



# Understanding Life Settlements And Industry Issues Entering 2008

Published by

## **Insurance Studies Institute**

A non-profit foundation dedicated to advancing knowledge and understanding of the insurance industry's economic and social impacts in a free market economy.

January 21, 2008

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The purpose of this paper is to provide a practical framework for understanding the secondary market for life insurance and to highlight major issues facing the industry at the beginning of 2008.

## **BACKGROUND**

Life insurance came into existence to protect dependents and debt risks, but over centuries has been expanded to facilitate retirement, estate & financial planning, pay estate taxes and somewhat more recently to simply act as an investment. Life insurance is no longer simply mortality protection. It is sold in many different forms, the majority of which are highly complicated and often little understood.

A life settlement is the sale to a third party of an existing life insurance policy for more than its cash surrender value but less than its net death benefit. The insured is generally 65 years of age or older (a senior) and does not have a terminal illness. In a life settlement, the owner is provided an option to monetize (typically for cash) a life insurance policy that is no longer needed or wanted, or for which the monetized value is worth more to the insured than retention of the policy. A life settlement offers an alternative to surrendering a policy for its cash surrender value or allowing the policy to lapse for no value. A viatical settlement is similar to a life settlement, with the exception that the person insured in a viatical settlement is terminally ill. Both life settlements and viatical settlements allow the policy owner to immediately monetize an unneeded or unwanted asset, convert a valuable asset to a greater value, or convert an asset having a high cost (premiums) to a no-cost asset.

*(This paper addresses "life settlements" which for the most part includes "viatical settlements." Some states define all such settlements as "viatical settlements" which is inclusive of settlements for terminally ill and for those not terminally ill.)*

## **LIFE SETTLEMENTS CREATE NEW GROSS PRODUCT REVENUE AND TAX REVENUE**

A March 4, 2005 report published by Bernstein Research Call estimates that the life settlements industry had purchased \$13 billion of life insurance policy face value in force as of 2005. A 2007 report published by Conning Research & Consulting, Inc. entitled "Life Settlement Market" estimates that the likely annual life settlement transaction volume will grow from over \$7 billion in 2007 to almost \$15 billion in 2016. While this is very small compared to the \$18.4 trillion of individual life insurance in force as of the end of 2005, as reported in the American Council of Life Insurers – 2006 Life Insurance Fact Book, it is enough to cause some major insurance companies, legislators and state regulators to devote substantial effort to regulate life settlements. A comprehensive update of industry data is needed to ensure informed actions relative to proposed legislation and provide a realistic measure of the industry's current gross product revenues and tax revenues.

It is important to note that life settlements are revenue positive for state and federal taxing authorities and provide liquidity and additional value benefiting both the sellers (seniors) and the economy generally. A life settlement involves a "transfer for value," which creates a taxable event, and changes the tax-free nature of the death benefit into taxable revenue. In addition, proceeds paid to a consumer in excess of their tax basis in the policy are taxable as income. Life settlement transactions involve agents, brokers, providers and investors, each of whom derive various earnings and profits from the transactions which feed into the economy. Therefore, market priced life settlements (a) maximize value for the consumer, (b) create taxable revenue at the time of the settlement, (c) create taxable revenue upon the realization of the death benefit, and (d) provide revenues and profits to

intermediaries and investors which further fuel the economy and generate tax revenues. Further, life settlement proceeds reinvested in new life insurance policies (a common result of life settlements) create new revenue opportunities for insurers and another series of taxable events generated by the incomes of the insurers and agents. All of this revenue would not be created, absent a life settlement. While the magnitude of this revenue appears to be substantial and clearly increasing, it has not been quantified across the states or at the national level.

The estate tax issue lurking after 2010 raises an interesting sidebar to life settlements. The provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act") cease after 2010 and estate taxes revert back to the Internal Revenue Code of '86. Hundreds of billions of dollars of life insurance has been purchased for the purpose of paying estate taxes with tax free life insurance death benefits. If the estate taxes are eliminated, as happens in the year 2010 (but returns in 2011 because the Act expires) and the Act is continued by Congress, all of this life insurance would become unneeded. This would likely result in a reduction in premium payments to life insurance carriers. However, in such a case life settlements should expect a windfall of new settlements which would maintain the premiums to insurers and would generate substantial new tax revenues on the settlement proceeds. The economics of such developments need to be quantified for legislative considerations and Insurance Studies Institute has proposed such a study to the Department of Treasury.

### **THE LIFE SETTLEMENT PROCESS**

It is important to understand the players in the life settlement process:

- ❖ Policy Owner – An individual, several people jointly or an entity, very often a life insurance trust. May or may not be the insured.
- ❖ Insured – An individual or several individuals in a joint policy on which an insurance benefit is paid upon the insured's death.
- ❖ Agent – Typically the life insurance agent who originally sold the policy helps the owner determine whether or not a policy should be sold and seeks the best market price.
- ❖ Broker – Typically a firm (licensed if required by licensing states) that assists the Agent in getting all required information to market the policy. Brokers market policies to Providers to obtain the highest market prices.
- ❖ Provider – Typically a firm (licensed if required by licensing states) that represents investors by making offers to purchase the policies and that handles the purchase and closing process.
- ❖ Investor – Typically an institutional firm, e.g. pension fund, multi-national bank, international corporate conglomerate, global insurance company, hedge fund, investment bank, syndicated fund.
- ❖ Government – As of end 2007, 40 states have established laws and regulations governing the operation and execution of life settlements and/or viatical settlements. Regulators of these states provide oversight to the above industry players. In addition FINRA has established regulations applicable if the life settlement involves a variable policy which is a security.

