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Life Insurance Long View - Life Settlements Need Not Be Unsettling

Ticker	Rating	CUR	3/3/2005 Closing Price	Target Price	YTD Rel. Perf.	EPS			P/E			Yield
						2004A	2005E	2006E	2004A	2005E	2006E	
AFL	O	USD	39.00	46.00	-2.0%	2.29	2.63	3.03	17.0	14.8	12.9	1.1%
PFG	O	USD	38.71	46.00	-5.3%	2.43	2.70	3.10	15.9	14.3	12.5	1.4%
PRU	O	USD	57.30	66.00	4.4%	3.61	4.40	4.95	15.9	13.0	11.6	1.1%
NFS	O	USD	37.07	43.00	-2.9%	3.45	3.60	3.90	10.7	10.3	9.5	1.9%
MET	M	USD	41.10	43.00	1.6%	3.51	3.60	3.95	11.7	11.4	10.4	1.1%
LNC	M	USD	46.75	49.00	0.3%	4.05	4.20	4.60	11.5	11.1	10.2	3.1%
JP	M	USD	48.87	49.00	-5.9%	3.85	4.10	4.45	12.7	11.9	11.0	3.1%
SPX			1210.47			66.00	70.00	74.50	18.3	17.3	16.2	2.0%

O – Outperform, M – Market-Perform, U – Underperform

Highlights

We expect the life settlement business, an emerging secondary market for life insurance, will grow more than ten-fold to $160 billion over the next several years. Settlement companies purchase unwanted or unneeded life insurance policies from individuals and ultimately collect the death benefits. These payments are passed on to third-party institutional investors who are looking for returns that are not correlated with existing portfolios. A key component to this growth expectation is that business is conducted in a responsible manner. Poor sales practices by settlement firms could hamper growth and spark a new wave of litigation.

At present, there is roughly $13 billion of total in force settlement business. While small compared to the $9 trillion of individual life business on the industry's books, the settlement market has grown about 8x faster than non-traditional life insurance. We expect this growth rate differential will continue and could expand over the next few decades, which will draw more attention to the settlement business.

In terms of this business' near-term potential impact on the life insurance industry, conversations with industry participants indicate a mixed picture. On the one hand, the American Council of Life Insurers, one of the industry's main trade groups, has stated their primary concern with settlements relates to proper regulation and licensing of agents, which seems relatively innocuous in terms of profitability. In contrast, other industry insiders have suggested rapid expansion of settlements could alter some of the assumptions on which insurers base their profitability models, including lapse rates and mortality experience. As such, life insurers could see lower returns on certain existing blocks, but we expect the impact on consolidated profitability should be modest. **That said, over the long-term, we feel the settlement business, if conducted in a responsible manner, could have favorable ramifications for policyholders and the life**

U.S. Insurance/Life

See Disclosure Appendix of this report for important disclosures and analyst certifications.

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insurance industry. As such, we feel investors should closely monitor the development of this market. We would summarize our thoughts in the following points:

- **Sizing the Market: Small but Meaningful Growth Drivers Exist** – Industry sources estimate that the life settlement market has grown from $0 in the mid-1990s to around $13 billion today. While still small within the context of the $9 trillion of individual life insurance in force, we see numerous drivers of growth going forward. The first is the fact that individuals in the US are living longer. As such, they may outlive the usefulness of their life insurance policies. We note that the target market for life settlements (i.e., individuals above the age of 65) should grow by 90% over the next 25 years, more than 3x the 23% growth rate of the total US population. Second is the fact that the decline in interest rates over the past several years could result in lower cash values within existing policies relative to prior expectations. Third is the potential elimination of the estate tax, which may render many survivorship policies obsolete. Lastly, the development of this market could result in a new fiduciary duty on the part of financial planners to highlight this alternative to their clients. We feel these trends, coupled with low current penetration of the target market (i.e., 3%), suggest the life settlement market has ample room to grow, and we estimate that the total market could reach $160 billion over the next several years.

- **Settlement Business Could Alter Assumptions Used in Policy Pricing** – On the surface, the threat posed by any expansion of the life settlement market may not be apparent. The fact that a settlement company has assumed an individual's policy means the insurer will continue to collect premiums. Moreover, the ACLI has stated its primary concern of the settlement business relates to appropriate legislation and licensing of agents, which seems relatively innocuous in terms of industry profitability. That said, rapid expansion of the settlement business could adversely alter some of the experience embedded in existing blocks of insurance business relative to prior expectations. Specifically, the industry prices its products using long-term averages for lapse rates and mortality. To the extent that the life settlement business causes adverse change in these assumptions, the industry could see lower returns on certain existing blocks of business, but we expect the impact on consolidated profitability should be modest.

- **Assessing the Long-Term Impact on Life Insurers – It's Not All Bad** – Despite the impact on pricing assumptions discussed above, expansion of the settlement market may not be all bad for primary insurers. A critical assumption here is that the business is conducted in a responsible manner. The increased liquidity provided by a secondary market for life insurance might make individuals more willing to purchase cash value life insurance policies. Moreover, insurers may conclude that having lapse supported pricing is not in their best interests or those of their clients. Therefore, they may encourage persistency by offering features such as accelerated death benefits or guarantees on cash value performance that could also increase the appeal of their products. Second, greater familiarity on the part of institutional investors with respect to the life insurance market could serve as a catalyst for securitizations, which could mitigate some of the capital pressures facing the industry. Lastly, life companies may themselves begin to offer settlement options for their clients, particularly if they can roll the cash proceeds into payout annuities, which play into the trend of increasing longevity. In summary, we feel that expansion of the settlement business could ultimately benefit all parties involved, again, assuming business is conducted in a responsible manner.

