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COVER STORY

By [Matthew Goldstein](#)

Profiting From Mortality

Death bonds may be the most macabre investment scheme ever devised by Wall Street



COVER
STORY
PODCAST

In May, as the subprime mortgage market was cracking, many of the biggest players in finance gathered at a conference in New York to talk about the next exotic investment coming down the pike: death bonds. When the event was held two years ago, just 250 people showed up. This time, nearly 600 descended on the Sheraton Hotel & Towers for the three-day confab, including delegations from Bear Stearns (**BSC**), Deutsche Bank (**DB**), Lehman Brothers (**LEH**), Merrill Lynch (**MER**), UBS (**UBS**), Wachovia (**WB**), Wells Fargo (**WFC**), and other big firms. They flocked to seminars with titles such as "Legislative Review," milled about the exhibition hall picking up the usual conference swag, and buzzed at luncheons and a Carnegie Hall gala about the big push into the market being made by Cantor Fitzgerald, a major bond-trading shop. With all the happy banter, you wouldn't

have known they were there to learn about new and imaginative ways to profit from people dying.



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Death bond is shorthand for a gentler term the industry prefers: life settlement-backed security. Whatever the name, it's as macabre an investing concept as Wall Street has ever cooked up. Some 90 million Americans own life insurance, but many of them find the premiums too expensive; others would simply prefer to cash in early. "Life settlements" are arrangements that offer people the chance to sell their policies to investors, who keep paying the premiums until the sellers die and then collect the payout. For the investors it's a ghoulish actuarial gamble: The quicker the death, the more profit is reaped. Most of the transactions are done by small local firms called life settlement providers, which in the past have typically sold the policies to hedge funds. Now, Wall Street sees huge profits in buying

policies, throwing them into a pool, dividing the pool into bonds, and selling the bonds to pension funds, college endowments, and other professional investors. If the market develops as Wall Street expects, ordinary mutual funds will soon be able to get in on the action, too.

BUT THE INVESTMENT BANKS are wading into murky waters. The life settlements industry increasingly finds itself in the grip of dubious characters devising audacious and in some cases illegal schemes to make money. Many are targeting elderly people with deceptive sales pitches—so many that the National Association of Securities Dealers has issued a warning about abusive practices. Others are promising investors unrealistic returns or misleading them about the risks. Some are doing both.

That didn't discourage the high-powered guests at the New York conference, though. As they tossed back cocktails and dined on pan-seared filet mignon, they enthused about the market's possibilities. "Wall Street firms are here because they know this is an asset class that isn't going away," says David C. Dorr, president and CEO of Life-Exchange Inc. (**LFXG**), an electronic platform for trading life settlements. "There's big potential."

The truth is, at this early stage, there's no way of knowing how popular death bonds might become. Wall Street's innovation machine has turned out both huge hits and big flops over the years. But the growth of the underlying market for life settlements has been torrid so far. In 2005 about \$10 billion worth were transacted, according to Sanford C. Bernstein & Co. (**AB**), up from virtually nothing in 2001. Industry analysts say this number rose to \$15 billion in 2006, and could double this year, to \$30 billion. Over the next few decades, as the ranks of retirees swell, Bernstein predicts that the face value of life settlement deals will top \$160 billion a year in today's dollars. Death bonds will never approach the size of the mortgage market, which saw \$1.9 trillion of securities issued last year. But if Wall Street achieves its goal of turning most of the life settlements created each year into death bonds, the market could rival the size of today's junk-bond market, where issuance totaled \$128 billion in 2006,

up from \$56 billion in 1996, according to market watcher Dealogic.

Investment banks have already drawn up their sales pitches to well-heeled institutional customers. Firms say death bonds should return around 8% a year, right between the expected returns of stocks and Treasury bonds. Moreover, they're "uncorrelated assets," meaning their performance isn't tied to what's happening in other markets. After all, death rates don't rise or fall based on what's happening to commodities, say. Uncorrelated assets like these are highly prized in an increasingly connected global financial system.

It all sounds great, except that many of the life settlements that Wall Street firms are buying fall into categories ranging from sketchy to toxic. "They are creating a very risky product," says Janet Tavakoli, a Chicago financial consultant who specializes in advising clients on asset-backed investments. "They may be planning to sell them to sophisticated investors, but they could be roping in people who don't appreciate the risk."

