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Life Settlements: Product Flow Opportunities and Constraints

By Sean McNealy and Marlene Frith

With the market potential estimated at \$188 billion¹ and a 70 percent annual growth rate² since 1998, the life settlement industry has captured serious attention from institutional investors from all corners of the globe. As increasing numbers of hedge fund managers, investment banks, and private equity funds enter the marketplace in pursuit of life settlement portfolios, the demand for product flow increases.

Financing entities seeking to carve out their space in this attractive non-correlated asset class should be aware of the dynamics, impediments, and opportunities as it relates to product supply and demand. The balance between the demand for policies and the number of policies available for purchase has a direct correlation to investors' profit margins. For financing entities, expertise in aggregating policies for assembly into investment portfolios is a given. On the other hand, awareness of how policies are sourced at the ownership level is not well-understood, but nevertheless the singular commodity that supports the entire industry.

This article presents a general overview of the life settlement market; examines the dynamics and players involved in product flow; and identifies the main drivers and constraints in sourcing policies at the point of sale.

General Overview:

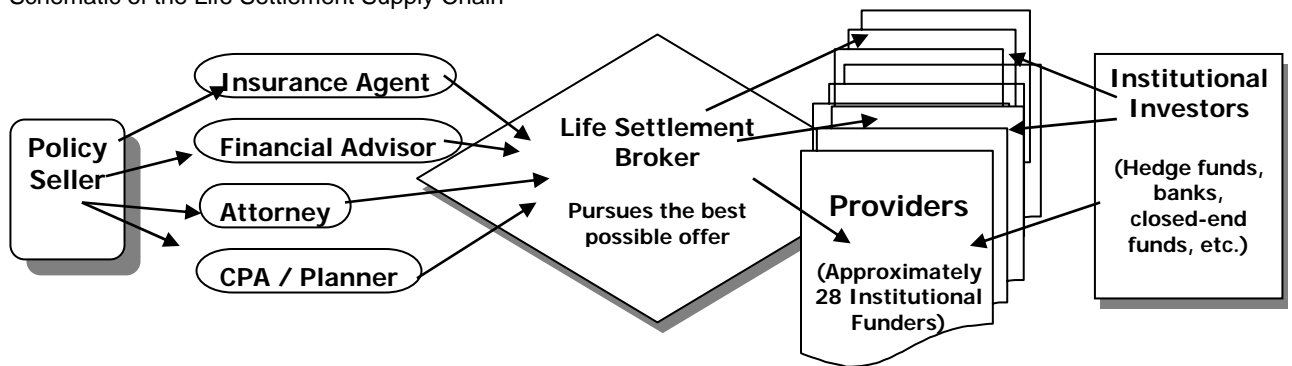
A variety of indicators point to the fact that the life settlement industry is poised for remarkable growth over the next few years. In addition to the entry of institutional capital more than six years ago, and the fact that more than 50 percent of the states now regulate life settlements, other factors cited by industry researchers responsible for spurring the life settlement industry's rapid growth, include: (1) longer life expectancies which may cause seniors to outlive the usefulness of their current life insurance policies; (2) the

decline in interest rates over the past few years that may have resulted in lower cash values within existing policies, and (3) the reduction in estate tax burdens along with the potential elimination of the estate tax altogether.

But at the end of the day, most industry players agree that the life settlement industry is growing so rapidly simply because it is providing a valuable service where one did not previously exist.

Exhibit 1

Schematic of the Life Settlement Supply Chain



Product Flow Opportunities: How Policies Are Initially Sourced

Senior Consumers and Financial Professionals

The life settlement process typically begins with a senior and his/her financial professional evaluating the performance of a life insurance policy that was purchased for income replacement, or for the senior’s heirs to pay estate taxes upon their death. In most cases, policyholders first learn about the life settlement option from their insurance agent. However, more recently seniors have begun to initiate the process after hearing about the product from their social network and others who have sold their policies. Although most life settlement transactions originate through insurance agents (producers), today’s affluent seniors often have a team of professional advisors such as CPAs, wealth management professionals, attorneys, certified financial planners, and others to whom they turn for advice when considering a life settlement transaction. As a result, some producers have recognized the wisdom of developing referral networks with these “gatekeepers to the wealthy” as a way to source new life settlement cases.