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Investment Conclusion

What to do with the Stocks – Given the size differential between the life settlement business and the overall life insurance market, we do not expect the industry will be meaningfully impacted by settlements in the near-term. That said, the combined impact of life settlements and other challenges such as low interest rates, increasing capital requirements, the potential elimination of the estate tax and rising reinsurance costs does raise concerns over the profitability of the protection business.

In our opinion, insurers that are less diversified and have a significant earnings contribution from individual life could see the largest negative impact from all of these issues. In our coverage, such names include JP, LNC and NFS, which generate about 30-60% of total earnings from individual life. More diversified insurers with large earnings contributions from international insurance (e.g., AFL and PRU) as well as retirement savings (e.g., PFG) should have lower exposure. MET is also well diversified and has a low earnings contribution from individual life.

We recommend investors market-weight the US life insurance sector. Reasons include valuations that are close to long-term averages, a lack of a strong catalyst in terms of core product trends and various regulatory and political pressures. Our top picks for 2005 are those insurers with unique business mixes that yield strong growth prospects and justify premium valuations (i.e., AFL, PFG and PRU). We feel NFS represents an interesting and rare value opportunity. The stock is discounting an 9% ROE versus our expectations for 11%.

Please see page 14 for our price targets and valuation methodology.

Details

Setting the Stage – Background on Life Settlements

A life settlement is a transaction in which policyholders sell the rights to the death benefits associated with their insurance policies to third party settlement companies. In other words, this process creates a secondary market for life insurance products. The typical market for these products includes individuals over the age of 65 with life expectancies of 4-10 years. Exhibits 1 and 2 illustrate and describe how life settlement transactions work. A settlement firm, representing third-party investors, will provide a cash payment to the policyholder that exceeds the cash surrender value embedded in the policy. From that point on, the original policyholder will have no further involvement or association with the policy. The life settlement firm will continue to make premium payments on the policy to the life insurer, until a death benefit is claimed. The death benefit will be collected by the settlement company and passed on to third party investors, who are likely interested in returns that are not highly correlated with their other assets.

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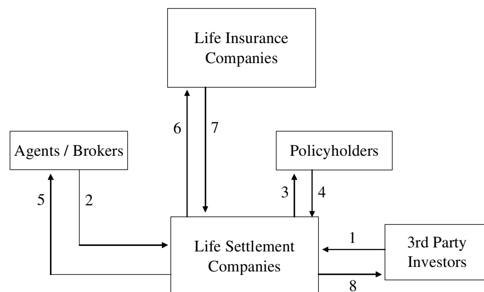
Exhibit 1
How the Life Settlement Process Works (Flowchart)



Source: Corporate reports and Bernstein estimates

Exhibit 2
How the Life Settlement Process Works (Description)

Steps	Discussion
1.	Institutional investor supplies capital to life settlement firm
2.	Agent or broker refers an exisiting client for a settlement transaction
3.	Client case is reviewed; life settlement firm makes cash offer for policy
4.	Client reassigns beneficial ownership of the policy to the life settlement firm
5.	Life settlement pays agent / broker a commission
6.	Life settlement firm continues to make ongoing premium payments to the primary life insurance company
7.	Life insurer pays benefit claim upon the death of the original policyholder to the settlement firm
8.	Returns are passed on to 3rd party investors

Source: Corporate reports and Bernstein estimates

In making the case that policyholders should consider selling their policies, life settlement companies are banking on the possibility that an individual no longer needs or wants it. For example, the circumstances that drove the original purchase may no longer be relevant. Exhibit 3 shows the results of a survey conducted by The Hartford as to the rationale behind life insurance purchases. By far the most frequently cited reason is income protection. Clearly, to the extent that such protection is no longer needed, an individual may consider surrendering a policy or selling it to a settlement company. Alternatively, an individual's economic circumstance may also change later in life. As such, the policyholder may no longer be able to meet premium payments. In addition, as cash values decline, cost of insurance charges increase. Therefore, the fact that interest rates have generally been falling over the past several years has likely limited cash value growth and could potentially increase cost of insurance charges going forward, putting a greater strain on an individual's ability to pay premiums.

Exhibit 4 highlights other reasons that policyholders may no longer want to maintain their policies. To make the settlement option more compelling, settlement companies offer cash payments that exceed the surrender value embedded in the contract but are below the death benefit. In doing so, they are making the bet that the net present value of the death benefit they will ultimately receive is above the settlement offer. To the extent it is, the settlement company and its investors pocket the difference less related any commissions or expenses.

