



Life Insurance Settlement Series Edition No. VIII

A Critique of GAO Life Settlement Survey Data

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Abstract

The purpose of this paper is to evaluate and put into perspective the survey data collected by the Government Accountability Office (“GAO”) from the life insurance secondary market. This paper does not seek to challenge any of the discussion in the GAO July 2010 Report to the Special Committee on Aging, U.S. Senate titled, “LIFE INSURANCE SETTLEMENTS Regulatory Inconsistencies May Pose a Number of Challenges.” Any statement in this paper that may appear to be agreeing or disagreeing with GAO discussion in its report is unintended. All **yellow data** cells represent calculations developed by the Insurance Studies Institute (“ISI”) using the GAO survey data.

While the GAO data provides some measurements of the Life Insurance Secondary Market (“LISM”)¹, several important points of information are absent in the report, such as:

- Trends in insured life expectancy for policies sold
- Relative number of policies sold by policy type
- Principal health impairments of the insured
- Ability to estimate taxable income to sellers
- Identification of insurers by policies sold
- Pricing by policy size and life expectancy of insured
- Premium loads and how they affect policy pricing
- Rate of policy maturities following purchase

Such data would more comprehensively reveal the inter-complexities of the secondary market, and provide valuable information to help policy sellers and investors to make wiser decisions.

The GAO survey data reveals that the LISM has provided substantial value to those seniors fortunate enough to discover and understand the benefits of the life insurance settlement option. The survey data demonstrates that the LISM is rapidly maturing as life settlement laws, STOLI laws and regulations take hold. The survey data also shows that the financial market meltdown in 2008 and 2009 has had a daunting impact on the LISM, which is unfortunate for the many seniors who now seek maximum value from their life insurance to help replace depleted retirement funds.

While data collected by the GAO is an important step in assessing the value provided to seniors by life insurance settlements, the landscape of the LISM is changing and important issues remain unresolved:

- Whether or not life settlements should be treated as securities.
- Whether the federal government should replace state life settlement regulations.
- Whether insurers should be allowed to change terms of policies after they are sold thus decreasing the LISM value of policies to seniors.
- Whether insurers should be allowed to discriminate against seniors seeking to sell policies.
- Whether insurers should be allowed to intimidate and threaten agents with their jobs to discourage life settlements.
- Whether insurers should be allowed to engage in manipulative paper work beyond existing laws and regulations to discourage sellers.
- Whether a senior should be allowed to purchase a policy with the intent to sell it for profit.
- Whether insurers should be required to advise policyholders of the life settlement option when considering lapsing or surrendering a life insurance policy.

These are the issues facing the LISM going forward. They need to be addressed and resolved promptly as they are frustrating investors and impeding further investment into the LISM, which is materially hurting seniors who need liquidity now.

I Understanding the GAO data sample

| | |
|---|--------------|
| # states requiring provider licenses as of 9/2009 | 34 |
| # of licensed providers | 98 |
| # of providers licensed in two or more states | 55 |
| # of providers contacted | 49 |
| # of providers returning surveys | 25 |
| Participating providers as % of total licensed providers | 25.5% |
| Participating providers as % of those licensed in 2 or more states | 45.5% |
| Participating providers as % of total contacted | 51.0% |

The GAO determined that there are 98 licensed life insurance settlement providers in the U.S., but for the purpose of the study, attempted only to contact providers who are licensed in two or more states. Of the 49 providers contacted, only 25 responded to the survey. A sample size of 25.5% in large surveys with normal distributions of data is typically statistically significant. Unfortunately, the GAO survey does not provide sufficient data to determine the real size of the LISM. Further, several participating providers did not answer every question on the survey. As the GAO noted in its report, “Because no comprehensive life settlement data exists, we (the GAO) were



not able to estimate the share of market held by the providers responding to our (the GAO) survey.” Further, the data did not enable interpolation to estimate the full size of the LISM.

- It is well known that several providers are materially larger than the typical provider and their data cannot be interpolated as representative of the others.
- Even though 43 providers² are licensed in only one state, it is not possible to conclude that these providers did not engage in substantial life settlement transactions in non-licensed states or purchase policies in other licensed states through other licensed providers. By excluding them from the survey, substantial LISM transactions may have been omitted.
- Where a provider not licensed in a particular state purchased policies through another licensed provider, did the policy get reported twice to the GAO? Such error could be prevalent and thus cause data to be exaggerated.
- Capturing data from only 51% of a strategic sample of 49 solicited providers, particularly when the business volume of the participating providers is not known relative to the total LISM calls into question the reliability of the returning sample to be statistically representative of the total population.