The life settlement process begins with a policy owner and the insured (if different from the owner) filing a life settlement application which contains basic information concerning the policy, its owner and the insured. The Agent and Broker typically facilitate this application step but a policy owner can contract directly with a Provider. A life settlement Provider verifies the insurance coverage, reviews the

insured's medical status, obtains actuarial life expectancy evaluations on the insured and determines the policy's viability for a life settlement (including reviewing the case for potential fraud). The life settlement Provider determines suitability for funding and either (1) matches the policy with an appropriate institutional Investor that could acquire the policy and makes an offer to the Broker/Agent/Owner, or (2) may offer to purchase the policy with its own proprietary capital. If the offer is accepted, a detailed closing package is delivered to the policy owner. Signed documents are returned to the life settlement Provider and, assuming everything is complete, the insurance carrier is notified to change ownership of the policy. Following written verification of the change of ownership of the policy, settlement funds are transferred to the policy owner.

### **THE CONSUMER BENEFITS OF LIFE SETTLEMENTS**

Billions of dollars in excess value (i.e. the value in excess of the cash surrender value), have been paid in recent years by life settlement providers to policy owners who elected to sell their policies. The vast majority of the policy owners are insured seniors. In regulated states (states that have adopted life settlement laws), the life settlement must pay more to the owner than is otherwise available in the policy surrender value. However, even in unregulated states, due to competition, owners are paid more than the available cash value. A 2007 study by the Life Insurance Settlement Association, reports that a small sampling of the life settlement industry (only 11 life settlement firms) "paid a total of more than \$854 million above cash surrender value to owners of life insurance policies during the years 2004 and 2005." That translates to an average approximating \$250,000 per policy based on a total of 3,437 policies reported in the same study for the same period. These excess dollars flow directly to the owners of the policies. The money received by the owner is unrestricted and after paying transaction fees and costs, the owner may spend or invest it as he/she chooses, e.g., fund retirement, improve a home, fund a grandchild's education, start a business, pay medical expenses, repay debts, purchase new life insurance or deal with an unexpected life change such as nursing home care. For such consumers, the ability to sell some or all of their life insurance policies provides opportunity to realize current value of an asset rather than wait for it to materialize upon death.

In addition to straightforward sales of insurance policies for the typical reasons, some consumers have learned that they can purchase life insurance policies and potentially sell them at a profit. Of course their profit potential is influenced by the value of the policy in the secondary insurance markets when they attempt to sell it. The value at time of sale is influenced by the price capital markets (investors) are willing to pay, and to a greater extent, by the life expectancy or mortality rating of the insured. While this strategy has issues, it has been expanding among high net worth consumers and has become a cause for concern among insurers and life settlement firms, particularly when premium financing arrangements are involved.

### **IS A LIFE SETTLEMENT GAMBLING ON SOMEONE'S LIFE?**

Life insurers actually make a series of "wagers" on longevity, or mortality, on given groups of people. The carriers are simply making a series of decisions based on probability (wagers) of the likely mortality profile of a particular cohort of insured. Carriers hope, based on actuarial analyses, that they price the risk and timing of mortality properly and charge an appropriate risk premium, including their assumed policy lapse and surrender rates. If they are right, their payouts of death benefits will be less than the premiums collected including all associated costs and overhead.

Just like life insurers, institutional investors in life settlements own an interest in a pool of diversified mortality risk, which has been actuarially analyzed and modeled based on mortality profiles. If they invest accurately, their payouts to purchase the policies plus premiums to maintain the policies and associated costs will be less than the death benefits they will collect.

Thus, to view a life settlement as wagering on mortality is to view the initial issuance of a life insurance policy or a life annuity as no less a wager. The pejorative term “wager” should not confuse the fact that both parties, institutional investors and insurance carriers, are making the exact same business analysis and decision. The fact that both insurers and institutional investors are calculating risk on a group of insured removes the concern that life settlements are wagering on any one insured.

On December 14, 2007 the Associated Press reported: “Goldman Sachs announced the first of a new series of indices to help financial institutions with exposure to American mortality and longevity rates better understand their risk in these positions.” “The index will independently track monthly a pool of 46,290 anonymous U.S. citizens over age 65, providing real-time publication of mortality information.” The intent of this index is to provide a mechanism to manage their mortality exposure in the capital markets. Such an index further removes the wagering aspect of individual policies by enabling institutional investors to hedge the mortality risks evident in their particular pools of insured.

### **INSURABLE INTEREST REQUIREMENT**

The law in all states requires any person who buys an insurance policy to have an insurable interest in the life of the insured or the property insured in the case of casualty insurance. This requirement, derived hundreds of years ago in English common law, exists to prevent a person with no insurable interest from buying a policy on someone else’s building and then burning it down. These laws apply to life insurance. Every person has an “insurable interest” in something when loss or damage to it would cause that person to suffer a financial loss or certain other kinds of losses. For property, one has an insurable interest in any property one owns, that is in one’s possession or acts as collateral security.