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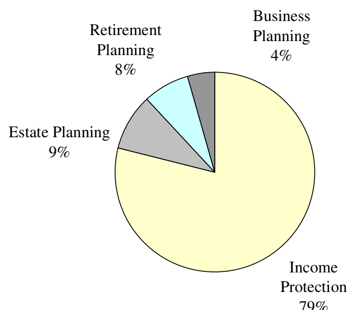
Exhibit 3
Drivers Behind Life Insurance Purchases



Source: The Hartford (2003 Consumer Survey)

Exhibit 4
Policyholder Rationales for Selling Life Policies

Seller	Rationale / Reason
Individual	
1.	Needs cash for major expenses (e.g., medical treatments)
2.	Outlived need for coverage (i.e., all major expenses are paid for)
3.	Needs different coverage / different features
4.	Financial distress / unable to meet future premium payments
Family / Estate	
1.	Change in beneficiaries (e.g., divorce, death of dependents)
2.	Second-to-die policyholder (i.e., spouse) has passed away
3.	Material change in the value of estate
Business	
1.	Change in key executives / partners
2.	Change in succession plan (e.g., family business)
3.	Need cash / seek to monetize assets

Source: Corporate reports and Bernstein estimates

Exhibit 5 summarizes the primary inputs and cash flows included in a life settlement transaction, while exhibit 6 details the IRR of the settlement transactions based on different assumptions for life expectancy (i.e., post settlement). Inputs include the settlement offer as a percentage of the death benefit, the agent's commission, the ongoing premiums the settlement company must pay and some discount factor. As would be expected, the settlement company's offer exceeds the cash surrender value embedded in the contract. Depending on the prevailing crediting rate and whether or not the policy has a secondary guarantee, the cash surrender value may be lower and may increase the return on the settlement transaction as a result. Based on an average holding period of 7-8 years, we estimate that the expected return on a settlement is 9-13%. Industry players have confirmed this expectation is reasonable. We note that the ultimate return to third-party investors may be higher or lower, depending on issues such as transaction costs.

Exhibit 5
Life Settlement Model – Inputs and Cash Flows

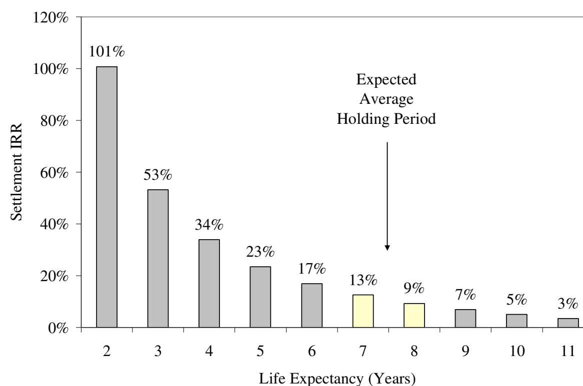
Inputs:		
Settlement Offer (% Death Benefit)	20.0%	
Agent Commission	10.0%	
Annual Premium	$ (7,532)	
Discount Rate	10.0%	(Used for exhibit 6)

Age of Insured	Cash Surrender Value	Life Settlement Offer	Settlement vs. Surrender Value		Commission to Agent	Annual Premium	Death Benefit
			$ O/(U)	O/(U) %			
65	$ 121,386	$ 200,000	$ 78,614	64.8%	$ (20,000)	$ (7,532)	$ 1,000,000
66	128,927	200,000	71,073	55.1%	(20,000)	(7,532)	1,000,000
67	136,377	200,000	63,623	46.7%	(20,000)	(7,532)	1,000,000
68	143,694	200,000	56,306	39.2%	(20,000)	(7,532)	1,000,000
69	150,813	200,000	49,187	32.6%	(20,000)	(7,532)	1,000,000
70	157,583	200,000	42,417	26.9%	(20,000)	(7,532)	1,000,000
71	163,758	200,000	36,242	22.1%	(20,000)	(7,532)	1,000,000
72	169,147	200,000	30,853	18.2%	(20,000)	(7,532)	1,000,000
73	173,546	200,000	26,454	15.2%	(20,000)	(7,532)	1,000,000
74	176,752	200,000	23,248	13.2%	(20,000)	(7,532)	1,000,000
75	178,569	200,000	21,431	12.0%	(20,000)	(7,532)	1,000,000
76	178,788	200,000	21,212	11.9%	(20,000)	(7,532)	1,000,000

Note:
(1) Cash surrender values based on sample UL policy illustration for 45-year old male, using "preferred best" rate, interest rate of 5.10% for first 20 years and 5.45% thereafter, and current (i.e., non-maximum) charges.

Source: UL Policy Illustration and Bernstein estimates

Exhibit 6
Life Settlement Model – IRR of Settlement Transaction



Note: Excludes year 1 expected IRR of 351%.

Source: Bernstein estimates

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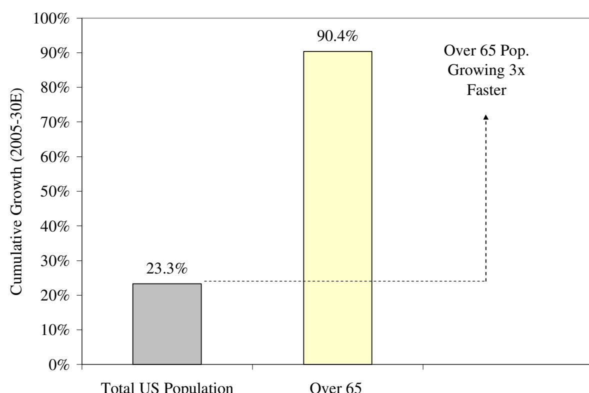
Sizing the Market: Small, but Meaningful Growth Drivers Exist

