, the terminology used in this market is still evolving. For the purposes of this study, Conning will use the following terminology:

Life Settlement Glossary

Term	Definition
Physical Life Policy	A life insurance policy that is underwritten and issued by an insurance company on the life of an insured.
Traditional Life Settlement	The purchase of a physical life policy by a buyer on an investor's behalf.
Extracontractual Loan	Loaning an individual an amount in excess of their physical life policy's cash surrender value, and using that policy's death benefit as collateral.
Synthetic Life Policy	A virtual policy created by investment firms based on data from a pool of lives.
Measuring Life	An individual whose demographic and health data are used to price a synthetic policy and whose death triggers the payment of a synthetic death benefit. This is similar to the insured in a physical life policy.
Synthetic Life Settlement	The purchase of a synthetic life policy by a buyer on an investor's behalf.
Gross Market Potential	The total face amount of all policies that meet life settlement buyer criteria, regardless of whether the policyholder wants to sell.
Net Market Potential	The percentage of all policies that meet life settlement buyer criteria where the policyholder is likely to consider selling.
In Force Amount	The cumulative face amount of all life settlements where the insured is still alive.
Annual Volume	The face amount of all life settlements transacted in a given year.
Buyer	An institution that purchases policies on a fund manager or investor's behalf.
Fund Manager	An institution or individual that manages a portfolio of life policies on behalf of investors.
Investor	An institution or individual that supplies capital to purchase life settlements.
Secondary Market	A market where the original policyholder sells their policy to a buyer.
Tertiary Market	A market where buyers, or fund managers, resell individual policies or portfolios of policies.

3. Market Review and Forecast

Conning estimates that life settlement sales decreased for the third consecutive year in 2010. Capital continues to remain skittish about returning to this asset class, and investors are focused on acquiring distressed portfolios rather than purchasing new policies. Given the combination of death claims and lapses on settled policies, the amount of in force life settlements barely increased over 2009. Based on our analysis of the life settlement market, we estimate that in 2010:

- Policyholders settled approximately $3.8 billion worth of U.S. life insurance face values.

- Investors held approximately $36 billion of in force U.S. life settlements at year-end.

The following sections analyze the 2010 U.S. life settlement market and its potential growth over the coming decade. Subsequent chapters analyze the factors and issues influencing the current market and its future development.

Life Settlement Market Review

Questions regarding the current size of the life settlement market are among the most frequent queries we receive at Conning. There is no official source of the information, or independent party, to which all life settlement providers report the volume of policies purchased. As a result, Conning bases its estimate on a variety of sources.

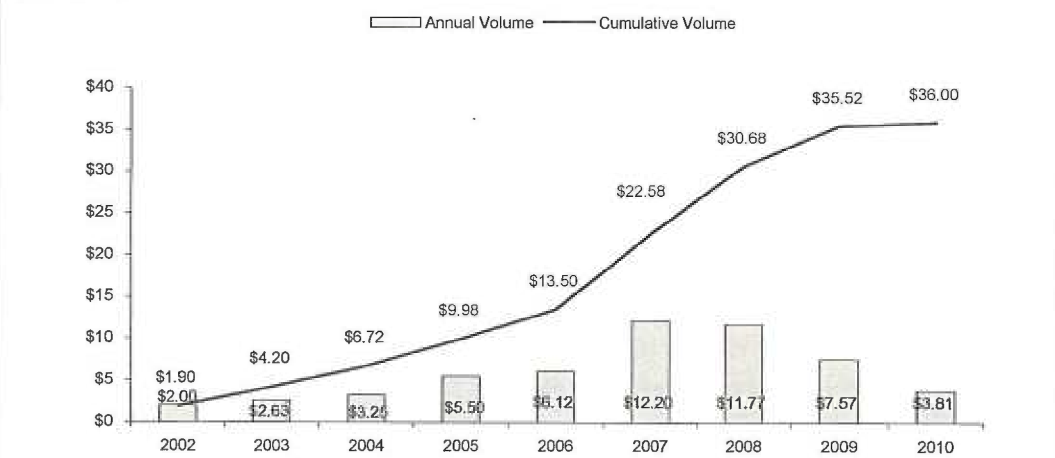
In addition, beginning with this edition, we must recognize that it is not possible to distinguish the resale of already settled policies from newly settled policies. Anecdotal evidences indicate that a significant amount of capital that did come into the asset class in 2010 was directed at purchasing existing portfolios of settled policies, rather than new policies. Therefore, our annual volume for 2010 forward reflects a mixture of new and resold policies.

Conning Annual Estimate

After analyzing the current market from several perspectives, we estimate that U.S. life settlements in 2010 represented approximately $3.8 billion in face value. This was almost a 50% decrease from our estimated $7.6 billion in 2009.

Our analysis indicates that the cumulative face amount of in-force life settlement policies, which are polices still in force with insurers and owned by life settlement investors, increased 1% in 2010 to approximately $36.0 billion. This small increase reflects the combination of lower new sales combined with death claims on policies already settled as well as lapses of settled policies from fund managers unable to continue premium payments due to their financial difficulty.

Conning Estimate of Annual and Cumulative U.S. Life Settlement Volume
($ in billions)



Source: Company filings, Conning Research & Consulting analysis

Estimate Methodology

The life settlement market lacks a central database of reported transactions. As with our prior studies, we begin our estimate by using the growth in face amount for several life settlement funds and investors. These funds reported approximately $22 billion of in force life settlements for 2010.

Not all of the funds in our sample experienced growth in 2010. In fact, individual results ranged between –5% and 179%. It is important to note that a new life settlement policy has a greater impact on a portfolio with fewer policies than one with a large number of policies. In dollar terms, the growth of in force life settlements ranged from –$121 million to $1.4 billion for the funds in our sample.

In addition to being a source to estimate settlement volumes, these life settlement funds are a data source about the numbers of policies in their in force business. These funds reported 7,100 policies in their portfolios in 2010, a 5.8% increase from 2009, albeit the majority of the increase was in two funds.

Key Long-Term Drivers

The conditions that brought about the current buyer's market continue to exist. How long these market conditions will last is unknown. However, certain key long-term drivers provide signposts of changes to the current buyer's market.

Key Long-Term Drivers

Driver	Impact on Line of Business
Credit Markets	The availability of affordable credit affects the ability of portfolios to finance and acquire policies.
Consumer Demand	Consumer demand affects the availability of policies for purchase.
Regulatory Oversight	Regulation can affect the availability of investor capital as well as consumer demand.
The Tertiary Market	The availability of a tertiary market affects investor demand for new policies.
Life Expectancy Estimates	Significant changes in life expectancy estimates can reduce investor confidence in current policy valuations.
Life Insurer Responses	The development of life settlement alternatives by life insurers can absorb policyholder demand, reducing the available supply for investors.

Credit Markets

In 2010, the ability of some fund managers to finance policy premiums remained restricted. This hampers the settlement of new policies, as fund managers are unable to finance premiums on policies.

Consumer Demand

In 2010, fallout from the recession continued to affect many policyholders, particularly in the form of persistent high unemployment. This created a potential market environment where more policyholders may consider settling their policies. Life settlement's challenge moving forward is whether the life settlement industry can successfully attract the capital to meet this demand.

Regulatory Oversight

Life settlements have attracted regulatory attention over the past few years with the NAIC (National Association of Insurance Commissioners) and NCOIL (National Council of Insurance Legislatures) proposing model legislation aimed at curtailing abusive practices. In 2010, several court cases, most noticeably *Kramer v. Phoenix Life Insurance, et al.*, clarified issues surrounding the contestability of death claims by insurers.

The Tertiary Market

Conning refers to the sale of existing life settlement assets from one investor to another as occurring in the tertiary market. The presence of existing portfolios owned by funds that are in financial difficulty enables capital to focus on acquiring those portfolios rather than purchasing new policies. As long as these sales continue to attract capital, the ability of current policy owners to settle their policies will remain limited. In 2010, and continuing into 2011, the sales of several large portfolios were announced. These sales provide some indication that capital is willing to purchase existing portfolios.

Life Expectancy Estimates

Competition for policies has led to an increase in what investors and buyers view as acceptable life expectancies. Longer life expectancies increase the longevity risk, the risk that an insured may outlive their policy, borne by investors. Therefore, investors are especially concerned about the accuracy of the life expectancies used to calculate purchase prices and value portfolios. There were no major announcements of changes being made to life expectancy calculations during 2010. In that same year, several key life expectancy underwriters began to collaborate to produce an industry standard for estimating life expectancy.

Life Insurer Responses

Looking ahead, how life insurers respond to increasing consumer awareness of the potential to access greater-than-cash surrenders values from their policies will be crucial in shaping the life settlement industry's future. In 2010, several court cases were resolved that reduced the ability of insurers to restrict legitimate life settlements.

Conning's Life Settlement Market Forecast

Estimating the amount of life settlements in the previous year is important; however, the key strategic question for life settlement investors and buyers is the market's growth potential. Is there a sufficient pool of capital to support a growing demand from policy owners who want to settle their policies?

We believe that over the coming decade, demand will be larger than the capital available to absorb it. As a result, this asset class will find itself being reset to an earlier part of its development in terms of annual volumes being settled.

Gross Market Potential Forecast

Two factors drive the demand for life settlements. The first is the number of policies that could meet investor criteria. Conning refers to the total of in-force life insurance face amounts that meet the criteria used by life settlement buyers and investors as the U.S. Gross Market Potential.

U.S. Gross Market Potential*

*Gross Market Potential is not the amount that Conning projects to be settled in any given year. Rather, it provides the starting point for developing that estimate.

This represents the amount of policies that meet buyer and investor criteria, regardless of whether the policyholder has settled their policy, or has any interest in settling their policy.

Forecast Criteria

In our 2007 strategic study, *Life Settlement Market—Increasing Capital and Investor Demand*, we identified the criteria commonly used by life settlement investors in selecting a policy. Based on those criteria, we estimated the life settlement's Gross Market Potential. At that time, our criteria were that the original policyholder was:

- 55 years old or older,
- Owned a cash value life insurance policy,

- Was possibly lapsing or surrendering that policy, and

- Their health, while not terminal, is significantly impaired.

- Finally, the policy's face value was $100,000 or higher.

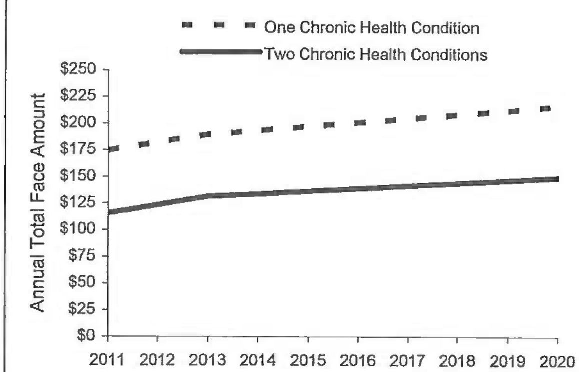
These criteria point towards an increasing gross market potential in both the number of transactions and the face amounts of insurance they represent in 2011 through 2020.

The Gross Market Potential for 2011-2020

Conning estimates the average U.S. Gross Market Potential where the insured is impaired by only a single health criterion will range between $174 billion and $216 billion in face value for 2011 through 2020, for an average Gross Market Potential face value of $198 billion.

Should investors focus on policies where the insured suffers from two health criteria, this would reduce the number of eligible polices. As a result, the range would be between $115 billion and $150 billion in face value with an average Gross Market Potential face value of $136 billion.

Conning Forecast of U.S. Life Settlement Gross Market Potential
($ in billions)



Source: Company filings, Conning Research & Consulting analysis

Our analysis of market conditions indicates that investors have used the buyer's market to purchase higher face value policies from older individuals with shorter life spans. Given lower capital levels flowing into this asset class, we would expect that investors would be more selective in their policies, primarily in terms of life expectancy.

Net Market Potential Forecast

The second factor that determines the demand for life settlements among policy owners is their willingness to settle policies. Not everyone who has a policy that meets investor criteria would be willing to settle their policy. We refer to the percentage of policy owners that meet investor criteria and who would consider settling their policies as the

Net Market Potential. Net Market Potential is important because it puts a ceiling on the face amount of policies that could be settled at any given point.

With an average annual Gross Market Potential with one health condition of $198 billion over the next ten years, Conning estimates that the average annual Net Market Potential is 69% or $138 billion.

The Net Market Potential for 2011-2020

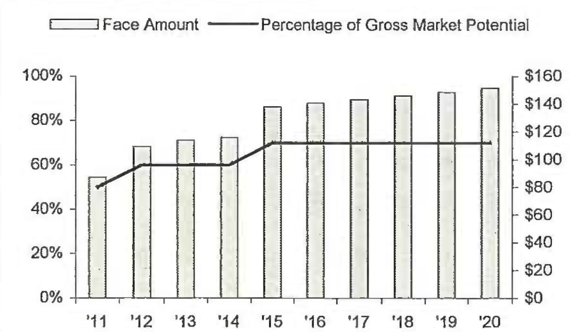
Our forecast indicates that Net Market Potential will increase from $87 billion in 2011 to $151 billion in 2020. This increase represents two forces at work. First, the Gross Market Potential increases over time driven by demographic forces. This translates into more policies being available for surrender. Even in the percentage of individuals willing to surrender their policies remains unchanged, the net market potential's face amount would increase.

Second, policy owner awareness of life settlements continues to increase, raising the percentage of owners who might consider settling their policies. That said, the percentage of policy owners willing to consider settling their policies will reach a limit. The exact timing of when policy older awareness reaches that limit, and the percentage that limit might be, is subject to judgment.

The accompanying chart illustrates the impact of these changes on Net Market Potential. We hold the upper limit at 70% because a certain percentage of policyholders will not settle their policy. The increasing face amount in the years 2012 through 2020 reflect the increase in Gross Market Potential.

Conning Forecast of U.S. Life Settlement Net Market Potentials

($ in billions, one health criterion)



Source: Company filings, Conning Research & Consulting analysis

The implication for the development of the life settlement market over the next decade is one of continued growth in the number, and face amount, of policies that could be settled.

Identifying the Net Market Potential

Estimating the percentage of policyholders who might settle their policies is difficult because little data exists to measure consumer awareness of life settlements. We rely on what data is available to establish upper and lower boundaries of demand. We compare those boundaries with our estimate of the current in force block of life settlements to create a current Net Market Potential. We adjust the current estimate based on our understanding of where consumer awareness is heading and what may increase or decrease that awareness over time.

Our $36 billion estimate of the face value of in force life settlements, for 2010, is 22% of the Gross Market Potential if one health condition is used, and 36% if two health conditions are used.

In April 2010, the Insurance Studies Institute announced the results of a small survey of U.S. seniors. In this survey, 40% had lapsed or surrendered their life insurance policies. Of those who had lapsed or surrendered, 61% stated they were not interested in a life settlement. At the same time, 69% of respondents said they were not concerned about investors owning policies on their lives. Combining these results produces a Net Market Potential band with 40% as the lower limit (100% less the 60% who expressed no interest in life settlements) and 70% as the higher limit (100% less the 30% who were concerned about investors owning their policies). We use these limits to guide our estimates over the forecast period. The average between these two bands is 55%, and we further reduced it 50% to provide a degree of conservatism to our estimate.

Drivers of Change to Net Market Potential

Our Net Market Potential forecast assumes that it should not remain level at current levels, but rather increase over time. The drivers of this increase are consumer and broker awareness and need.

Educational campaigns by the life settlement industry to both brokers and policyholders should increase awareness. Recent economic conditions have led to increased reporting on the potential to use life settlements as a revenue source for policyholders strapped for cash. Both should further contribute to consumer and broker awareness about life settlements.