Members of the media, whose job it is to sell stories, and The GAO survey data reveals some interesting findings, for example, the discovery of 98 providers in licensed states suggests that a large number of firms sought business in the LISM. How many more existed in unlicensed states remains unknown. It is unfortunate the survey did not reveal the number of licensed providers for each of the years by state so the growth of the LISM could be measured in terms of new entries into the market. Because of the survey data limitations, many insights to the LISM are not able to be captured. Nevertheless, the GAO report represents the most comprehensive set of data collected to date and provides greater clarity into the LISM.

II The LISM Was Expanding Rapidly Until the Financial Crisis, Then Plummeted.

GAO 1

What was the total number of life insurance policies purchased by your firm in calendar year?

| | | % Change |
|------|-------|----------|
| 2006 | 3,148 | |
| 2007 | 3,703 | 17.63% |
| 2008 | 4,505 | 21.66% |
| 2009 | 2,636 | -41.49% |

The GAO data reveals that the LISM was expanding at a healthy rate until the 2008/2009 financial market meltdown caused investor capital to vanish. Knowing that the meltdown started in mid 2008 suggests that the first half of 2008 represents much of the reported 4,505 policy purchases. It seems reasonable to infer that both policy seller appetite and investor demand was growing with confidence. The question is, was seller appetite or investor demand driving the market?

In addition to financial market turmoil, other pressures contributed to the plummet in policy transactions. It was in the latter half of 2008 when life expectancy underwriters materially lengthened their mortality tables. This resulted in a paradigm shift in investor confidence and added to the withdrawal of capital.

Also, prior to 2008, the life insurance industry had promoted and issued premium financed policies which quickly became products in the LISM. In 2008 and 2009, however, the absence of “insurable interest” in the lives these policies insured (now known as STOLI³ policies) was comprehended and concerns were brought to the attention of legislators. Lobbying by the ALCI with support of the LISM caused most states to pass laws prohibiting such policies, which further reduced life settlement transactions in 2009.

Finally, with the impact of the above pressures, many life insurance portfolios were required to take market value write downs of 10-40%, which further led to investor pullback.

It is not surprising that life insurance settlement transactions plummeted in 2009, continuing to percolate in 2010 at lower volumes and lower prices. With shortage of capital, the LISM is now a “buyers” market.

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III Market Size Exceeded \$13 Billion in 2008 and Policy Size Rapidly Increased But Is Receding

GAO 2

What was the total face value of the policies purchased by your firm in calendar year?

| | | % Change | Average Policy | % Change |
|------|------------------|----------|----------------|----------|
| 2006 | \$5,501,932,247 | | \$1,747,755 | |
| 2007 | \$9,025,862,851 | 64.05% | \$2,437,446 | 39.5% |
| 2008 | \$12,946,270,383 | 43.44% | \$2,873,756 | 17.9% |
| 2009 | \$7,005,574,470 | -45.89% | \$2,657,653 | -7.5% |

The GAO data reports \$12.9 billion of total face value in 2008 for 25 providers, 25.5% of 98 licensed providers and unknown more unlicensed providers. Because the GAO data represents less than all providers, it can be concluded that the total market exceeded \$13 billion in 2008 ... but how much more cannot be determined by the GAO survey data.

Policy size increase from 2006 to 2007, and again to 2008, is reflective of several things:

- As the LISM transitioned from its early focus on viatical settlements (insured having terminal illnesses, typically AIDs) and short life expectancies (“LEs”), the LISM turned its attention to the purchasing of policies insuring the lives of elder people having more normal life expectancies. This resulted in longer LEs and longer holding periods, thus higher costs. Because the cost to track and manage a policy is the same for small death benefit policies and large death benefit policies, the LISM focused on larger policies, i.e., higher investment yields with lower carrying costs.
- Agents and brokers who undertook to identify policies appropriate to be sold in the LISM sought larger policies because the commissions were higher. This pushed the market to larger policies.
- Premium financed and STOLI policies were promoted to wealthier individuals because larger policies paid agents higher commissions and were more profitable to the policy owners as well as the financing firms. This caused the average size of settled policies to rapidly increase.

Because the manufacturing of STOLI policies has ceased, the size of life settlements are decreasing. In addition, there is an awareness among life insurance policy investors that adding smaller policies and shorter LEs to a portfolio helps diversify investment risks. Thus, a gradual decrease in policy size should be expected to continue.