Industry sources estimate that the life settlement market has grown from $0 in the mid-1990s to around $13 billion today. While still small within the context of the $9 trillion of life insurance in force, we see numerous drivers of growth going forward. The first is the fact that individuals in the US are living longer. As such, they may outlive the usefulness of their life insurance contracts. The target market for life settlements (i.e., individuals above the age of 65) should grow 3x faster than the total population over the next 25 years (see exhibit 7). In addition, exhibit 8 shows that life expectancy of these same individuals has increased over the past several decades. Assuming these individuals are living beyond the years where they must provide financial support for their dependents, they may not have the same need for life insurance as when the policy was originally purchased. In other words, the importance of income protection likely declines as individuals get older. Considering the settlement company's returns decline as life expectancy increases, this business requires careful underwriting, which we discuss below.

Exhibit 7

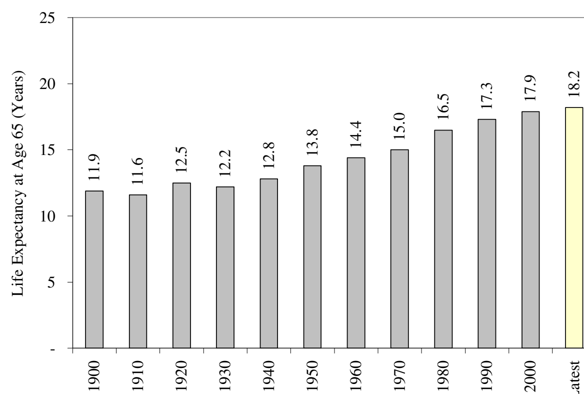
Trends in US Population Growth – 65 & Older vs. Rest of Population



Source: US Census Bureau and Bernstein estimates

Exhibit 8

Life Expectancy of Individuals Over the Age of 65



Source: CDC and National Vital Statistics System

A second catalyst is the fact that the decline in interest rates over the past several years could result in lower cash values within previously purchased life policies relative to prior expectations. Part of the appeal on the part of individuals for purchasing non-traditional life insurance policies (e.g., universal life) is the fact that if they live beyond the protection period, they can still collect cash surrender values. Said another way, this policy feature provides an incremental benefit over "use it or lose it" term insurance. Milliman, a life insurance consulting firm, has estimated that the industry pays death benefits on only 20% of universal life business. Given the rate of interest credited on such policies is likely running below levels assumed when they were originally purchased increases the possibility that cash surrender values will be lower than prior expectations. Assuming life settlement companies can offer individuals more up front cash for their policies, policyholders may find such transactions more appealing relative to policy surrenders.

A third driver is the potential elimination of the estate tax. The Bush Administration appears committed to repealing this tax (see exhibit 9). In the past, individuals may have purchased survivorship life insurance to help their heirs fund this tax payment. Referring back to exhibit 3, estate planning was the second most commonly cited reason for life insurance purchases. If we assume that wealth individuals have a greater need for such policies, then it is logical to conclude that the related policies would have higher face values, meaning they could represent a larger share of in force life insurance relative to what would be implied by

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exhibit 4. If this tax is indeed repealed, we feel in force survivorship policies will be fertile grounds for life settlement companies.

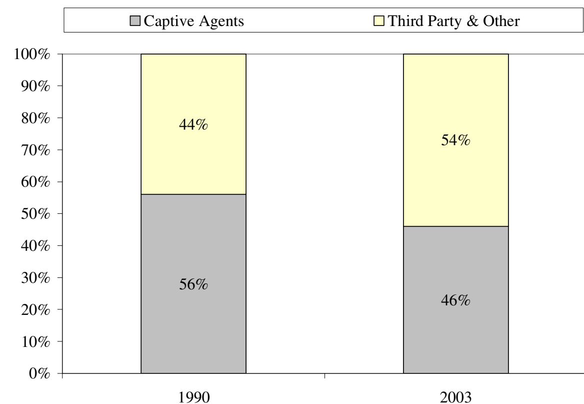
Exhibit 9
Statement of Administration Policy Regarding Estate Tax

"**Eliminating the death tax is a matter of basic fairness**. The death tax results in the double taxation of many family assets while hurting the sources of most new jobs in this country - America's small businesses and farms. Unfortunately, the provision of the 2001 Act to repeal the death tax expires at the end of 2010, creating significant uncertainty for family estate planning. Its permanent elimination today would relieve thousands of family businesses, farms and ranches of the excessive costs of tax compliance. **The permanent repeal of the death tax would mean that many more family businesses would be preserved and could thrive as a source of continuing job creation and economic growth**."

Executive Office of the President
Office of Management and Budget
6/18/03

Source: Office of Management and Budget

Exhibit 10
Life Insurance – Trends in 3rd Party Distribution



Source: Corporate reports and Bernstein estimates

In our opinion, the fourth driver of industry growth that we cite may prove to be the most influential. The development of the settlement market could result in a new fiduciary duty on the part of financial planners. Specifically, we feel insurance agents and other producers (e.g., brokers and estate planners) will feel an increasing responsibility to present life settlements as an option to their clients. The alternative today is simply to take the path of least resistance and let customers surrender their policies. It is clear that the overall financial services industry faces a heightened level of regulatory scrutiny today than in years past. Within the life insurance industry, examples include investigations life and annuity sales practices. Given that life settlements typically offer payments that exceed policy cash surrender values, regulators in the future may perceive that it is part of a financial advisor's fiduciary duty to investigate life settlement options on behalf of clients. An article in the *Banking Law Journal* (2002) suggests that the role of any fiduciary, including insurance agents and estate trustees, will evolve so that life settlements will be another financial planning tool.