For purposes of life insurance, everyone is considered to have an insurable interest in their own lives as well as the lives of their spouses and dependents. Unlike property and casualty insurance, the insurable interest for life insurance needs to exist only at the time the policy is purchased. Moreover, an insured can designate any beneficiary of the policy without regard to insurable interest and the owner of the policy can transfer it to any other party after it is issued provided that at the time the policy was put in effect a valid insurable interest existed. The concept of insurable interest is relevant to life settlements in that the Provider endeavors to ensure that the original owner had an insurable interest in the life of the insured. A key point of analysis is whether the insured established the policy “on their own initiative.” If so, then the public policy concerns protecting the insured have been satisfied.

The legal definition of insurable interest is determined by state laws and statutes and codifying of this common law principle varies among states, and often is less than clear in some transactions. But the following relationships and arrangements generally qualify for and maintain the insurable interest:

- ❖ A policy loan by a life insurance company pursuant to the terms of the life insurance policy;
- ❖ A collateral assignment of a life insurance policy by an owner;
- ❖ A loan made by a lender pursuant to a legal Life Settlement Contract;

- ❖ An agreement where all the parties and related entities have a lawful economic interest in the continued life, health and bodily safety of the person insured.
- ❖ A designation, consent or agreement by an insured employee in connection with the purchase by the employer of life insurance on the employee;
- ❖ A business merger or succession planning arrangement including the insured (which business was not established for the purpose of avoiding insurance laws and regulations),
- ❖ An agreement entered into by an insured service recipient and a third party service provider who performs significant services for the service recipient's trade or business.

Other arrangements may also sustain a finding of insurable interest, but may be subject to challenge. For example, premium finance transactions where the financing entity has entered into substantial agreements with the insured prior to applying for an insurance policy and where the financing entity has no prior insurable interest in the insured and where the agreement essentially requires the policy to be transferred to the financing entity shortly after issue, is one that is currently being challenged by insurers and regulators. In such an arrangement, the finance company has no insurable interest in the insured prior to the issuance of the policy, but does have an interest after the loan is made. Insurers are even challenging loans when all that is transferred is a security interest in the policy, especially if the loan is "non-recourse," meaning that in the event of a default the only recourse left to the lender is to take the policy which is the subject of the loan.

#### **THE ECONOMIC IMPACT OF LIFE SETTLEMENTS**

The impact of life settlements encompasses a broad spectrum of economic considerations. While there has been much written on this in recent years and some studies have been published, there remains considerable discovery to determine the full economic impact on consumers, insurers, investors, intermediaries and governments.

In theory, a life settlement should benefit the insurer that issued the settled policy. The insurer priced and sold the policy based on its actuarial analysis of mortality. If a policy is surrendered, the insurer pays out the surrender value and ceases to collect premiums, (i.e. the policy is terminated). The same happens if the policy is allowed to lapse (i.e. premiums payments cease resulting in termination of coverage). However, a life settlement ensures that the policy continues to maturity and that the premium payments are paid by the new policy owner to the insurer that issued the policy. Thus, in theory the insurer should be satisfied with the continuation of the policy. Indeed, according to the 2006 Life Insurance Fact Book published by the American Council of Life Insurers, "The life insurance business vigorously seeks to minimize the lapsing of policies." Notwithstanding this, insurers assume a substantial degree of lapse/surrender in their business and pricing models and according to that same source 6.5 – 7% of policies lapse every year.

According to a 2005 joint study by the Society of Actuaries and LIMRA International:

- ❖ About 9.5% term insurance lapses every year. For seniors the figure is even higher and nears 20% per annum in policy year 11 and above.
- ❖ For Universal Life policies, over 5% lapse per annum, but for seniors the figure is higher and in the first five-years approximately 24% of Universal Life policies issued to seniors lapse.

- ❖ For Variable Universal Life policies the annual lapse rate is 8.2% for all lives. Again, policies issued to seniors lapse at a somewhat higher rate with nearly 40% of such policies lapsing within 5 years of the date of issue.

While not summarized in the study, it appears that in excess of 85% of all life insurance policies issued never result in a death claim.

If policy owners, and in particular seniors, are prohibited from selling their policies within five-years from date of issue, as is proposed in some model acts and legislative bills (noted below in the section pertaining to a five-year ban), these consumers can be faced with materially greater costs to carry their policies to the five-year period (versus two years under current practices) and potentially lose economic value available from sale of their policies. Such economic loss to consumers can have materially negative impact on retirement and estate planning. On the other hand, forcing the holding period for policies to five-years creates materially greater profit opportunity for insurers which can benefit their reserve requirements and keep their policy pricing models consistent with recent practices.