Changes in Life Settlement Net Market Potential Drivers

Criteria	2011–2012	2013–2020
Consumer Awareness	Moderate	Strong
Consumer Demand Drivers	Beginning need for additional retirement income	Increased demand for retirement income and long-term care

Source: Conning Research & Consulting analysis

Over the long term, life settlements may be a source to fund retirement income as Baby Boomers exit the work force beginning in 2011. There are life settlement providers collaborating with long-term care providers to provide a solution for families confronting the challenge of paying for long-term care. This development holds the potential to increase policyholder awareness of life settlements, the supply of policies, and because of the rising cost of Medicaid payments, this may alter the debate within state legislatures about efforts to dissuade the growth of life settlements.

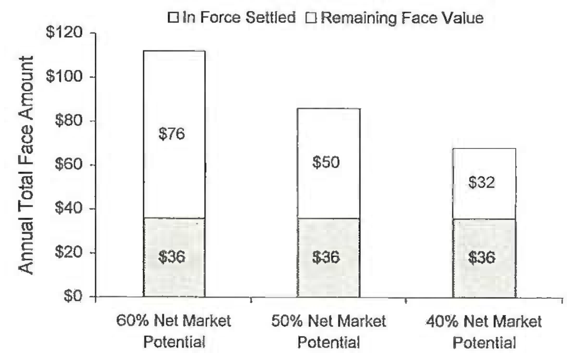
Offsetting this increase is the reinstitution of the estate tax. Large face value policies have always been a tool used by wealthy individuals in their estate tax planning. The lack of such a tax may have contributed to the decision of some individuals to settle these policies because there was less need to provide for that eventual tax. Should the estate tax return, future policy owners may elect to keep their policies, even though they are aware of the possibility of settling them. It is not possible to quantify with accuracy the negative impact this could have on Net Market Potential.

As a result, we forecast that the Net Market Potential will not remain static, but rather has increased and will continue to increase.

In Force Life Settlements Forecast

Net Market Potential establishes a ceiling on the growth of life settlements. The amount of in force life settlements acts as a floor. Any remaining growth can only reflect the "space" between the floor and ceiling. If the ceiling remains static, in force growth will reduce the amount of available life settlements. Alternatively, if the amount of in force grows faster than the increases in the ceiling, the amount of available life settlements also becomes smaller.

Conning Estimate of 2010 U.S. Policies Remaining for Life Settlement
($ in billions, one health criterion)



Source: Company filings, Conning Research & Consulting analysis

In Force Estimate Methodology

Conning estimates the in force block of life settlements by taking the earliest amount of settlements from our annual estimate. We track the average life expectancies of the portfolios in our sample set. Using their average life expectancy, we project the maturation of that initial block of settled policies. We repeat the exercise for each subsequent year's annual volume. We then sum the amount of settled policies still in force for each year.

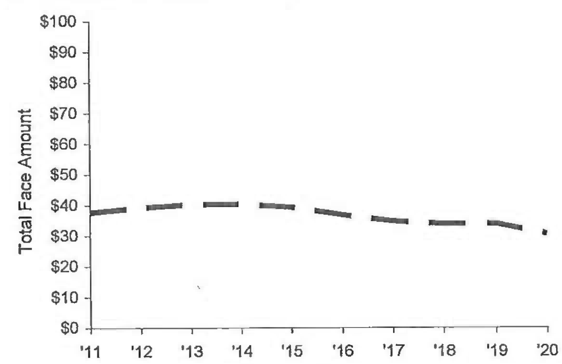
Two key factors can change the amount of in force life settlements. The first is the amount of new life settlements purchased each year. The second is the life expectancies of those policies. Longer life expectancies mean that the policies remain in force for a longer length of time. This adds to the amount of in force policies.

A Lower In Force Amount for 2011-2020

The prolonged buyer's market will significantly reduce the amount of in force business over the period of 2011 through 2020. Over this period, Conning estimates the average in force amount of life settlements will be $36 billion. This is significantly lower than the $63 billion in our prior forecast.

The reason for this difference is that we feel capital will not return in significant amounts to this asset class over this period. As a result, the number of new policies settled each year offset those that either lapse or have death claims filed rather than increase the amount of in force settled policies. Over time, the number of lapses and death claims exceed the number of new policies settled, resulting in a lower in force amount of life settlements. By the end of the forecast period, the in force amount will be slightly over $30 billion, a 17% decrease from the estimated amount for 2010.

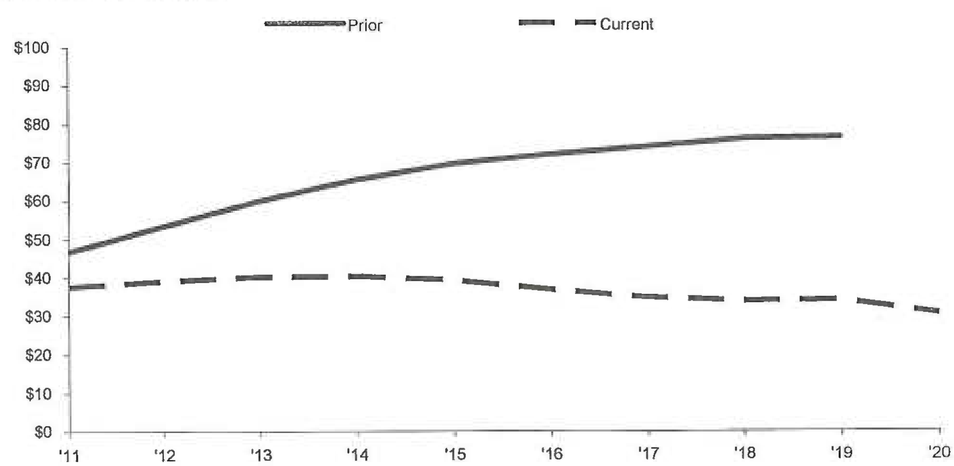
Conning Forecast of In Force U.S. Life Settlements
($ in billions, one health criterion)



Source: Company filings, Conning Research & Consulting analysis

The following graph illustrates the differences between our 2010 strategic study and this 2011 strategic study.

Conning In Force Forecast Comparison
($ in billions, one health criterion)



Source: Company filings, Conning Research & Consulting analysis

It is important to note that lapses of settled policies due to an inability of fund managers to continue making premium payments may play a significant role in lowering the amount of in force policies. Some funds have struggled to maintain premium payments on policies they purchased as credit became less available, or unavailable, and deaths did not occur as projected. As their policies lapse, the amount of in force settled policies decreases.

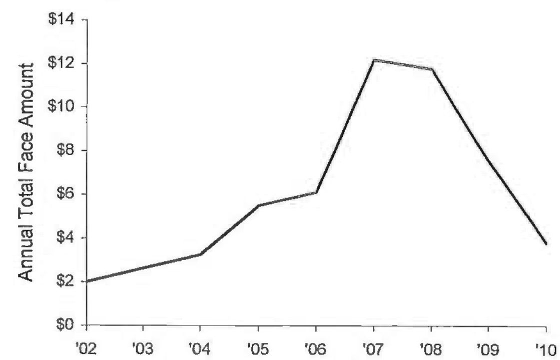
Annual Volume Forecast

Over the ten-year period from 2011 through 2020, Conning estimates the average annual amount of life settlements will be $4 billion. While annual growth with continue to decrease over the short-term, we estimate it will return to positive, albeit low, growth over the medium-term and remainder of the forecast period. We base this on our analysis of broader investor concerns and continued uncertainties around this asset class.

A Decade in Review

To understand where this asset class is heading, it is important to look back over its first decade. Conning has estimated the annual volume, in face amount, of policies settled since 2002. This historical record provides a context to evaluate where this asset class might be headed over the coming decade.

Conning Estimate of Annual U.S. Life Settlement Volume: 2002 - 2010
($ in billions)



Source: Company filings, Conning Research & Consulting analysis

When we look at the period of 2002 through 2010, we see four distinct periods of change in annual volumes. The first period, 2002 through 2004, represents the emergence of this new asset class from the ruins of the viatical settlement market. Annual volumes went from $2 billion to $3.3 billion as investors and policy owners began to learn about life settlements. In 2005 and 2006, an influx of capital, primarily from German investors seeking a tax-advantaged investment and the development of STOLI, increased annual sales to $5.5 billion and $6 billion.

In 2007 and 2008, an influx of capital from Asia as well as from larger institutional players combined with growing awareness of life settlements among brokers and policy owners (and the continued sale of STOLI policies) to increase significantly annual volumes to the $12 billion range. This capital created a seller's market as investors sought more policies to build portfolios. Of course, changes in life expectancy and the economic and credit crisis led to a collapse in annual volumes in 2009 and 2010, and the emergence of buyer's market for policies.

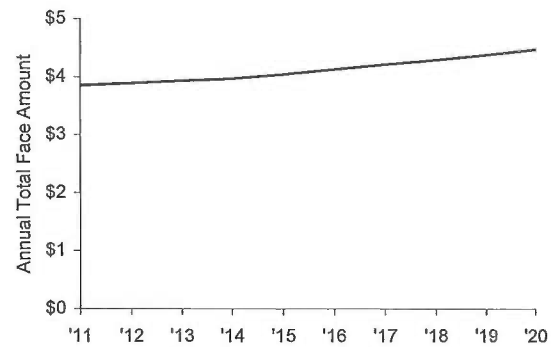
A Market Resets

Looking ahead, Conning forecasts that the annual volume of life settlements, in face amounts, will average around $4 billion per year. In essence, the asset class has reset itself to its initial growth period of 2002 through 2004.

This is a reduction from our prior two forecasts. Therefore, what has caused us to make the adjustment?

Conning Forecast of Annual U.S. Life Settlement Volume: 2011-2020

($ in billions, one health condition)



Source: Company filings, Conning Research & Consulting analysis

The Positive Side

On the positive side, several factors are in play that suggests this asset class will not disappear. First, and foremost, is that unless life insurers develop a mortality-adjusted cash surrender value, life settlements will continue to provide an economically competitive alternative to lapsing or surrendering some policies. Combined with growing broker and policy owner awareness of life settlements (especially as states adopt regulations that require disclosure to the life settlement options to policy owners) the supply of policies will not decrease. In fact, as seen in our forecast for Gross Market Potential and Net Market Potential, that supply and demand is projected to increase.

Second, and equally important, we forecast there will be some ongoing demand from some alternative asset investors for the low correlation to equity and debt markets that life settlements can offer.

Third, the issue around changes in life expectancy should lessen as an impediment for investors. Efforts to educate investors by fund managers, along with initiatives to standardize the methodologies used to estimate life expectancies and improvements to the pricing of policies and portfolios to account for the variability in those estimates, should increase investor confidence. It is important to note that we are not saying that life expectancy will be reduced as a risk. Rather these efforts may shift the perception of that risk among investors from an unexpected event (which occurred in late 2008 and early 2009) to a widely understood risk that an investor needs to accept (similar in fashion to fluctuations in the equity prices.)

Fourth, the regulatory environment surrounding life settlements continues to settle. At the state level, the adoption of NAIC and NCOIL model acts improves the disclosure of information to policy sellers. At the same time, interest in the asset class by the SEC (Securities and Exchange Commission) and European securities regulators should strengthen investor protection, reducing concerns about investment fraud. In addition, court rulings in favor of life settlements increase the likelihood that insurers will be less able to deny death claims.

The Negative Side

If there are several factors that suggest the continued growth in the supply of policies, why are they not reflected in higher levels of annual growth? The simple answer is a lack of capital. Some level of capital will continue to flow to this asset class. What we are less certain of, and have difficulty seeing develop, is a strong return of capital in amounts that reflect the 2007 and 2008 levels.

As we look at investor concerns, liquidity appears to be the largest hindrance to a strong return of capital to life settlements. Without an efficient tertiary market where already settled policies can be sold, it will remain difficult for fund managers to provide a degree of liquidity to their investors. It is important to note that we view this as a hindrance, not a roadblock. There will always be some number of investors willing to commit capital for an extended period in a product with low, or no, liquidity. However, concerns about liquidity reduce the number of investors ready to make that commitment.

This is one place where life expectancy does come into play. If investors are being asked to commit capital to life settlements for a seven to ten year period, and have little expectation of being able to withdraw capital in a timely fashion if at all, then one of two things happen. Either there are fewer investors willing to invest, or the returns on their investment will need to increase.

If fewer investors are willing to make that commitment, then the amount of capital will be lower. On the other hand, fund managers can only offer so much in the way of return before the offering price to a policy owner is no longer economically competitive against a policy's cash surrender value.

Adding to this challenge is that interest rates have been artificially low over the past few years, and will inevitably rise over the coming decade. An increase in interest rates, all else being equal, creates the same difficulty in offering a competitive price for the purchase of new policies. At the same time, rising interest rates increase the appeal of other investments with greater liquidity, which attract some capital that could have gone to life settlements.

Looking Ahead

Conning feels that, given current economic conditions and investor sentiment, life settlements will continue to be a small asset class. Demand for the settlement of policies will continue to grow. However, the level of capital needed to meet that demand may not match it. Annual volumes will remain relatively flat over the forecast period. This flatness creates a challenge to the in force amount because it may not be sufficient to replace the amount of policies either lapsing of filing death claims. Should this occur, the type of maturing market that we projected, where the amount of in force policies approaches the net market potential, may not materialize.

It is important to consider what the lack of a maturing market means when it comes to the future development of this asset class. Given a growing supply of potential life settlements, if the buy side can identify and develop solutions to issues surrounding liquidity (as it is in the process of doing for life expectancies), it is possible that capital may return in a stronger fashion. If it does, investors will find a richer supply of policies that may be purchased at more attractive prices than would be the case in a mature market.

The remainder of this study will look at some of issues on the supply side and buy side that key players in this asset class should be thinking about if life settlements are ever to reach their potential of providing a value added benefit to policy owners.

Summary

Conning estimates life settlement sales decreased for the third consecutive year in 2010. Capital continues to remain skittish about returning to this asset class, and investors are focused on acquiring distressed portfolios rather than purchasing new policies. Given the combination of death claims and lapses on settled policies, the in force amount of life settlements barely increased over 2009. These developments have implications for the future growth of the life settlement market. If new assets are not added in sufficient amounts to offset policies that lapse or have death claims filed, over time the amount of in force settled policies will decrease.

Based on our analysis of the life settlement market, we estimate that in 2010:

- Approximately $3.8 billion worth of U.S. life insurance face values were settled.

- Approximately $36 billion of U.S. life settlements were in force at year-end.

To understand where this asset class is heading, it is important to look back over its first decade. When we look at the period of 2002 through 2010, we see four distinct periods of change in annual volumes. The first period, 2002 through 2004, represents the emergence of this new asset class from the ruins of the viatical settlement market. Annual volumes increased as investors and policy owners began to learn about life settlements. In 2005 and 2006, an influx of capital, primarily from German investors seeking a tax-advantaged investment and the development of STOLI, increased annual sales.

In 2007 and 2008, an influx of capital combined with growing awareness of life settlements among brokers and policy owners (and the continued sale of STOLI policies) to increase significantly annual volumes to a high point of $12 billion. This created a seller's market as investors sought more policies to build portfolios. Changes in life expectancy and the economic and credit crisis led to a collapse in annual volumes in 2009 and 2010, and the emergence of buyer's market for policies.

Looking ahead, Conning forecasts that the annual volume of life settlements, in face amounts, will average around $4 billion per year. In essence, the asset class has reset itself to its initial growth period of 2002 through 2004.

Observed then from a distance, life settlements seem to be entering a new phase that may well result in smaller volumes over the short term. Meanwhile, the fundamental appeal of life settlements remains. Life settlements continue to offer a value added benefit to policyholders as long as insurers are unable to provide cash surrender amounts that reflect a policy's mortality-adjusted economic value. Life settlements also retain their attraction as an alternative asset class for investors due to the low correlation with equity markets and competitive returns.