A corollary is the reality that life insurance distribution has been moving away from the captive agency channel in favor of independent distributors over the past several years (see exhibit 10). The importance of this trend is our view that independent agents and advisors likely have a greater allegiance to their customers rather than the insurance carriers. Conversations with industry sources suggest primary writers often prevent their captive agents from offering life settlement options to their customers. To the extent that the trend shown in exhibit 10 continues, these writers will lose some of their influence on the overall business.

We feel these trends suggest the life settlement market has ample room to grow, and we estimate that the total market could reach $160 billion over the next several years. We arrive at this forecast by using

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estimates for the growth in the target market for settlements (i.e., individuals over the age of 65) and increases in the penetration of this market.

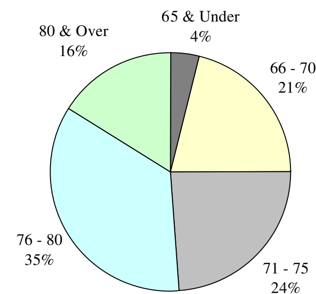
Exhibit 11
Size and Growth of the Life Settlement Business

	Transations (Face Value)		Annual Growth		
	Life Settlements $ Billion	Cash Value Life (1) $ Trillion	Life Settlements	Cash Value Life	Settlements as a % of Life Sales
1998	0.2	1.1			0.0%
1999	1.0	1.1	400.0%	3.1%	0.1%
2000	1.1	1.2	10.0%	11.0%	0.1%
2001	1.3	1.3	18.2%	3.0%	0.1%
2002	1.4	1.4	7.7%	8.1%	0.1%
2003	2.5	1.4	78.6%	-0.2%	0.2%
2004	5.0	1.5	100.0%	6.6%	0.3%
2000-04 Average			42.9%	5.7%	0.2%

Notes: (1) Excludes term life sales

Source: ACLI and Bernstein estimates

Exhibit 12
Age Distribution of Life Settlement Clients



Source: National Underwriter

To dimension the potential size of this market, we start with some statistics from the life settlement business. According to industry representatives, settlement companies have written about $13 billion of business over the past 7 years (see exhibit 11). Exhibit 12 shows that individuals over the age of 65 represent 96% of all settlement cases. An industry survey of consumer ownership of life insurance indicates that roughly 47% of individuals over the age of 65 have policies. Moreover, this same study suggests average coverage for this age bracket is $23,600. Given that there are currently 37 million individuals over the age of 65, these statistics suggest this group controls roughly $416 billion of life insurance. Assuming that all of the $13 billion of in force settlement business relates to this population segment, we arrive at a penetration rate of 3%. Based on the growth statistics shown in exhibit 7 above, the over 65 segment of the population should increase to 72 million by 2030. Using the same percent ownership of 47% and average coverage statistic of $23,600 against this new base, we estimate that this segment will control $800 billion of insurance by 2030. Applying the current 3% life settlement penetration rate, we estimate population growth alone could add $12 billion of settlement business. Industry sources also indicate that the 3% penetration rate is understated and the true potential is closer to 20%, which reflects expectations in terms of the proportion of policies with low cash values and the number of people willing to settle. If we assume the settlement business achieves this penetration rate, the industry could add another $137 billion of business. Based on these assumptions, the settlement business could increase from $13 billion currently to as much as $160 billion over the next few decades (see exhibit 13). Our estimate could prove conservative to the extent that increased awareness of the settlement option drives penetration above 20%, which we feel is possible. In addition, given that increasing penetration represents the more significant catalyst for growth, the settlement industry could exceed $160 billion well before 2030.

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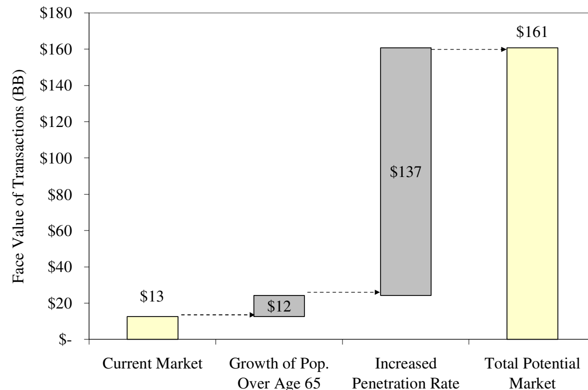
Exhibit 13
Dimensioning the Size of the Life Settlement Opportunity



Source: US Census Bureau and Bernstein estimates

Like any new business, the path to growth may not be smooth as aggressive players as well as third party capital enter and exit the market. That said, we feel exhibit 13 suggests there is a long-term growth opportunity in the settlement business.

Settlement Business Could Alter Assumptions Used in Policy Pricing

On the surface, the threat posed by any expansion of the life settlement market may not be apparent. After all, the fact that a settlement company has assumed an individual's policy means the life company will continue to collect premiums (i.e., no change a primary writer's cash flows). That said, our research suggests the impact could initially be negative on certain blocks of insurance business.

