

**Testimony Before the
United States House of Representatives Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises**

“Recent Innovations in Securitization”

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by

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Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee:

Summary:

Good afternoon. My name is Russel Dorsett, and I am delighted to have the opportunity to appear before you representing the Life Insurance Settlement Association (LISA). LISA is the oldest, largest, and most inclusive body serving the Life Settlement industry; it is an honor and privilege to serve as LISA’s current President. Membership in LISA is available to any interested party actively involved in the industry and who can demonstrate good character and reputation, and includes institutional investors and financing entities, service providers (life expectancy underwriters, lawyers, servicing agents, consultants, and escrow agents) and the brokers and providers who, as licensed and regulated intermediaries, assist policy owners in finding buyers, negotiating terms, and completing transactions.

The latter category (brokers and providers) make up the bulk of our membership, and the major mission for LISA is promoting an orderly and transparent marketplace, sound regulation, and best practices to enable consumers (policy owners) to maximize the value of a financial asset—a life insurance policy which is no longer, needed, wanted, or some cases, affordable. We are very appreciative of the opportunity to appear before you today, as one of our primary missions is to educate consumers, regulatory bodies, and policymakers about the potential benefits to both individual consumers and the economy as a whole afforded by a robust secondary market for life insurance policies.

LISA’s members are part of the negotiated process whereby individual policy owners sell their policy through Brokers to Providers who are licensed and regulated in regulated states. In this context we have delivered nearly \$10 billion to those policy owners, making it possible for them to afford retirement, medical care, or simply to enjoy the lifestyle they have earned. The average settlement pays policy owners 4 to 6 times the policy’s cash value. Over the past decade the life settlement industry has delivered to policy owners approximately \$6 billion above what they would have received had they simply lapsed or surrendered the policy.

Life settlements also generate additional revenue for the US Treasury. When a policy is “transferred for value”, what would otherwise be tax-free income to the beneficiary becomes taxable in the hands

of the policy's new owner. Revenue Ruling 2009-13 and 2009-14 were issued earlier this year to help clarify the proper treatment of these transactions. It has always been recognized that the gain received by the seller (policy owner) was taxable; these rulings provide some guidance as to how that gain should be calculated. Unfortunately, these rulings are not entirely clear or consistent, and we look forward working with Treasury as well as Congress to fully and properly address the issues surrounding the taxation of life settlement transactions.

This appearance is occasioned by the Committee's concern that growth of the secondary market and the potential for securitizations based upon the asset class (settled policies) might somehow be seized upon by Wall Street's rocket scientists and grow to the point where it constitute a systemic threat. Life settlements represent a niche marketplace residing (rather uneasily) between two colossuses; the institutional capital markets and the life insurance industry. In comparison to either the life settlement market is miniscule. In the best of times perhaps \$ 3-\$4 billion of capital was actually employed to purchase policies, which might translate to face amounts of \$12 to \$15 billion purchased in any one year. While this is certainly not an inconsequential sum, it is tiny in comparison to the mortgage markets (\$14.6 trillion of outstanding debt and \$8.9 trillion of outstanding mortgage related securities, not including credit default swaps or other exotic counter party instruments¹) or the life insurance market (\$19 trillion of face amount in force, \$10 trillion of which is individual policies²).

It is somewhat ironic that we might be perceived to be a threat, in that this particular industry has suffered mightily due to the current financial crisis. At best the number of completed life settlement transactions during calendar 2009 might approach 50% of those completed in the prior year; there are some indications that the volume of completed transaction declined by as much as 75% during the first half of 2009 compared to the prior period, primarily due to dearth of investment capital available to purchase policies. While many attribute the ongoing financial crisis to rampant and poorly supervised innovation on the part of Wall Street, in our case the effect has been to greatly reduce the opportunity for senior Americans to realize the full market value of their financial property via the life settlement option. In the five years preceding the financial crisis, however, the secondary market did experience growth, driven both by increased awareness on the part of consumers that such an option existed and the undeniable appeal of life settlements as an alternative asset class.

Although securitization of life settlements has been a topic of considerable interest for some time, the number of transactions actually completed can be counted on one hand—with several fingers left over. A number of hurdles exist, including but not limited to the relatively small number of policies available to create “pools”, the lack of sufficient credible experience to validate actual to expected results in terms of life expectancy, and the evolution of an accepted methodology and criteria for obtaining ratings.