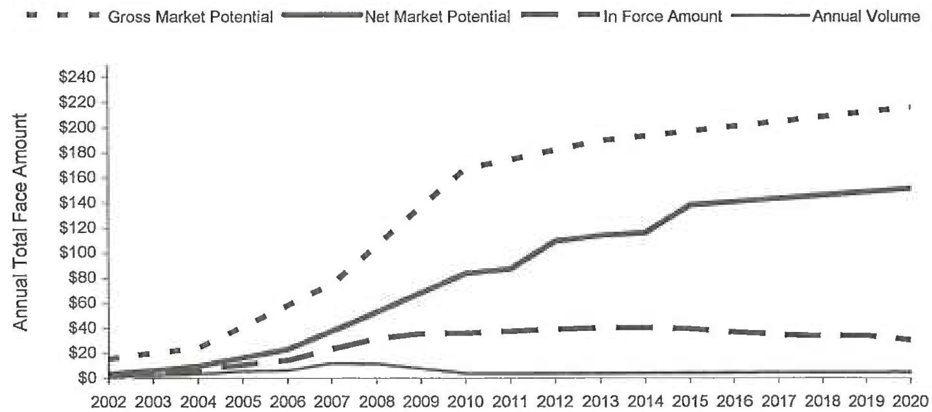
Given current economic conditions and investor sentiment, life settlements continue to be a small asset class. Demand for the settlement of policies continues to grow. However, the level of capital needed to meet that demand may not be available. As result, annual volumes will remain relatively flat over the forecast period. This creates a challenge to the in force amount because new settlements may not be sufficient to replace the amount of policies either lapsing or filing death claims, eventually reducing the amount of settled policies.

Over the medium- and long-term, the asset class's largest growth challenge will be attracting more capital to purchase new policies, rather than seeks vulture-investing opportunities among distressed portfolios. Meeting that challenge will determine the asset class's ultimate size.

Face Value Projection Summary—Key Forecasts

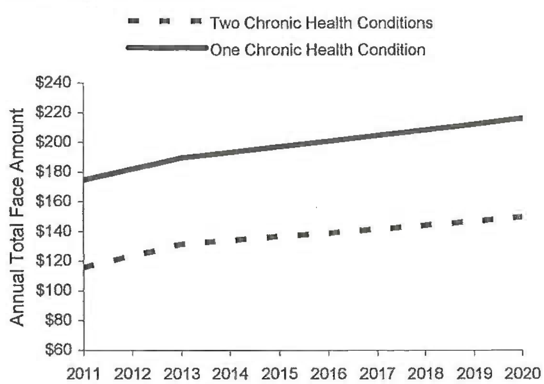
Conning U.S. Life Settlement Market Development and Forecast

($ in billions, one health criterion)



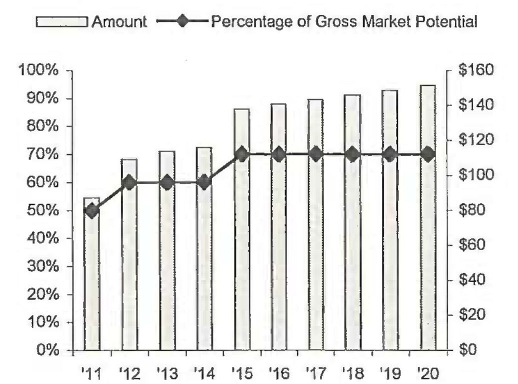
Conning Forecast of U.S. Life Settlement Gross Market Potential

($ in billions, one health criterion)



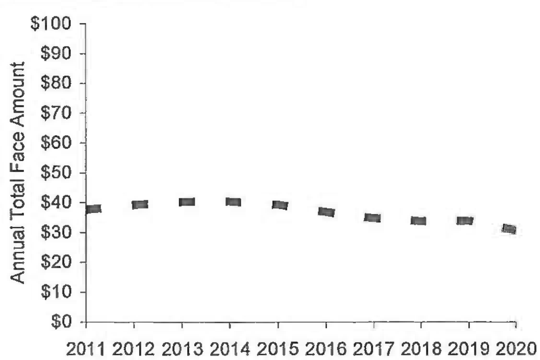
Conning Forecast of U.S. Life Settlement Net Market Potentials

($ in billions, one health criterion)



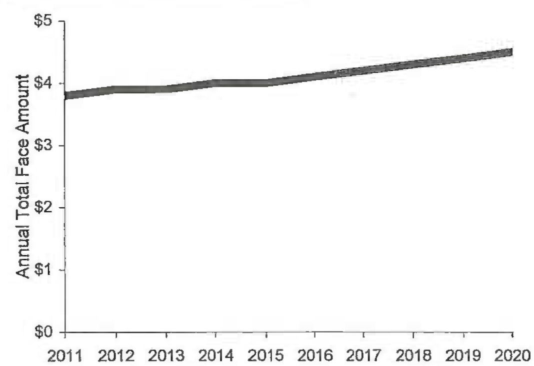
Conning Forecast of In Force U.S. Life Settlements

($ in billions, one health criterion)



Conning Forecast of Annual U.S. Life Settlement Volume

($ in billions, one health criterion)



Source: Company filings, Conning Research & Consulting analysis

Conning Estimated Face Value History and Projection—Key Forecast

($ in billions)

Year	Annual Volume	In Force	Net Market Potential	Gross Market Potential
2002	$2.0	$1.90	$3.2	$15.81
2003	$2.6	$4.20	$6.0	$20.04
2004	$3.3	$6.72	$9.7	$24.27
2005	$5.5	$10.83	$16.5	$41.19
2006	$6.1	$14.48	$23.2	$58.11
2007	$12.2	$23.54	$37.5	$75.03
2008	$11.8	$31.78	$52.9	$105.72
2009	$7.6	$35.56	$68.2	$136.42
2010	$3.8	$36.00	$83.6	$167.11
2011	$3.8	$37.64	$87.3	$174.63
2012	$3.9	$39.19	$109.3	$182.15
2013	$3.9	$40.27	$113.8	$189.68
2014	$4.0	$40.37	$116.1	$193.43
2015	$4.0	$39.32	$138.0	$197.19
2016	$4.1	$36.82	$140.7	$200.95
2017	$4.2	$34.72	$143.3	$204.68
2018	$4.3	$33.79	$145.9	$208.48
2019	$4.4	$33.96	$148.6	$212.35
2020	$4.5	$30.57	$151.4	$216.29

Source: Company filings, Conning Research & Consulting analysis

4. The Policy Seller's Market Landscape

As with all types of assets and the markets where they are traded, life settlements exist in a changing landscape. If the life settlement market is resetting itself, in terms of annual face amount settled, to the 2005/2006 era it is useful to understand how the current landscape is both similar and different from that era. The comparison between these similarities and differences may provide some indication of what challenges have been resolved and which remain.

This chapter explores the similarities and differences from the policy seller's point of view. One factor that has not changed is the investment opportunity found in life settlements.

An Unchanged Opportunity

Have life settlements lost their fundamental appeal? Are life settlements destined to go the way of viaticals? The short answer is no.

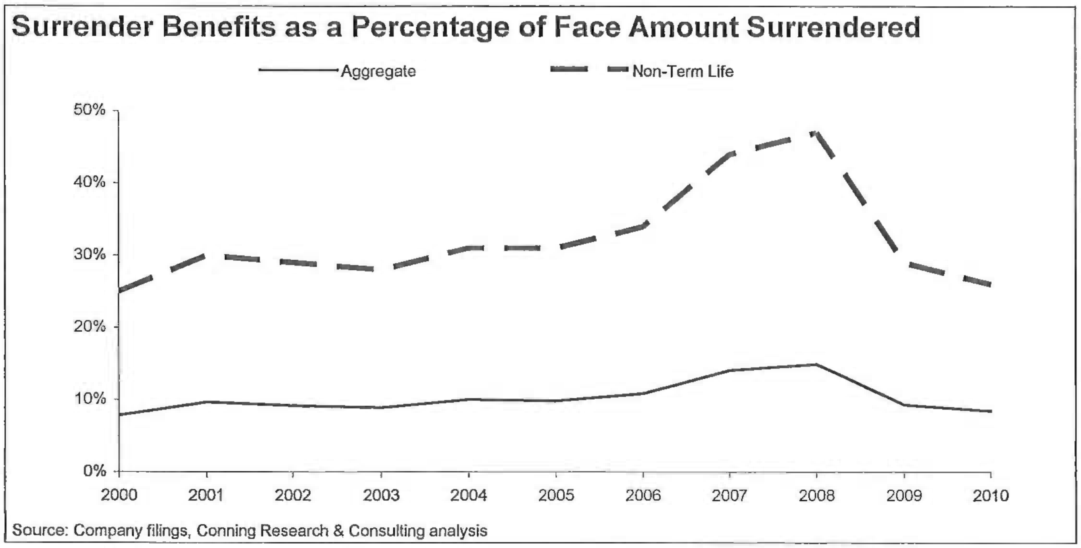
The Continued Appeal of Life Settlements

The appeal of life settlements to policy owners stems from the relatively higher amounts they receive for selling their policies than for surrendering or lapsing. That difference is the result of the low surrender values priced into an insurance policy.

Analyzing statutory data from 2000 through 2010, we found that on average, policy owners received 10% of their policy's face value as a surrender benefit. However, this is artificially lower due to the presence of term life, which has no surrender value, in the total amount of face value surrendered.

We can gain a better idea of the historic pattern if we remove the effect of term life. Statutory data does not separate the face amount surrendered by product. We can produce a rough estimate, however, by looking at the percentage of face amount sold by product. LIMRA has reported this percentage in its quarterly review of the individual life market since 2009. Since then, term life has averaged 68% of the face value of all policies sold.

Assuming that surrenders follow a similar pattern, we can reduce the face amount surrendered to reflect the percentage of non-term life policies. The following chart illustrates this difference.



Life settlements, on the other hand, have averaged around 20% in payout to policy owners, according to the GAO survey of life settlement providers. According to AA-Partners *AAP Life Settlement Market Review* for July 2011, the average offer to face value ratio was 13.5% for the first six months of 2011, which reflects the buyer's market for life settlements. Life Policy Dynamics surveyed life settlement transactions in 2007 and 2008 and found that 22% was the average offer to face value percentage.

Younger Policies Have Greater Appeal

At first glance, it would appear that life settlements do not provide a better benefit than the average cash surrender value. However, the cash surrender value builds over time. Younger cash value policies, in terms of the length of time since issue, have little if any cash value built up. Older policies, on the other hand, can have significant cash build up. The chart shown above provides some indication of this.

In 2007 and 2008, surrender benefits paid increased 27% and 24%, respectively. However, the change in amount of face surrendered was a decrease of 2% in 2007 and an increase of 16% in 2008. In essence, the increases in the surrender ratio were caused by the surrender of policies with higher cash value relative to their face amount. The following table shows these values.

Surrender Benefits and Face Value
($ in billions)

Year	Surrender Benefit	Non-Term Life Face Amount Surrendered
2000	$26.04	$105.93
2001	$29.00	$95.99
2002	$31.24	$108.81
2003	$33.16	$119.12
2004	$33.72	$107.80
2005	$36.35	$118.26
2006	$35.74	$105.16
2007	$45.54	$103.46
2008	$56.35	$120.62
2009	$40.13	$137.97
2010	$32.65	$123.48

Source: Company filings, Conning Research & Consulting

However, the majority of life settlements have focused on younger policies, in terms of time since issue. According to Life Policy Dynamic's surveys of life settlement transactions in 2006, 2007, and 2008, 51% of the policies settled were within four years of issue. Over that three-year period, 5% of policies were less than two years from issue, for those two years to three years from issue the range was 28% to 37% of policies settled, and for policies issued three years to four years prior to settlement, the percentage ranged from 9% to 17%.

It is this higher payout to policy owners whose cash value policies have not been in force for a significant period that is the appeal of life settlements. In essence, life settlements meet a need that insurers cannot match. Even if nonforfeiture laws allowed for medically underwritten surrenders, the insurers incurs costs associated with acquiring a contract that affect its ability to match the offer. In the early years of a policy, these costs have not been recouped, and paying the higher surrender value on younger policies creates an immediate loss.

If policy owners of relatively young policies were thinking of either lapsing or surrendering their policies, then it made economic sense for them to seek the highest possible value for those policies.

Because nonforfeiture regulations do not permit insurers to differentiate cash surrender values based on current life expectancy, creating the opportunity for life settlement providers to offer more for a policy, on a selective basis, than the insurer is able to pay, the appeal of life settlements remains.

Insurers Respond to the Impact of STOLI and Life Settlements

The length of time since a life settlement policy was issued has another implication on the future of the life settlement market. If the majority of the policies settled in the past were within a few years of issue, it may be some indication that STOLI sales played a much greater role in the life settlement market than suspected. For example, the life settlement industry has stated that its target audience is a policy owner who no longer wants or needs their policy. It also explicitly states that STOLI is not a legitimate life settlement. LISA (the Life Insurance Settlement Association) explains STOLI and warns consumers against engaging in STOLI sales on its website.

> *"STOLI is the initiation a life insurance policy for the benefit of a person who, at the time of the creation of the policy, has no insurable interest in the insured. Trusts that are created to give the appearance of insurable interest and used to initiate policies for investors also violate insurable interest laws and are STOLI. STOLI is not a life settlement. STOLI transactions are arranged in an attempt to circumvent insurable interest laws. As such, they are illegal.*
>
> *It is important for consumers to seek information about the legitimacy of life insurance practices. It is equally important that consumers know the difference between lawful and illegal. Consumers should read, ask questions, and educate themselves before entering into any transaction. Financial advisors must employ all financial tools available to provide consumers with products that fit their specific needs and to avoid the traps of illegal practices. Practices must be evaluated following public policies and laws."*

STOLI Cases Continue to Surface

However, if 51% of policies were settled within four years of issue, this would appear to challenge that point. Either these figures contain many STOLI sales, or agents are selling policies (especially high face value policies) to older individuals who are either unable to continue premium payments or perhaps never needed the product in the first place.

STOLI is often the result of fraud committed by the agent or insured. This may take the form of applying for high face value policies on individuals with little or no net worth, to lying on applications about the intent to settle the policy. As a result, insurers are taking efforts to monitor applications and in force policies for potential STOLI. In some cases, this monitoring has led to rescission of the policy or the contestation of claims. *The Wall Street Journal* reported in 2010 that insurers had filed more than 200 civil law suits in various states over alleged STOLI transactions. Some of these cases have been ruled in the insurer's favor, but not all. A few key lawsuits that have affected the life settlement landscape, and their impact on future life settlement investors, are discussed in the following chapter.

This monitoring has also led some insurers to report suspected STOLI cases to legal authorities, which in turn, has led to criminal charges brought against the individuals involved in the STOLI scheme. AXA Equitable, for instance, found five cases it had issued where the agent was suspected of using fraud at the time of application to have STOLI policies issued. The company turned these cases over to the Florida Department of Financial Services that investigated them. The result was the filing of 22 charges for violations of state insurance laws as well as grand theft against the agent involved.

A case from Ohio provides another example of the use of fraud during the application process to issue a STOLI policy. In March 2010, Ohio regulators revoked the license of an agent who submitted an application on a 74-year-old Cleveland woman for a $9 million policy. The woman and her husband had a net worth of $2,000 and a monthly income of $950. In the application he stated that the woman's net worth was $12.5 million. Prudential suspected fraud and reported the transaction to Ohio regulators.

Minnesota regulators, in December 2010, revoked an agent's license and fined him $250,000 after it was discovered he had secured 44 policies totaling $127.8 million on the life of one man. Minnesota authorities claimed the agent misrepresented the total amount of insurance outstanding on the client and hid the number of policies by applying for the additional coverage over a several year stretch.

Regulatory Actions to Reduce STOLI

States are also taking an active role in combating STOLI sales. One action has been the implementation of laws banning STOLI sales. During the early years of the life settlement market, STOLI was not against the law in most states. That changed as awareness about its existence increased. In June of 2011, for example, Texas passed a law that banned STOLI.