At present, the American Council of Life Insurers (ACLI) has stated its primary concern with respect to the settlement business relates to appropriate legislation and licensing of agents, which seems relatively innocuous in terms of industry profitability.

That said, rapid expansion of the settlement business could adversely alter some of the expected experience embedded in existing blocks of insurance business. The primary reason is the fact that the industry prices its products using assumptions based on long-term averages. Therefore, to the extent that an external factor, such as the emergence of the life settlement business, alters actual experience relative to these averages, pricing assumptions may not be met.

For example, lapse rates are a key variable in life insurance product pricing. In fact, of the three primary economic drivers underlying life contracts (i.e., lapses, interest rates and mortality), lapse rates are perhaps the most difficult to predict given they are tied to consumer behavior. Several writers of long-term care insurance have already felt the adverse impact of lower than expected lapse rates and have had to raise pricing on in force business.

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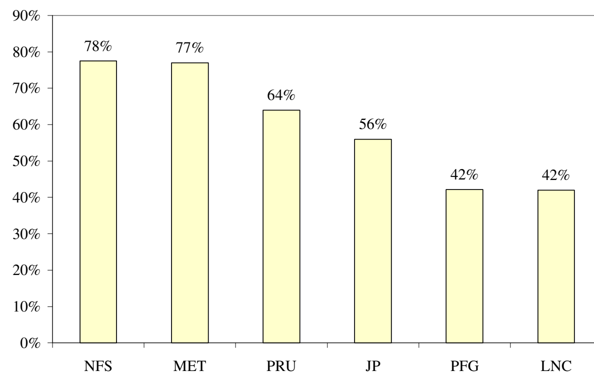
We feel universal life with secondary guarantees represents a product that may be negatively impacted by higher than normal lapse rates. Exhibit 14 shows that this product was a key driver of 2004 life insurance sales for several carriers. The idea behind these policies is that as long as individuals pay a minimum premium, their policies will remain in force regardless of the underlying performance of the contract. In our opinion, the most likely customer for these products is an individual that is primarily concerned with the death benefit as opposed to cash value accumulation but also likes the flexibility provided by UL relative to term insurance. In addition, some insurers offer products that provide secondary guarantees for a specific period of time. Given that in UL products with secondary guarantees, cash value accumulation takes a backseat to death benefits, life insurers may be assuming that a portion of related policyholders may decide to lapse their contracts once the death benefit is no longer needed. If true, they could use some of the related reserve building to help support benefits on policies that remain in force. That said, the low cash values of these policies could render them more attractive to life settlement companies as it would be easier for them to offer a more compelling value. So, given the influence of the settlement companies, the average lapse rate could be lower relative to the primary writer's original assumptions.

Exhibit 14
Life Insurance – Percentage of 2004 UL Sales with Secondary Guarantees



Note: Percentage for PFG may be diluted by fact that the company includes VUL with UL sales.

Source: Corporate reports

Exhibit 15
Illustration of the Impact of Settlements on Life Insurance Assumptions

	Scenario #1 With Out Life Settlements			Scenario #2 With Life Settlements		
	Total Pool	**Healthy**	**Unhealthy**	**Total Pool**	**Healthy**	**Unhealthy**
Policies	100	50	50	100	50	50
% Lapsed		20.0%	20.0%		20.0%	5.0%
Lapses	20	10	10	13	10	3
In Force	80	40	40	88	40	48
Actual Lapses	20.0%			**12.5%**		
Mix of Unhealthy	50%			**54%**		

Source: Bernstein estimates

Compounding the impact of lower lapse rates is the potential impact on morality experience. While mortality expectations clearly vary by individual, life insurers typically assume average mortality for a large pool of policies. Therefore, any trend that would cause actual experience to differ from prior estimates could adversely impact life companies. In our opinion, life settlement companies have an advantage over primary carriers with respect to underwriting. Specifically, life companies underwrite a policy only once (i.e., when it is written). To the extent an individual's health circumstances change, the carrier cannot change product pricing. That said, the life settlement company's underwriting process starts later in life, at which time a new health condition may have surfaced. In other words, they are working with more current data. As noted above, life settlement returns are tied to life expectancy. As such, this underwriting advantage is critical to identifying the most appropriate policies for settlements.

Exhibit 15 provides an illustration of how life settlements can impact the lapse and mortality experience of a primary carrier. Scenario 1 shows our base case in terms of pricing assumptions. We are assuming an insurance company has 100 policies in force of which half represent healthy individuals. Moreover, we

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assume that 20% of the pool lapses before the death benefit is paid. As a result, even with these lapses, the balance of risk in the pool is largely unchanged (i.e., 50/50 blend of healthy and unhealthy). Scenario 2 shows the impact that the settlement business can have on this pool. Here, we have assumed that the settlement company lowers the lapse rate on the unhealthy pool to 5% by purchasing several policies that would have otherwise surrendered. As a result, the overall lapse rate declines from 20% to 12.5% and the health profile of the pool has changed, potentially lead to sooner death benefit payments relative to assumptions embedded in pricing.