IV Net Amount Paid to Policy Sellers for Settlements Is Trending Down

GAO 3

What was the total amount paid to policy owners (exclusive of broker compensation, such as commissions) for the policies purchased by your firm in calendar year?

| | | % Change | % of Death Benefit |
|------|-----------------|----------|--------------------|
| 2006 | \$1,170,878,009 | | 21.28% |
| 2007 | \$1,801,390,695 | 53.85% | 19.96% |
| 2008 | \$2,319,081,754 | 28.74% | 17.91% |
| 2009 | \$888,003,867 | -61.71% | 12.68% |

While aggregate net payments to policy sellers increased dramatically in 2007 and 2008, the net amount paid to policy sellers as a percentage of death benefits, after all commissions paid to agents and brokers, trended down. Several factors contribute to this trend:

- The gradual shift to healthier insured, as evidenced by longer LEs, resulted in higher costs to maintain and service policies.⁴ Thus to satisfy investor return requirements, policy prices were necessarily reduced.
- As STOLI issues surfaced in legislatures, investors demanded higher yields to accept these higher risk policies.
- With the financial meltdown of mid 2008 investor capital started pulling back, concurrently triggering an increase in investor yield requirements which led to lower prices for policies purchased. This pattern continued with vengeance through 2009.
- Substantial new life settlement legislation occurred in 2007 through 2008, resulting in laws, regulations and operating changes that caused increases in costs, risk uncertainties, insurer anti life settlement pressures, and negative publicity. All of this led to amplified investor skittishness⁵ and demand for higher yields.
- Finally, in 2008, the life expectancy underwriter firms adopted new mortality tables that resulted in 20-30% longer life expectancies. This automatically translated into lower prices paid to sellers.

The downward net price paid to policy sellers has continued into 2010, mostly because of reduced investor capital. Seller appetite, on the other hand, has remained steady. This has resulted in a “buyer’s” market. A return of capital should be expected to cause amounts paid to sellers to increase, but probably not to the levels seen prior to 2009.



V The Amount of Associated Cash Surrender Values Has Trended Down

GAO 4

What was the total amount of associated cash surrender value of the policies purchased by your firm in calendar year?

| | | % Change |
|------|---------------|----------|
| 2006 | \$99,965,301 | |
| 2007 | \$199,300,307 | 99.37% |
| 2008 | \$149,741,970 | -24.87% |
| 2009 | \$109,432,850 | -26.92% |

Because three provider firms did not submit data for this item, and it is not known if these firms represent a substantial portion of the total data reported, a comparison of the cash value surrender amounts to the total policies sold by number and/or death benefit would produce unreliable results. Even the general decrease in the amount of cash surrender value of the policies sold may be somewhat misrepresentative of the LISM for these years. Nevertheless, a decreasing trend is evident and may be reflective of several factors:

- The advent of premium financed and STOLI policies in 2007 and 2008 brought a disproportionate amount of younger policies to the LISM, which would have lesser surrender values. This is evident in the data reported for Item GAO 6 below where data show a greater increase in younger policies in 2007 and 2008.
- An increasing practice by some investors to purchase term policies, which have no cash surrender values, would decrease the amount of policies purchased having cash surrender values.

Concurrently, both the number and aggregate face value of policies sold in 2007 and 2008 increased materially as reported in GAO items 1 and 2 above. This suggests that the impact of factors noted above were materially substantial. But with STOLI gone and conversion risk of term policies increasing, it may be reasonable to expect that older policies having more cash surrender values will increase in market share.

VI Amounts Paid to Sellers Materially Exceeded Cash Surrender Values

Attempts have been made to compare the data in GAO item 4 with data in GAO item 3 to establish a relationship between the net amounts paid to policy sellers versus the amount policy sellers would have obtained by lapsing or surrendering the same policies. Unfortunately, because 3 providers, who appear to represent a significant portion of the total did not report cash surrender data for GAO item 4 (See discussion in Section 8 below), such a direct comparison is not reliable. This is because the totals in GAO item 3 include data from all 26 reporting providers, but totals in GAO item 4 include data only

from 23 reporting providers, and the data in GAO item 3 for the three non-reporting providers cannot be separated. Thus any comparison could be overstated.