The insurance producers who are supplying the bulk of the product flow represent a fraction of the potential. In a recent study³ conducted by Agent Media Corporation, six in 10 agents surveyed stated they simply do not know enough about life settlements to offer the product to their clients. Although more producers and professional advisors are recommending life settlements to their clients than those who participated in the industry five years ago, it is clear from a sourcing perspective that the market is operating on four cylinders only. More needs to be done to reach the inter-disciplinary professional advisors (numbering in the hundreds-of-thousands) interfacing on a daily basis with seniors who may benefit from a life settlement.

Settlement Brokers

The industry's largest settlement brokers with longevity in the industry are keystone players in the marketplace due to their capacity to source and supply large volumes of policies that match the pricing parameters and portfolio objectives of the various institutional investors. Moreover, providers benefit by working with sophisticated settlement brokers who employ compliance and underwriting staff which helps to address red flags over licensure issues before the cases proceed through the review process and reach the provider's door step.

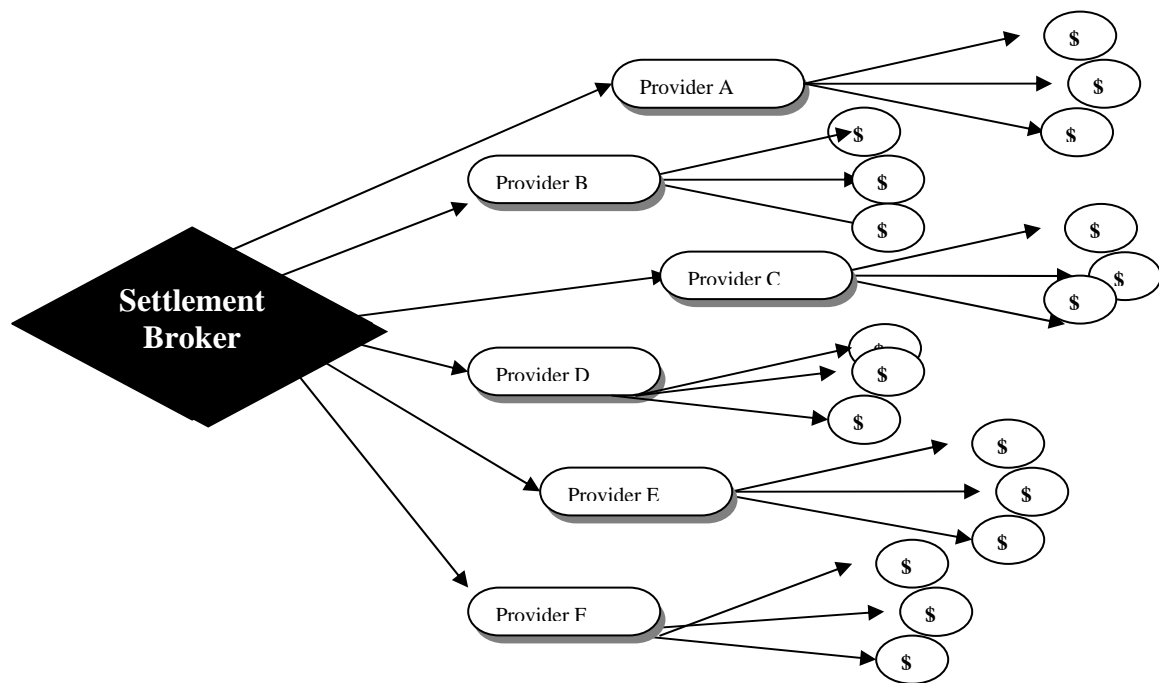
The hallmark of the life settlement broker is the ability to source product flow to multiple, qualified institutional funders. The settlement broker represents the policy seller in pursuit of the best possible offer, while on the other hand the provider represents the interests of investors to purchase policies at the greatest possible discount. Therefore, brokers create an auction-like environment where multiple providers present competitive offers for the same policy. Similar to the manner in which retail competition helps establish fair prices for consumers, multiple funding sources that operate on the secondary market for life insurance create an environment where the economics of competitive pricing establish the policy's true economic value.