Many life settlement providers, for example, are trying to lure people who don't even hold insurance. In this tail-wagging-the-dog scenario, speculators take out policies on the individuals' behalf, pay them something up front, cover the premiums, and then wait for the people to die so they can collect. At the most outlandish extreme, one outfit devised a plan involving the population of the Federation of St. Kitts and Nevis in the Caribbean.

Investors, meanwhile, have been burned by operators who have misrepresented the profit potential on deals. Two men now awaiting trial in California hatched an allegedly fraudulent scheme aimed at the entire congregation of a black church in South Central Los Angeles. They promised investors 25% annual returns because African Americans die earlier than other racial groups—an ugly pitch that prosecutors say overstated the upside potential.

Even some of the biggest life settlement firms operate under a cloud. Philadelphia's Coventry First, for example, faces civil charges from the New York Attorney General's office and is in danger of being barred from doing business in Florida. It denies any wrongdoing.

The eight-year-old industry certainly has an ignominious history. It grew from the shards of the so-called viaticals business, which imploded in the late 1990s amid allegations of fraudulent dealings with AIDS patients and other terminally ill people. The word viatical comes from viaticum, a religious term for the communion given to a person near death. As AIDS spread during the 1980s, patients turned to the viatical settlements market to unlock insurance money to pay for care. But advances in medicine in the 1990s extended patients' lives, making viaticals less profitable for the buyers. At the same time, the industry was rife with abusive sales practices that drew the attention of prosecutors. By 1999, business had all but dried up.

Surprisingly little has changed in the latest iteration. Only 26 states require professional licensing for life settlement brokers; elsewhere, anyone can hang a shingle. The market is especially popular among former stockbrokers, mortgage brokers, insurance agents, and lawyers. But all sorts of people from small-time movie producers to dentists are setting up shop.

There's nothing inherently wrong with life settlements. In fact, for people who need quick cash or want to supplement their retirement nest eggs, the market can be a boon. Without it, a person looking to unload a policy would have only one choice: to sell it back to the insurer for the so-called cash surrender value, a fraction of the face value. "No one is forcing anyone to sell insurance policies," says Meir Eliav, president of Legacy Benefits Corp., a New York life settlements provider that was involved in one of the first death bond deals in the U.S., a \$70 million offering in 2004. "This is a terrific option for the consumer."

Wall Street's intense interest says much about the world of high—and low—finance in 2007. In earlier eras, big firms' success or failure rested mainly on their ability to turn long-term client relationships into full-service operations—advising corporate clients on potential acquisitions, managing investments, and arranging financing. But Wall Street has been overtaken by securities trading and the endless creation of financial products, such as asset-backed bonds, collateralized debt obligations, credit default swaps, and other exotica.

Cast in that light, Wall Street's move into death bonds seems almost inevitable. Goldman Sachs (**GS**) and the other firms consider these instruments the next stage in a trend that started with mortgage-backed securities in the 1970s and has since expanded to include everything from credit-card receivables to intellectual property. The term of art is "securitization," and it has become a multitrillion-dollar business. The mechanics are straightforward: Assets are pooled together and then sold off in the form of bonds or pieces of bonds. By collecting many different assets, the risk is dispersed: Even if a few don't pay off, the rest will. At least that's the theory.

ALREADY THERE'S a bustling market in Germany and London for unrated death bonds—that is, ones that aren't graded by big ratings agencies such as Moody's Investors Service (**MCO**) or Standard & Poor's (which, like *BusinessWeek*, is a unit of The McGraw-Hill Companies (**MHP**)). So far there have been only two small rated deals in the U.S. But given how

aggressively the banks are stockpiling life settlements, most market watchers expect big, rated deals to become commonplace soon, at which point mutual funds can dive in. "The product just lends itself to securitizations, like what has been done with mortgage-backed securities," says Philippe Hatstadt, who heads the new "longevity derivatives" group at Bear Stearns & Co (**BSC**). Cantor Fitzgerald, one of Wall Street's savviest bond-trading shops, is rolling out an electronic trading platform for life settlements and, ultimately, death bonds. The LexNet platform has been in the works for more than a year and is a major priority inside Cantor, say insiders.