The payment to the life settlor (owner) represents a value greater than the policy surrender value, thus, a net increased tangible benefit is created for the settlor. However, when selling a policy, the death benefit is transferred to another owner and beneficiary, thus those who are beneficiaries of the policy prior to its settlement will no longer share in the death benefits. One can argue that they lose, but they also lose if the policy is surrendered or allowed to lapse. On the other hand, if the policy is sold in a life settlement versus a lapse or surrender, the beneficiaries may stand to benefit from accumulation of cash not paid in premiums, by having other estate liabilities settled, and/or be entitled to the net money realized from the settlement in an estate.

Apart from economics, there is the issue of who should control ownership of life insurance. Should owners have the right to decide lapse, surrender, assign, sell or finance their life insurance policies as they might with any other personal asset? Or should insurers retain the power to determine the ultimate disposition of life insurance policies when an owner needs to or desires to dispose of it? Or should the federal or state governments determine these issues by law? These are issues that are being currently debated by insurers, life settlement firms, special interest groups, legislators, insurance commissioners, the NAIC, NCOIL, FINRA, and others, including the media.

The synergistic economics and social values of these issues are complex and do not appear to have been fully researched. Trade-off of future death benefits versus current liquidity is not always determined in hard dollars. Intrinsic value of current benefit to quality of life has to be weighed in.

#### **CURRENT EFFORTS TO INFLUENCE THE LIFE SETTLEMENTS INDUSTRY**

Life settlements are not new. The concept of selling life insurance policies as an industry has existed in both Europe and the United States for many decades. The life settlement "industry" in the United States started in the late 1980s in response to the needs for people afflicted with AIDS. At that time, the term for a life settlement was "viatical." Today that same term persists and usually refers to the sale of a policy where the insured has a terminal illness and a life expectancy of 24 months or less. In the earlier days of the industry, prior to the pervasive regulation that exists today, some bad actors took advantage of viators and more commonly, investors. While most players in the industry have been honorable and honestly working for the best interests of the policy sellers, there were some early market participants who did not pursue honorable practices. Today, regulation is influenced by the substantial expansion of the life settlement industry and the involvement of major institutional

investors, legislators and regulators, and regulatory oversight has been intensified. In addition, life insurance carriers are seeking to influence regulations and practices to curtail the impact of the life settlements industry on their industry. But concurrently (and as will be further discussed below), several large insurers are joining the life settlement industry as competitive and/or value added players. For example, AIG is a major purchaser of life settlements. Berkshire Hathaway has previously been a buyer and more recently, Phoenix Life Insurance and Transamerica Insurance have become principals in the life settlement business.

In an effort to curtail or moderate the impact of life settlements, some Insurers are taking proactive actions including:

- ❖ Refusing to accept life insurance applications where the applicant indicates that he or she is aware of life settlements;
- ❖ Rejecting life insurance for applicants who have indicated an intent to take out a loan to help pay premiums;
- ❖ Undertaking a lobbying effort to associate life settlements with certain improper premium financing programs, having the possible intent of causing life settlements to be restricted along with legislation restricting premium financing programs;
- ❖ Sponsoring legislation to prevent policy owners from selling a policy for five-years from the date the policy is issued.
- ❖ Promoting special federal excise taxes on the sale of policies on which the owner obtained premium financing and/or on the ultimate profits realized by investors.

Should these efforts succeed; the net effect on consumers can be loss of the economic benefit provided by the life settlements industry. Absent the option of life settlements, many consumers would be forced to let policies lapse or be forced to accept what often is a smaller amount from the cash surrender for their policy assets. During the early years of a policy the cash surrender value is typically materially less than the policy account value because the surrender charges are intentionally set high to assure target policy profit and risk protection to the insurer. This practice correlates with the high lapse and surrender rates and encourages policy owners to hold policies for the long-term. The gap between the account value and the surrender value is retained by the insurer rather than being paid out to the policy owner if the policy is surrendered. However, a life settlement transaction monetizes this gap and enables a policy seller to realize the value of this gap upon sale, regardless of the policy's actual cash surrender value.

Individuals who sell their life insurance policies are living proof that as individuals' needs change, life insurance coverage may no longer be appropriate. Through life settlements, consumers are learning that the market value of their life insurance policies can be substantially greater than the cash surrender value offered by the carriers. Consumers are learning that their life insurance policies are tangible assets that can be managed just like stocks and bonds. In fact, some consumers purchase life insurance policies for the sole purpose of selling them at a profit within a couple of years from issue. This speculative purchasing and selling of policies has raised the eyebrows of insurance carriers who are concerned about the long-term impact that such transactions may have on their industry. Clearly, the growth in the life settlement industry is evidence that more and more people (and their financial and legal advisers) are learning how much value is lost in a lapsed or surrendered policy and the increased value that the life settlement markets can bring to them.

While the long-term socio-economic impact of the life settlement industry on consumers, insurers, intermediaries, investors and governments remains to be proven, recent growth of the industry provides evidence that it is delivering material value to consumers and all industry players.

### **SHOULD THE FEDERAL GOVERNMENT IMPOSE AN EXCISE TAX ON LIFE SETTLEMENTS?**

In June, 2006 the American Council of Life Insurers (ACLI) in Washington, a life-insurance-company trade group, proposed a 100% excise tax for premium financed policies and is lobbying for it in Congress. ACLI's proposal would apply to life settlements entered into before a policy has been in effect for five - years. The classes of people exempt from the tax include those generally viewed as having an insurable interest in the insured (family members, etc.), life insurance companies (American Council of Life Insurers members), certain qualified lenders, and settlement companies if the transaction involves a terminally or chronically ill person.