In 2007, the NAIC proposed in its viatical settlement model law to increase the contestable period from two years to five years to enable insurers to contest suspected STOLI claims. As of summer 2011, thirteen states had adopted this act. NCOIL also proposed a model law that addressed transparency of fees and charges paid by the policy owner. However, the NCOIL model law kept the contestable period to two years. As of summer 2011, eighteen states had adopted the NCOIL model act. Further differences between these two laws are discussed in the following chapter. As of mid-2011, only a handful of states currently lack any prohibition against STOLI.

Insurer Actions, or Inactions, to Reduce STOLI

However, the existence of so many STOLI cases may indicate a potential weakness in the underwriting and approval process for high face value policies. In these cases, somehow, the insurer issued policies that it later contested in court. Either the agent committed fraud and it was not detected during underwriting, or it was detected during the underwriting process, yet approved for issue anyway.

Two things are troubling if insurers are issuing high face value policies after being aware of potential STOLI issues. First, these policies, relative to smaller face value policies, have a larger financial impact on the insurer if the insured dies before policy costs are recouped. While the policy may be reinsured above a certain face amount, the impact may still be a significant cost for the insurer. At the same time, higher cost claims at the reinsurance level may lead to increased reinsurance premiums or the reduction in coverage for high face value policies.

Second, problems in the underwriting and approval process that allow potential STOLI cases to be issued may hinder later efforts to contest any claims. Two recent court cases illustrate this.

In a case filed by federal prosecutors in February 2011 in Brooklyn, New York, a policy was found to have been issued after the insurer's inspection report (prepared during policy underwriting and approval) found so many concerns that it included a "High Risk Fraud Alert." That federal indictment also covers a $5 million policy issued to a woman who claimed to have a net worth of $20 million, despite the fact the insurer's background check could not find any real property held by her and that her resident address was a Jewish temple.

Acting on these kinds of fraud awareness indicators during the underwriting and approval process is crucial if insurers are to defend themselves. Given the high face amounts, and high premiums to pay for those amounts, overlooking or missing key indicators of fraud and allowing a policy to be issued enables STOLI defendants to argue that the insurer knew about the STOLI, yet ignored these warning in order to receive the large premium payments. One example of this defense having some success occurred in March 2011. A Brooklyn, New York federal judge ruled that an insurer could not rescind a policy "because (1) it had 'sufficient information' that there were misrepresentations in the Application; and (2) it continued to accept payments after discovering those misrepresentations."

What does this mean for policy sellers as the life settlement market reboots? Most importantly, the length of time after policy issue matters. If the policy has been in force for a long period, insurers may be less likely to challenge the death claim or sale. On the other hand, policy owners who want to sell their policies relatively quickly after issue may find their policies contested by insurers.

In addition, the passage of the NAIC model law increased the period before a policy can be resold. In the states where the model law has been adopted, policy owners must now wait five years rather than two years before settling a policy. This means that those policy owners who purchased a policy and later decided they no longer wanted or needed the policy, must continue paying premiums for a policy they no longer want if they are to have the possibility of receiving a value that is greater than the cash value.

Insurer Efforts to Mitigate STOLI may Impact Emerging Insurer Opportunities

Life insurers sell policies to a wide age range of individuals. These can broadly be defined as young consumers (those ages 0 to 44), middle-aged consumers (ages 45 to 59), and older consumers (those ages 60 and over). That said, insurers are selling more policies to older individuals, and fewer policies to younger individuals. In fact, life insurers may be facing a growing opportunity to sell policies to a growing population of older clients, especially clients with higher net worth who will be seeking larger face value policies. Part of this opportunity is the result of the Baby Boom generation beginning to turn age 65. There are simply a growing number of older persons, and some will want and need to purchase new life insurance.

The MIB (Medical Information Bureau), for example, has documented an increase in older age life insurance applications over the past few years. When compared to the percentage of the U.S. population for each age group, The *MIB Life Index 2010 Annual Report* data reveals that applications from older age individuals continue to increase, as a percentage of all life insurance applications. The MIB data found that the percentage of all applications in the 60+ age group has increased from 10.7% in 2006 to 15.3% in 2010. Over the same period, the percentage of applications in the 44 to 59 age group has increased from 27.6% to 29.1%. These increases are matched by a decrease in the 0 to 44 age group.

Percentage of Life Insurance Applications by Age Group

Age Group	2006	2010
0 to 44	61.7%	55.6%
45 to 59	27.6%	29.1%
60+	10.7%	15.3%

Source: MIB

Additional evidence of the impact older aged consumers have on life insurance sales is that, according to LIMRA, in 2009 individuals purchasing universal life accounted for 11% of all UL policies sold. However, those policies represented 42% of total new annualized UL premiums.

Older aged consumers are looking for increased life insurance for several reasons. Growing concerns over potentially higher taxes is certainly one, especially among high net worth clients. This concern may have lead some individuals to purchase a policy in anticipation of the return of the estate tax in 2010, only to have them want to settle it when the probability of its return decreased. However, other worries also exist that cause some older aged individuals to purchase additional life insurance.

Some individuals may be worried that the payment for end-of-life costs for someone who is ill could negatively impact their retirement planning. These concerns may increase as politicians consider how to reduce medical costs associated with Medicare. Purchasing life insurance is one solution to alleviate these concerns because it can provide the economic resources to cover end-of-life expenses.

The emergence of innovative riders such as The Hartford's long-term care insurance and longevity riders on its UL policies is another reason for an increase in life insurance sales to older consumers. These riders enable a person to withdraw part of their face value under certain conditions such as the need for long-term care or to supplement retirement income because of unexpected longevity. In its second quarter 2011 earnings call, executives from The Hartford announced that one-third of new UL sales included one or both of these riders. Together with the growing number of customers, this bodes well for the sale of higher face value policies to older clients.

For an older individual looking to buy high face value policies, insurers may well be tightening their underwriting process to identify STOLI during application and protect the insurer's ability to successful sue after issue. This tighter underwriting can lead to delays in policy issuance. Those delays in issuance and tighter underwriting hold the potential to discourage agents and potential customers from seeking new coverage. To that extent, insurers need to balance legitimate concerns about detecting STOLI and the potential growth in new sales business from an aging America.

Not Another Viatical Market

Life settlements will not go the way of viatical settlements. Three factors combined to end the viatical market. First, there were medical advances that significantly affected life expectancies. Second, insurers responded by developing nursing home and terminal illness riders than enabled policy owners to access their policy values. Finally, investor concern about viatical investment scams led to capital withdrawing from the life settlement market.

In the case of medical advances, life settlements have yet to be affected by dramatic increases in life expectancy. It is true that the methods to estimate life expectancy have changed, increasing those expectancies. That, however, has been the result of underwriting improvements, not medical breakthroughs.

Insurers continue to develop new living benefits that allow the insured to access their policy's death benefit. For example, The Hartford introduced its Life Access Rider in 2008 and its Longevity Access Rider in 2011. However, nonforfeiture laws still prohibit insurers from offering different cash surrender values based on the insured's current health.

While life settlements do not have two of the three factors that effectively ended the viatical market, there have been and continue to be significant investment frauds in this market. These frauds have generated negative publicity that increased regulatory actions and reduced investor appeal.

The Sell-Side Market Reboots

The life settlement market, in 2005, was a wild west for policy owners. It was largely unregulated. Transparency about the fees and commissions taken from the offering price from investors was lacking. As a result, policyholders were at a disadvantage in evaluating the true value of their policy. Both agents and policyholders were largely unaware about the existence of life settlements and the settlement process. Investors were selective in the types of policies they purchased, the face amounts, and health criteria.

The sell-side is no longer the wild west of 2005. Like the old frontier towns, civilization has arrived and tamed the west. Consumer and agent awareness of life settlements has increased. Once the existing pool of settled policies has been repurchased, lapsed, or had death claims filed, those investors that remain will return to buying policies.

As life settlement investors return to the asset class, they will have clearer, and more stable, regulation. Returning investors will be dealing with better-educated consumers and agents. At the same time, policyholders will find that the criteria investors used to judge the appeal of a policy has changed. Having focused on high face values and older (and sicker) policy owners when the life settlement market emerged, investors relaxed those criteria when it was at its height in 2007 and 2008. However, the buyer's market has led to the retightening of these criteria. As a result, policyholders may find themselves with less opportunity to sell their policies.

Policy Owner Awareness Increases

Life settlements are new as both an asset class and as a policy owner option. Part of its growth is the result of increasing policy owner awareness. The enactment of legislation that mandates the notification of policy owners of life settlements will continue to increase that awareness.

NCOIL Model Disclosure Law

First emerging in 2009, the requirement for insurers to disclose the option of life settling a policy to policyholders gained traction in 2010. Six states: Kentucky, California, Maine, New Hampshire, Florida, and Washington have some form of law requiring the disclosure of the life settlement option at the time of this publication. This led NCOIL to consider creating a model law covering these disclosures for all states.

Discussions leading to a draft model law began in July 2010 by NCOIL's Life Insurance and Financial Planning Committee. NCOIL was concerned that simply accepting that the policyholder should lapse or surrender without considering other options was not in the policyholder's best interest. From a consumer perspective, NCOIL felt a policyholder must be provided full and complete information about lapsing, surrendering, or settling a policy in order to make an informed decision regarding the disposition of their life insurance.

In September 2010, NCOIL posted a draft model bill that would require insurers to inform policyholders who are 60 or older, or are known by insurers to be chronically or terminally ill, to be told about life settlements or other options if they are planning to surrender or lapse their policies. The draft calls for each state insurance commissioner to provide a model notice. In addition, the draft stated that the notice shall be developed at no cost to insurers or other licensees and must be written in lay terms. In addition to telling policyholders about the life settlement option, the notice must also tell about other alternatives to letting the policy lapse, such as seeking an accelerated death benefit and assigning the policy as a gift.

This draft drew comments from both the insurer and life settlement side. Generally, the life settlement industry supported the disclosure, while the life insurance industry raised key points about who should supply such a notice (the insurer or the policyholder's agent or planner). NCOIL's Life Insurance and Financial Planning Committee approved the final language of the model law in November 2010. If passed by NCOIL, states can use the model act as a basis for state laws beginning in 2011.

LISA Public Awareness Campaign

LISA launched a consumer awareness campaign in February 2011. It received approval from New York State to pursue a public awareness program for New York consumers who may be considering a sale of their life insurance policies. LISA worked with the insurance department to provide an efficient and cost-effective alternative for its members to comply with the requirements of the law.

Information created for and disseminated through the campaign explains life settlements and life settlement transactions; gives policy owners information on detecting and avoiding fraud; and provides consumers with information on how to contact the New York State Insurance Department. LISA Executive Darwin Bayston stated, in announcing receipt of the approval, "We welcome the approval and very much appreciated the support the New York Insurance Department provided in developing our public awareness program. The program ensures that consumers will receive consistent information."

The public awareness campaign consists of a web page on LISA's website. This website is an approved consumer brochure provided to New York life insurance policy owners who are considering a life settlement along with an informational brochure for life settlement professionals. In addition to being available on-line, the New York Office of Aging will also distribute the consumer brochure throughout New York, according to LISA.

Agent Awareness Increased

Agent awareness of life settlements has increased over time. This awareness takes two forms. First, overall awareness of what life settlements are and how they operate has increased. Second, the adoption of NCOIL disclosure model laws and new suitability standards will increase the ability of some agents to discuss life settlements.

Agent Willingness to Discuss Life Settlements Increased

Agents are more willing to discuss life settlements with older clients that may be thinking of lapsing or surrendering policies they no longer want. LISA, in conjunction with Agent Media, has conducted an annual survey of agent attitudes towards life settlements since 2005.

As the life settlement market emerged, a lack of agent knowledge would have inhibited its growth because fewer agents would have discussed it with their clients. With the improvement in agent awareness, and increased knowledge about the life settlement process, more agents may be discussing life settlements with their clients. This adds to the potential for a growing demand among policyholders to settle their policies.

In 2005, 61% of those agents surveyed expressed a willingness to discuss the life settlement option with an appropriate client. That increased to 71% by 2009. However, 59% of agents felt they would not perform a life settlement in 2010. Of those agents that felt they would not do a life settlement in 2010, the largest reason (with 48% of respondents) for not performing a life settlement was a lack of knowledge about life settlements.

Both responses are a change from 2005, when 73% felt they would not perform a life settlement in the coming 12 months and 60% of those gave a lack of knowledge as the reason for not performing a life settlement. On the other hand, in 2005, 6% of agents not planning on offering a life settlement gave that response because of prohibitions by their insurance companies. In 2009, that increased to 23%.

Change in Agent Attitude about Life Settlements

Question	2005	2009
Willingness to discuss life settlements with an appropriate client	61%	71%
Do not expect to perform a life settlement in next 12 months	73%	59%
Lack of knowledge the reason for not performing a life settlement	60%	48%
Insurer prohibition the reason for not performing a life settlement	6%	23%

Source: Agent Media, company filings, Conning Research & Consulting.

Over the same period, the percentage of agents who gave "Expertise/Experience" as the reason for working with a life settlement broker decreased from 31% in 2005 to 23% in 2009. Again, this indicates some degree of confidence among agents in their ability to understand life settlements and manage a transaction.

Agent Suitability May Impact Settlement Awareness

State securities regulators remain at odds over whether a single fiduciary standard that holds all investment advisors and broker-dealers to a higher code is in the best interests of the insurance and financial services industries. Currently broker-dealers can sell products that are deemed suitable for their clients but may not be in their client's best interest. Investment advisors are required to sell and recommend products that are most advantageous for their clients. The SEC is currently studying this issue.

The adoption of a single standard would increase the standard for all broker-dealers and could lead to increased costs as they adapt their internal controls. During that transition period, these firms may be exposed to a higher level of compliance risk.

One result of the adoption of the NCOIL model law, and the stronger fiduciary standard, is that agents of companies that prohibit them from doing life settlements will find themselves with a dilemma. On one hand, agents must comply with any restrictions placed on them by their insurer. On the other hand, those same agents will need to act in the best interests of their clients. At some point, the insurance companies and broker-dealers that prohibit their producers from participating in a life settlement will have to recognize the responsibility that producers have to their clients. If that occurs, consumer awareness of life settlements will increase.

Policy Criteria Tighten

Not every policy owner that wants to settle their policy meets the criteria investors are looking for. In 2005, for example, investors were looking for large face value policies and individuals with what they believed to be shorter life expectancies. As capital moved into the life settlement market in 2006 through 2008, those criteria expanded. Investors were willing to consider investing in a wider range of policy types and in lower face amounts.

As the life settlement market reboots, it does so with investors looking to purchase higher face value policies than before the market crash. This will have implications for policy owners with smaller policies who want to sell them. It may be more difficult for these policy owners to find willing buyers for their smaller face value policies.

Policy Type

Universal life was the preferred type of policy that investors sought to purchase in 2005. The SOA (Society of Actuaries) surveyed life insurers in July-August 2008 and published the results in a 2010 report to the Society's Life Settlement subcommittee, titled *Report of the Society of Actuaries Life Settlements Survey Subcommittee*. The Survey asked respondents whose companies had policies settled in the secondary market to indicate the product type of those settled policies. Eight respondents answered this question, choosing from among seven product types. The following table shows the results.

Percentage of Settled Policies by Product Type: 2007

Product	Percentage of Settled Policies
Whole Life	19%
Traditional Universal Life	45%
Variable Universal Life	4%
Universal Life with Secondary Guarantee	49%
Joint/Last Survivor	12%
Term Life	26%

Note: Numbers do not add to 100% because respondents had settled policies in multiple categories.

Source: Society of Actuaries, Conning Research & Consulting analysis.

Minimally funded UL contracts have been the primary target of life settlement providers. The low funding level generates only small cash surrender values, making it easier for the settlement offer to look attractive to the insured. In addition, the flexible funding aspect of a UL contract allows the provider to adjust its premium payment pattern to consider future interest rates, optimizing the provider's return.

Aggressively priced UL contracts provide additional potential gain, in that lower required premium payments allow the life settlement provider to take advantage of the lower mortality and/or higher lapse assumptions used in policy pricing, maximizing the arbitrage. One drawback of minimally funded UL contracts is that they have little cash value available for paying ongoing mortality charges, which increase sharply as the insured ages.