But the push into increasingly complicated securitizations carries with it ever greater risk. That's what Wall Street is dealing with now as bonds backed by pools of subprime mortgages blow up left and right. A surge in defaults on these riskiest of loans is battering the hedge funds that invested—and the banks that arranged, packaged, and sold them. In June, two Bear Stearns hedge funds that bet on bonds backed by subprime loans collapsed, sparking panic on Wall Street about the health of other risky investments. Tavakoli says the same kinds of missteps are bound to happen with death bonds. But Wall Street is good at justifying its moves into new lines of business, however iffy they might seem, notes Kenneth C. Froewiss, a professor of finance at New York University's Stern School of Business and a former JPMorgan Chase & Co. (**JPM**) investment banker: "At the end of the day, what Wall Street does best is figuring out what investors might want and structuring products to meet those needs." And its own needs.

That's not to say it isn't aware of appearances. Wall Street is doing its best both to polish the life settlement industry's image and to downplay its own direct involvement. The New York conference was put on by the Life Insurance Settlement Assn. (LISA), an organization of market players that began as the Viatical Association of America in 1994, changed its name to the Viatical & Life Settlement Assn. in 2000, and then dropped the "viatical" altogether three years ago. In an attempt to put even more distance between Wall Street and the old viatical crowd, six investment houses, including Bear Stearns, Credit Suisse (**CS**), Goldman Sachs (**GS**), and UBS, in March formed a trade group called the Institutional Life Markets Assn. to lobby for "best practices" and "appropriate regulation."

Until some degree of legitimacy is in place, firms will keep as low a profile as possible. Goldman Sachs, for example, came close last year to acquiring San Diego's Life Settlement Solutions Inc., a large provider, but backed out at the last minute, according to people familiar with the potential deal. Instead, Goldman, which declined to comment for this story, is quietly building up its own subsidiary under the nondescript name Eastport Capital. That unit sent four representatives to the LISA conference.

It's no wonder that Wall Street is simultaneously attracted and cautious. The alchemy going on in the finance labs is real, but the market for life settlements is deeply troubled. There's a persistent problem with brokers offering lowball prices and failing to disclose transaction costs. The marketing to investors has often been suspect, too. In late 2005, for instance, the big accounting firm KPMG sent a cease-and-desist notice to Keydata Investment Services Ltd., a London firm that was using KPMG's name in its marketing material for unrated death bonds without permission. A Keydata official didn't return phone calls seeking comment. A KPMG spokesman says: "We do not endorse or recommend these products."

IMPROPER MARKETING is just one of the things that got two California men into trouble. Next March, Curtis D. Somoza and Robert A. Coberly are scheduled to go on trial in federal court in Los Angeles on charges that they bilked dozens of investors out of tens of millions of dollars in a scheme involving an African American church group in Los Angeles called the Personal Involvement Center. The men, whose lawyers declined to comment, raised \$69 million for an investment trust called Persistence Capital, which arranged to buy policies from Transamerica Corp. on the lives of some 2,000 members of the inner-city church. The deal was structured so that Persistence would pay for the premiums, while the \$275,000 death benefit on each policy would be split three ways: \$15,000 to the deceased person's family to cover burial costs, \$20,000 to the church group, and the remaining \$240,000 to the trust. The trust's haul would go toward paying the premiums on the remaining policies and providing payouts to investors.

Somoza and Coberly pitched the deal to the Reverend J. Benjamin Hardwick as an opportunity for the 75-year-old pastor to get a modest death benefit for his mostly poor members and raise funds for the group's charitable works. Somoza and Coberly sold it to investors as a way to score a high annual return of 25% because the church group's members "were predominantly African Americans and had a higher mortality rate than the average population," according to the indictment. Prosecutors say the pitch reflected inflated return assumptions. Hardwick didn't return several phone calls seeking comment.

Soon after the deal was set up, say prosecutors, Coberly and Somoza began looting the trust to buy mansions and sports cars. In September, 2005, a year after Persistence bought the policies from Transamerica, it was forced into bankruptcy by investors demanding their money back. Trying to salvage the scheme, Coberly and Somoza shopped the policies to other investors but could find no buyers. They were arrested in May, 2006, and charged with 27 counts of securities and wire fraud.

