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# Wall Street Pursues Profit in Bundles of Life Insurance

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After the mortgage business imploded last year, Wall Street investment banks began searching for another big idea to make money. They think they may have found one.

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Michael Appleton for The New York Times

**Rating the New Products:** Jan Buckler and Kathleen Tillwitz of DBRS, which is reviewing proposals for life- insurance securitizations.

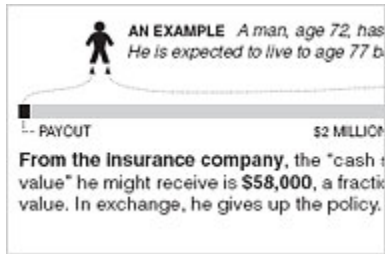
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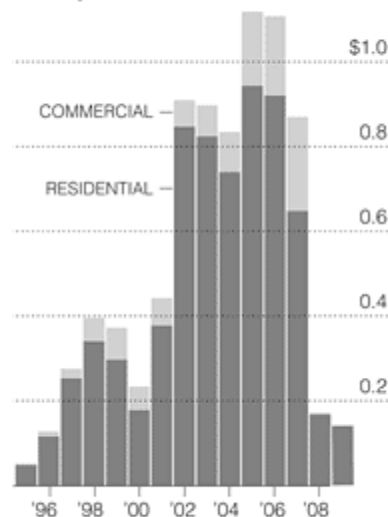
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## Looking to Profit From Life Insurance

### Previous Boom and Bust

The market for mortgage securities has shrunk to less than a fifth of its peak size.

**U.S. mortgage-backed securities market, in trillions**



2009 figure is year-to-date

Source: Dealogic

THE NEW YORK TIMES

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The bankers plan to buy “life settlements,” life insurance policies that ill and elderly people sell for cash — \$400,000 for a \$1 million policy, say, depending on the life expectancy of the insured person. Then they plan to “securitize” these policies, in Wall Street jargon, by packaging hundreds or thousands together into bonds. They will then resell those bonds to investors, like big pension funds, who will receive the payouts when people with the insurance die.

The earlier the policyholder dies, the bigger the return — though if people live longer than expected, investors could get poor returns or even lose money.

Either way, Wall Street would profit by pocketing sizable fees for creating the bonds, reselling them and subsequently trading them. But some who have studied life settlements warn that insurers might have to raise premiums in the short term if they end up having to pay out more death claims than they had anticipated.

The idea is still in the planning stages. But already “our phones have been ringing off the hook with inquiries,” says Kathleen Tillwitz, a senior vice president at DBRS, which gives risk ratings to investments and is reviewing nine proposals for life-insurance securitizations from private investors and financial firms, including [Credit Suisse](#).

“We’re hoping to get a herd stampeding after the first offering,” said one investment banker not authorized to speak to the news media.

In the aftermath of the financial meltdown, exotic investments dreamed up by Wall Street got much of the blame. It was not just subprime mortgage securities but an array of products — [credit-default swaps](#), structured investment vehicles, [collateralized debt obligations](#) — that proved far riskier than anticipated.

The debacle gave financial wizardry a bad name generally, but not on Wall Street. Even as Washington debates increased [financial regulation](#), bankers are scurrying to concoct new products.

In addition to securitizing life settlements, for example, some banks are repackaging their money-losing securities into higher-rated ones, called re-remics (re-securitization of real estate mortgage investment conduits). [Morgan Stanley](#) says at least \$30 billion in residential re-remics have been done this year.

Financial innovation can be good, of course, by lowering the cost of borrowing for everyone, giving consumers more investment choices and, more broadly, by helping the economy to grow. And the proponents of securitizing life settlements say it would benefit people who want to cash out their policies while they are alive.

But some are dismayed by Wall Street’s quick return to its old ways, chasing profits with complicated new products.

“It’s bittersweet,” said James D. Cox, a professor of corporate and securities law at [Duke University](#). “The sweet part is there are investors interested in exotic products created by underwriters who make large fees and rating agencies who then get paid to confer ratings. The bitter part is it’s a return to the good old days.”

Indeed, what is good for Wall Street could be bad for the insurance industry, and perhaps for customers, too. That is because policyholders often let their life insurance lapse before they die, for a variety of reasons — their children grow up and no longer need the financial protection, or the premiums become too expensive. When that happens, the insurer does not have to make a payout.

But if a policy is purchased and packaged into a security, investors will keep paying the premiums that might have been abandoned; as a result, more policies will stay in force, ensuring more payouts over time and less money for the insurance companies.

