Institutional Life Markets Association

INVESTOR NOTES

What will the New Financial Reform Law Mean to the Longevity Markets?

Congress will shortly enact the *Restoring American Financial Stability Act of 2010* (Act), also known as the Dodd-Frank Act. This is the most significant reform of the US financial system in the past 77 years. Whether the new law will achieve its main goal – restoring confidence in the US financial system – remains to be seen.

The new law will impact almost every facet of our financial system and creates a major new regulatory regime governing financial transactions with consumers. Although not specifically referenced, the new law will impact the life settlement and longevity markets.

<u>Impact on the Insurance Industry and the Longevity Markets</u>

The insurance industry remains largely unaffected by the provisions of the bill, as the proposal continues the McCarran-Ferguson Act regime of state regulation of insurance carriers and other industry participants. Notwithstanding the specific exclusion of insurance from the legislation, the Act, for the first time creates a federal office within the U.S. Treasury Department entitled the Federal Insurance Office (FIO). This office is directed to monitor the insurance industry, with a charge of recommending to the newly created Financial Stability Oversight Council specific insurance companies that should be treated as systemically important.

Within 18 months of its creation FIO is required to provide a report to Congress that includes, among other things, systemic risk regulation with respect to insurance. This mandate can have a positive impact on the life settlement industry by helping to ensure that carriers remain financially healthy, thus ensuring the viability of carriers and their ability to pay death benefits. Additionally, FIO is mandated to examine if state insurance regulation is nationally uniform. This mandate would allow FIO to examine inconsistencies and or lack of clarity of state law and regulations as it relates life settlements.

Further, the mandate is to report on consumer protection for insurance products and practices which could impact the longevity markets by protecting insureds from restrictive carrier conduct. Such conduct could include the recent notice by Phoenix Life to certain policy owners of the change in the cost of insurance or dilatory practices to delay providing verifications of coverage by carriers.

Also mandated in FIO's report to Congress will be an analysis of any gaps in state regulation, the costs and benefits of potential federal regulation of the insurance industry, and the ability of a federal regulator to provide robust consumer protection for policy holders. This could allow for examination of carrier conduct.

Impact on the Longevity Tertiary Market

The new law requires a securitizer to retain not less than 5 % of the credit risk for **any** asset, other than certain securitizations of qualified residential mortgages. This requirement could apply to any potential securitization of life settlement transactions.

This retention standard is subject to an exemption "as may be appropriate in the public interest and for the protection of investors" as well as securitizations relating to assets issued or guaranteed by the United States, any state and other entities defined in the bill.

Impact on Longevity Derivatives

The treatment of derivatives was one of the most contentious portions of the new law. The Act will extend comprehensive regulation to the "over-the-counter" derivatives market, including the trading of the products and the companies that sell them. In a compromise between maintaining the status-quo and requiring banks to divest themselves of any derivative activity, Congress decided that banks could conduct some of the permitted derivatives activities described above in an affiliate while it could conduct others in the bank itself.

The law allows banks to continue to engage in interest rate swaps, foreign exchange activities, credit derivatives relative to investment grade entities that are cleared, gold and silver and hedging for the bank's own risk. What would be required to go under the affiliate would be cleared and non-cleared commodities, energy commodities and non-precious metals and all equities and any non-cleared credit default swaps.

Although it is difficult to predict how the law will affect the derivatives market and there will be significant developments as the regulations are adopted, in all likelihood, the new rules regarding derivatives and swaps will significantly limit the nascent longevity swap marketplace and synthetic life settlement business, at least in the United States. Unless engaged in for the purpose of hedging the bank's own risk and exposure, US banks and their affiliated will not be able to enter into longevity swaps or synthetic trades in life settlements. Furthermore, the laws forces most of the over-the-counter derivates market onto exchanges and clearing houses, resulting in increased collateral requirements. Today, the longevity swap market and synthetic life settlements are bespoke transactions. Whether this market can be adapted for an exchange or work with a clearing house remains to be seen. As a result of the law, the longevity swap and synthetic life settlement market, which is most active in Europe, will continue to develop there, but may be forestalled from developing in the United States.

Other changes applicable to derivative activity include:

- Provides the SEC and Commodity Futures Trading Commission ("CFTC") with authority to regulate over-the-counter derivatives.

- Requires central clearing and exchange trading for derivatives that can be cleared and provides a role for both regulators and clearing houses to determine which contracts should be cleared. Requires the SEC and the CFTC to pre-approve contracts before clearing houses can clear them.

- Requires data collection and publication through clearing houses or swap repositories to improve market transparency and provide regulators important tools for monitoring and responding to risks.

- Provides for the regulation of the $60 trillion foreign exchange swaps market, unless the Secretary of the Treasury determines to exempt such swaps from regulation.

- Increases enforcement authority to punish those who knowingly defraud third parties or the public.

- Establishes business conduct requirements for all registered swap dealers and major swap participants. In addition, when acting as counterparties to a pension fund, endowment fund, or state or local government, dealers are to have a reasonable basis to believe that the fund or governmental entity has an independent representative advising them.

<u>Consumer Financial Protection Bureau</u>

The Act creates a consumer protection "watchdog", designated the Consumer Financial Protection Bureau (Bureau). This Bureau will be able to autonomously write rules for consumer protections governing all financial institutions- banks and non banks- offering consumer financial services or products. It will have broad powers to define the activities that will be regulated and the statute gives it the authority to define who is a "covered person" governed by the law. While the Bureau does not have the authority to regulate persons deemed engaged in the *business of insurance*, it has broad oversight authority regarding "financial advice" that is given to consumers. Within the Bureau are an Office of Financial Literacy and a Consumer Complaint Hotline that will assist consumers with education and a repository for consumer complaints.

Additionally, and most significant, the Bureau will have an Office of Financial Protection for Older Americans dedicated to helping "seniors recognize warning signs of unfair, deceptive, or abusive practices, protect themselves from such practices…and monitor certifications or designations of financial advisors who advise seniors and alert the Commission and State regulators of certifications or designations that are identified as unfair, deceptive, or abusive." This grants very broad authority to regulate those products and services that are senior-related or those that involve a financial advisor, even if they involve insurance products. This gives the Office the ability to provide guidance to seniors and oversight of products such as life settlements. The Office has the potential to play a significant role in the future of the life settlement industry and could serve as forum for the development of standards of conduct for the primary life settlement market to ensure that older Americans are protected and that life settlements are suitable transactions for their participation.

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.

ILMA's members include: Credit Suisse; EFG Bank; JP Morgan Chase & Co.; Mizuho International plc; and WestLB AG.

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