

Life Settlement Securitizations Under Scrutiny

The recent article in *The New York Times* forecasting a continued upsurge in life settlement securitizations serves not only to underscore the increased activity that market participants have experienced first-hand over the past year, but also to highlight certain challenges inherent to this asset class.¹ The life settlement market may indeed be poised for significant additional growth, with a rated deal rumored to be on the way and at least one of the rating agencies focused on the asset. Some experts predict that the market, presently estimated by some to be as large as \$20 billion, could grow to \$500 billion in the months ahead.² But while it is fair to say that many players are looking at life settlements with renewed interest, it is also true that legal, business, and regulatory issues continue to cloud the horizon, making any prediction as to a future life settlement securitization boom uncertain at best.

Overview

A life settlement, or senior life settlement, is a contractual right to receive the proceeds of an individual life insurance policy paid by the issuing insurance company upon the death of the insured. The rights to these proceeds, along with the related insurance policies themselves, are purchased by licensed originators at prices that are steeply discounted from the face values on the policies but higher than the cash surrender value offered by the issuing insurance companies. The life settlements are then

aggregated within a bankruptcy remote special purpose vehicle, which issues securities with payment characteristics that mirror the performance of the life settlement pool. When an individual insured passes away, the issuing insurance company pays the proceeds of the policy to the issuer of the securities and these amounts ultimately flow through to noteholders.

As an asset class, life settlements are similar to, but distinct from, viatical settlements. Whereas life settlements typically involve life insurance policies for which policyholders have passed retirement age, viatical settlements involve life insurance policies for which the related insured suffers from a terminal illness.

A Closer Look

Much of the recent buzz surrounding life settlement securitizations results from a renewed interest in the asset class by the rating agencies—particularly Dominion Bond Rating Service (“DBRS”). In February of last year, DBRS became the first rating agency to publish criteria pertaining to securities backed by life settlements.³ A.M. Best Company published its relevant criteria in March 2008.⁴ DBRS has indicated that it may soon begin assigning ratings to life settlement securitizations, a

¹ Jenny Anderson, *Wall Street Pursues Profit in Bundles of Life Insurance*, N.Y. Times, September 5, 2009.

² *Id.*

³ The DBRS criteria piece, “Rating U.S. Life Settlement Securitizations,” February 2008, is available at www.dbrs.com/research/218569/rating-u-s-life-settlement-securitizations.pdf.

⁴ The A.M. Best Company criteria piece, “Life Settlement Securitization,” March 24, 2008, is available at www.ambest.com/debt/lifeselement.pdf.

number of which are currently under review by the rating agency. The rating agency methodology focuses on certain risks inherent to the asset class and the means by which market participants may mitigate these risks, several of which are summarized below.

Longevity Risk. The primary risk involved in life settlement-backed securities is longevity risk—the risk that individual insureds will live longer than expected. Rating agency criteria require that each policy be examined by two independent medical underwriters, who assign a numerical life expectancy to each insured. Projected cash flows for the securities are then based upon an actuarial analysis of the entire life settlement pool. A number of structural mitigants may be employed to protect against deviations from projected life expectancies, including some form of third-party guarantee or insurance, a derivative product, or overcollateralization.

Insurance Company Financial Strength. The primary *credit* risk involved in life settlement transactions relates to the creditworthiness of the issuing insurance companies. To address this risk, deals typically impose a minimum ratings requirement on each issuing insurance company, as well as concentration limits upon the portion of the pool that may be made up of policies issued by any single insurance company.

Policy Origination. There are a number of considerations relating to the origination process. Originators must be licensed in those states with licensing requirements where policies will be purchased. Under state law, the policy must have been originally procured by a person with an “insurable interest” in the continuation of the life of the insured. Typically, this means that the policy must have been initially purchased by the insured, a close family member, or, in some jurisdictions, an employer or certain charitable organizations. In certain jurisdictions, the beneficiary of a policy must have an insurable interest in the life of the insured throughout the term of the policy. Contravention of these statutes, which have been the subject of several high-profile cases during the past year, could cause the issuer to be unable to collect on a particular policy. Compliance with “insurable interest” laws is often covered by a legal opinion. Another consideration relates to a policy’s “contestability period”—the period during which an insurance company may contest a claim for reasons including fraud or misrepresentation by the insured or suicide. Once this contestability period has expired, it becomes much more difficult for the insurance company to refuse to pay out on the policy. As a result, it is generally the case that only life

settlements that are beyond their contestability period may be included in the collateral pool for a life settlement transaction.

Servicing. The servicing component of a life settlement transaction also presents certain unique challenges. In order to maintain the effectiveness of the insurance policies, the servicer must ensure that all premium payments are made in a timely fashion. Typically, reserves will be set aside on the closing date to cover premium expenses for the first two to three years of the transaction. After this period, premium payments are expected to be paid from the proceeds of maturing policies. In some transactions, liquidity facilities are employed to further protect against premium shortfalls. Another key aspect of servicing life settlements is tracking. Until an individual insured passes away, the servicer must monitor or “track” the insured in order to be able to promptly file a claim upon the insured’s death. Typically, this tracking procedure consists of quarterly correspondence with each individual insured. Once the insured does pass away, the servicer is responsible for obtaining all documentation required to complete the claim and collect the proceeds of the policy on behalf of the issuer.

Tax. Recently, the Internal Revenue Service has provided guidance to buyers and sellers of life insurance policies on the tax treatment of the purchase, sale and maturation of a life insurance policy. Please see our May 2009 *DechertOnPoint* entitled “IRS Clarifies Tax Treatment of Sellers of and Investors in Life Insurance Contracts” for a description of the IRS guidance and a discussion of certain issues raised by such guidance.⁵

Regulation. In recent months, there have been a number of indications that the federal government may seek an expanded role in the regulation of life settlements. Whether the sale of life insurance policies or a transaction involving the sale of life insurance policies could, under certain circumstances, implicate state or federal securities laws has been an open question for some time. In April 2009, SEC Chairman Mary Schapiro acknowledged that courts have adopted different positions when asked to determine whether or not life settlements fall within the jurisdiction of the SEC and indicated that the Commission intends to scrutinize the asset class. In September, an SEC spokesman

⁵ “IRS Clarifies Tax Treatment of Sellers of and Investors in Life Insurance Contracts,” May 2009, at http://www.dechert.com/library/Int_Domestic_Tax_SA_05_09_IRS_Clarifies_Tax_Treatment.pdf.

confirmed the existence of a multidisciplinary task force assembled from various divisions within the SEC investigating the life settlement market to determine “whether gaps in oversight exist.”⁶ Most recently, Congress waded into the water, when the House Committee on Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a hearing entitled “Recent Innovations in Securitization of Life Insurance Settlements,” which focused on life settlement securitization. At the hearing, spokespersons for the life settlement industry and other market participants faced skeptical lawmakers and sought to draw distinctions between the nature and scope of the life settlement securitization market and the sub-prime mortgage securitization market.⁷

⁶ Liz McKenzie, *SEC To Investigate Life Settlement Market*, Law360, September 16, 2009 at www.law360.com/articles/122679.

⁷ U.S. House, House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises. *Recent Innovations in Securitization of Life Insurance Settlements*, September 25, 2009. Washington: Federal News Service, Inc., 2009.

Conclusion

There is no doubt that life settlements raise a unique and complex set of issues. While recent trends would seem to suggest a continued increase in activity in the area of life settlement securitization, these issues and the uncertainty surrounding the government’s response to them make any prediction as to future industry growth unreliable.



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