Institutional Life Markets Association

INVESTOR NOTES

Trends in Cost of Insurance

Introduction

A life settlement is based on one fundamental item, a life insurance contract. Absent fraud, contractual limitations or carrier default, the certainty that the net death benefit will be paid out is not a matter of if, but when. Given a large and diversified pool of life settlements, an investor should be able to create a relatively predictable and low volatility return.

One factor that can impact the return on a life settlement portfolio is the level of premiums necessary to pay each year to keep the policies in force. If premium streams increase, a potential drag on the return could arise. Many life insurance contracts provide for a guaranteed premium stream so premiums are not subject to change. However, non-guaranteed universal life insurance contracts, which are regularly sold in the life settlement market, allow insurers to raise the cost of insurance (COI) of the policy for reasons stated in the policy contract. In doing this, the insurer must raise the COI for all life insurance contracts that constitute a class for a specific issuance of the policy product and cannot isolate an individual policy for a COI increase. Insurers have historically been reluctant to raise the COI levels. Such a move would hurt the insurers' reputation, alienate existing policy owners and distribution agents, and negatively impact future policy sales by the carrier.

Recently, there have been two events relating to attempts by insurers to raise COI due to the deteriorating financial condition of the carrier. In both cases, the COI increases should be reversed, which should provide life settlement investors with a higher level of confidence when projecting future premium obligations.

CNO Financial Group, Inc. formerly Conseco, Inc.

Prior to filing for Chapter 11 bankruptcy in 2002, CNO Financial Group (Conseco) proposed to drastically increase the COI rates for the Valulife and Valuterm products. This would affect approximately 50,000 life insurance contracts, leading to premiums increasing by a factor of three.

The insurer's justification for drastically raising COI was twofold – the financial difficulties arising from a problematic acquisition and lower than expected lapse rates for these two product pools. Neither of these were legitimate factors under the applicable policy forms for such a drastic increase in COI rates. Only mortality experience (or lack thereof) was a permissible consideration for such an increase on those policy forms.

Consequently, with COI rate increases scheduled to take effect in 2010, a class-action lawsuit was filed against the company, heard by a California federal district court in early 2011. The court ruled the drastic increase in COI constituted a breach of contract and that even the formulation of the proposed increases violated the terms of the policy contract. The policy contract states specifically stated that the insurer must determine the COI rates based on future mortality experience and not lapse rates or interest factors.

The Phoenix Companies, Inc.

Effective April 1, 2010, The Phoenix Companies, Inc. (Phoenix) substantially raised the COI rates for a certain subset of policies within its flexible premium universal life products generally known as Accumulator Universal Life Policies. Phoenix claims the increase in COI rates was due to the policy owner failing to maintain sufficient accumulation value within the life insurance policy.

Pursuant to the policy form: “[a]ny change in rate will be based on a change in [o]ur expectations of future investment earnings, mortality, persistency and expense/administrative costs.” (See page 11 of the policy contract). The policy contract does not state that Phoenix has the right to increase the COI based on the accumulated amount of policy value, yet this is exactly the reason set forth by Phoenix for the rate increase. Moreover, Phoenix marketed this product as being designed to allow owners to pay “flexible” amounts of premiums so it would appear improper to penalize owners for doing so.

Various life settlement industry trade associations and investors have filed complaints with relevant regulators regarding Phoenix’s COI increase. Following the precedent set by the Conseco class action lawsuit and the actions taken by industry trade associations, many life settlement industry participants believe that Phoenix will be ultimately forced to reverse its proposed increase as it violated its own contract provisions and the manner in which Phoenix marketed the relevant policies.

Conclusion

While insurers have attempted to use COI rates as a tool to combat negative movements in their financial strength and lapse rates, the regulators and courts should find that policy contracts do not allow for changes in such circumstances. Rather, COI rate increases are to be reserved for unexpected changes in mortality performance of specific classes of life insurance contracts and any other reasons set forth in the applicable policy.

The amount and timing of COI rate increases are variables that make the life settlement asset class less predictable than certain other asset classes. Most life settlement investors have viewed this as a secondary risk in the asset class as there has not been much historical evidence of carriers increasing premiums. Many investors mitigate the risk by investing in a diverse set of carriers with strong financial strength ratings. The expected outcomes of these recent events should likely lead investors to continue to view the risk of premium increases as a secondary risk and investors should continue to have a high level of confidence in modeling future premium streams.

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The Institutional Life Markets Association, Inc. (ILMA) is a not-for-profit trade association comprised of a number of the world’s leading institutional investors and intermediaries in the longevity marketplace, formed to encourage the prudent and competitive development of a suite of evolving longevity related financial businesses, including the businesses of life settlements and premium finance

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