Coventry First has also been accused of wrongdoing. Last October Eliot Spitzer, in one of his final acts as New York's attorney

general, charged the firm with cheating elderly insurance holders. In a civil suit in New York State Court, the now-governor accused Coventry, which buys life settlements and resells them, of making "dozens" of secret payments to brokers as a reward for not seeking competing bids. (The investigation is now overseen by Attorney General Andrew Cuomo.) Coventry CEO Alan Buerger says the lawsuit was based on "a handful of out-of-context e-mails."

True or not, the allegations against Coventry sent a shock wave through the life settlement business. Most damagingly, they torpedoed a planned \$300 million death bond offering from a partnership formed by Coventry and Ritchie Capital, a hedge fund. The deal, which was to be underwritten by Lehman Brothers Inc (**LEH**), would have been backed by a pool of life insurance policies with a face value of \$1.16 billion, by far the largest U.S. death bond offering to date.

What's alarming is how far the deal had progressed before blowing up. Investors were cued up and ready to buy. On Oct. 10, 2006, Moody's (**MCO**) even tagged the senior notes, which had a face value of \$166 million, with a rating of A3, an investment-grade status that would have allowed ordinary mutual funds to pile in. Then the Coventry suit was filed, and Moody's quickly withdrew its rating, citing the "uncertainty surrounding the transaction." Michael N. Adler, a Moody's spokesman, says the firm wasn't aware Coventry was under investigation when it issued the rating. The 10-page report that accompanied the rating is no longer available to the public. In the report, obtained by *BusinessWeek*, Moody's said it believed that Coventry's "due diligence was adequate for the rating being requested." Jay Eisbruck, a Moody's managing director, stresses that "this is an asset class that we are very careful about."

What especially worries regulators are so-called stranger-initiated deals, in which an investor persuades people to take an expensive policy and lends them money for the premium. In the boldest example yet, an investor group pitched a bank on a deal involving all 45,000 residents of St. Kitts and Nevis. The promoters claimed the islands' government was on board. But the deal got a cool reception from Wall Street bankers, who all stress that they perform ample due diligence before buying policies. A government finance official said he had never heard of such a deal.

Yet hedge funds and other finance firms have been diving into other stranger-initiated deals in the past two years, wooing seniors into taking out policies by offering cruises and other gifts. Industry sources estimate that \$10 billion to \$20 billion in such policies have been created since 2004. Some state insurance commissioners have joined with insurers in calling for a crackdown.

Amazingly, such problems have merely delayed the emergence of death bonds, not derailed it. G. Andrew Karolyi, a finance professor at Ohio State University's Fischer College of Business who specializes in international markets, says Wall Street's interest is predictable given the "demographic bubble" of aging baby boomers, many of whom will be looking to cash in insurance policies. "For investment banks," he says, "all of this sounds like an opportunity to make money." Tavakoli, the securitization consultant, is more blunt. The idea of death bonds, she says, "creeps me out."

Goldstein is an associate editor at *BusinessWeek*, covering hedge funds and finance

