The Game of Life

Investors' and insurers' mortal clash.

WITH FINANCIAL ENGINEERS busily devising ways for hedge funds to bet on everything from snowfall in Central Park to the price of tea in China, it was only a matter of time before they concocted a play on the mortal coil itself. So successful have they been, that the young market for these transactions has ballooned in recent years to more than $3 billion in face value—and its backers say it could grow to several times that amount this year. The market has also attracted the ire of many life insurance companies, who are actively seeking to put an end to it.

Specialist brokers in this "life settlement" market offer affluent clients, usually over the age of 70, two years of free life insurance and occasionally an upfront payment. The brokers finance the premiums on the policy and, after the two years, they assume ownership of it. They then pool it with other policies and repackage it for sale to hedge funds and other investment vehicles (hence the name, investor-owned life insurance or IOLI). When the insured individual dies, the policy's death benefit goes to the new owner.

In many cases, affluent individuals are also the principle investors in these pools. They earn returns in the low to mid-teens, but bear "mortality risk"—essentially the threat that the insured individuals will live longer than expected, causing the premium payments to outstrip the amount of the eventual death benefit.

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LAPSE OF REASONING

Insurers dislike this type of arbitrage for several reasons. One is that they expect some proportion of normal policies to lapse, and set their prices accordingly. The life settlement policies never lapse—all are held until the insured dies. However, unlike the high lapse rate seen among younger policyholders, most policies taken out by people in their 70s or later are for estate planning purposes, and only an inconsequential percentage of them normally lapse, so this has had little effect on the industry's overall profitability, notes Laurie Lewis, senior vice president at the American Council of Life Insurers, a lobbying group in Washington. Arthur Fliegelman, an insurance specialist and senior credit officer at Moody's Investors Service in New York, agrees, but says insurers are now considering their pricing more carefully. "It's opened the industry's eyes to products that are overly sensitive to lapse rates," he notes.

Others worry that federal tax authorities will come to see these transactions as a threat to revenues and change the tax treatment of death benefits for all policies. "The largest concern for the industry is IOLI's potential to cause problems in Washington," Fliegelman says. "[Insurers] have every reason to be fearful." However, Lewis notes that the transfer of ownership in these deals typically makes the death benefit taxable, so the government should not see them as a threat to tax revenue.

Instead, Lewis says the industry opposes these transactions because they benefit individuals who bear no relationship to the insured, undermining the logic of life insurance. She argues that this also violates state regulators' insurable interest standards, which require the beneficiary of a policy to have a relationship with the insured. "We don't think [life policies] are an appropriate thing to arbitrage, especially with these schemes having questionable validity under state laws," she says.

Lewis adds that investors may be unaware of the extent of the mortality risk they assume. She recalls how the returns on viatical settlement investment vehicles backed by AIDS patients' life policies evaporated in the early 1990s when medical breakthroughs greatly extended those individuals' lives. "Think of what your return is based on," she says. "It's based on when elderly people are going to die. Is that a secure investment?"

But life settlement specialists argue that the industry's opposition stems mainly from the fact that the life settlement market gives the insured more lucrative options. "If the life settlement industry were to go away, the only one who could buy the policy back is the insurance company," notes Nemo Perera, managing partner at Risk Capital Partners in New York, a firm that arranges these transactions. The surrender value paid by an insurance company is much less than the value the insured receives from life settlement transactions, he says. As for the mortality risk issue, Perera acknowledges this is a significant concern for investors, but he says it can be hedged effectively.

The insurance industry did win a significant victory in December, when the New York State Insurance Department ruled that one specific type of IOLI transaction did not meet the insurable interest requirements. Some New York insurers involved in IOLI have stepped back from the market, Perera notes. "But they haven't elsewhere—the market is still growing."

—*Dwight Cass*