Life settlements are seen as a growth opportunity over the longer term. Demographic trends alone make it certain that more and more policy owners will, due to age and health status, find themselves in a position where a life settlement becomes a viable option, and even the most skeptical of

¹ The Bond Market Association

² ACLI Insurance Fact Book 2008

observers have concluded that life settlements can greatly benefit consumers in the circumstances where they are appropriate. To the extent that securitization can be accomplished in a financially sound and transparent manner, and in so doing increases the capital available to purchase unneeded or unwanted life insurance policies, we cannot help but believe that both social and economic utility are enhanced.

It is worth noting that even under the most optimistic growth scenarios only a very small fraction of the insured population would ever qualify as candidates for life settlement, and the total face amount of policies purchased is unlikely to approach even \$200 billion over the next decade. While this is a substantial sum, it is several orders of magnitude away from the potential for creating systemic problems comparable to those experienced in the mortgage markets.

Life insurance, after all, is generally accepted to be a tremendous engine for wealth creation. It provides unmatched entrepreneurial opportunities for those with the energy and enthusiasm required to prosper as life insurance agents, and it creates jobs for clerical, administrative, and professionals within life insurance companies. The premiums collected are productively employed to generate investments in stocks, bonds, real estate and private placements, and in that context the life insurance industry is one of the bedrocks of the global financial system. It promotes planning and self-reliance on the part of individuals and via the cash values created and the benefits paid upon the death of the insured, it protects families from financial ruin upon the death of a breadwinner and puts capital in private hands to finance businesses small and large.

In our view the existence of a secondary market only enhances an already tremendous value proposition for both individuals and society at large, and results in more people buying policies and keeping them for longer. Should their health decline or they reach an age where they need the money now rather than later, the life settlement option can provide funds to meet their needs at a time when other assets have been depleted or declined in value due to adverse market conditions.

History and Purpose:

The secondary market for life insurance, more commonly known as “life settlements” is a relatively new addition to the financial services landscape. The legal right of a policy owner to sell to an unrelated third party has been recognized for over 100 years and affirmed by the Supreme Court in 1911 in *Grigsby v. Russell*. A loosely organized secondary market first appeared in the 1980’s when “viatical” settlements arose, largely as outgrowth of the AIDS epidemic. Today’s secondary market evolved from those foundations: pricing methodologies, contractual provisions for conveying ownership, and a nascent regulatory structure under state insurance regulators.

The evolution of a robust and transparent secondary market has not been smooth or seamless. In the early stages of the market’s evolution, potential sellers (often AIDS victims) were paired with “Angel Investors” who were willing to provide funds for the compassionate purpose of allowing a terminally ill individual to afford housing, medical care, or to simply live out their final months or years with a measure of dignity. Because the market was “private”, new, and outside the boundaries of existing experience or regulatory structures, returns promised to early investors were high.

As policymakers and regulators became aware of this market there were two obvious areas of concern. The seller (policy owner) was presumed to be terminally or catastrophically ill and thus an obvious candidate to fall into a class needing special consideration and protection. Investors participating in the market were doing so with little regulatory guidance, and were thus also potentially in need of protection against fraud and misrepresentation. Despite these quite legitimate concerns, complaints from either buyers or sellers were relatively infrequent.

Since the underlying asset involved in these transactions was a life insurance policy, state based insurance regulators stepped into the breach and in 1992 the NAIC began work on a model law for the regulation of Viatical Settlements. Model laws focused on creating and regulating the activities of two new classes of insurance intermediary:

- The Broker, who is charged with representing the interest of the seller (policy owner) and owes a fiduciary duty to his client
- The Provider, who acts as a principal in the transaction and acquires the policy, either on their own behalf or for an investor (or investors)

When anti-viral treatments began to emerge, AIDS became a chronic but treatable condition rather than a certain death sentence. As a result, many of the “viators” (policy sellers with terminal illnesses defined in the NAIC Models) who had been deemed terminally ill proved to be anything but, and the returns promised to angel investors failed to materialize. In 1996, the SEC, concerned with the welfare of these investors, filed suit (unsuccessfully) against Life Partners for their practices in the solicitation of private angel investors. This suit failed and others saw this as a green light to solicit private investors for the purchase of policies.³

The secondary market of today is almost entirely focused on life settlements,⁴ and most investors are institutional investors working with professional asset managers. A life settlement involves the negotiated purchase of an in-force life insurance policy for an amount in excess of the cash surrender value but less than the face amount (death benefit) of the policy. Candidates for life settlement

³ During this same period insurance regulators made an attempt (still contained in Model legislation of the NAIC), to regulate the investment in these products. Meanwhile, the SEC renewed its efforts, bringing several successful cases to stop inappropriate investments by unwary individuals. The North American Securities Administrators Association (NASAA) noted in 2006 that nearly every state had taken a firm position concerning such investments by average investors that they were securities. These positions were based on investment contract analysis or specific state law in all but three states. LISA supported this effort and encouraged NASAA to make this position clear for the National Conference of Insurance Legislators as they developed new model laws governing settlements in 2008. The general consensus was that no entity without considerable financial sophistication and analysis was equipped to make such investments and that only qualified institutional investors should participate in this arena.