The only statement that can be made is that the reported aggregate total amount paid to policy owners for 2006 through 2009 approximated \$6.2 billion, while the reported aggregate cash surrender value for policies purchased in 2006 through 2009 approximated \$.6 billion. But even if the missing data were to represent another \$.6 billion of cash surrender value (it likely is less than that), for a total of \$1.2 billion, the amount paid to sellers for purchase of policies is materially greater than what they would have received for lapses and surrenders by nearly \$5 billion. When considering the total number of policies purchased over the same years, the aggregate value of \$5 billion averages to over \$440,000 per policy seller in excess of cash surrender values.

Given the limitations of the data, along with some evaluation of the data, it seems reasonable to say that on average the net amounts paid by the LISM to sellers exceeded average cash surrender values by multiples of 5 to 10 times.

VII Compensation Paid Has Materially Decreased, and Continues Down

GAO 5

What was the total amount of compensation (e.g., commissions) paid to brokers for the policies purchased by your firm in calendar year?

| | | % Change | % of Gross Paid to Sellers | % of Death Benefit |
|------|---------------|----------|----------------------------|--------------------|
| 2006 | \$202,774,451 | | 14.8% | 3.7% |
| 2007 | \$263,454,952 | 29.93% | 12.8% | 2.9% |
| 2008 | \$275,676,198 | 4.64% | 10.6% | 2.1% |
| 2009 | \$92,229,350 | -66.54% | 9.4% | 1.3% |

The downward pressure on agent and broker compensation has been dramatic. While total death benefits for policies purchased increased by 64% in 2007 and 43.4% in 2008 (See Section 3, GAO Item 2), compensation for brokers increased only by 29.9% in 2007 and 4.6% in 2008. Further, compensation as a percentage of death benefits has steadily decreased from 3.7% in 2006 to 1.3% in 2009. This trend results from numerous factors:

- The net amounts paid per policy to sellers has decreased, which has caused agents and brokers to accept less compensation to complete a life insurance settlement transaction.
- Media and regulatory actions have pressured brokers to be more competitive.





- Investors have pressed to pay lower transaction costs in order to increase investment yields.
- As more brokers entered the LISM prior to the 2008 downturn, there was increasing pressure on compensation competitiveness.
- Another trend that started in the past few years is for providers to bypass brokers and go directly to agents or policy owners.

Of particular interest in the data is the amount of the gross payment from investors that was paid in compensation versus paid to the policy owners. This is reflected in the data above titled, “% of Gross Paid to Sellers.” These figures were calculated by adding the total compensation to the “Net Amount Paid to Policy Sellers (excluding compensation)” in GAO item 3 to determine the gross amount that was paid by the providers for the policies in each year. There have been concerns expressed in various circles that compensation paid to brokers and agents was too much in relation to what the policy seller was paid. The GAO data reveals that broker/agent compensation steadily decreased from 14.8% of the gross purchase amount in 2006 to 9.4% in 2009. This is a direct result of the factors noted above for decreases in broker/agent compensation.

The question remains, what is a fair compensation for helping a policy owner find a buyer for their policy? Over time, as investors and sellers become more educated in life settlements and as balance between buyers and sellers returns, the market will sort this out.

VIII Age of Policies When Sold Have Trended Lower

GAO 6
What was the total number of policies purchased by your firm, based on the age of policy at the time of settlement (i.e., the time between policy’s issuance and settlement), for calendar year.

| | < 2 yrs | 2-5 yrs | >5 yrs | % of Total Reported | | |
|------|---------|---------|--------|---------------------|-------|-------|
| | | | | | | |
| 2006 | 37 | 844 | 880 | 2.1% | 47.9% | 50.0% |
| 2007 | 21 | 1366 | 1296 | 0.8% | 50.9% | 48.3% |
| 2008 | 10 | 1790 | 1301 | 0.3% | 57.7% | 42.0% |
| 2009 | 3 | 780 | 609 | 0.2% | 56.0% | 43.8% |

Because 3-4 provider firms did not report data for GAO item 6, comparisons to the total number of policies in GAO item 1 are not conclusive, which explains, in part, why the number of policies for each year in the above table is materially less than the total number of policies reported in GAO item 1 above, i.e. by 43% to 27% of all data reporting⁶. This suggests that the non reporting firms represent some of the larger provider firms in terms of policies purchased.

However, comparison of the data within the table above for each year reveals that there has been a clear decrease in the percentage of policies purchased having an age less than 2 years in either absolute terms, or percentage of total policies purchased.

The percentage of policies purchased having ages of 2 to 5 years increased in 2008 and leveled in 2009. Given the magnitude of the missing data, it is not possible to say if the number of policies purchase with ages 2 to 5 years is significantly different from the number of policies purchase having ages greater than 5 years.

