

■ Restoring The Balance

In 2009, The Industry Managed To Stay Balanced

By Jim Connolly

2009 was like a balancing beam during a California trembler: staying sure-footed was a challenge even for the most seasoned life settlement pros.

Industry experts described the challenges the past year held.

"2009 was quite a challenge, not just for the industry but for the economy of the country and the world as well," says Meir Eliav, president of Legacy Benefits, New York. A credit liquidity crunch slowed business substantially, he adds.

Eliav says that his firm was able to use internal equity and provide liquidity to clients that were not available through other lending sources. That liquidity along with service was critical to ending the year on a solid note, according to Eliav.

"2009 was definitely a buyer's market," J. Mark Goode, CEO of the Peninsula Group, LLC, Washington, notes. "There was an exceptional opportunity for return for investors." A decline in the equity value in homes and savings forced many people to monetize assets, he

says. But other factors including a global slowdown and credit crisis and currency volatility of the Euro/\$ exchange rate made for a challenging year, he continues. Additionally, modified life expectancy methodologies created challenges

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for the industry, Goode adds.

"It was also a year to explain the benefits of life settlements to both legislators and regulators at both the state and federal levels," according to Goode. He says he believes that the industry made progress as evidenced by comments he cites from Sen. Herb Kohl, D-Wisc. and Rep. Barney Frank, D-4th District, Mass. Goode says that

Kohl noted that the life settlement industry provides a service to consumers and that Frank confirmed that it is part of the life insurance industry. And, according to Goode, new interest from the U.S. Securities and Exchange Commission, Washington, is not a bad thing because it will help differentiate a life settlement which is not a security from investment products wrapped around life settlements which are securities.

The other "monumental" breakthrough, according to Goode, was the signing of life settlement legislation in California by Gov. Arnold Schwarzenegger in October 2009 and in New York by Gov. David

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Paterson in November 2009. These states represent the highest concentration of life settlement transactions in the country with a respective 24% in New York and 18% in California, he adds.

Doug Head, executive director of the Life Insurance Settlement Association (LISA), Orlando, Fla., describes how challenging the effort to establish fair legislation in the states proved in 2009. Head says that industry opponents “tried to overwhelm us and failed.” One offensive tactic was to approach state legislatures and quietly try to establish prohibitions, he says. Head cites “stealth maneuvers” in Nevada, Oregon and Vermont.

Even with such tactics, according to Head, “we have ended up with reasonable laws in California, Illinois and New York” and a scorecard of 18 new laws that includes 12 that are based upon a model law adopted by the National Conference of Insurance Legislators (NCOIL), Troy, N.Y., and six that reflect a model developed by the National Association of Insurance Commissioners (NAIC), Kansas City, Mo. (see accompanying chart.)

Michael Fasano, president of Fasano Associates, Washington, laid out the year in plain language: “2009 was a very bad year reflecting a number of developments: the shock to the credit markets beginning in 2008 and the pricing shock that resulted when some major LE providers extended the LE estimates in the fall of 2008.”

“This was a significant blow to portfolios, to the point that certain funders and providers have left the market and may not return.”

But work on best practices for LEs was the biggest achievement in 2009, he says. “LE providers are working to create a common methodology and approach to measure actual to expected accuracy,” Fasano continues. “Without a question, it

will help to restore confidence to the market.” It creates an apples-to-apples comparison that will provide greater transparency, he continues.

Philip Loy, owner and founder of AVS Underwriting, LLC, Kennesaw, Ga., says that activity in 2009 was much smaller than in 2008. He says that “the big players are still the big players” and the number of small clients is increasing. However, he qualifies this trend noting that a few small clients have gone away, so it is unclear whether some of those clients are starting new companies.

For AVS, 2009 was a year to build data bases and debit/credit models, Loy continues. The year allowed AVS to take files it had and enter them into the company’s database, he says.

“We are in a better place than the draconian place we were at near the start of the year [2009],” according to David Mickelson, president and founder of Mickelson Capital Consulting, Oceanside, Calif. “I can’t imagine anything worse than the 2008 collapse of the markets and the change in LEs. The effect killed the market and it took months before it crawled back.”

There were no deals early in the year and as the year ends, “the industry is limping along,” he continues.