LISA has supported that approach by supporting specific language in all models which recognize the role of such investors in the markets. LISA has steadfastly joined with the NASAA effort to establish that the regulation of investments in this arena must occur under state and federal securities laws, while recognizing that the sale of an individual policy to a licensed Provider should properly be the domain of insurance regulators equipped to protect the seller in such a transaction. Over thirty-five states³ now regulate these consumer transactions through insurance law. LISA has participated in the development of all of these laws through our direct activity or through the activity of our members. We maintain a comprehensive data base of these laws for our members and are delighted to share that information with the committee members or staff.

⁴ Viatical settlements still occur, but are a very small part of the market

would generally include policy owners where the insured is age 70 and up and where the insured's health status has undergone a change since the policy was first issued.

The reasons for considering a life settlement are many and varied. Insurance is often purchased for specific purposes: income replacement in the event of the untimely demise of a breadwinner, debt, estate liquidity, etc. All of these needs are forward looking, and over time circumstances change, particularly as insureds achieve senior status. They may, for example, have out-lived their beneficiaries and paid off the mortgage and all their other debts. The estate may not have grown as anticipated, or the need for liquidity may have been reduced by the repositioning of assets. Last but not hardly least, insured may simply decide that they are no longer willing or able to continue paying premiums, and that receiving a lesser sum while they are still alive to enjoy it outweighs the potential of a larger sum paid to their beneficiaries or their estate.

It is worth noting that seniors who have participated in the life settlement market as "sellers" have generally been very satisfied with both the process and the outcome. Even as the number of regulated jurisdictions has grown substantially, the number of complaints about the activities of life settlement brokers and providers has been negligible. Thus far in 2009, no complaints have been registered regarding life settlements with the NIAC's complaint database, and only 9 have been registered during the preceding four years.

Size and Recent Growth:

Over the past decade, the market for Life Settlements has grown substantially as measured by a steady increase in the face amount of policies presented for sale. Various authorities estimated the total face value of life settlement transactions completed during 2006 was at \$5 billion in face amount. In 2005, Sanford C. Bernstein & Co., LLC, a research unit of Alliance Bernstein, L.P., estimated that approximately \$13 billion in face value of policies had been purchased from 1998 through 2005. Since establishment of those benchmarks, industry insiders have spent considerable time trying to measure the size and direction of the growth. A 2002 Wharton School study estimated \$100 billion in face value as potentially available, while a Bernstein Research study last year suggested that approximately \$160 billion in face amount would become available for purchase over a ten year period.

In the early years of this decade, institutional investors become big players in the life-settlement business, with substantial investment capital coming from German institutional funds. Current estimates are that life-settlement purchases have increased from \$2.5 billion of face amounts in 2003 to \$10 billion to \$15 billion during 2008.

It is worth noting that for the volume estimated, the capital actually employed to purchase policies may amount to, at most \$3 to \$4 Billion in any one year. That number has not changed significantly in recent years. This figure is, however, substantially smaller than the number recently cited in the New York Times. But we see little sign that the market for policies could possibly exceed the \$100 Billion of purchased policy fact mentioned in the studies of 2004. In the current year, with stress on all investment classes and a reluctance to invest, we believe that the total market has declined from

2008 and that investment may have fallen to as little as \$1.5 Billion. At this level, it would represent .01 Percent of the total market for life insurance and be an insignificant factor in life policy pricing, far lower than executive compensation and much, much lower than a rounding error in the investment results of the insurers.

Regulatory Structure:

Life settlements are currently regulated by the insurance departments in 35 states, and legislation covering life settlement transactions has currently either been passed or is pending in major jurisdictions such as Illinois, California and New York. LISA has worked diligently to support responsible regulation in all jurisdictions, and it is expected that by the end of 2010 more than 90% of the US population will reside in states where settlement transactions are regulated.

State based regulation of life settlement transactions has generally evolved from the models developed for the regulation of viatical settlements, and the primary focus is on the licensing and supervision of life settlement brokers and life settlement providers. Both the National Conference of Insurance Legislators (NCOIL) and the National Association of Insurance Regulators (NAIC) have developed model legislation for life settlements⁵; in most states that have recently passed legislation have used the NCOIL model as a starting point.