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CoverStory

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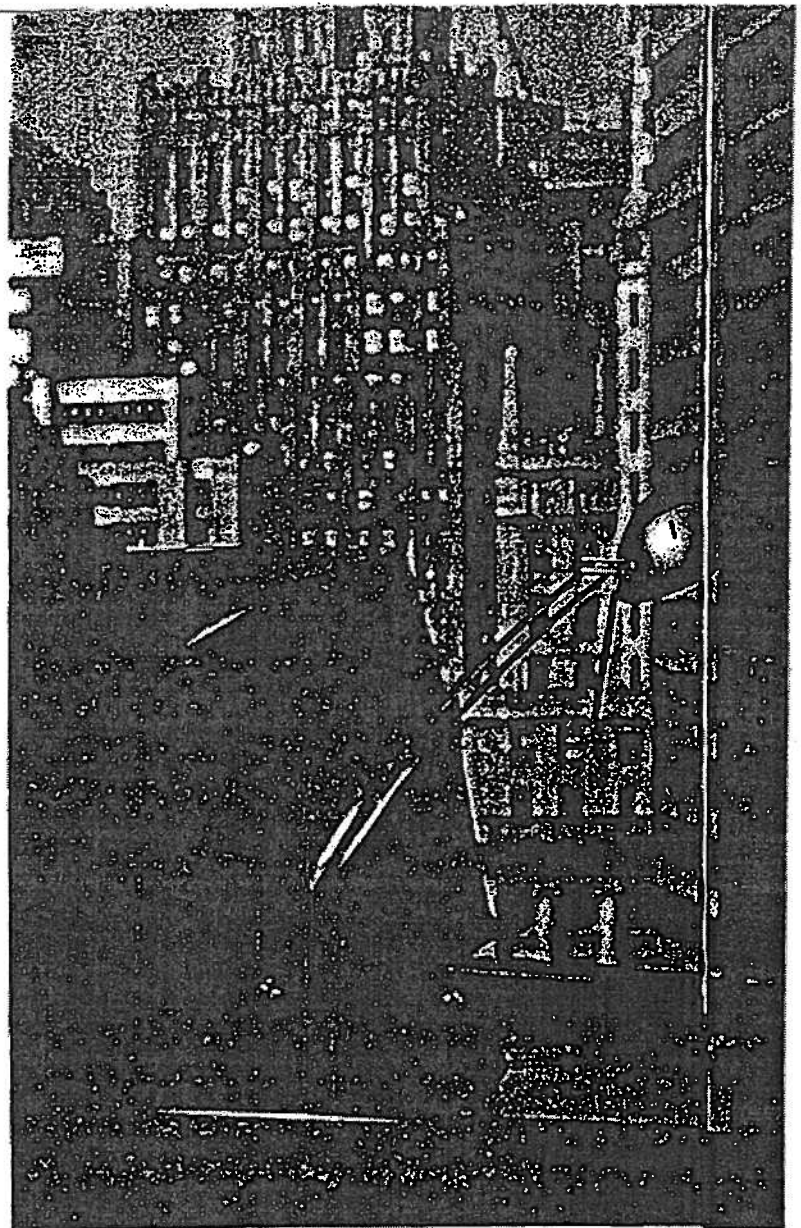
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HOT ON THE GRIM REAPER'S TRAIL

ONLINE: More background on the colorful cast of characters in the life settlement business.

PODCAST: BW Online Editor-in-Chief John A. Byrne gets the story behind the story from Associate Editor Matthew Golsteir.

Watch for a demographic bubble of aging baby boomers eager to cash in their life policies