Reasons for the trends, if any, are the same as those described in Section 3 above.

IX Median GAO Data Does Not Provide Any Meaningful Knowledge

GAO 7
What was the median face value for all policies purchased by your firm in calendar year?

| | Low | High | Average Face |
|------|-----------|-------------|--------------|
| 2006 | \$150,000 | \$5,000,000 | \$1,747,755 |
| 2007 | \$200,000 | \$5,000,000 | \$2,437,446 |
| 2008 | \$225,000 | \$6,000,000 | \$2,873,756 |
| 2009 | \$247,500 | \$8,000,000 | \$2,657,653 |

GAO 8
What was the total amount of associated cash surrender value of the policies purchased by your firm in calendar year?

| | Low | High |
|------|----------|-------------|
| 2006 | \$7,200 | \$765,000 |
| 2007 | \$11,500 | \$5,775,000 |
| 2008 | \$46,000 | \$1,072,000 |
| 2009 | \$37,780 | \$992,618 |

GAO items 7 and 8 sought to gather median data to identify the more “typical” values (versus an average that could possibly be skewed by a few large purchases) of purchased policies and the amounts paid for them. Unfortunately, without knowing the number of policies represented by each “low” and each “high” data point, it is not possible to glean any materially useful knowledge from the reported data. For example, if the “low” or “high” value in any of the years represents a provider having completed only a few purchases, a generalization from the data would be unreliable. Further, at least one data point in





GAO item 8 appears spurious when compared to its respective data point in GAO item 7, i.e., it seems unlikely that the median amount paid for a policy (\$5,775,000) would be greater than the median death benefit (\$5,000,000). While the actual data points may be accurate, this demonstrates the difficulty of drawing any meaningful knowledge from such misaligned data points.

Conclusion

The GAO data provides some measurements of the Life Insurance Secondary Market (“LISM”), but it misses important knowledge such as: trends in insured life expectancy for policies sold; relative number of policies sold by policy type; principal health impairments of the insured; ability to estimate taxable income to sellers; identification of insurers by policies sold; pricing by policy size and life expectancy of insured; premium loads and how they affect policy pricing; and rate of policy maturities following purchase. Such data would more comprehensively reveal the inter-complexities of the secondary market, and provide valuable information to help policy sellers and investors to make wiser decisions.

Given the findings from the GAO survey data, it is clear that the LISM has provided substantial value to those seniors lucky enough to have learned about the life insurance settlement option. It is clear that the LISM is rapidly maturing as life settlement laws, STOLI laws and regulations take hold. It is also clear that the financial market meltdown in 2008 and 2009 has had a daunting impact on the LISM, which is unfortunate for the many seniors who now seek maximum value from their life insurance to help replace depleted retirement funds.

Footnotes

- ¹ When a consumer embarks upon the sale of a life insurance policy, often the only communication they receive is from their insurance agent or financial representative. That person in turn brings that policy to market, which is made up of many parties who assist in the completion of the transaction. A life settlement broker works with the insured’s financial representative to receive bids from life settlement providers, who purchase policies and have third-party investors. Medical underwriters assist in the process by providing life expectancy estimates so that the providers can determine the value of the policy. Other servicing firms include tracking agents, collateral managers, escrow agents, auditors, and information service providers. Together, these parties make up the Life Insurance Secondary Market (“LISM”).
- ² There are 98 licensed life insurance settlement providers, 55 of which have licenses in more than one state, leaving 43 providers who are licensed only in a single state.
- ³ A STOLI is an illegal transaction where a third party, authorized to sell life insurance policies but having no “insurable interest” in the life of the insured, convinces a person to apply for a life insurance policy with an agreement that the third party will have a material ownership or control of the policy in return for some form of compensation. STOLI is an acronym for “Stranger Originated Life Insurance.”
- ⁴ Paul Siegert, *Evolution of Life Expectancies in the Life Insurance Secondary Market...Current Trends and New Developments*, The Insurance Studies Institute, 2010.
- ⁵ Jesse Miller, Christopher Kampa, Paul Siegert, *Portrayal of Life Settlements in Consumer-Focused Publications*, The Insurance Studies Institute, 2010.
- ⁶ The number of policies reported in GAO 6 divided by total policies reported in GAO 1 by year reveals that 27% to 43% of policies reported in GAO 1 were not reported in GAO 6. This 27% to 43% represents data not reported by 3-4 providers, which suggests they represent a substantial portion of total data reported.