“When they set their premiums they were basing them on assumptions that were wrong,” said Neil A. Doherty, a professor at Wharton who has studied life settlements.

Indeed, Mr. Doherty says that in reaction to widespread securitization, insurers most likely would have to raise the premiums on new life policies.

Critics of life settlements believe “this defeats the idea of what life insurance is supposed to be,” said Steven Weisbart, senior vice president and chief economist for the Insurance Information Institute, a trade group. “It’s not an investment product, a gambling product.”

### After Mortgages

Undeterred, Wall Street is racing ahead for a simple reason: With \$26 trillion of life insurance policies in force in the United States, the market could be huge.

Not all policyholders would be interested in selling their policies, of course. And investors are not interested in healthy people’s policies because they would have to pay those premiums for too long, reducing profits on the investment.

But even if a small fraction of policy holders do sell them, some in the industry predict the market could reach \$500 billion. That would help Wall Street offset the loss of revenue from the collapse of the United States residential mortgage securities market, to \$169 billion so far this year from a peak of \$941 billion in 2005, according to Dealogic, a firm that tracks financial data.

Some financial firms are moving to outpace their rivals. Credit Suisse, for example, is in effect building a financial assembly line to buy large numbers of life insurance policies, package and resell them — just as Wall Street firms did with subprime securities.

The bank bought a company that originates life settlements, and it has set up a group dedicated to structuring deals and one to sell the products.

[Goldman Sachs](#) has developed a tradable index of life settlements, enabling investors to bet on whether people will live longer than expected or die sooner than planned. The index is similar to tradable stock market indices that allow investors to bet on the overall direction of the market without buying [stocks](#).

Spokesmen for Credit Suisse and Goldman Sachs declined to comment.

If Wall Street succeeds in securitizing life insurance policies, it would take a controversial business — the buying and selling of policies — that has been around on a smaller scale for a couple of decades and potentially increase it drastically.

Defenders of life settlements argue that creating a market to allow the ill or elderly to sell their policies for cash is a public service. Insurance companies, they note, offer only a “cash surrender value,” typically at a small fraction of the death benefit, when a policyholder wants to cash out, even after paying large premiums for many years.

Enter life settlement companies. Depending on various factors, they will pay 20 to 200 percent more than the surrender value an insurer would pay.

But the industry has been plagued by fraud complaints. State insurance regulators, hamstrung by a patchwork of laws and regulations, have criticized life settlement brokers for coercing the ill and elderly to take out policies with the sole purpose of selling them back to the brokers, called “stranger-owned life insurance.”

In 2006, while he was New York attorney general, [Eliot Spitzer](#) sued Coventry, one of the largest life settlement companies, accusing it of engaging in bid-rigging with rivals to keep down prices offered to people who wanted to sell their policies. The case is continuing.

“Predators in the life settlement market have the motive, means and, if left unchecked by legislators and regulators and by their own community, the opportunity to take advantage of seniors,” Stephan Leimberg, co-author of a book on life settlements, testified at a Senate Special Committee on Aging last April.

### Tricky Predictions

In addition to fraud, there is another potential risk for investors: that some people could live far longer than expected.

It is not just a hypothetical risk. That is what happened in the 1980s, when new treatments prolonged the life of AIDS patients. Investors who bought their policies on the expectation that the most victims would die within two years ended up losing money.

It happened again last fall when companies that calculate life expectancy determined that people were living longer.

The challenge for Wall Street is to make securitized life insurance policies more predictable — and, ideally, safer — investments. And for any securitized bond to interest big investors, a seal of approval is needed from a credit rating agency that measures the level of risk.

In many ways, banks are seeking to replicate the model of subprime mortgage securities, which became popular after ratings agencies bestowed on them the comfort of a top-tier, triple-A rating. An individual mortgage to a home buyer with poor credit might have been considered risky, because of the possibility of default; but packaging lots of mortgages together limited risk, the theory went, because it was unlikely many would default at the same time.

While that idea was, in retrospect, badly flawed, Wall Street is convinced that it can solve the risk riddle with securitized life settlement policies.

That is why bankers from Credit Suisse and Goldman Sachs have been visiting DBRS, a little known rating agency in lower Manhattan.

In early 2008, the firm published criteria for ways to securitize a life settlements portfolio so that the risks were minimized.

Interest poured in. Hedge funds that have acquired life settlements, for example, are keen to buy and sell policies more easily, so they can cash out both on investments that are losing money and on ones that are profitable. Wall Street banks, beaten down by the financial crisis, are looking to get their securitization machines humming again.