In a typical transaction, a settlement broker may present a case to 12 providers who are licensed to do business in the state where the policy ownership resides. Each of these

providers respectively may have three financing entities (money sources) with very different investment horizons. In this scenario, the broker has essentially exposed the case to 36 potential pricing models, and thus the likelihood that the case will garner the highest or best possible offer is exponentially enhanced.

Exhibit 2

Settlement Brokers working with multiple funders magnify and optimize the competitive bidding process. This illustration represents a case presented by a settlement broker to six (6) providers, each of whom has three (3) money sources. Thus, the opportunity to match the seller's policy to all available pricing models is exponentially increased to 18.



In addition to offering compliance expertise, larger brokerage firms have the marketing capacity to reach targeted professionals (agents, planners, CPAs, attorneys) who interface with high-net-worth seniors. From a marketing perspective, life settlements are still within the introductory stage of the product life cycle and, as such, requires substantial investment to build awareness of the product among financial professionals, to cultivate stable relationships with them, and to begin receiving product flow.

From the time a financial professional gains knowledge of life settlements and incorporates it into their practice as a new estate planning tool, it will typically take from six months to a year before the settlement broker will see any cases. In order to assist

insurance and financial professionals in building their life settlement expertise, some life settlement brokers provide free marketing consultation and graphic design services, free errors and omissions coverage, and licensure assistance.

The function of a settlement brokerage firm with longevity in the marketplace, therefore, goes beyond representing the seller in obtaining the best possible offer for their life insurance policy. As a value-added intermediary (VAI), settlement brokers provide numerous services to financial professionals to sustain product flow. Because most financial professionals at the point-of-sale do not have the sophisticated resources and technical expertise to navigate their way around the secondary market, brokers provide value-added services that include handling back-office functions; providing case underwriting; purchasing life expectancies; gathering intelligence on each provider's pricing models; and effectively negotiating with multiple funders for the highest possible offer.

Marketplace Compression – Providers Going Direct for Product Flow

While some providers have begun marketing directly to broker general agencies, broker dealers, insurance agents and financial professionals in an effort to by-pass settlement brokers, this marketplace compression strategy is viewed with caution by some industry insiders. The downside to this strategy should be carefully weighed by providers and their financing entities as it relates to the return on their investment.

The financial resources and human capital required to market directly to financial professionals are significant. Funding advertising and marketing campaigns, sponsoring education and training seminars, exhibiting at trade shows, and hiring additional staff to deliver similar value-added services currently provided by brokers requires substantial investment. Brokers have found it effective to invest in such marketing campaigns and turn-key services in order to cultivate relationships with producers and begin seeing a steady stream of cases from them. However, providers who choose to market directly to agents will effectively be spending investors' capital to educate and cultivate those who owe no allegiance to any one provider. The agent's objective is to shop the policy for the

best offer, and irrespective “from whence they came,” most agents will go wherever that objective leads them.

As illustrated in Exhibit 2, settlement brokers working with multiple funders magnify the chances that a case will be matched with the best pricing model on the secondary market. Were an agent to work directly with one provider who has only three money sources with three pricing models, the likelihood of the seller receiving an offer that represents the policy’s true economic value is reduced exponentially.

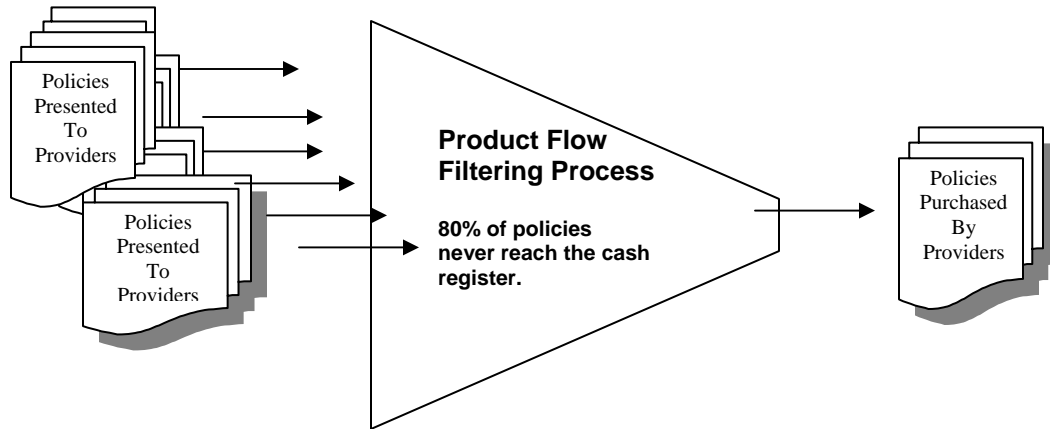
At the end of the day, providers will have to assess (1) whether competing with settlement brokers will hinder their established business relationship and negatively impact the product flow that only brokers are capable of generating; (2) whether the resources spent on cultivating relationships with producers is worthwhile given the fact that these professionals hold no loyalty or allegiance to any one provider but are driven by the highest settlement offer; and (3) whether emulating the settlement broker business model detracts them from their core competency of purchasing policies on behalf of their institutional investors.