This effort has not gained wide support. While its stated goal is to have such a tax apply to speculative purchases of life insurance, so called Stranger Owned Life Insurance (STOLI), the proposal effectively captures all life settlements conducted during that five-year period. According to life settlement industry advocates, proposed new laws define STOLI transactions so broadly that the five-year limitation applies to virtually all life settlements, thus denying consumers the opportunity to realize economic benefit upon sale of their policy.

Currently the sale of a life insurance policy is effectively prohibited (and in some states illegal) until after two years from the date of issue. Two years represents the historic and current contestable period in which insurers have opportunity to verify facts used in the application for the policy and if inaccurate, may rescind the policy. Because high lapse rates occur within the first 5 years of most policies, a 100% excise tax would apply to a large number of policies that could be potential life settlement transactions.

What is at stake is the economic freedom of consumers to manage and sell their assets. Some believe the imposition of such a tax is regressive and would rob seniors of a valuable retirement and estate planning option. And if such a tax materially curtails life settlements, the U.S. Treasury and many states would realize materially less tax revenues derived from the gross revenue streams of life settlements. Of course a 100% excise tax is not a tax but rather it is confiscatory and operates as a ban. Accordingly, the effect of such a tax becomes revenue negative.

### **CONSUMER LIFE INSURANCE PROPERTY RIGHTS AND INSURABLE CAPACITY**

American consumers enjoy freedom to buy and sell their assets when they deem appropriate without government established holding periods (except as applicable to capital gains tax rates or other tax incentives such as in 401(k) plans). This applies to stock/bond/mutual fund/commodity/options/futures markets, real estate, oil and gas, cattle, grain, art, jewels, automobiles, i.e., any investment, personal or real property. Should the sale of a life insurance policy be otherwise restricted by law?

Life insurance is a personal asset and every individual has an insurable capacity, much like a loan capacity in relation to the asset's value. Insurable capacity is typically determined by the individual's economic situation, including net worth, rate of income, amount of liabilities, obligations to dependents and survivors, business interests, etc. Insurable capacity is the maximum aggregate amount of all life insurance that insurers are willing to issue to any one individual. For example, one individual may have a maximum insurable capacity of \$1,000,000, while another may be \$10,000,000 and another

\$100,000,000. Whatever amount of insurance an individual purchases up to his/her insurable capacity is a personal asset and under current laws can be managed and sold as the individual wishes.

Life insurance companies are proposing unprecedented restrictions on the rights of consumers to manage and sell life insurance policies. Insurers claim they need this to protect their policy pricing and profit models by assuring continuation of their expected lapse and surrender rates of policies during the policies' first five-years. The proposed restrictions are in the form of a five-year ban in state legislative bills and in the form of a 100% excise tax at the federal level. (see comments above regarding excise tax)

As a matter of current public policy, the only exception to the transferability of life insurance provided at law throughout the United States is found in some state statutes whereby the sale of a policy is limited for the two-year contestability period. And some investors believe a two year restriction is unfair to consumers. By state law, life insurance policies cannot be contested by the issuer once two years have elapsed.

These incontestability laws are a fundamental consumer protection which act in similar fashion as statutes of limitation, and which were established in response to public distrust of insurers resulting from numerous charges of corruption, fraud, and dishonesty among life insurance carriers which prompted legislatures to enact laws to remedy the dishonesty then rampant in the life insurance industry.

#### **CAN A FIVE-YEAR BAN ON SALE OF LIFE INSURANCE BE EFFECTIVE?**

The five-year ban on life insurance policy transfers provides benefits to insurers by protecting the economics of the lapse rates of policies. But what are the benefits to consumers, government and the life settlement industry?

While the NAIC Model Act includes certain exceptions to the five-year ban, life settlement advocates claim the five-year ban on transfer does not serve as a bar to stop the concerns of stranger-initiated life insurance. They claim it does not resolve the issues of so-called Stranger Initiated Life Insurance or Stranger Originated Life Insurance ("STOLI"), and would instead impede legitimate life settlements that benefit consumers, mostly senior citizens. This is so because as drafted the NAIC Model Act does not apply to a host of STOLI transactions where the policy is never "life settled", which are the true targets of the NAIC Model act.

While the intent of the five-year ban is to curtail STOLI transactions, the five-year ban on sale or transfer of life insurance policies can create financial burdens on or prohibit consumers who do not have the needed liquid assets to pay for policy premiums and who seek premium financing to enable them to purchase a needed life insurance policy. Moreover, life settlement advocates claim the language of the NAIC model act is susceptible to a much broader reading and can be read as banning any transfer of life insurance within 5 years of the issue date.

No apparent broad public support exists for a 5 year holding period other than among some life insurance carriers. It is being promoted by the commission members of the National Association of Insurance Commissioners (NAIC) who voted in June, 2007 to approve the amended NAIC Model Act. However, the ban has been rejected by the legislator members of the National Conference of Insurance Legislators (NCOIL) as well as New York regulators who are finalizing draft legislation.