Ms. Tillwitz, an executive overseeing the project for DBRS, said the firm spent nine months getting comfortable with the myriad risks associated with rating a pool of life settlements.

Could a way be found to protect against possible fraud by agents buying insurance policies and reselling them — to avoid problems like those in the subprime mortgage market, where some brokers made fraudulent loans that ended up in packages of securities sold to investors? How could investors be assured that the policies were legitimately acquired, so that the payouts would not be disputed when the original policyholder died?

And how could they make sure that policies being bought were legally sellable, given that some states prohibit the sale of policies until they have been in force two to five years?

### Spreading the Risk

To help understand how to manage these risks, Ms. Tillwitz and her colleague Jan Buckler — a mathematics whiz with a Ph.D. in nuclear engineering — traveled the world visiting firms that handle life settlements. “We do not want to rate a deal that blows up,” Ms. Tillwitz said.

The solution? A bond made up of life settlements would ideally have policies from people with a range of diseases — leukemia, lung cancer, heart disease, breast cancer, diabetes, Alzheimer’s. That is because if too many people with leukemia are in the securitization portfolio, and a cure is developed, the value of the bond would plummet.

As an added precaution, DBRS would run background checks on all issuers. Also, a range of quality of life insurers would have to be included.

To test how different mixes of policies would perform, Mr. Buckler has run computer simulations to show what would happen to returns if people lived significantly longer than expected.

But even with a math whiz calculating every possibility, some risks may not be apparent until after the fact. How can a computer accurately predict what would happen if health reform passed, for example, and better care for a large number of Americans meant that people generally started living longer? Or if a magic-bullet cure for all types of cancer was developed?

If the computer models were wrong, investors could lose a lot of money.

As unlikely as those assumptions may seem, that is effectively what happened with many securitized subprime loans that were given triple-A ratings.

Investment banks that sold these securities sought to lower the risks by, among other things, packaging mortgages from different regions and with differing credit levels of the borrowers. They thought that if house prices dropped in one region — say Florida, causing widespread defaults in that part of the portfolio — it was highly unlikely that they would fall at the same time in, say, California.

Indeed, economists noted that historically, housing prices had fallen regionally but never nationwide. When they did fall nationwide, investors lost hundreds of billions of dollars.

Both [Standard & Poor's](#) and [Moody's](#), which gave out many triple-A ratings and were burned by that experience, are approaching life settlements with greater caution.

Standard & Poor's, which rated a similar deal called Dignity Partners in the 1990s, declined to comment on its plans. Moody's said it has been approached by financial firms interested in securitizing life settlements, but has not yet seen a portfolio of policies that meets its standards.

### Investor Appetite

Despite the mortgage debacle, investors like Andrew Terrell are intrigued.

Mr. Terrell was the co-head of [Bear Stearns's](#) longevity and mortality desk — which traded unrated portfolios of life settlements — and later worked at Goldman Sachs's Institutional Life Companies, a venture that was introducing a trading platform for life settlements. He thinks securitized life policies have big potential, explaining that investors who want to spread their risks are constantly looking for new investments that do not move in tandem with their other investments.

“It's an interesting asset class because it's less correlated to the rest of the market than other asset classes,” Mr. Terrell said.

Some academics who have studied life settlement securitization agree it is a good idea. One difference, they concur, is that death is not correlated to the rise and fall of stocks.

“These assets do not have risks that are difficult to estimate and they are not, for the most part, exposed to broader economic risks,” said Joshua Coval, a professor of finance at the Harvard Business School. “By pooling and tranching, you are not amplifying systemic risks in the underlying assets.”

The insurance industry is girding for a fight. “Just as all mortgage providers have been tarred by subprime mortgages, so too is the concern that all life insurance companies would be tarred with the brush of subprime life insurance settlements,” said Michael Lovendusky, vice president and

associate general counsel of the American Council of Life Insurers, a trade group that represents life insurance companies.

And the industry may find allies in government. Among those expressing concern about life settlements at the Senate committee hearing in April were insurance regulators from Florida and Illinois, who argued that regulation was inadequate.

“The securitization of life settlements adds another element of possible risk to an industry that is already in need of enhanced regulations, more transparency and consumer safeguards,” said Senator Herb Kohl, the Democrat from Wisconsin who is chairman of the Special Committee on Aging.

DBRS agrees on the need to be careful. “We want this market to flourish in a safe way,” Ms. Tillwitz said.

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