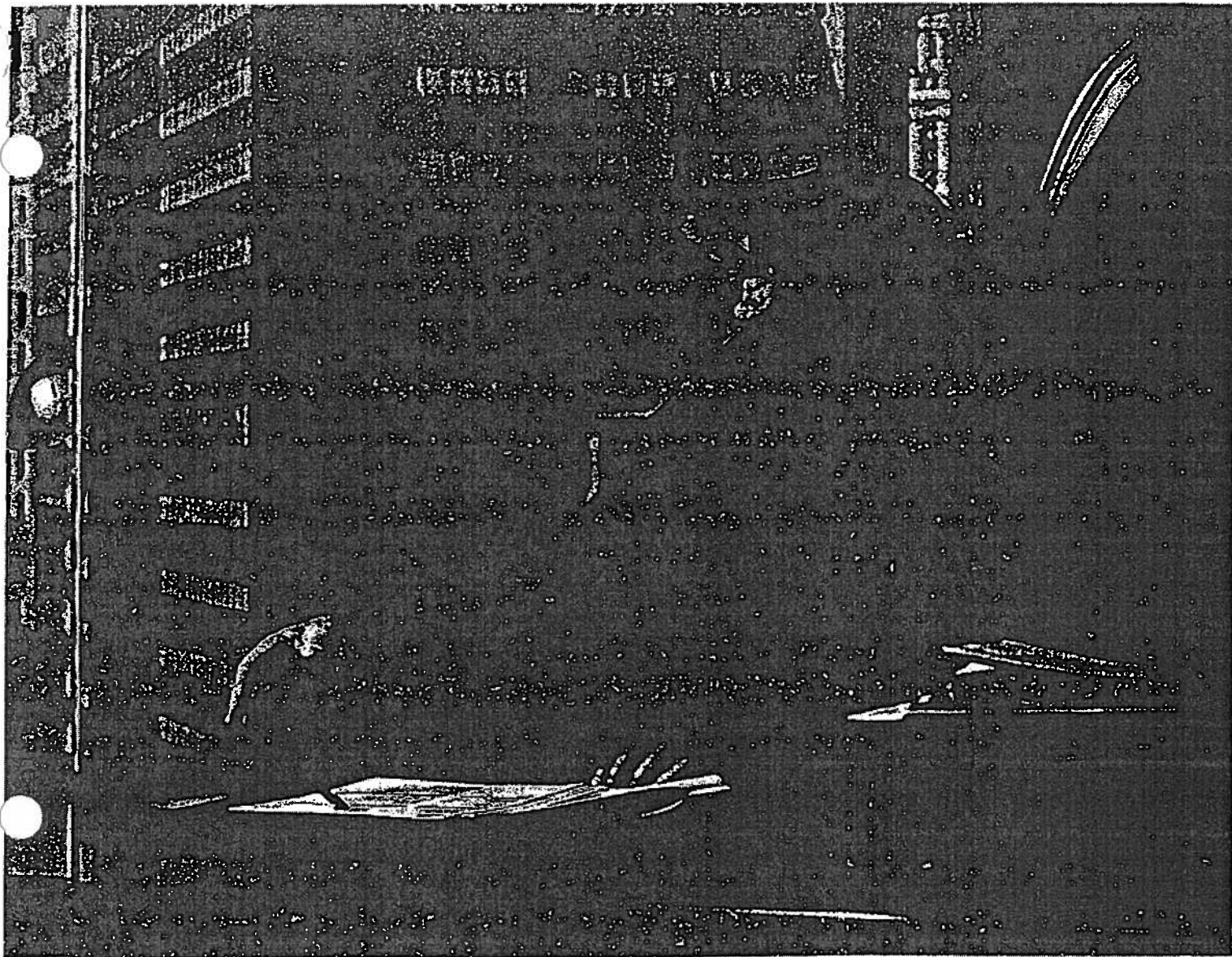
Even the Insurers Have Hopped On Board

BIG INSURERS DON'T KNOW what to make of life settlements. On the one hand, they can jeopardize profits that for years have been easily gleaned; on the other, this burgeoning market can't be ignored.

Before the emergence of life settlements, customers who no longer wanted coverage either stopped paying the premiums or sold their policies back to their insurers for a fraction of the potential death benefits—the so-called cash surrender value. Insurers have long banked on not having to pay on a certain percentage of their policies. Life settlements eat into those profits.

Insurers are especially critical of stranger-initiated policies, which are paid for by hedge

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funds or other outfits rather than individuals. Here's how they work: Elderly customers are enticed to buy life insurance with promotional offers such as free cruises or a promise of free coverage for a short time. After two years, those consumers usually sign over the policies to a hedge fund or another financier, which collects when they die.

The insurance industry is fighting back, lobbying regulators to crack down on what it thinks are predatory or outright fraudulent practices. So far North Dakota and a few other states have enacted rules to make it more difficult to generate such policies.

Increasingly, insurers are also challenging policies in the first two years after issue, in

what's known as the contestability period. During that time, insurers can void a policy if they find evidence of misrepresentation. Others, like American International Group Inc., the world's largest insurer, are making those policies less attractive by hiking premiums for customers over 70. AIG figures it will sacrifice income now to protect future profits by scaring off speculators. A stranger-initiated policy "is different from an investment in a legitimate life settlement," says Chris Winans, an AIG spokesman. "Our position on [such policies] is consistent throughout AIG. Not only do we oppose that market, we have taken steps to inhibit it."

But most insurers also realize life settle-

ments aren't going away—and so they're getting into the game. AIG, for example, is one of the biggest buyers of life settlements, snapping up policies with a face value of \$1.1 billion since October, 2001. It isn't alone. Bermuda reinsurer Axis Capital Holdings Ltd. recently purchased a \$400 million life-settlements package. CNA Financial Corp., a 100-year-old Chicago insurer, has \$108 million invested in life settlements.

By sinking money into the sector, insurers can get back at least some of the money they now have to pay out in death benefits. If someone is going to profit, insurers have realized, it might as well be them.

-By Matthew Goldstein