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LIFE SETTLEMENTS AS AN ALTERNATIVE INVESTMENT

26 Aug 2005

Larry Simon, CEO, Life Settlement Solutions, Inc., looks at the life settlement industry as an alternative investment.

Thank you, Mr. Shairp, for the warm introduction. I am honored to be here today to discuss the life settlement industry as an alternative investment. It is an exciting asset class, and I consider myself fortunate to have been involved in the early stages and the creation of the industry itself.

Many of you may have heard about the secondary market for life insurance which is quickly becoming a primary investment opportunity. Although most of you have not entered the market yet, it is my prediction that within the next 3 years that at least 50% of all major hedge funds and family offices will have some involvement in the space. As a non-correlated asset class, generally independent of interest rates and the stock market, it is an investment with minimal gap risk.

Before explaining why you should consider investing in life settlements, let me first give a brief historical industry overview. Next, I'll provide a current market perspective and a discussion of developments and finally, I'll focus on advantages and risks to the institutional investor.

A viatical is the sale of a life insurance policy by an insured who has a terminal illness and a life expectancy of two years or less. The seller can be of any age, and policy death benefits are often in the $100,000 to $250,000 range.

The viatical industry was first conceived in Europe in the 1880's. The United States, however, did not venture into viaticals until 1989 with the onset of the HIV virus. Individuals who had the virus often found themselves in financial straits, with expensive costs of medication and treatment. This led to resourceful individuals finding that they had an extremely valuable asset – a life insurance policy with a death benefit that could possibly be realized in a very short amount of time.

The beginning for the viatical business seemed bright. Investors helped those in need by providing them with the capital necessary to pay for medical treatments, while at the same time making a sizeable return on their investment. It wasn't long, however, until unscrupulous individuals realized this was an unregulated market and it became riddled with fraud.

Life settlements (also known as "senior settlements" or "high-net-worth transactions") differ greatly from viaticals. In the case of life settlements, the seller is generally not dying of an imminently terminal illness, but may have some health impairments that could contribute to a shorter life expectancy. The average seller is approximately 78 to 80 years old, has a life expectancy of 4 to 5 years, and generally does not need the money from the sale of the insurance to pay for medical expenses. Instead, the sale

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of the policy is based on the proposition that the insured no longer needs the life insurance policy for any the following reasons:

• The policy was purchased for a need which no longer exists;

• The beneficiaries are either deceased or financially independent;

• Another type of investment would be more advantageous;

• A change in tax laws or a reduction in estate size makes the policy coverage unnecessary; or

• The premiums are no longer affordable.

Instead of selling the policy back to the issuing insurance company at less than market value, or allowing the policy to lapse and forfeiting the value, life settlements allow another exit option that can quickly maximize the cash value for the policy owner, and in many cases producing purchase prices well in excess of current cash surrender values. The average policy purchased today is in the range of 1 to 2 million dollars in policy death benefits, as compared to a viaticals that are often in the $100,000 to $250,000 range.

In 1999, I realized that the viatical market in the U.S. was wrought with insurance fraud and other regulatory issues. At the same time, there was an apparent lack of funding available for the newly evolving life settlement market. This was primarily due to the much larger size of the investment required, generally eliminating the mom and pop investor from the market place.

It became apparent to me that what was needed was a source of institutional funding to give size and credibility to this industry. In an effort to secure this funding, we hired Deloitte and Touche to help us develop the business plan, the actuarial studies and the tax planning necessary to move forward. As part of that effort, my firm developed the original Lloyd's Contingency Insurance Policy. It guaranteed payment of the face value of a life insurance policy if mortality went two years past the projected life expectancy. This Lloyd's policy gave early institutional investors the confidence they needed to enter this newly emerging market.

As a result, in 2000 I structured what was to become the first institutionally funded transaction that accomplished and exceeded the goals I had set. This structure has become the basis for the market today.

In addition, I, along with several other institutional buyers, founded the Life Settlement Institute, a not-for-profit corporation dedicated to:

• Increasing the knowledge and awareness on the part of financial planning professionals and advisors of the life settlement industry;

• Increasing the awareness of life insurance policyholders of the option of obtaining more value (where appropriate) for their policy than otherwise would be available from the issuing life insurance carrier;

• Promoting the use of institutional financing in the life settlement industry;

• Supporting laws and regulations that foster the use of such institutional financing; and

• Preventing fraudulent or dishonest life settlement transactions.

The first few transactions in the market were generally funded by large European banking institutions with the originator owning the asset pool. The Lloyd's policy was generally purchased as a means of repayment. Then, in 2003, we represented the first two German private equity firms to invest in the marketplace. These two funds also used the Lloyd's policy, but were among the last to do so as the Lloyd's syndicate was no longer committing to new coverage. Once the first two German funds were fully invested, the fund managers raised additional funds with no Lloyd's policy or its equivalent! The barrier to entry was now gone, and approximately 15

German based funds rushed to the market in 2003 and 2004 with approximately 1.5 billion of new capital Pricing became noticeably more competitive. Most of these German funds were also structured as tax free investments. Unfortunately, analysts for some of the German funds had overestimated early maturities, and had to restructure their funds to allocate additional funding for premium payments.

