LIFE SETTLEMENTS—2006 TRENDS, DEVELOPMENTS AND EMERGING ISSUES

by Michael L. Frank

What is a life settlement? It is the sale of an unwanted life insurance policy and is done since it provides a greater cash settlement than lapsing or surrendering a policy. Upon selling a policy (completing a life settlement transaction), the covered insured will typically be the same as before but the policy owner and the beneficiaries will be a different party, typically the company buying the policy (i.e., life settlement company). The life settlement company takes over premium payment and receives a death benefit.

These transactions exist since a life settlement company can individually price a policy, and depending on the characteristics of the risk, exceed the nonforfeiture (cash) values of a policy. Substandard or impaired risks could see higher purchase prices as a percentage of face amounts. The impact of individual medical underwriting (if an individual has a deterioration in health since policy issue date) can potentially offset the added expense provided by the life settlement company. These expenses include overhead, licensing/bonding fees, financing facility costs and life settlement brokerage commissions.

This document will focus on recent trends including the insurance company debate, consumer advocacy, premium financing and the changing environment for the secondary insurance market with focus on the life settlement industry.

Insurance Company Debate

Among life insurance companies, there is an ongoing debate about life settlements. Insurance companies traditionally do not want their sales force to be involved in life settlements. Their agents are either not permitted or the practice is frowned upon (agents may not have coverage under their insurance company's professional liability). However, some insurance companies, including reinsurers, have had an interest in life settlements for the perceived returns and have participated in the life settlement industry as a funder (financial backer).

Other discussions cover whether or not life settlements will have an adverse financial impact in the life insurance industry. As of today, a very small percentage of life policies have been sold as life settlements, so the impact today is probably minimal. However, as the life settlement market grows, one concern is that life insurance policies are lapse-supported, so a life settlements (remember a policy does not lapse from a life settlement but stays inforce) will have an adverse impact to insurance companies since policies will more likely payout a death benefit. Conversely, many life insurance policies (*e.g.*, increasing term) have increasing premium rates and mortality charges with the insured's age so policies remaining inforce will receive more premium to cover increasing mortality.

Empirical Data

It will be interesting to see how this debate will change over time as the industry obtains empirical data in the future. Empirical data will be difficult to measure since there are many moving parts and changes in key areas in life settlements, for example:

- Changing practices in medical underwriting (this is a key factor in setting the price on a transaction) since market perception was that life expectancy calculations were artificially low (aggressive) and now have become artificially high (conservative).
- Changes in risk management such as varying facilities costs, financing and stop loss protection (*e.g.*, Lloyds type reinsurance policies of

expected life expectancy plus two years are no longer available).
- Changes in the economics of the transaction (life settlement brokers are now receiving less fees as a percentage of the entire transaction with policyowners receiving a bigger piece of the transaction).
- Changes in origination and sourcing of policies (e.g., increasing number of premium financing companies).
- Size of the existing market is debatable and ever changing.
- Changing insurance company practices with rating older ages and changes in table shaving practices.
- Changes in practices of the seller as the consumer becomes more educated, as they learn the potential for financial arbitrage and the importance of selecting reputable buyers (flight to quality).

Furthermore, A.M. Best's release of Life Settlement Securitization guidelines will increase the interest of life settlements as an investment vehicle and may create changes in how portfolios are accumulated, priced and managed. More analysis will be needed with actuaries and financial analysts becoming more involved in the pricing and growth in venture capital and hedge funds in this market. For details on A.M. Best's release in September 2005, see Web site link *http://www.ambest.com/debt/lifesettlement.pdf*.

The market could also see significant turnover in portfolios in the future if venture capital and hedge funds are unable to accumulate a critical mass in policies and achieve the rates of returns desired when they entered the business.

Consumer Advocacy

Regulators have developed various requirements and compliance to protect consumers purchasing life and health insurance products. For example, there are requirements pertaining to: (1) advertising including words used and print size; (2) handbooks explaining insurance; (3) regulations to protect brokers from churning or replacing policies (e.g., NY Regulation 60) for additional fees; (4) licensing requirements for insurance companies and agents; and (5) other—we could go on forever with this.

Very little guidance or requirements exist for individuals that sell their policies. This is a work in progress and not consistent by state. One critical area not addressed is disclosure for the transaction. For example, does the seller of the policy (policyowner) know what fees are associated with the transaction (e.g., brokerage commissions)? This issue was debated at the November 2005 SOA annual meeting, and probably will be debated in future SOA meetings.

One might argue that a life settlement transaction might be viewed similar to a security, so entities facilitating the transaction should have a securities/broker dealer license (NASD oversite) plus be required to fully disclose all fees to protect the consumer from expense gauging.

THE MARKET COULD ALSO SEE SIGNIFICANT TURNOVER IN PORTFOLIOS IN THE FUTURE IF VENTURE CAPITAL AND HEDGE FUNDS ARE UNABLE TO ACCUMULATE A CRITICAL MASS IN POLICIES AND ACHIEVE THE RATES OF RETURNS DESIRED WHEN THEY ENTERED THE BUSINESS.

However, mandating disclosure is a challenging item and could potentially backfire on the insurance industry. Consumer expectation might be to get more disclosure of insurance company fees (beyond surrender charges) in the original purchasing of an insurance policy. For example, insurance companies will need to disclosure insurance brokerage commissions, profit margins, overhead, etc., which are typically not disclosed to the consumer. Most policyowners do not know the commission rate that their agents receive.