Whole life contracts are not as attractive, although they are subject to some life settlements. Whole life contracts generally have a much higher cash surrender value, increasing the amount the investor must pay and/or reducing the excess value that a life settlement broker is able to provide. They also have much less flexibility in the amount and timing of future premium payments.

Face Amount

Before the economic crisis of 2008 and 2009, the average face value of life settlement policies had risen. One reason for this is that universal life policies have higher face amounts, due to their lower premium per thousand, than whole life. The SOA survey mentioned earlier provides some evidence for this. It asked respondents to indicate the average face amount of their settled policies by product type.

Median Average Face Amount Settled by Product Type: 2007
($ in '000s)

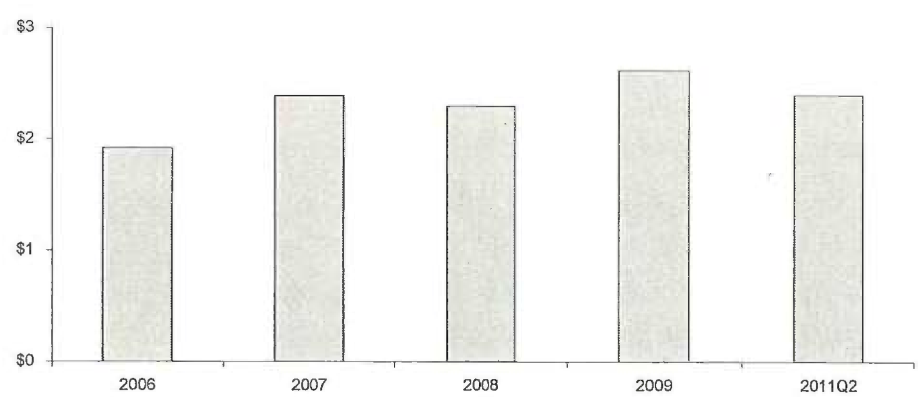
Product	Amount of Settled Policies
Whole Life	$53
Traditional Universal Life	$724
Variable Universal Life	$870
Universal Life with Secondary Guarantee	$1,085
Joint/Last Survivor	$2,287
Term Life	$230

Source: Society of Actuaries, Conning Research & Consulting analysis.

The reason universal life policies have larger face values than whole life is that the cost of insurance is lower than in whole life, and much closer to term life. This enables an individual to purchase UL policies at a much larger face amount for the same premium than they could with whole life.

With investors preferring UL products, it is not surprising that average face values for settled policies would rise. The increase can be seen in data from Life Policy Dynamics, a life settlement service provider and AA-Partners, a German alternative asset management firm that also tracks the life settlement market. Life Policy Dynamics tracked settlement demographic data submitted by several providers for 2006 through 2009. Among the data, published in its annual market analysis, was the mean face value of the policies settled in a given year. AA-Partners collected and published similar data for the first half of 2011 based on information supplied by seven life settlement providers. Combining this data, we see the increase and leveling of face values.

Mean Policy Face Amount Settled
($ in millions)



Source: Life Policy Dynamics, AA-Partners, Conning Research & Consulting analysis

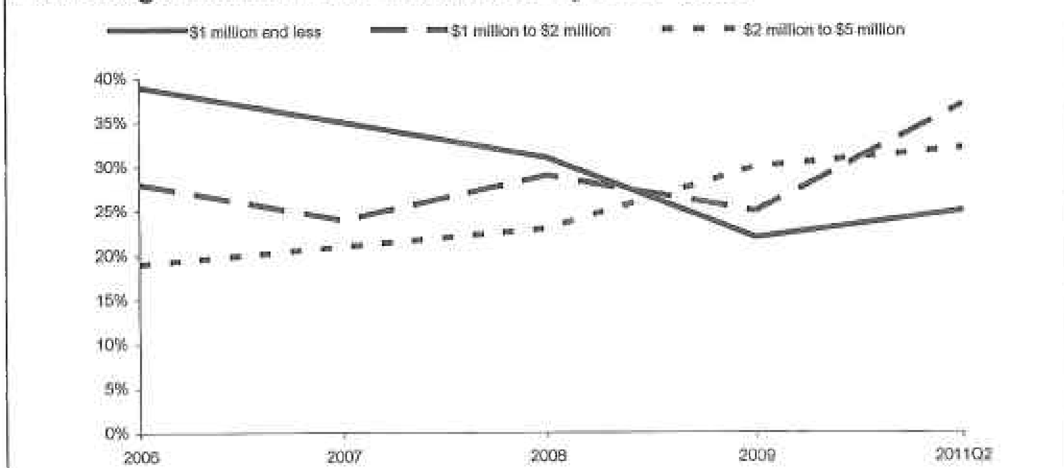
To adjust for the impact of larger face value policies, Life Policy Dynamics also calculated the median face value for the policies settled within its data set for 2006 through 2008. Their results showed a much lower and consistent result of $1 million in face value settled per policy.

The percentage of policies settled in a given year, grouped by face amount, varies based on two major factors. The first is policy supply. In any given year, the number of policies within a face value range will vary. For example, policies with face values above $5 million can be subject to supply restrictions because they are a very small percentage of policies sold. LIMRA reported that in 2007, 8% of new life insurance policies sold across all product types had a face value of $1 million or higher, and only 1% had a face value of $3.5 million or higher.

Second, and more important, is investor appetite. Our prior studies in 2006 and 2007 identified a trend among investors to consider investing in smaller face value policies as capital competed for policies. A key result of the lack of capital flowing into life settlements has been that investors have focused less on smaller face value policies and more on larger policies.

Data from Life Policy Dynamics and AA-Partners illustrate this trend. It shows the percentage of the policies settled with face values of $1 million or less and between $2 million and $5 million. Because of their supply driven volatility, this analysis excludes policies with face values of $5 million or higher.

Percentage of Annual Life Settlements by Face Value



Source: Life Policy Dynamics, AA-Partners, Conning Research & Consulting analysis

Over time, investors have moved away from smaller policies and towards policies with larger face values. While policies with a face value of $1 million or less appear to have increased in the first half of 2011 (based on AA-Partner's data), it was a slight rise of 2 percentage points, approximately the same as for policies with face values between $2 million and $5 million.

Owner Criteria Tighten

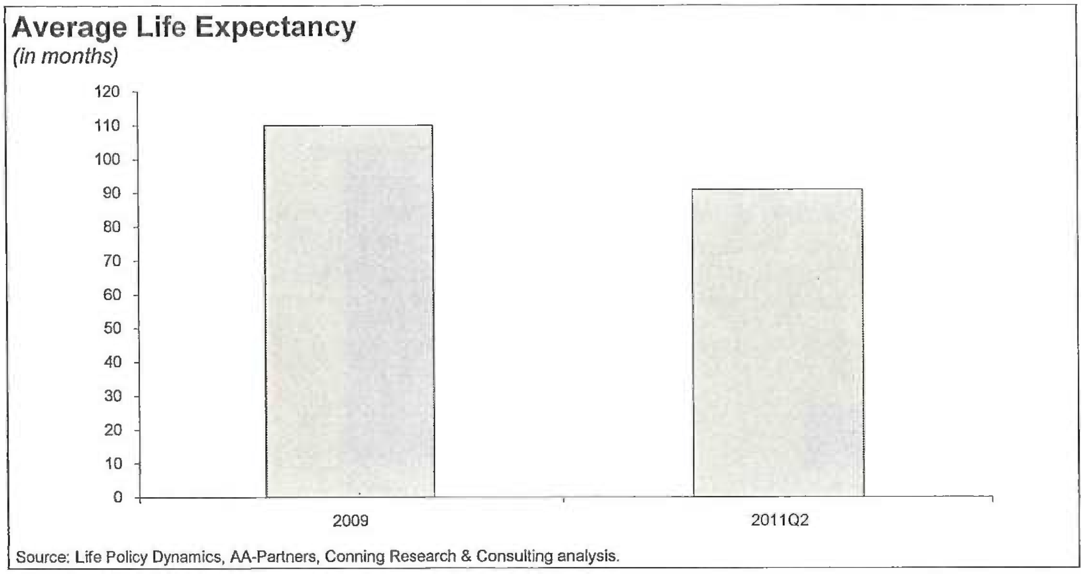
Life settlements originated as a transaction aimed primarily at high net worth individuals with policy face amounts in excess of $1 million, generally age 65 or older, and with impaired health. However, by 2008, the combination of increasing competition among investors for life settlements and a relatively small pool of policies that met these criteria led investors to lower their policy criteria. In effect, investors traded some profit for the ability to acquire more policies.

As the life settlement market reboots, a key change is that those investors who remain in it will be more selective in the life expectancy and issue ages. The reason to be more selective is to reduce longevity risk and increase returns (all else being equal, shorter life expectancies translate into fewer premium payments.)

Life Expectancy

As the life settlement market was being established, investors were selective about the insured's health criteria. Generally, investors wanted shorter life expectancies, focusing on sicker individuals.

Our analysis of data from 2009 and the first half of 2011 finds that the average life expectancy decreased 19 months, or 17%, between the two years.



While these are the results of only a sample of policies settled, they support the idea that life expectancy has shortened as capital has remained on the sidelines.

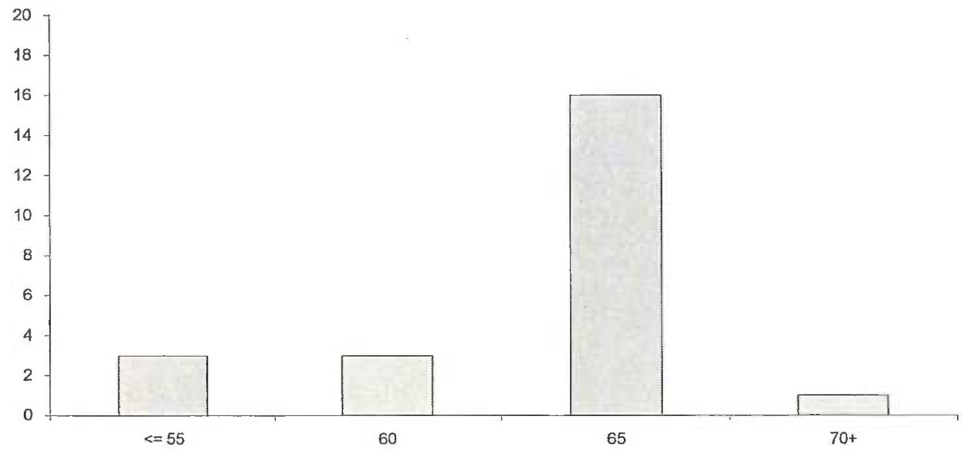
Perhaps more interesting is that these life expectancies have shortened while the methodologies used to calculate life expectancies have improved. These improvements have, in general, lengthen results rather than shorten them. This may mean that the shorter life expectancies of 2011 may be more accurate than the longer life expectancies of 2008 and earlier.

Insured Age at Settlement

Another reason life expectancies have shortened is that the age of the insured has increased. In 2008, we analyzed the minimum ages of insureds for 22 life settlement providers. These ages ranged from 45 to 70, with the greatest concentration at age 65. Six of the 22 providers are willing to accept policies from insureds age 60 or lower.

The providers willing to accept life settlements from younger insureds were seeking to achieve two strategic objectives. First, providers could expand the number of policies they could bid on because they were using lower criteria than the competition. The second advantage is that at younger ages there is simply less competition. The following chart shows the distribution across all 22 providers in that analysis.

Number of Life Settlement Providers by Minimum Age of Insured



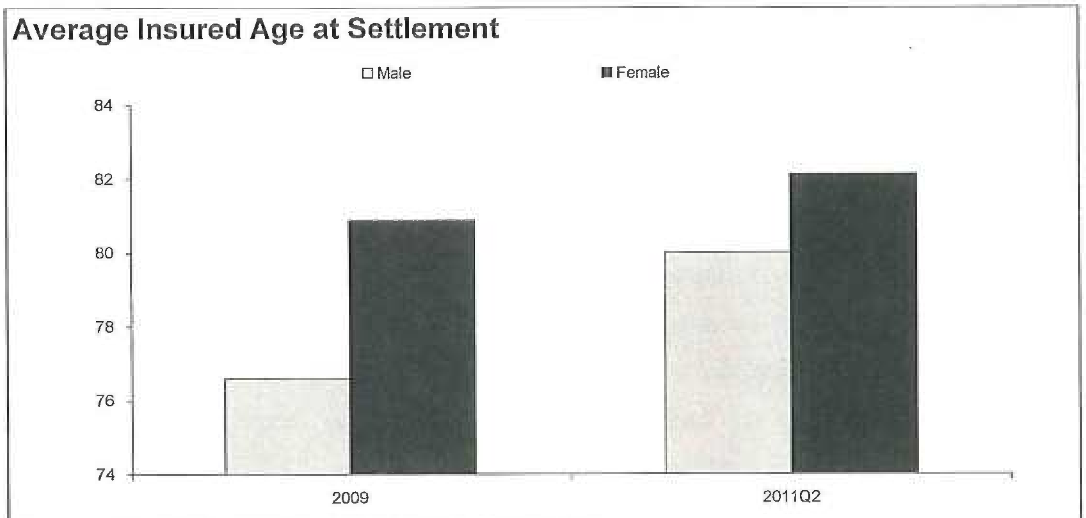
Source: Conning Research & Consulting, Inc. analysis

Trinity Life Settlements, one of the three providers accepting insureds at age 55 or lower, gave the competitive advantage of moving towards younger insureds on its website:

> *"As a new venture in an emerging market, Trinity Life Settlements aims to seize an enormous opportunity, define, lead, and grow an industry where few competitors exist...Trinity Life Settlements will focus on Boomers with life expectancies between 15-25 years."*

A focus on younger insureds, however, also represents a willingness to accept longer life expectancies. Given that younger insureds are better positioned to benefit from any improvement in health care or medical technology that would increase life expectancy risk. Post-2008, with increased concerns about the accuracy of life expectancies as well as the continued buyer's market, issue ages are increasing.

Evidence of this increase is that the average age for life settlements for male insureds has increased from 76.6 years in 2009 to 80 years in 2011, or 4%. The average age for female insureds experienced an increase from 80.9 years in 2009 to 82.1 years in 2011, or 1.5%.



Source: Life Policy Dynamics, AA-Partners, Conning Research & Consulting analysis.

Historically, life settlement investors have preferred males; Life Policy Dynamics for example reports that the male/female ratio was 2-to-1 for 2006 through 2009. The reason for this preference is that men tend to die before women. This makes the increase in male ages more important because the increase would have a greater impact on improving the returns from life settlements.

Life Settlement Transparency Increased

In 2005, individuals looking to sell their policies were often unaware of the commissions and fees deducted from the initial offering price from investors. In addition, states regulators were concerned about the rise of STOLI, which violated insurable interest laws. To address these concerns the NAIC and NCOIL adopted two model acts.

Two Model Acts, Differing Degrees of Impact

The adoption of both the NAIC and NCOIL model laws have stabilized the sell-side of the life settlement market. As the life settlement market reboots, these regulations increase the transparency regarding costs to policy owners of a life settlement. These regulations also contributed to the decline of STOLI. As a result, policy owners seeking to settle their policies are doing so in a more transparent environment.

NCOIL adopted a new Life Settlements Model Act on November 16, 2007. LISA endorsed that Act as it was written. The NAIC passed a Life Settlements Model Act Revision in June of 2007. LISA opposes that Model because of its concerns that the Act damages the interests of participants in the insurance industry and makes life settlements difficult for consumers. LISA has also expressed concerns that some language in the Act may conflict with other areas of law, especially securities and banking law.