A five-year transfer restriction period applicable to life insurance policies has no evident basis in public policy or law, and would represent a restriction on the alienability of personal property that is without precedent. There is no evident economic value of the five-year ban to consumers in estate planning, retirement planning or asset management because there is no evidence that the consumer gains any economic advantage from the insurer or the life settlement market by holding a policy for the required five-years.

Laws and regulations created to regulate STOLI transactions should narrowly focus on just that and avoid limitations to other consumer rights.

### **WHO BENEFITS FROM A LIFE SETTLEMENT?**

Life settlements are an important tool for many consumers, including the following situations:

- ❖ Funds are needed to pay for health care, long-term care or other end of life costs
- ❖ Retirement and estate planning can be enhanced with liquidity from sale of insurance assets rather than waiting for death benefits to be paid to survivors.
- ❖ Premium payments have become unaffordable
- ❖ A policy is no longer needed (e.g., death of a spouse; divorce; children are grown up; business is sold or closed; retirement funding is fulfilled; earnings and assets enable full financial independence; etc.)
- ❖ Changes in estate or financial plans or changes in law, etc., occur subsequent to policy issuance
- ❖ The cost of the investment in the insurance is no longer appropriate.
- ❖ People change their minds

But life settlements are not proper for everyone, e.g., where there is a strong need to keep the policy in force to protect against real risk. It is essential that individuals considering a life settlement clearly understand the resulting tax ramifications, trade-off of current liquidity versus ultimate death benefits, continuing obligations to investors who purchase the policy, impact on beneficiaries, and other alternatives that may be available to them. It may not always be advantageous to sell, and a sale certainly should not be considered if the cash surrender value of the policy is greater than the market value. While it is the obligation of agents, brokers and providers to assure full disclosure to owners and insured considering selling their policies, the owners and insured should seek independent legal and financial advice before selling.

### **THE LIFE SETTLEMENT INDUSTRY IS REGULATED BY THE STATES**

The business of insurance, itself, is not federally or nationally regulated. Instead, the McCarran-Ferguson Act (15 U.S.C. §§1011-15) of 1945 gave authority to the states to regulate the business of insurance. While the states' authority over the business of insurance has been limited by federal statutes enacted since the McCarran-Ferguson Act, states retain primary control over it.

As of the end of 2007, life settlements are regulated by 28 states, viatical settlements are regulated in 38 states and D.C. and 12 states have no regulation. However, new and expanded legislation to regulate

life settlements have been or are expected to be introduced in numerous other states during 2008. Regulation of life settlements is generally administered by the insurance departments of each state.

Some life settlements are treated as securities because they involve variable policies which are classified as securities. All life settlement transactions involving a security policy must be handled by a licensed securities broker/dealer. However, such a securities based settlement does not exempt the transaction from applicable state level insurance and life settlement regulations.

In 2006, Senator John Sununu (R-NH) and Senator Tim Johnson (D-ND) introduced the "National Insurance Act of 2006" which establishes a parallel federal/state system of regulation and supervision for insurers and insurance agents/brokers, similar to the dual banking system, in which insurers and agents/brokers are free to elect federal or state regulation, charter and licenses. This concept certainly might be supported by those who prefer federal government, but it may be difficult to ascend with the strong power of state insurance commissioners and existing state regulators. The argued advantage is to remove complexity in insurance regulations among the states and establish national consistency. The disadvantage would be material disruption to existing laws, regulations and to established insurance products.

The Act does not directly address life settlements, but there could be advantages to consumers by leveling the playing field across the nation, eliminating the complexities of the many different state laws, and for consumers in states which have no comprehensive life settlement laws.

#### **LIFE SETTLEMENT INVESTORS ARE TYPICALLY LARGE INSTITUTIONAL INVESTORS**

The same institutions that invest in life insurance companies also purchase life insurance policies through life settlements. These include multi-national banks, international corporate conglomerates, global insurance companies, pension funds, hedge funds, investment banks, syndicated funds and other major financial institutions.

The practice of individuals purchasing policies as in the years preceding the life settlement industry and in the early years of the industry has essentially ceased. Any such transactions are rare and typically done to accommodate some special situation. Most state laws permit a non-licensed purchaser to purchase at most one such policy each year.

Today, with the substantial presence of institutional investors, policy sellers and insured have little need for concern regarding who owns their policies.

#### **WHO IS REPRESENTING CONSUMERS IN LIFE SETTLEMENT ISSUES?**

With the exception of the Insurance Studies Institute (ISI) and a few other independent foundations that support insurance research, ISI is not aware of any organization that is objectively watching out for consumer interests with regard to life settlements.

State insurance commissioners are charged with a responsibility to protect consumers and some have been noticeably aggressive in their efforts. However, insurance commissioners are also responsible for the overall practice of insurance in their states and must weigh-in on all sides of regulatory issues.

Several associations have undertaken extensive lobbying and drafting of model life settlement acts. The more notable include: NAIC (National Association of Insurance Commissioners), NCOIL (National Conference of Insurance Legislators), ACLI (American Council of Life Insurers), LSI (Life Settlement Institute), LISA (Life Insurance Settlement Association), and ILMA (Institutional Life Markets Association). All of these represent some facet of the life settlement industry or regulatory function, and none directly represent consumer interests.