Clearly, one advantage for the life company from scenario 2 is that it continues to collect premiums from business that would have otherwise lapsed. That said, if the product pricing had assumed that some of the reserves building on the policies that should have lapsed would fund the remaining in force business, there could be a mismatch in terms of the timing of cash flows (i.e., the additional premiums collected may not be sufficient to compensate for lower lapses). Again, we feel the fact that life settlement companies can in effect cherry pick the most attractive cases with more current underwriting knowledge creates a competitive advantage relative to primary writers.

Assessing the Long-Term Impact on Life Insurers – It's Not All Bad

As noted above, growth in the life settlement market could force life insurance companies to alter some of their practices. One example is the potential that life insurers would have to lower lapse rate assumptions built into their product pricing. That said, assuming business is conducted in a responsible manner, we feel the development of this market could have positive long-term ramifications for policyholders and the life insurance industry (see exhibit 16).

Exhibit 16
Potential Benefits of Life Settlements to Policyholders and Life Insurers

Benefits to Policyholders

1. Drive insurers to increase the value proposition of life insurance products to consumers (i.e., similar to VA living benefits)
2. Increase the liquidity of policies that are no longer needed

Benefits to Life Insurers

1. Drive increased demand for non-traditional insurance (i.e., excluding term)
2. Increase institutional investor interest in life insurance securitizations (i.e., mitigating capital pressures)
3. Encourage life insurers to participate in life settlement business (e.g., roll funds into payout annuities)

Source: Bernstein estimates

For example, insurers may conclude that having lapse supported pricing is not in their best interests or those of their clients. Therefore, insurers may encourage persistency by offering features such as accelerated death benefits or guarantees on cash value performance that could also increase the appeal of their products. The latter would be consistent with recent trends in the variable annuity business. For years, VA's were sold at least in part on their advantage relative to mutual funds related to tax-deferred growth. It was argued that this growth more than compensated for their higher fees. The market declines from 2000 to 2002 coupled with a favorable tax change related to dividends lowered this value proposition. In response, the industry has focused on offering living benefit guarantees, which has reinvigorated variable annuity demand

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in recent periods. Enhancing the value proposition of life insurance products could do the same for the protection business.

A related benefit is the possibility that a secondary market for life insurance might make individuals more willing to purchase cash value life policies. Even though term insurance tends to be a "use it or lose it" proposition, individuals may prefer term polices given they are generally cheaper than variable and universal life insurance. Said another way, individuals may be reluctant to lock in a stream of high premiums and policy charges that are typically associated with non-traditional insurance. Moreover, the increased liquidity provided by the settlement market could make non-traditional life policies more attractive.

In terms of the insurance industry, clearly, features that add to the appeal of such products could lift overall growth rates, persistency and profitability. In addition, the settlement business could serve as a means through which institutional investors can get more familiar with the life insurance market. As such, we would argue that expansion of the settlement industry might be a catalyst for securitizations, which could mitigate some of the capital pressures facing the industry (e.g., A-XXX).

Lastly, life companies may themselves offer settlement options for their clients, particularly if they can roll the cash proceeds into payout annuities, which play into the trend of increasing longevity. The Retirement Security for Life Act was recently introduced in Congress. This act would shelter the first $20,000 in annual payments from annuities from all taxes assuming the lifetime payout option is selected. Given that only life insurance can offer lifetime contingent annuities, the lump sum of cash received from settlements could in effect be reinvested in payout annuities, which would mitigate the impact on life insurance companies.

Other Issues to Consider – Where There Could be Drama

While we feel the settlement business has meaningful growth opportunities going forward, we would note that players in this market will need to contend with some hurdles along the way. Perhaps the most important issue relates to sales practices. Given that life settlement returns are tied to life expectancy, settlement firms must be careful that the solutions they provide are appropriate for each client. In addition, we feel disclosure that a third party will benefit from an individual's death may be a key issue. The life insurance industry's recent experience with "janitor insurance" shows that a lack of appropriate disclosure can create meaningful headline and potential litigation risk. Therefore, if this small business is to realize its growth potential, it is critical that business is conducted in a responsible manner.

Another frequently discussed challenge is a natural comparison to the rather ugly history of the viaticals industry. In the 1980s, a number of firms began offering financially-distressed AIDS patients cash for their life insurance policies. These viatical companies (i.e., based on the Latin phrase for "traveling money") purchased policies at a discount to their face values and sold them as retail investments. The practice was controversial for two reasons: 1) the public was generally leery about any practice that appeared to prey on the terminally ill; and 2) viatical investments skirted SEC regulations, given that they did not meet the pure definition of securities, and were often sold with promises of high returns. As medical treatments for AIDS became more effective, patients began living longer. As such, investors in these settlements, whose returns were largely tied to the timing of death benefit payments, did not achieve their promised returns. State

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regulators closed down many viatical firms as a result of their aggressive marketing practices. Moreover, some high profile cases involved outright fraud and misuse of investor assets. A notable case in Florida involves Mutual Benefit Corp, which is now the target of a class action lawsuit and an SEC investigation.

A third issue for the settlement industry is regulation. While the NAIC has issued model regulation for life settlements, not all states have adopted the recommended statutes. At the current time, 36 states have some form of regulation for life settlements, including minimum payouts (as a % of face value). Still, the issue of agent licensing remains, with about 15 states allowing agents with standard life insurance licenses to "sell" life settlements to clients. According to industry insiders, the lack of licensing in other states does not prevent life settlements from taking place. Rather, it could give rise to poor quality transactions that may or may not benefit policyholders, which could have a detrimental impact on market growth. Another issue is whether underwriters need to be registered with insurance regulators, which again appears to vary by state.