The two model acts are similar in many ways. Both exempt traditional premium finance arrangements from the definition of a life settlement contract. The two model acts require life settlement providers to file an annual statement with the commissioner as well as provide general rules governing life settlement transactions. Both require the life settlement provider and broker to disclose specified information to the policyholder as well as implementation of anti-fraud control. The two model acts also prohibit advertising materials from expressly referencing or implying that insurance is free for any period and prohibit transactions where the settlement provider and broker are under common control or have a control relationship with each other.

The model acts are also similar in that neither provides an exemption for life settlement transactions with policy owners who are accredited investors under federal securities laws (although some states currently provide such an exemption in their life settlement law.) Both model acts also appear to recognize that premium finance programs, which only provide for the financing of interest and closing costs, are not life settlement transactions.

While both model acts seek to strengthen consumer protection provisions and address concerns about STOLI transactions, the NAIC Model Act is more restrictive on life settlement providers and investors in every area in which the model acts differ materially, such as timing of settlements, length of rescission periods, and settlement broker bond requirements.

Under the NAIC Model Act, no policy may be sold prior to or within a five-year period after its issuance unless otherwise exempted. NCOIL's ban on life settlement is for only a two-year period after policy issuance. As a result, states adopting the NAIC Model Act will limit the options of insureds, who have life insurance needs that have shorter time horizons than the five-year period contemplated.

While both model acts provide a period during which a policyholder has a right to rescind a settlement contract, the NAIC Model Act establishes a much longer rescission period. Under the NAIC Model Act, the policyholder has a right to rescind a life settlement contract prior to the earlier of 60 days after contract execution or 30 days after receipt of settlement proceeds. Under the NCOIL Act, the policyholder has the right to rescind the settlement contract within 15 days of its execution.

The longer rescission period creates a higher probability that life settlement transactions will be unwound. Thus, if a state adopts the NAIC Model Act, life settlement providers bidding on policies must be cognizant of the fact that the policy owner can close a deal and continue to shop for a better price. Finally, the NCOIL Model Act contains no bonding requirement for life settlement brokers. Under the NAIC Model Act, such brokers must obtain a $250,000 surety bond.

Different Rates of Adoption

In January 2011, two states regulated only viatical settlements. One state only prohibited STOLI, four states and the District of Columbia had no regulation. The remaining 43 states had adopted the NAIC or NCOIL Acts.

In its 2010 report on life settlements, the SEC found that five states had adopted the NAIC model act in a uniform and substantially similar manner. Thirteen states had adopted portions of the NAIC model act. Among states that had recently enacted life settlement related legislation, the majority followed the NCOIL model act or combined elements of the NAIC and NCOIL model acts. Of the 30 states enacting life settlement legislation, including anti-STOLI legislation, since spring of 2008, 14 followed the NCOIL model act provisions, and 12 states combined elements of the NAIC and NCOIL model acts.

Because of the two competing Model Acts, the state in which the life settlement takes place in can be crucial. For example, if a New York resident who spends their winters in Florida settles their policy through a Florida agent and broker, which state has jurisdictional control? What happens if the states have adopted different Acts?

These types of questions, along with the increased compliance costs associated with them have raised transaction costs for life settlement providers. All else being equal, higher transaction costs reduce the offer price to the individual policyholder.

STOLI is a Reduced Factor

Stranger Owned Life Insurance or STOLI is a type of insurance fraud where elderly individuals are persuaded to obtain life insurance policies for investors who lacked an insurable interest in the elderly person. It is usually sold under some sort of non-recourse or partial recourse financing arrangement and was a significant cause for concern in the mid-2000s. However, a variety of factors have come together to eradicate this unsavory activity.

Regulatory Actions Reduced STOLI

About 40 states have passed either the NCOIL or NAIC model acts aimed at reducing STOLI. Although both model laws broadly regulate life settlements, they also include anti-STOLI provisions. For example, the NCOIL model makes almost any sort of agreement to sell a life insurance policy within two years of issue a fraudulent act punishable by criminal and civil penalties. The NAIC Model, which is subject to limited exceptions, bans all sales of life insurance for the first five years after issue. This model, however, does not close a major loophole, which is the sale of beneficial interests in a policy (which is, selling an interest in a trust that owns the policy rather than selling the policy itself.)

Insurer Actions Reduced STOLI

Insurers are doing their part as well in combatting STOLI. Life insurers have increased the monitoring of new policies fitting the STOLI profile: large face amounts on insureds around age 75. In addition, lawsuits have been brought by insurers to rescind policies that were issued under suspected STOLI schemes. In addition to rescission, insurers frequently seek to keep all premiums received and recover all sales commissions that were paid.

The Buyer's Market Reduced STOLI

One of the most compelling reasons for the demise of STOLI occurred in the fall of 2008 when the mortality tables used by some major life expectancy companies were increased by 20% to 30%. Until that change, the moment a policy was issued there was usually a discrepancy between the insurer's life expectancy and that of life expectancy providers. That discrepancy increased the projected rate of return on death benefits to levels that were attractive to third-party investors. With that arbitrage gone, newly issued life insurance policies are no longer an attractive investment.

Not only will the policies, that were previously originated, likely produce very disappointing results (due to apparently incorrect life expectancies projections), but investors have come to realize that they also bear substantial legal and headline risks. As a result, at a time where capital is already in short supply due to the recession, investors have lost their appetite for STOLI life insurance schemes.

After the Reboot

Based on the changes in the life settlement market since 2005, what can a rebooted life settlement market expect from the sell side?

Consumer Demand Continues to Increase

Policyholders, and their agents, will have an increased awareness of the life settlement option. This will lead a growing number of them to attempting to sell their policies.

It is important to note that the Baby Boomers will not have an impact on life settlements until later in the next decade. The first Baby Boomer turns 70 in 2015. He or she will not reach the average age for a life settlement (based on 2011Q2) of 80 until 2025. That means that if the life settlement market is to grow in terms of the number of new policy owners looking to sell their plans, it needs to achieve this growth by increasing awareness.

Policy and Owner Criteria will Lower

Investors can only purchase settlement portfolios for only so long. At some point, these portfolios will be held until the policies in them lapse or a death claim is paid. This will cause capital to return to buying new policies. When capital returns to buying new policies, competition for policies will lead investors to lower their policy and owner criteria.

Potential Consumer and Agent Disappointment

If investors remain away from life settlements, the life settlement market may be setting itself up to disappoint significant numbers of agents and policyholders. The educational efforts to increase awareness of life settlements may be leading to an expectation that there are large numbers of buyers waiting to purchase all types of policies. That will not be the case, even in the best of times. The inability of many policyholders, and their agents, to sell a policy may lead to frustration with the whole life settlement market.

Summary

As with all types of assets and the markets where they are traded, life settlements exist in a changing landscape. If the life settlement market is resetting itself, in terms of annual face amount settled, to the 2005/2006 era it is useful to understand how the current landscape is both similar and different from that era. The comparison between these similarities and differences may provide some indication of what challenges have been resolved and which remain. This chapter explores the similarities and differences from the policy seller's point of view.

An Unchanged Opportunity

Have life settlements lost their fundamental appeal? Are life settlement destined to go the way of viaticals? The short answer is no. The appeal of life settlements to policy owners stems from the relatively higher amounts they receive for selling their policies than for surrendering or lapsing. That difference is the result of the low surrender values priced into an insurance policy.

It is this higher payout to policy owners whose cash value policies have not been in force for a significant period that is the appeal of life settlements. In essence, life settlements meet a need that insurers cannot match. Even if nonforfeiture laws allowed for medically underwritten surrenders, the insurers incurs costs associated with acquiring a contract that affect its ability to match the offer. Those costs had not been recouped, and paying the higher surrender value on younger policies creates an immediate loss.

If policy owners of relatively young policies were thinking of either lapsing or surrendering their policies, then it made economic sense for them to seek the highest possible value for those policies. Because nonforfeiture regulations do not permit insurers to differentiate cash surrender values based on current life expectancy, creating the opportunity for life settlement providers to offer more for a policy, on a selective basis, than the insurer is able to pay, the appeal of life settlements remains.

Insurers Respond to the Impact of STOLI and Life Settlements

The length of time since a life settlement policy was issued has another implication on the future of the life settlement market. If the majority of the policies settled in the past were within a few years of issue, it may be some indication that STOLI sales played a much greater role in the life settlement market than suspected. For example, the life settlement industry has stated that its target audience is a policy owner who no longer wants or needs their policy. However, if 51% of policies were settled within four years of issue, this would appear to challenge that point. Either these policies contain many STOLI sales, or agents are selling policies (especially high face value policies) to older individuals who are either unable to continue premium payments or perhaps never needed the product in the first place.

Insurers are making efforts to monitor policies for STOLI. In some cases, this monitoring has led to rescission of the policy or the contestation of claims. *The Wall Street Journal* reported in 2010 that insurers had filed more than 200 civil law suits in various states over alleged STOLI transactions. This monitoring has also led some insurers to report suspected STOLI cases to legal authorities, which in turn, has led to criminal charges brought against the individuals involved in the STOLI scheme. States are also taking an active role in combating STOLI sales by implementing anti-STOLI legislation as well as filing charges in cases of suspected fraud.

However, the existence of so many STOLI cases may indicate a potential weakness in the underwriting and approval process for high face value policies. In these cases, somehow, the insurer issued policies that it later contested in court. Either the agent committed fraud and it was not detected during underwriting, or it was detected during the underwriting process, yet approved for issue anyway.

Two things are troubling if insurers are issuing high face value policies after being aware of potential STOLI issues. First, these policies, relative to smaller face value policies, have a larger financial impact on the insurer if the insured dies before policy costs are recouped. Second, problems in the underwriting and approval process that allow potential STOLI cases to be issued may hinder later efforts to contest any claims.

What does this mean for policy sellers as the life settlement market reboots? Most importantly, the length of time after policy issue matters. If the policy has been in force for a long period, insurers may be less likely to challenge the death claim or sale. On the other hand, policy owners who want to sell their policies relatively quickly after issue may find their policies contested by insurers.

Mitigating STOLI may also impact the ability of insurers to realize new sales from an emerging market opportunity. The growth in new insurance sales among older individuals is greater than for younger customers. In addition, these older insureds tend to buy high face value policies. However, insurers may well be tightening their underwriting process to identify STOLI during application and protect the insurer's ability to successful sue after issue. This tighter underwriting can lead to delays in policy issuance, which can frustrate the agent and the customer.

The Sell Side Market Reboots

The life settlement market, in 2005, was a wild west for policy owners. It was largely unregulated. Transparency about the fees and commissions taken from the offering price from investors was lacking. As a result, policyholders were at a disadvantage in evaluating the true value of their policy. Both agents and policyholders were largely unaware about the existence of life settlements and the settlement process. Investors were selective in the types of policies they purchased, the face amounts, and health criteria.

The sell-side is no longer the wild west of 2005. Like the old frontier towns, civilization has arrived and tamed the west. Consumer and agent awareness of life settlements has increased. Once the existing pool of settled policies has been repurchased, lapsed, or had death claims filed, those investors that remain will return to buying policies.

As investors return to life settlements, they will have clearer, and more stable, regulation. Returning investors will be dealing with better-educated consumers and agents. At the same time, policyholders will find that the criteria investors used to judge the appeal of a policy has changed. Having focused on high face values and older (and sicker) policy owners when the life settlement market emerged, investors relaxed those criteria when it was at its height in 2007 and 2008. However, the buyer's market has led to the tightening of these criteria. As a result, policyholders may find themselves with less opportunity to sell their policies.

5. The Investor's Market Landscape

From the perspective of life settlement investors, the events of 2008 and 2009 changed their landscape. The risks of inaccurate life expectancies and dependence on leverage became apparent. Larger institutional investors, especially investment banks, exited the asset class. Taxation changed causing funds to relocate their operations. Investment fraud continued to rear its head, causing some degree of concern among potential new investors. These factors came together to create the current buyer's market. However, for those investors that continue to participate there are several key points that point towards a more positive future.

The appeal of life settlements to investors remains, especially given the low interest rate environment for fixed income investments and equity market volatility. The lack of capital enables current investors in life settlements potentially earning higher rates of return than those who were buying policies in 2007 and 2008. At the same time, improved life expectancy underwriting and regulatory environment creates a more stable market.

The Investor's Opportunity Remains

Life settlements attracted investors for two main reasons. First, the asset class has a low correlation to fixed-income and equity securities. Second, life settlements still offer investors the potential to generate a competitive return.

The Attraction of Low Correlation Remains

Life settlement investors view insurance as an asset with a low correlation to equity or interest rate changes. For investors who have a large portion of their assets in equity or debt, adding life settlements as an alternative investment is one way to reduce a portfolio's exposure to sudden downturns in the stock or bond markets.

Low correlation is not the same, however, as noncorrelation. This is something that some investors discovered in 2008 and 2009 when interest rates fell as central banks attempted to stave off recession and increase liquidity in the credit markets.

Lower Interest Rates Impact UL Rates

When interest rates decrease, especially as they have done since 2008, investors who purchased minimally funded universal life policies may find themselves facing an increase in premiums. For example, in August 2011, Moody's stated that its stress test of the impact of continued low interest rates would be detrimental to life insurers, especially UL players.

> *"While life insurers are not expected to incur significant losses in the near term, if interest rates were to remain at historical lows, most affected would be firms with sizable exposure to fixed-rate annuities, universal life policies with high crediting rates, variable annuities with lifetime guaranteed income benefits, and long-term care and disability."*

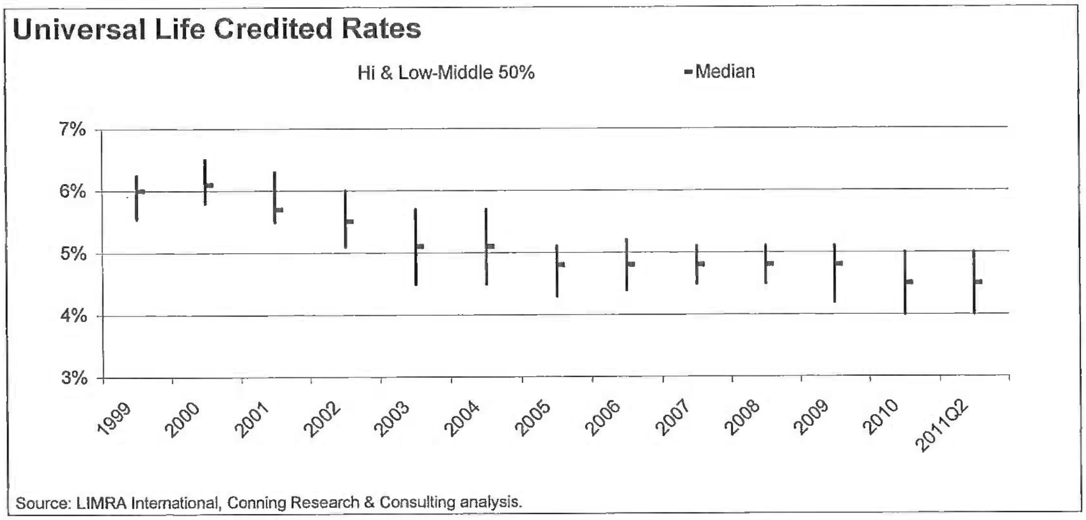
Universal life's difference from whole life, in fact its innovation, was to unbundle the premium factors that drive cash value build-up and keep the policy in force. Insurers tell the policyholder what the charge is for each factor. This unbundling, combined with the transparency of those factors for policyholders, lies at the heart of UL product design. Pacific Life describes this in the UL product brochure:

> *"As long as there is sufficient accumulated value in your policy to cover monthly charges, you can set the amount of each premium payment based on your policy's death benefit and your financial objectives."*

Unbundling creates premium flexibility and enables policyholders, and investors, to optimize their premium payment.

The second key difference of UL, compared to whole life, was that making a premium payment did not guarantee that a policy would remain in force. Deductions could exceed the combination of premiums paid plus interest credited, in which case the policy would lapse or insurers would ask the policyholder to make an unscheduled premium payment to maintain the policy. Both outcomes are undesirable to life settlement investors because it reduces the return on that particular policy.