The insurance industry lobby ("Insurance Lobby") has been notably powerful in all aspects of insurance, including legislation and regulations. The Insurance Lobby claims that they are trying to protect consumers' life insurance because they claim life settlements are seldom in the best interest of customers. The Insurance Lobby claims to be acting as consumer advocates for life insurance customers, protecting consumers from significant consumer protection issues, the potential risk of fraud, wagering on human lives, and a life settlement industry that lacks regulatory consistency. They claim that policy owners are often approached at a vulnerable time and may not understand the economic tradeoff of retaining a life insurance policy compared with any consideration that a life settlement company can offer.

Life settlement lobbies ("LS Lobby") claim the Insurance Lobby is only seeking to protect the windfall profits earned from lapsed and surrendered policies. The LS Lobby claims older Americans selling their life insurance policies only do so after a great deal of disclosure and with the advice of legal and/or financial counsel. The LS Lobby has fought at every level against the life Insurance Lobby attempts to restrict the availability of life settlements as an unwarranted restriction on a property right. The LS Lobby claims the insurers are more concerned with protecting their franchise and industry, including the unique tax-favored status of their products and the profits supported by the early lapsing of life insurance so they can continue to collect premiums and not ultimately become liable for the payment of the death benefit under the contract of insurance.

Ironically, some insurers who oppose life settlements are themselves affiliated with life settlement providers. For example, AIG is a major purchaser of life settlements but has supported efforts to curtail providers.

Two model acts have been drafted by government based associations in 2007, NAIC "Viatical Settlements Model Act Revisions" (For more information, visit NAIC on the Web at: [http://www.naic.org/press\\_home.htm](http://www.naic.org/press_home.htm)) and NCOIL "Life Settlements Model Act" (See <http://www.ncoil.org/schedule/200730day/Summer30Day/LatestLifeSettlementsModel.pdf>.) These model acts include many protections for consumers that both the Insurance Lobby and the LS Lobby accept. However, there are several provisions which are being debated, the five-year ban being one of them. Both the Insurance Lobby and the LS Lobby are pressuring state legislators and regulators to modify these debated provisions. But again, there is no consumer advocate lobby actively engaged in these debates.

It appears the outcome of these debates may be determined by which lobby has the most influence and perhaps not by what is best for the socio-economic welfare of consumers and the balance of revenues. One has to ask if the balance of protection among consumers, insurers, life settlement players, investors and government is being fairly weighed.

As bills are presented to state legislators in 2008, it will be their responsibility to weigh the debates and to assure that the consumer rights and economic opportunities in their states are protected. And it will be their responsibility to weigh the economic vitality of insurers, life settlement firms and investors in their states. In balance, the legislators must determine what is more important -- protecting insurer profits or consumer economic interests. Everything in between will follow accordingly.

### **LIFE INSURERS ARE ENTERING THE SECONDARY MARKET**

Ironically, life insurance companies are entering the secondary life insurance markets. In the past few months, Transamerica Life Insurance Company, Phoenix Life Insurance Company and most recently Genworth Financial have all announced intentions to enter into the secondary market and begin the purchase of life insurance policies. Insurance giant AIG is and has been a major purchaser of life settlements. If the secondary market and life settlements are harmful to consumers as the Insurance Lobby claims, why are such respected issuers of life insurance policies entering this market? Are they attempting an end-run to use their financial strength to drive other life settlement firms out of the market? Are they recognizing and wanting to advance the benefit of life settlements to consumers? Are they seeking additional profits? This movement is expected to expand to other insurers in 2008 and should result in a benefit to consumers by increasing capital available to purchase life settlements and by adding efficiency to the market resulting in better prices for selling consumers.

### **DO CONSUMERS HAVE A RIGHT TO SELL LIFE INSURANCE POLICIES?**

The purchase of an insurance contract is an investment decision not materially different than buying a stock, borrowing to buy a home, or investing in a mutual fund (variable insurance products are investments in existing mutual funds). The insurance policy is a personal asset. Consumers have the right to sell personal assets, so long as such assets are not contraband, stolen or drugs. So yes, consumers can sell legally owned life insurance policies.

Do consumers have the right to borrow money and assign their insurance policy as collateral? Yes they do. But the concern to prevent "strangers" from purchasing insurance on an individual life has led to provisions in the proposed model acts that appear to limit the right of consumers to borrow money and assign their policy as collateral. What is the greater issue -- protecting consumers from stranger initiated insurance structures, or protecting the right of consumers to manage their assets?

Part of the benefit implicit in an insurance policy investment is based on one's view of their mortality profile. If one believes they may live longer than the mortality rates applicable to such person, they will strategize their assets accordingly, and vice versa if they expect to die sooner. Maximizing one's investments is presumably the goal and right of every investor and certainly any sensible person. Contrarily, what are the socio-economic considerations that should legally prevent a person from purchasing a life insurance policy today as an investment contract, and potentially selling it at a profit in the future (subject, to life expectancy and taxation)?