Also, will the consumer care what costs the life settlement company has to pay to manage their business as long as they get their price? Likely, the consumer will want to know what their broker gets for a life settlement transaction and may even want to know what their broker gets for life insurance policies at issue.

continued on page 18

Life Settlements ... from page 17

Another concern is whether or not the consumer understands the pros/cons of doing a transaction. The insurance departments require insurance companies and brokers to provide basic information to consumers about a life insurance policy. Clearly the consumer would benefit if this was required as part of a life settlement transaction. Life settlement companies advertise the pros of doing a life settlement (your insurance policy becomes liquid—you get cash for selling your policy beyond the nonforfeiture values that an insurance company would pay for your policies).

HOWEVER, AS THE LIFE SETTLEMENT MARKET GROWS, ONE CONCERN IS THAT LIFE INSURANCE POLICIES ARE LAPSE-SUPPORTED SO DOING A LIFE SETTLEMENT WILL HAVE AN ADVERSE IMPACT TO INSURANCE COMPANIES SINCE POLICIES WILL MORE LIKELY PAYOUT A DEATH BENEFIT.

From the consumers' perspective, policyowners could potentially be made aware of the following:

- When you sell your policy, the buyer of the policy may not keep it for the life of the policy and could sell it to another organization. A consumer may think that institutional money is buying their policy, but the buyer may not ultimately be keeping it. This is a key non-financial aspect of the transaction that a consumer should be aware of, and may influence the seller on whether to deal with quality organizations or "fly-by-night" companies.
- The seller of the policy may have potential tax implications so discuss with your accountant or financial planner.
- Someone else gets paid a benefit if the insured (or potential original policyholder if the same person) is deceased. Some people may not be comfortable with this issue, but this is the fundamental premise of a life settlement and viatical transaction.
- A life settlement company makes more money if the insured dies sooner (*i.e.*, the benefit is paid earlier and the premium and financing fees are paid on the policy) and the company loses if the insured lives longer. Interestingly, a similar argument could be made about annuity policyholders that insurance companies make more money if they die sooner, and lose if they live longer.
- It would be of interest to know whether the life settlement buyer has board of directors or owners with criminal records or litigious issues with their local insurance department.
- Does the seller have the same estate planning needs or another solution for estate planning? Are there any beneficiaries (e.g., family members) that would need financial protection when the insured dies?
- Even if beneficiaries are revocable, do you want their blessing before doing the transaction? This may potentially deter some life settlement transactions from being done. This could be a potential requirement for beneficiaries who are immediate family. It might provide additional protection to a life settlement company as well since the liability of family members complaining later that he or she were eligible for a benefit is mitigated.

Licensing

Licensing requirements for life settlements vary by insurance department jurisdiction (state specific). A significant number of states do not have any licensing requirements. Others may require solely an insurance broker/agent license. As a result, lawyers, accountants, financial planners, etc., are able to handle these transactions. Certain states require a Viatical license, which could be deemed different from a life settlement license (viaticals are typically associated with terminally ill patients with less than 24 months to live; life settlements are typically for seniors ages 65 and above). Insurance departments are focusing more attention in this area, so expect a more consistent licensing requirement over time for life settlement licenses including clarifications between life settlements and viaticals. It will be interesting to see if certain jurisdictions require a securities license for certain types of transactions.

Definition of Insurable Interest & Premium Finance Companies

Insurable interest for the beneficiary and policyowner is established at the original purchase of an insurance policy. It has been debated whether insurable interest exists on policies purchased through premium finance companies. If an individual buys a policy through a premium-financing company, and elects not to repay the loan, then the premium-financing company may be the potential owner of the policy. This creates a potential life settlement even before a policy goes outside the incontestability period (two to three years) when the insured decides not to repay the loan.

Premium finance companies are spending significant dollars on legal fees to ensure or at minimum mitigate the risks that could be associated with insurable interest. As an example, New York insurance law section 3205(a) defines insurable interest as:

(a) in the case of persons closely related by blood or by law, a substantial interest engendered by love and affection.
(b) in the case of other persons, a lawful and substantial economic interest in the continued life, health, or bodily safety of the person insured, as distinguished from an interest which would arise only by, or would be in enhanced in value by, the death, disablement or injury of the insured.

This regulation may create potential hurdles for premium finance companies focused on life insurance.

However, the insurance industry reaction pertaining to premium finance companies is mixed. These companies are clearly a source of premium production for insurance companies and create the opportunity for additional policies to be purchased.

Some premium finance companies have become more sophisticated and are looking at trying to arbitrage policies (create life settlement transactions) for policies receiving a better rating (pricing table) at policy issuance than expected. Some insurance companies will not write life insurance policies financed by premium finance companies.

Insurance companies are assessing other approaches in identifying policies at issuance that could be potential life settlements by requesting completion of questionnaires at policy issue asking whether the insured (policyowner) will potentially either use the policy as a collateral assignment or potentially sell it in the future. These questionnaires could be attached to the issued policy with the insurance company's intent to make this part of the contract. It will be interesting to see the insurance industry reaction if insurance companies attempt to enforce these questionnaires such as:

- Denying coverage for unfavorable answers to questionnaires;
- Restricting transfer of policies to premium finance companies for policies that insureds (policyowners) that do not want to pay back premium loans; and
- Enforcing incontestability clauses if policies are transferred or sold within the incontestability period (or potentially beyond it).

It will be interesting to follow the secondary insurance market including life settlement transactions and premium financing corporations over the next few years. ✺

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