Over the past ten years, credited rates on UL decreased significantly, with the median rate falling from 6.5% in January 1996 to just 4.8% in the middle of 2005. It has remained within a few basis points of that level through the balance of 2005 and through the second quarter of 2011. This decrease in credited rates is not surprising, as it has followed the downward trend in fixed income interest rates over the same period. While the median rate has not changed, the impact of the low interest rate environment can be seen in the broader range of middle quartile credited rates.



In 2010 several insurers, among them AVIVA, The Hartford, and Lincoln Financial, lowered their crediting rates on both new and existing UL policies. Looking ahead, life settlement investors may be faced with another round of premium increases.

Low Interest Rates Affect Premium Optimization

Lower interest rates affect the premium optimization used by life settlement investors. The premium flexibility of UL allows life settlement investors to increase their return by "optimizing" the premiums they pay to the insurer. As described on Legacy Benefits website in July 2010:

> *"Q: Why are universal life policies more attractive from a life settlement perspective than other types of life insurance?*
>
> *A: Universal life insurance policies generally do not have fixed premium payment requirements, so it is possible to pay more or less than the scheduled amount shown in the "in force" illustrations used by life settlement providers to evaluate each policy. For this reason, the ability of life settlement providers to pay more for this type of insurance relative to the cash surrender value of the policy is often greater."*

Premium optimization is the analysis of the credits and debits to a universal life policy's account value, as well as any accumulated account value, to determine the minimum amount of additional premiums necessary to keep the policy in force. Optimizing UL premiums begins by gathering several key pieces of information about the policy. An important source for this information is the policy's in force illustration. Chief among these are the credited interest rates (both guaranteed and current) applicable to the policy's cash values, the death benefit option currently applicable to the policy, the rating classification applicable to the insured life, and the minimum premium tests or requirements. The life settlement manager, or service provider, combines this information with their knowledge of UL design and pricing, at an aggregate and policy form level, to calculate the minimum amount of premium needed to keep the policy in force.

The accuracy of the calculations used to optimize the premium flows is crucial to avoid over or underpayment. Overpayment may reduce returns because the excess premium may not be recaptured when the death benefit is collected, while underpayment may result in the policy lapsing.

Ideally, premium optimization occurs in two places. First, it occurs as part of the policy valuation process during the initial calculation of an offering price for the policy. The optimized premium analysis provides the ongoing capital commitment the investor needs to make until the policy's death benefit is paid. As such, it becomes a key factor in determining the offering price made to the original policyholder.

For life settlement investors, the changing nature of UL's crediting and debiting factors is a double-edged sword. It allows them to deconstruct the policy's charges and more effectively optimize premiums (compared to whole life or term life). At the same time, it requires an ongoing commitment to monitor changes in each UL policy. Having purchased a policy, premium optimization continues to play a role. Premium optimization enables the investor to adjust premium payments as changes occur to credited interest rates and policy charges.

That said, low correlation continues to be an advantage that life settlements have in attracting investors and indicates the potential for a continued flow of capital seeking life settlements.

Commanding a Buyer's Premium

Life settlements continue to offer the potential to generate competitive returns for investors. However, the buyer's market has brought forth two distinct markets for policies. The secondary market involves the purchase of policies from the individuals who initially took the policy out. The tertiary market involves the purchase of already settled policies, either singularly or in portfolios, from other life settlement investors. Both markets command a premium over similar risk-free rates, however, the secondary market appears to offer a higher premium for investing in new policies.

A Strong Secondary Buyer's Premium

Like all investors considering allocating capital to life settlements, they are aware that they are at some degree of risk of losing their investment. Therefore, life settlement investors either consciously or subconsciously require an investment risk premium over a comparable risk-free investment. Life settlement investors also appear to be commanding a buyer's premium due to the lack of investor capital available to purchase policies in the secondary market. To understand how large that premium might be, and how it has possibly changed over time, we looked at estimated IRRs (internal rates of return) on settlement transactions.

We used the IRRs on transactions for two reasons. First, data on actual IRRs earned on polices after the payment made for a death claim are not available. Second, while actual returns may well vary from what investors hoped for, these expected IRRs determine the offering price to the policyholder. Higher expected IRRs mean that current policy owners will receive a lower offer (all else being equal). Conversely, lower IRRs results in higher offer to the policy owner. Therefore, changes investors have in their expected IRRs directly translate into changes in the amount a policyholder will receive.

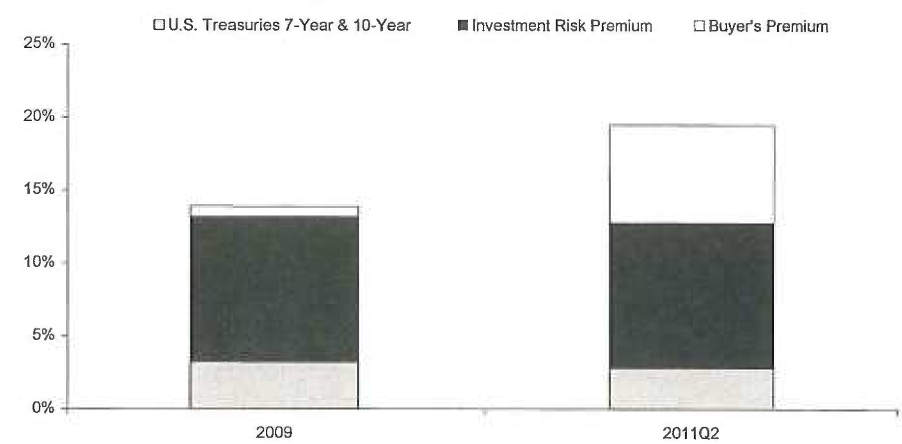
To identify a risk-free rate of return, Conning used the estimated life expectancy for the settlement to establish an expected maturity for the investment. We then used the rate for a U.S. treasury of a similar maturity. For example, if the estimated life expectancy were five years, we would consider the rate for a five-year U.S. treasury to be the risk-free rate. Based on data from AA-Partners and Life Policy Dynamics reports on actual life settlement transactions, we found that the average life expectancy was 7 years for 2011Q2 and 10 years for 2009.

With a risk-free rate identified, we applied a rule of thumb that life settlements would command a 10% premium over the risk-free rate to attract investors. This rule of thumb reflect anecdotal evidence we gathered over observing the life settlement industry, individual investors may have higher or lower investment risk premiums. With the average 10-year U.S. treasury earning 3.9% in 2009, and a 7-year treasury earning 2.8% in mid-2011, the inclusion of a 10% investment risk premium would suggest that life settlement investors would be expecting returns of approximately 14% and 13% for 2009 and 2011, respectively.

In 2009, IRRs were around 14%. However, as capital withdrew, those investors that remained are able to command a buyer's premium in addition to the 10% needed to cover investment risk. The buyer's premium is the excess return available to investors because of a lack of capital in a market space. Those with capital and a willingness to invest can ask for higher expected IRRs.

We find that in mid-2011, expected IRRs had increased from approximately 14% to almost 20%. With a risk-free rate of less than 3%, investors are able to ask for much higher premiums than before.

Projected IRR for Secondary Life Settlements



Source: AA-Partners, Life Policy Dynamics, Conning Research & Consulting analysis.

Of course, the split between investment risk and a buyer's premium is somewhat arbitrary. In addition, increased awareness of life expectancy risk may well have led to a higher investment risk premium. Still, the point remains that investors in a capital constrained market are commanding higher premiums compared to earlier investors.

It is also important to note that this is for the purchase of new policies. To the extent that there is greater investor awareness of the risks associated with inaccurate life expectancies in the purchase of new policies, rather than more seasoned ones in existing portfolios, the higher premium may reflect continuing uncertainty about those accuracies.

Because estimated IRRs affect the offering price, a higher premium over the risk-free rate means policyholders looking to settle their policies may continue to face lower offers than those who did so in 2007 and 2008. That said, if these policies remain relatively young when it comes to length from issue, the offer could still be above any cash surrender value.

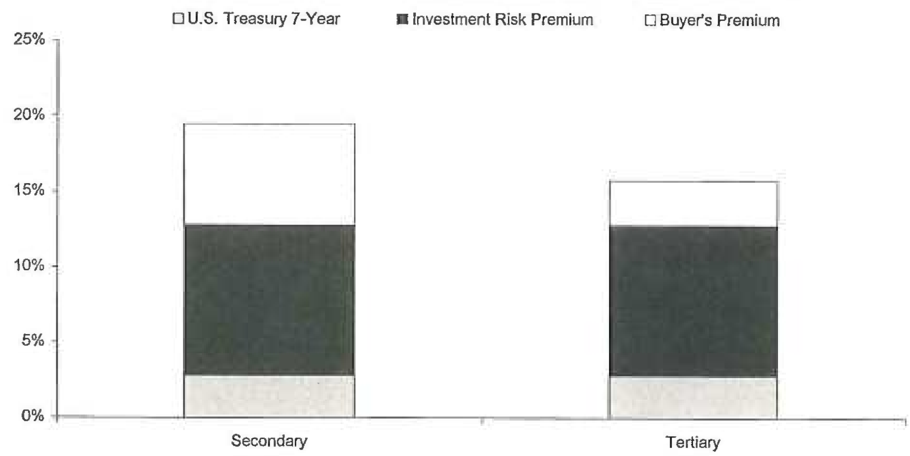
That said, as mentioned in the previous chapter, with the reduction in STOLI sales, the availability of young policies may become limited in the future. This means owners of policies may require a higher offer price to overcome the accumulated cash value in the policy. On the other hand, investors may find the higher cash value useful to help fund policy premiums. This would help reduce their costs and increase their returns. At the same time, a continuation of tight credit markets for the financing of life settlement premiums may also increase the appeal of older policies with higher cash values.

A Lower Buyer's Premium in the Tertiary Market

By Conning estimates, there is approximately $38 billion in settled face at year-end 2010. This is a not a large supply of policies and will not require a great amount of capital focused on purchasing those policies. As a result, investors focused on the tertiary market find themselves in a more competitive environment than in the secondary market. This is leading to reduced IRRs and, by extension, higher offers to the investor who own the already settled policy or portfolio.

The impact of the capital competition for tertiary policies is seen in the difference in the buyer's premium. The tertiary market commands a smaller buyer's premium than the secondary market.

Projected IRR for Secondary and Tertiary Life Settlements: 2011H1



Source: AA-Partners, Conning Research & Consulting analysis.

All else being equal, higher IRRs produce lower offers to policyholders. The reverse is also true, lower IRRs produce higher offers.

It is possible that investors in the tertiary market seek a higher investment risk premium because the policies may have been settled when disclosure and anti-STOLI regulation was less robust. As a result, concerns about the collectability of death benefits may be higher. This leads to tertiary investors incurring higher due diligence costs because they need to investigate the conditions and documentation of the original sale. In addition, life settlement investors in the tertiary market are unable to re-underwrite the insured and therefore need to rely on adjustments made to the original life expectancy. At the same time, worries about the accuracy of LEs may be higher with existing portfolios.

Combined with the factors described above, this would lead to the expectation that tertiary market investors would command a high buyer's premium. However, as seen in the chart above, IRRs for the tertiary market are in fact lower than for the secondary market. This may indicate that the focus of investors on the tertiary market is creating enough competition for already settled policies and portfolios, and that investors need to reduce their IRRs and, by extension, increase their offer in order to win business.

Taken together, the investor focus on tertiary sales appears to have produced a small seller's market among current policyholders. That seller's market is leading to lower overall IRRs and a reduced buyer's premium. Given that LEs and face amounts are comparable between the secondary and tertiary markets, any advantage found in bottom fishing for bargains among already settled policies or portfolios may be declining.

The Investment Side Reboots

As the life settlement market reboots, investors will continue to find an opportunity to make returns that are higher than other fixed income investments. Life settlement investors will understand life expectancy risk better and will face a legal landscape that has seen several recent cases that strengthened their ability to receive death benefits. In addition, if the life settlement market remains small in terms of the number of buyers, then IRRs may remain high.

Life Expectancy Risk Better Understood

Investors rely on life expectancies from underwriters, and often from more than one, as a major pricing component. Those life expectancies flow through to portfolios, where fund managers use them to calculate policy values over time. As the life settlement market reboots, investors will continue to remain concerned about the accuracy of life expectancies. However, efforts to standardize life expectancy methodologies should contribute to a reduction of concern among some investors.

Continuing Refinement

In 2008 and early 2009, the major underwriters adjusted their methodologies, resulting in an increase in life expectancies. The change in underwriter methodology was the second increase in two years and reflected the increased amount of experiential data the underwriters had accumulated. The underwriters have now been providing life expectancies to life settlement buyers long enough to have accumulated a statistically significant amount of experiential data. It is access to, and the analysis of, this experiential data that produced the changes.

The underwriters have been discussed at conferences that as more experiential data is gathered, future refinements to methodologies are inevitable, as is the potential for further increases in life expectancies. One example of this continuing refinement was announced in August 2011, when 21st Services issued a release stating it would begin using exact ages rather than industry-standard "age nearest birthday" or "age-last birthday" when it calculates life expectancies.

Vince Granieri, Chief Actuary at 21st Services, said in the press release announcing the change that: "For many years now, both the life expectancy industry and the life insurance industry have underwritten based on broad definitions of an insured's age. The most common underwriting conventions are 'age nearest birthday' and 'age last birthday.'"

Underwriters round to the nearest whole year if they use the "age nearest birthday" method. For example, using age nearest birthday, both an insured who was 55 years and seven months old and one who is 56 years and 5 months old would be underwritten as a 56-year-old. This approach was developed to simplify the process at a time when many calculations were done by hand, without the assistance of today's technologies.

Granieri pointed out that using "age last" or "age nearest" to calculate a person's life expectancy could distort the estimate, particularly for a short life expectancy. For example, on a life expectancy of 60 months, a difference of up to six months between an exact-age calculation and an 'age nearest' calculation is potentially a 10% distortion. Further, the current practice leads to a person's life expectancy being constant for a year and then changing significantly, only to remain constant at the new level for another year. He said, "This stair-step result is not consistent with what we understand about mortality."

An Emerging Standard

To address ongoing concerns about the accuracy of life settlements, as well as the variation among estimates, in July 2010, major life expectancy providers announced they would work to identify and refine best practices to guide their profession. Their work attracted the attention of the American Academy of Actuaries who announced they would begin developing a formal approach to estimating life expectancy.

The group, known as the LEPr or Life Expectancy Providers would work to develop a new actual-to-expected mortality table to help investors compare life expectancy estimates among the underwriters. The common table using life expectancy company experience would enable investors to compare results among life expectancy underwriters.

A number of best practices guiding LEPr also had been agreed to by a LISA committee in 2010, which was headed by Mike Fasano, president of Fasano Associates, a Washington, D.C.-based life expectancy provider. In October of 2010, LEPr announced the formation of a focus group that would be creating best practices standards to the life settlement and longevity markets. In December 2010 and January 2011, full day meetings with investors and providers were held in New York City to review the LEPr draft document of *Best Practices*.

By March 2011, the LEPr group had finalized and released its *Life Expectancy Providers Best Practices* at the BVZL meeting in Munich. All members of LEPr are expected to implement these practices by January 1, 2012 and the group recommends early implementation by its members.

The document seeks to provide consistency and transparency (with clear definitions of format and reporting) in the following areas:

- Privacy, Fraud,
- Confidentiality,
- Life Expectancy Client Reports,
- Actual to Expected Performance Reports,
- IBNR (Incurred But Not Reported),
- and Definitions.

At that time, LEPr announced it would continue to review and refine its best practices as well as provide educational opportunities to the longevity and life settlement markets, which currently includes; expansion of privacy policy, audit guidelines, and workflows that provide insight into the life expectancy process.