For buyers, there were “super deals early in the year,” Mickelson continues. And, “there is still tremendous inventory,” he continues. Investors could get a return in the vicinity of 20% at the start of the year, but toward the end of 2009, returns were in the mid-teen range, Mickelson says.

While there has been a buzz about securitization, it hasn’t really happened, according to Mickelson. However, he believes that at some point in the near future, someone will “crack the code and get a deal done.”

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Returns in the mid-teens at the end of 2009, will drop even further as more investors come into the market, he adds.

“Overall, it has been a flat year. There are not as many funders coming back to the market as was hoped,” according to Scott Kirby, co-president, business development and compliance issues, with Advanced Settlements, Orlando, Fla. “This wasn’t a complete surprise. There was a major capital market meltdown that affected us as well as the rest of the market.”

A lot of money that would have come into the life settlement market did not because this market segment is not the main focus of many funders who buy life settlements as a part of their investment strategy, according to Kirby.

For buyers, he continues, it has really reverted back to the time when the viati-

cal industry was transitioning to the life settlement industry. Around 2000, a jumbo policy was \$5 million but between 2003 and 2006, as the economy grew, that number also grew to as much as \$30 million. Today, longevity has declined to under five years, whereas between 2003 and 2006, it was between 10-12 years. Kirby says that today, an IRR for a funder is in the 14-15% range whereas two years ago, it was in the lower double digits.

Manish Kapoor, a managing principal with West Wheelock Capital, LLC, New York, said that in 2009, if you looked across all asset classes, there are signs that credit is loosening. For instance, credit spreads for mezzanine debt is a lot tighter, which he says is a good sign. For non-traditional assets there was a lack of liquidity and funding. Very few were trying to obtain leveraged and structured loans and even if money was available, there was no will to pursue transactions,

Kapoor says.

However, Kapoor continues, there was an uptick in liquidity starting in September that gave some cause for optimism. However, he cautions, “too early to say if there will really be a recovery in 2010.”

This past year created a lot of shakeout for every sector of the business, according to Rob Haynie, managing partner, Life Insurance Settlements Inc., Fort Lauderdale, Fla. However, Haynie adds that “the industry held strong even in the face of turmoil.” One of the bright spots in the year, was the requirement in some states to inform a policyholder that is going to surrender a contract that there is a life settlement option, he says. ■

How To Rate The Accuracy of Life Expectancy Ratings

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used this information to estimate their survival. Using the methods outlined here, the actual number of deaths was then compared with the expected number. Preliminary results by time since underwriting are (see Table 1):

Overall there were 20% more deaths than expected (SMR = A/E = 1.2). The rating service underestimated mortality in the first (1.5) and second/third (1.2) years post underwriting. Thereafter their ratings appeared to be good (1.0).

A second partitioning of the person-years was into five groups defined by the mortality risk. Thus the lowest risk or “best quintile” consists of the 20% of the person-years with the lowest predicted death rates, and so on (see Table 2.)

MM denotes the mortality multiplier, which essentially compares the predicted life expectancy to those implicit in the VBT2001 non-smoking mortality rates. As can be seen, the predictions were excellent for the first three risk quintiles – those with the lowest MM’s. This indicates that (1) the chosen baseline mortality rate was a good fit to the empirical data, and (2) the relatively mild adjustments were done correctly. The predictions were unsatisfactory, however, in the worst quintile (SMR = 1.6). Additional analysis found that this excess was largely re-

stricted to the first 3 years post underwriting and that the ratings were too optimistic at younger ages. It was thus possible to pinpoint the type of insureds where the provider’s results were unsatisfactory. This, of course, is only an example of the myriad of analyses that could, and should, be done.

Summing Up

The method described here can be used to determine the accuracy of life expectancy estimates. It can thus be used to evaluate rating firms, individual raters, and the ratings themselves. We can also assess if a firm or its raters are improving with time, or if they are particularly good, or bad, for specific types of insureds (e.g., older males), diseases (e.g., Parkinsons), or policies (e.g., \$5M+).

These scientific comparisons can be made by any investor or other person who has both (1) the life expectancy predictions, and (2) the observed mortality experience of each insured. We hope this article shows that it can be done easily and correctly. ■