Product Flow Constraints

In the emerging life settlement industry, there are numerous variables that impede product flow, some of which have been previously discussed. A major consideration for financing entities as it relates to assembling a sufficient quantity of policies for investment portfolios is the ratio of cases submitted for funding to those that are ultimately purchased. Although estimates from industry insiders vary on this topic, our experience indicates that for every 100 cases submitted for purchase, only 15 to 25 will be purchased by a funder. There are numerous reasons policies do not make it to the cash register, the most common of which include: (1) The life expectancy does not fit the investors’ parameters; (2) premiums are too high relative to the life expectancy; (3) the policyholder was unable to qualify for replacement coverage; and (4) the policyholder did not like the settlement offer.

Exhibit 3

This illustration shows that the total number of policies presented to funders typically outnumber those that are ultimately purchased by 80%.



Other product flow constraints include:

- The introductory stage of the product's life cycle, and general lack of awareness of the product among financial professionals and their senior clients.
- Financial professionals who are not comfortable discussing the product with their clients because they lack sufficient education and training.
- News articles associating the product with viatical transactions or otherwise portraying the product in a negative light.
- Fee-only financial planners and CPAs who are hesitant to enter the market because they are unsure how to price their services when handling life settlement transactions for their clients.
- Prohibitions by the major wire houses and company-owned broker dealer firms whose registered reps are not permitted to offer life settlements to their clients.
- Although state regulation is considered a positive development for the industry because it establishes a comfort level for professionals and consumers when government oversight is involved, regulation can also impact the growth of the industry when it involves rigorous or burdensome licensing activities that result in constraints to market activity.

Conclusion

There is little doubt that the life settlement industry has taken a quantum leap forward over the past six years. Although thousands of life settlement transactions are being sourced through agents, brokers, and providers, much of the market potential remains untapped due to product flow constraints. Furthermore, approximately 80 percent of the policies presented to funders never make it to the cash register for various reasons.

Public awareness and acceptance of the product has gained traction as thousands of seniors turn to the secondary market each year to maximize the value of their unwanted life insurance policies. Numerous articles appearing in trade publications written by industry insiders as well as magazine staff writers are extolling the benefits of unleashing the cash potential of an overlooked asset. On the other hand, a few journalists in the news media are using a more skeptical lens to portray the marketplace as a morbid or tawdry business.

All perceptions aside, the fact remains that life settlements have provided thousands of U. S. policy owners with more than \$2 billion beyond cash surrender⁴ value within the past five years. The industry is poised for additional growth, propelled by a financially-sophisticated and aging population where seniors are discovering that an economically sensible exit strategy from unwanted life insurance policies does indeed exist.

In sizing up the life settlement marketplace, the lens that should matter most to those who are following the industry should be the perception of those on the receiving end of the product – senior consumers.

¹ Conning Research & Consulting, Inc., January 2006, *Life Settlements – The Concept Catches On*

² A. M. Best, November 2005, Presentation at Life Insurance Settlement Association Annual Conference

³ Agent Media Corporation, March 2006, *Agent Sales Journal*, “Producer’s Guide to Life Settlements”

⁴ Life Settlement Institute, May 25, 2006, News Release, “Life Settlement Institute Strongly Opposes ACLI Proposed Excise Tax on Life Settlements”