In June 2011, members of the AAA (American Academy of Actuaries) work group reacted to LEPr's work and said any new life expectancy projection guidelines should go through the formal Actuarial Standards Board development process. Linda Lankowski, chairperson of the Life Settlements Investment Work Group at the AAA in Washington, D.C., believes the board should, and will, develop a standard, a practice note, or some other document relating to life expectancy analyses.

While Lankowski stated that the LEPr did a good job of coming up with ideas and drawing eyes to an important topic that needs actuarial standard setters' attention, any standards an actuary is expected to follow must go through the full standards board research, development, review, and comment process. This would ensure that actuarial estimates are based on reasonable assumptions and calculated using clear, well-disclosed methods.

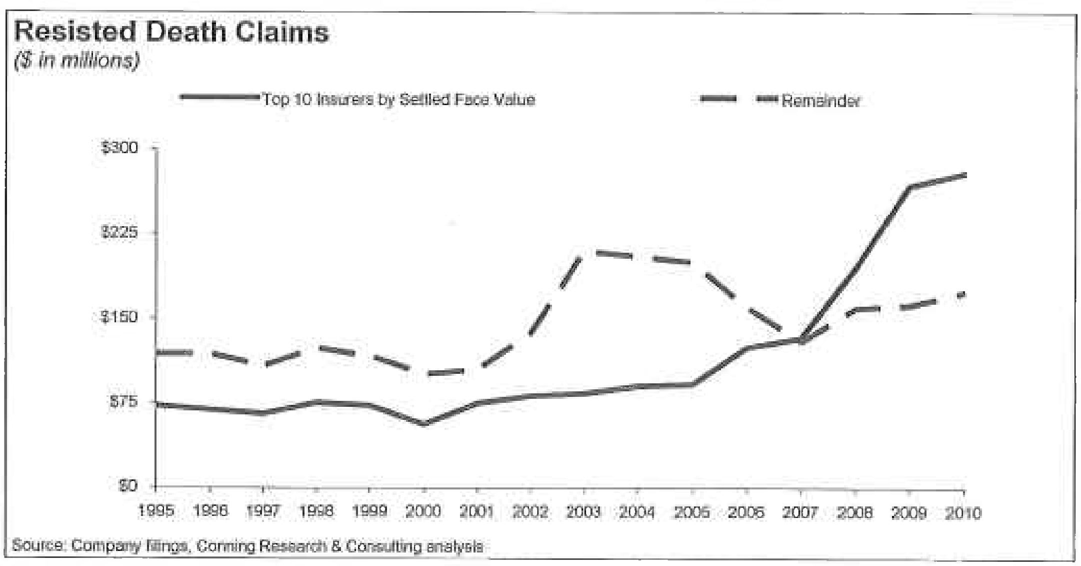
The Actuarial Standards Board's ASOPs (Actuarial Standards of Practice) require an actuary who is preparing a report to review current actuarial practices and follow relevant board guidance and precepts rather than to use documents such as best practices guides prepared by outside organizations. Otherwise, guidelines that seem reasonable could let actuaries manipulate their estimates or force actuaries to use rigid cut-offs or formulas that are a poor fit for the data being analyzed.

Contestability Risk Reduced

Several court rulings in 2010 and 2011 limited the ability of life insurers to contest death claims. The life settlement industry has engaged with life insurers over policy rescission and denial of death claims since it began. Recent court rulings have favored the life settlement industry and this is a positive development for investors.

An Increase in Contested Death Claim

Life insurers have always resisted some death claims. However, with the rise of life settlements, some insurers have been more forceful in resisting suspected STOLI and other life settlement claims. Evidence of this can be seen in comparing the dollar amount of resisted claims for the ten insurers who have been the greatest focus of life settlement investors against the remaining industry.



Face value of newly issued policies has increased over time, leading to a general increase in death claims. The dollar amount is important because life settlements have focused on larger face value policies. For the ten companies targeted by investors, there has been a significant increase in resisted claims since the life settlement market began to grow. In fact, this increase rocketed in 2007 and 2008, the peak years of the life industry. Conversely, the remaining industry has experienced a decrease in resisted claims. It is understandable that insurers would resist paying claims since it affects their bottom line.

Recent Court Rulings Favor Life Settlements

Against this background of an increase in resisted claims, recent court rulings have favored the life settlement industry. These cases are a positive development for investors.

Perhaps the most significant case in 2010 was the *Kramer v Phoenix Life Insurance, et al*, which focused on the question of policy owner intent at the time of issuance. The case eventually depended on a ruling by the New York State Court of Appeals. That court found that New York's insurable interest law was untenable and that no good faith requirement in which the insured must acquire a policy with the intent of providing a death benefit to his family. This ruling placed New York State alongside Minnesota and Arizona in viewing policy owner intent at the time of policy issue as irrelevant.

In a 2011 case, New York State Supreme Court Justice Paul Wooten denied Phoenix Life Insurance Company's motion to dismiss a lawsuit brought by a Credit Swiss subsidiary over the payout of an incontestable life insurance policy before the insured had died. The Credit Swiss subsidiary, CSSEL Bare Trust, wanted a ruling that Phoenix would pay the policy when the insured died if it was after the contestable period. The reason for this request was CSSEL Bare Trust's concerns over Phoenix Life's resistance to claims paying. Phoenix Life argued that CSSEL Bare Trust lacked standing because the insured had not yet died. The judge's ruling strengthened the life settlement industry because it allows a policy owner to request a declaration that a company will honor the policy when the death claim is filed, reducing some degree of investor uncertainty.

However, not all cases were in the life settlement industry's favor. Another key case was *Settlement Funding v. AXA Equitable*. In this case, denial of claims payment after the contestability period had expired was the issue. AXA Equitable refused to pay a death claim over questions about whether all the paperwork was accurately completed and whether there was an underlying case of fraud. The District Court for the Southern

District of New York found that the case could proceed because of the issues of alleged fraud. In the subsequent jury trial, the jury found that AXA Equitable was required to pay the claim. However, because the District Court allowed the case to go forward, there is some risk that the contestability period may not apply in cases of fraud or lack of insurable interest.

There are two cases that could have implications for exiting portfolios as well as for future new settlements. The Delaware Supreme Court issued a ruling in late September 2011 in the case of *PHL Variable Ins. Company v. Price Dawe 2006 Insurance Trust, et al* and *Lincoln National Life Insurance Company v. Joseph Schlanger 2006 Insurance Trust et al*. The court ruled that an insured has a common law property right to purchase a policy on his or her own life and sell it for market value, provided the procurement of the policy was not part of a straw purchase pursuant to a prior agreement to resell to an investor.

In these cases, the court was asked by to respond to questions it received from the federal courts in Delaware. The federal courts asked whether the purchase of a policy where it "would be immediately transferred to unrelated third-party investors and where the insured and his trust were used as straw men to allow the investor to conceal a wage on the insured's life" violated state insurable interest laws. The Delaware Supreme Court ruled than in such a case, the existence of a prior agreement violated the insurable interest laws. In essence, the Delaware court ruled that STOLI violated insurable interest laws. This ruling carries added importance because Delaware is the home of many insurance trusts that could possibly contain STOLI policies.

On one hand, this has implications for investors of already settled portfolios. Their investments may be at greater risk of having insurers successfully contest already settled policies based on suspected STOLI. At the least, it may lead to some portfolios incurring higher costs to investigate and defend themselves against suspected STOLI claims.

On the other hand, the life settlement industry found positive results in the ruling. The LISA applauded the ruling as being correct and a furtherance of efforts to reduce or eliminate STOLI. In addition, the court also stated that the "secondary market allows policy holders who no longer need life insurance to receive necessary cash during their lifetimes." It emphasized that the life settlement market was "perfectly legal," "highly regulated," and "provides a favorable alternative to allowing a policy to lapse, or receiving only the cash surrender value."

Adding to the positive results for the life settlement industry was a rejection by the Delaware court of an argument from the ACLI (American Council of Life Insurers). The ACLI argued that that the intent of the insured to possibly settle the policy at some future point also violated insurable interest laws. In rejecting the ACLI's argument, the court stated, "The insured's subjective intent for procuring a life insurance policy is not the relevant inquiry. The relevant inquiry is who procured the policy and whether that person meets insurable interest requirements."

After the Investment Reboot

What will be some broad investor themes that might emerge as the life settlement market reboots?

A Shift Towards Smaller Investors

The life settlement market of 2006 through early 2008 saw several large investment banks enter the space. After the credit crisis and recession of late 2008 and early 2009, many left for a variety of reasons. Their withdrawal was a major factor in the reduction in capital to buy policies. As of 2011, the gap created by the withdrawal of those large investors has not been filled.

At the same time, AIG has been the largest purchaser of policies over the course of the life settlement industry's growth. However, in August 2011, Robert Benmosche, AIG's chief executive officer, announced in the company's 2011 second quarter earnings call that going forward, the company would not be focusing on life settlement investments to the same degree. The reason for this was a $185 million impairment on its life settlement portfolio reported in the second quarter of 2011 after it adjusted the portfolio's value to reflect revised life expectancies. Over the first six months of 2011, the impairment totaled $254 million.

In place of these large investors, fund managers have turned to smaller investors and are trying to attract pension plans. One area of interest has been family funds, the investment offices of ultra-wealthy families. These groups have expressed some interest in increasing their alternative assets recently. For example, in June 2011, a survey of 151 family offices by the accounting firm Rothstein Kass found that 90% expected to increase their alternative investments. This was an increase from 70% in their prior survey. Because life settlement funds market their product as an alternative asset, life settlement funds may find some capital among these family firms.

At the same time, pension funds are also expanding their allocation to alternative asset classes. According to a Towers Watson survey in 2011, alternative assets managed on behalf of pension plans increased 16% and now account for 19% of all pension plan assets. Again, if some of these plans are looking at alternative assets, it is likely that some will consider investing in life settlements.

One key question for life settlements is whether these potential investors will have the ability to contribute enough capital to replace the loss of major investment banks as well as the pullback by AIG? After all, it can take many small and medium investors to equal the capital contribution of a large investor.

Investors Turn to New Settlements

As a rule of thumb, the offer price to face value has been somewhere around 20%. When it comes to tertiary sales, which are of policies already settled, it would not be unreasonable to expect a reduction in the 20% to account for investor concerns about the quality of the purchased policies as well the presence of distressed fund managers who need to liquidate portfolios. That said, even applying the 20% factor it would only take $7.6 billion in capital to repurchase all the currently settled policies. In addition, it also assumes that all life settlement investors would be willing to sell their policies. Given that not all investors are willing to sell, the potential for a continued robust tertiary market is limited.

Investors can only purchase settlement portfolios for only so long. At some point, these portfolios will be held until the policies in them lapse or a death claim is paid. This will cause capital to return to buying new policies. As it does, competition for policies will lead to higher offers being made, lowering the return for investors.

An Interest Rate Barrier to IRR

Investors demand an investment risk premium, over risk-free investments of similar duration. In a rising interest rate environment, this premium establishes a natural barrier for life settlement investments. The higher IRR created by rising interest rates will produce a lower offering value to policyholders. As a result, investors need to balance their needed IRR against the need to exceed cash surrender values.

However, if policies are low in cash value, then any offer might be attractive. In that case, a higher interest rate may have less of an impact. If, on the other hand, investors begin to acquire older policies because the pool of STOLI policies has diminished

Smaller May be Better for Investors

A smaller market, in terms of the number of players and the capital they bring, may benefit life settlement investors already in the life settlement market. The less capital available means that life settlement investors can continue to demand a capital premium in addition to their risk premium.

Put simply, from an investor's perspective, a smaller number of competitors is a good thing. The life settlement market's demand for the settlement of policies among policy owners should increase over time. If capital remains scares, due to a lack of investors, then IRRs will remain high. The challenge for investors, however, is timing. It will not take a large change for capital seeking policies to move the segment from a buyer's market to a seller's market. This may mean that earlier entrants in the life settlement market may find themselves receiving higher returns than late entrants.

Summary

From the perspective of life settlement investors, the events of 2008 and 2009 changed their landscape. The risks of inaccurate life expectancies and dependence on leverage became apparent. Larger institutional investors, especially investment banks, exited the asset class. Taxation changed causing funds to relocate their operations. Investment fraud continued to rear its head, causing some degree of concern among potential new investors. These factors came together to create the current buyer's market. However, for those investors that continue to participate there are several key points that point towards a more positive future.

CONNING

The Investor's Opportunity Remains

Life settlements attracted investors for two main reasons. First, the asset class has a low correlation to fixed-income and equity securities. Second, life settlements still offer investors the potential to generate a competitive return.

Life settlement investors view insurance as an asset with a low correlation to equity or interest rate changes. For investors who have a large portion of their assets in equity or debt, adding life settlements as an alternative investment is one way to reduce a portfolio's exposure to sudden downturns in the stock or bond markets. Low correlation is not the same, however, as noncorrelation.

Lower interest rates affect the premium optimization used by life settlement investors. Life settlement investors use the premium flexibility of UL to increase their return by "optimizing" the premiums they pay to the insurer.

Life settlements continue to offer the potential to generate competitive returns for investors. However, the buyer's market has brought forth two distinct markets for policies. The secondary market involves the purchase of policies from the individuals who initially took the policy out. The tertiary market involves the purchase of already settled policies, either singularly or in portfolios, from other life settlement investors. Both markets command a premium over similar risk-free rates, however, the secondary market appears to offer a higher premium for investing in new policies.

Like all investors considering allocating capital to life settlements, they are aware that they are at some degree of risk of losing their investment. Therefore, life settlement investors either consciously or subconsciously require an investment risk premium over a comparable risk-free investment. Life settlement investors in the secondary market also appear to be commanding a buyer's premium due to the lack of investor capital available to purchase policies in the secondary market.

In the tertiary market, the supply of capital interested in buying already settled policies and portfolios is creating enough competition for already settled policies and portfolios that investors need to reduce their IRRs and by extension increase their offer in order to win business. Given that LEs and face amounts are comparable between the secondary and tertiary markets, any advantage found in bottom fishing for bargains among already settled policies or portfolios may be declining.

The Investment Side Reboots

As the life settlement market reboots, investors will continue to find an opportunity to make returns that are higher than other fixed income investments. Life settlement investors will understand life expectancy risk better. Returning life settlement investors will face a legal landscape that has seen several cases recently that strengthened their ability to receive death benefits. In addition, if the life settlement market remains small in terms of the number of buyers, then IRRs may remain high.

Investors rely on life expectancies from underwriters, and often from more than one, as a major pricing component. Those life expectancies flow through to portfolios, where fund managers use them to calculate policy values over time. As the life settlement market reboots, investors will continue to remain concerned about the accuracy of life expectancies. However, efforts to standardize life expectancy methodologies should contribute to a reduction of concern among some investors.

Several court rulings in 2010 and 2011 limited the ability of life insurers to contest death claims. The life settlement industry has engaged with life insurers over policy rescission and denial of death claims since it began.

Life insurers have always resisted some death claims. However, with the rise of life settlements, some insurers have been more forceful in resisting suspected STOLI and other life settlement claims. Evidence of this can be seen in comparing the dollar amount of resisted claims for the ten insurers who have been the greatest focus of life settlement investors against the remaining industry. Against this background of an increase in resisted claims, recent court rulings have favored the life settlement industry. These cases are a positive development for investors.

What will be some broad investor themes that might emerge as the life settlement market reboots?

The life settlement market of 2006 through early 2008 saw several large investment banks enter the space. After the credit crisis and recession of late 2008 and early 2009, many left for a variety of reasons. Their withdrawal was a major factor in the reduction in capital to buy policies. As of 2011, the gap created by the withdrawal of those large investors has not been filled.

Investors can purchase settlement portfolios for only so long. At some point, these portfolios will be held until the policies in them lapse or a death claim is paid. This will cause capital to return to buying new policies. As it does, competition for policies will lead to higher offers being made, lowering the return for investors.

Finally, a smaller market, in terms of the number of players and the capital they bring, may benefit life settlement investors already in the life settlement market. The less capital available means that life settlement investors can continue to demand a capital premium in addition to their risk premium.