Today, the German funds are still in the market but to a much lesser extent. In the past year, many hedge funds and family offices have begun investing in the space along with premium finance. In addition, several of the large European banks and other major internationally known companies have been active in the space. These include such well know names as:

AIG Zurich Gen Re Securities
Abbey National Bank GE DZ Bank
Citibank Cargill Morgan Stanley
Fuban Bank CSFB Deutche Bank
Hypoversick Bank

I anticipate that, within the next 2 to 3 years, the next major source of capital for the market will come from term securitization, and the use of derivative products that we currently have under development.

According to the Viatical & Life Settlements Association of America, in 1999 the life settlement market was estimated at 1 billion, increasing in 2002 to approximately $3 billion of death benefits sold. In 2004, we project the market was approximately $12 billion. This year, market estimates are in excess of $15 billion of death benefits that will be transacted.

Other factors are likely to impact the market's increase. For example:

As the huge population of baby boomers enters its retirement years, it is estimated that there will be approximately $100 billion in life insurance coverage in the marketplace.

Further, in the United States, President Bush's plan is to eliminate estate taxes by 2006. Should this bill pass in the U.S. Congress, many seniors, who previously bought life insurance to pay estate taxes, will no longer need their policies.

With life insurance held by people over 65 estimated to be in excess of $500 billion, it is clear that this is a market with large growth potential, a market deserving of investor consideration.

Of course, entry to the market is not always easy, and investors should consider the following:

1. The industry is heavily regulated today with many of the major states having licensing requirements for companies dealing with sellers in the purchase of policies (originator/provider licenses). These licenses require, in many instances, large amounts of capital expenditures, extensive operational commitments, and it can take years to obtain approvals. Regulations also mandate very strict purchasing guidelines and record keeping. In my opinion, investors should not consider doing this function themselves, but should instead seek out experienced, licensed settlement providers that are already qualified to meet licensing and regulatory requirements. There is simply too much detail and learning curve. Funders should work with Providers that:

- Are both experienced and ethical, and are licensed as providers in most of the major states;

- Look for proven industry experience, preferably at least $500 million in purchased aggregate face value to date;

- Check with the state attorney general's office, state insurance department or your government's governing body for the insurance industry for any complaints or legal action against the settlement provider;

- Insist on a company that uses reputable, independent financial institutions to hold the money in escrow until the change of ownership closes;

- Make sure any firm you talk to has their own in-house legal department; and

- Holds a “Scope Rating” (German Rating Agency) of “A” or better.

2. There are accounting and tax issues to be considered in determining whether the asset fits your investment criteria. For example, under current US accounting rules, the asset must be carried at the current cash surrender value of the policy, which in many cases will be far less than the price paid for the policy thereby resulting in major losses. This is, however, expected to change this year, but should be taken into account. In addition, under current US tax law, interest expense in connection with a life insurance policy is not deductible.

3. The asset is for the most part a long term hold, and only funds with either the ability to lock up funds for five years or more, or to adequately leverage the asset to provide for liquidity events, should enter the market. It is not at this point a two year hold.

4. Premium reserves and the ability to leverage for the payment of premiums and other ongoing costs should be considered to give maximum internal returns.

5. While there currently is a tertiary market for the asset, the transfer of a portfolio in many cases may take some time, and valuation may be difficult.

6. Early anticipated cash flows should be stressed as there is a self selection process among sellers. People who feel sick do not sell their policies.

Of course, while there are many factors to be considered in making the decision to invest, keep in mind that:

1. The asset is non correlated;

2. The returns that are generally anticipated should be unlevered double digits;

3. The credit risk associated with the insurers can be managed by only purchasing policies issued by rated carriers; and

4. There is a tertiary market.

Through institutional funding, experience and efficiency, Life Settlement Solutions has become number one in the secondary market. We are not a brokerage firm and act solely as a life settlement provider.

Our company and its management have purchased life insurance policies in excess of $1 billion aggregate face-value to date.

As investors you will need to locate a company dedicated to meeting your needs and maintaining diverse customer relationships consisting of the largest settlement brokerage firms, broker dealers, insurance companies, financial planning firms and other financial professionals such as CPAs, attorneys and trust companies.

It is also important to consider a life settlement company that provides the following services:

- Consulting;

- Detailed information about the insurance policy structure;

- A highly structured and standardized origination process;

- Life tracking, by which the company stays in contact with the insured in order to monitor his or her health status, maintain current contact information, and ultimately to know when to submit a claim for policy benefits;

- Exceptional service provided by experienced professionals;

- Customized reporting;

- Assurance that the company will adhere to all insurance laws and regulations governing their business as a life settlement provider; and

- Leverage.

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