We believe that the States system of regulation has worked for our industry. We have our concerns in some jurisdictions, but expect them to be addressed and resolved. The nature of the process in fifty states is that we expect to see slight differences of opinion. For example some states have embraced the concept that consumers be aware of this option when lapsing or surrendering their life insurance policy and mandated such notice. Others have established enough obstacles to participation that no policies come to the market at all from the citizens of those states. We believe that the former pattern will prevail in the near future and that hurdles will diminish with greater familiarity with our market. That is happening rapidly, as evidenced by the extensive piece in the most recent issue of the AARP journal which explains the utility of the market with good cautionary notes to those who would avail themselves of its benefits.

LISA's role:

LISA is an industry trade group of 144 members which are licensed in many states:

- 40 Brokers
- 34 Providers
- 15 Financing Entities
- 51 Industry Services
- 4 Producers

⁵ The NAIC Model continues to use the archaic language of "Viatical Settlements" rather than "Life Settlements" supported by NCOIL.

We are proud that LISA members now hold over 1000 licenses in the regulated states. With a total of 888 licenses issued to the licensed Providers who are the policy buyers in all states, LISA members have obtained 624. Additionally, LISA Members represent nearly all of the nationally recognized brokerages who service residents of more than five regulated states.

We continually develop best practices for our members and refine them with a view to addressing emerging issues. We have developed extensive data bases for our members to allow for full compliance with and understanding of the laws of the states. Our efforts are extensive in seeking good regulation and we have been actively involved in dialogue with all industry regulators wherever permitted.

Securitization:

Much of the current concern seems to have arisen from a recent article published by the New York Times. We found this article to be poorly researched and somewhat misleading. Nevertheless, its publication caused a flood of calls from seniors to both LISA and our members, wanting to know how they could take advantage of the life settlement option for the policies they own. LISA did send out a response to this article, which is attached.

The life settlement marketplace isn't actually about Wall Street at all. It is, rather, about providing older Americans with the opportunity to profit from an asset for which they have bought and paid. Nor is it about "profiting from death"; it is about allowing seniors to benefit from a life insurance policy while they are still around to enjoy it. Owners of life insurance have long been able to treat these policies like any other "ordinary property", so said Justice Oliver Wendell Holmes in 1911 (*Grigsby v. Russel*). Indeed, as far back as 1855 New York's highest court held that policy owners enjoy the property rights in life insurance and, as such can "go to the best market the can find, either to sell it or borrow money on it."

While virtually every residential and commercial property in the US is mortgaged at some point, not everyone owns (or keeps) a life insurance policy. Of those that do, only a small percentage would qualify for the life settlement option, either now or in the future. For an in-force life insurance policy to have a value in the secondary market, the present value of the death benefit must exceed the present value of future premiums at an acceptable rate of return.

As an example, a 45 year old female non-smoker has a life expectancy of approximately 35 years.⁶ (This number represents the probability that 50% out of 1000 individuals at this age will have died 35 years into the future.) Accordingly, an investor purchasing this policy would have a 50% chance of paying premiums on an insurance policy for the next 35 years— and they would also have a 50% chance of paying premiums for more than 35 years in order to receive any return on their investment. Sophisticated mathematics are not required to know that this is not a good investment opportunity.

For the most part the life settlement option is only available to individuals age 70 and up. It is worth noting that a female age 70 with no major health issues has a life expectancy (on the same basis) of

⁶ 2008 VBT mortality table, female non-smoke age last birthday

nearly 17 years—still not a good investment, unless her health has changed substantially since the policy was issued. The numbers simply don't work and the policy has no value as a life settlement.

Efficient capital has entered the market in recent years and it is likely that some form of formal regulated securitization is indeed on the horizon. Done responsibly, and with proper oversight, this further development of the secondary market will bring more capital into the marketplace and thus provide more insureds with more value. This is good news for American consumers. Nor is there anything morbid or ghoulish about investing in settled policies as an asset class. Investments in mortality/morbidity are a multi-trillion dollar global industry which has been around for at least 200 years—it is indeed one of the foundations of the modern global economy, including annuities, cat bonds, and many other varieties of insurance linked securities.

In conclusion, we believe that life settlements provide a tremendous service for consumers. We believe the Committee should know that Life Settlements are a legitimate and well regulated market providing a true benefit to seniors in need. We believe that life settlements clearly provide social and economic utility, and make a positive contribution to society at large.

I want to thank you for your strong support for the American Economy. We believe that your work is invaluable and hope that we can be of further assistance in strengthening and enhancing good markets and confidence in those markets for the American consumer.

I would be happy to answer any questions you may have.