Given that the settlement market is so new, we would expect that regulatory issues may crop up over the next few years as this business receives more attention. While uncertainty related to these and other issues may alter the industry's glide path with respect to growth, we do not expect it will meaningfully impact its long-term prospects.

What to do with the Stocks

Given the size differential between the life settlement business and the overall life insurance market, we do not expect the industry will be meaningfully impacted by settlements in the near-term. That said, the combined impact of life settlements and other challenges such as low interest rates, increasing capital requirements, the potential elimination of the estate tax and rising reinsurance costs does raise concerns over the profitability of the protection business.

In our opinion, insurers that are less diversified and have a significant earnings contribution from individual life could see the largest negative impact from all of these issues. In our coverage, such names include JP, LNC and NFS, which generate about 30-60% of total earnings from individual life (see exhibit 17). More diversified insurers with large earnings contributions from international insurance (e.g., AFL and PRU) as well as retirement savings (e.g., PFG) should have lower exposure. MET is also well diversified and has a low earnings contribution from individual life.

We recommend investors market-weight the US life insurance sector. Reasons include valuations that are close to long-term averages, a lack of a strong catalyst in terms of core product trends and various regulatory and political pressures. Our top picks for 2005 are those insurers with unique business mixes that yield strong growth prospects and justify premium valuations (i.e., AFL, PFG and PRU). We feel NFS represents an interesting and rare value opportunity. The stock is discounting an 9% ROE versus our expectations for 11%.

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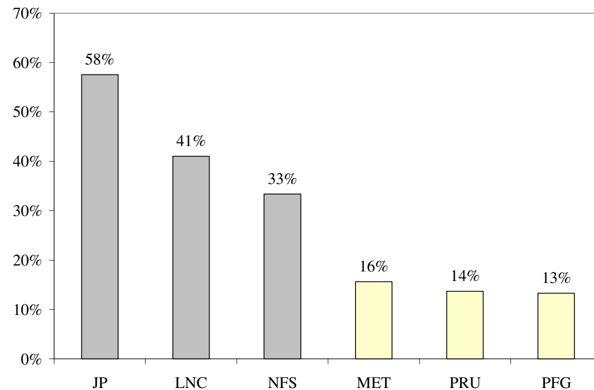
Exhibit 17
Life Insurance – 2005E Earnings Contribution from Individual Life



Source: Corporate reports and Bernstein estimates

Exhibit 18
SCB Price Targets

	Price 3/3/05	Price Target	Appreciation Potential	Rating
PFG	$ 38.71	$ 46.00	18.8%	O
AFL	39.00	46.00	17.9%	O
NFS	37.07	43.00	16.0%	O
PRU	57.30	66.00	15.2%	O
LNC	46.75	49.00	4.8%	M
MET	41.10	43.00	4.6%	M
JP	48.86	49.00	0.3%	M
Median			15.2%	
Average			11.1%	

Source: Bernstein estimates

Valuation Methodology

Exhibit 18 shows our price targets. For stocks other than AFL, we employ an equal-weight valuation framework that considers each company's:

- relative price to earnings multiple versus an industry target (with exceptions for JP and PFG),
- relative price to book multiple versus an industry target (with exceptions for JP and PFG), and
- the historical relationship we have identified between price / book and risk adjusted ROE (i.e., ROE / cost of equity)

We value AFL based on absolute and relative P/E targets of 18x and 100% respectively.

Consistent with past years, we expect to revise our price targets in 1Q:05 based on use of our 2006 earnings estimates rather than our 2005 forecasts. When we made similar adjustments in the past, our price targets generally increased, particularly for companies with high EPS growth, such as AFL, PFG and PRU. We would expect the same pattern will repeat later this year, which would add to the upside shown in exhibit 18.

Risks

We feel the biggest risks to our long-term growth forecast for life settlements are improper sales practice issues, which could lead to regulatory investigations and litigation and limit the potential for this market. Moreover, any instances or allegations of fraud, similar to cases in the viaticals market, could also significantly limit the growth of life settlements. In addition, to the extent the Bush Administration does not achieve a full repeal of the estate tax, the life settlement business may not see incremental upside from the survivorship life market. Furthermore, aggressive pricing by inexperienced life-settlement players could ultimately lower the potential returns and make life settlements a less attractive option to third-party, institutional investors.

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In terms of our market-weight recommendation for the sector, upside risks include further improvements in the operating environment, led by a gradual increase in new money rates. In addition, product innovation in asset accumulation and insurance segments could drive higher growth in product sales. Third, M&A activity that includes high takeover multiples could result in outperformance. In particular, to the extent that the Euro continues to strengthen against the dollar, European insurers may get a second chance to increase their presence in the US retirement market by acquiring US insurers, which tend to be smaller in terms of market capitalization. Lastly, favorable legislation out of Washington, such as the passage of tax reductions on annuity distributions could result in renewed interest in annuity products.

Downside risks to our market-weight recommendation include continued headline risk from various investigations of the sector. In addition, stocks could be adversely impacted by an increase in corporate credit losses, higher capital requirements on insurance and annuity products, lower equity markets and wide swings in interest rates, either up or down.

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