Long established federal and state laws also support the rights of consumers to treat their life insurance like any other asset. In *Grigsby v. Russell*, 222 U.S. 149, (1911) Justice Holmes wrote:

"On the other hand, life insurance has become in our days one of the best recognized forms of investment and self-compelled saving. So far as reasonable safety permits, it is desirable to give to life policies the ordinary characteristics of property. This is recognized by the bankruptcy law, § 70,<sup>FN1</sup> which provides that

unless the cash surrender value of a policy like the one before us is secured to the trustee within thirty days after it has been stated, the policy shall pass to the trustee as assets. Of course the trustee may have no interest in the bankrupt's life. To deny the right to sell except to persons having such an interest is to diminish appreciably the value of the contract in the owner's hands." *Id* at 156.

It seems legislation of insurance and consumer protections should focus on specific protection issues while concurrently protecting the rights of consumers to manage their assets, retirement funding and estate planning.

### **A NEW LIFE INSURANCE REVERSE LOAN CONCEPT**

A new insurance product being floated is designed to compete with life settlements. The new weapon, which is being developed by insurance companies, is a life insurance version of the "reverse mortgage." This option would provide for a loan based not on the cash value, as currently allowed under state insurance laws, but based on the face value of policy, similar to an accelerated death benefit, but more akin to a life settlement. The product structure can effectively become a "premium finance" arrangement. Life insurance companies are seeking to have these policies approved to allow for such reverse loans. Upon death the estate would simply be required to pay off the loan plus interest (unless the policy owner paid off the loan earlier), which would equal possibly as much as the face amount of the policy.

This proposed new structure recognizes the value of life settlements and premium financing. But unlike life settlements which provide a regulated environment where consumers can make an informed choice after review with counsel or other financial advisors, this reverse loan product potentially encourages consumers into a complex financial structure (considerably more complex than a typical insurance policy or life settlement transaction and more akin to a non-recourse premium financing arrangement) perhaps without the benefit of independent counsel or financial advice.

### **STRANGER INITIATED LIFE INSURANCE (SILI), INVESTOR OWNED LIFE INSURANCE (IOLI) OR STRANGER OWNED LIFE INSURANCE (SOLI)**

The issues and concerns regarding stranger initiated life insurance (SILI), investor owned life insurance (IOLI) or stranger owned life insurance (SOLI) have been mentioned several times in this paper. These acronyms do not have universally accepted meanings. Insurance carriers argue that certain "non-recourse premium financed transactions," where a consumer purchases a policy through financing and the only recourse the lender has in the event of a default, like an auto loan, is repossessing the collateral of the loan (the policy), is actually a scheme where an investment group is "borrowing" on the life of an insured and the insurance capacity of that person. There have been transactions where an investor (stranger) approaches an individual and offers payments to them if the individual will apply for a typically large insurance policy and immediately assign the policy to the investor. Payment of up-front fees or other financial inducements to the insured to enter into such transactions may violate state anti-rebating laws. These arrangements clearly raise issues concerning insurable interests and insurable capacity. Insurers are concerned with such transactions, presumably to assure that such investors are not taking unfair advantage of consumers and presumably to protect the insurers from abusive and potentially fraudulent insurance transactions.

In addition, some of these transactions have provided the insured with only ancillary benefits related to the issuance of the insurance contract. While some of these schemes may be improper, insurance

regulators currently possess the necessary tools to enforce existing state insurance and consumer protection laws to protect consumers. These tools, together with the adoption and enforcement of strong life settlement laws throughout the nation, can materially curtail the availability of these problem transactions. If additional laws are needed to assure that potentially abusive insurance financing transactions are curtailed, such laws should focus on those issues and carefully avoid laws that would limit consumers' rights to enter into legal insurance transactions and to manage their assets to their best advantage.

Red flag questions to consider in separating a potentially abusive financing situation from a perfectly legitimate one are:

- ❖ Is the insured being paid an up-front fee to procure insurance for the benefit of a third party who had no insurable interest prior to the policy issue?
- ❖ Did the insured take out the policy on their own initiative?
- ❖ Do the benefits of the policy flow to the insured spouse, children or other persons with legitimate insurable interests?
- ❖ Is there any commitment to sell the insurance policy at a time in the future?
- ❖ Is there a "put," "call" or similar device that would effectively strip the insured of the ability to retain the insurance or the decision making regarding what to do with the insurance policy?
- ❖ Does a third party not having an insurable interest receive a material portion of the death benefit or other proceeds if the policy is liquidated, sold, surrendered or otherwise disposed of?

## CONCLUSION

The synergistic economics and social values of life settlements, premium finance and alternatives being considered by insurers, are complex issues that require more research and evaluation in order to ensure the adoption of effective and fair laws. For the consumer, the trade-off of future death benefits versus current liquidity is not always determined in hard dollars and the intrinsic value of current benefit to quality of life has to be weighed. Concurrently, insurers are concerned that aggressive investment-based life insurance purchases are not taking unfair advantage of consumers and do not create abusive and potentially fraudulent insurance transactions. While the very long-term socio-economic impact of the life settlement industry on consumers, insurers, intermediaries, investors and governments remains to be proven, recent growth of the industry provides evidence that it is delivering material value to consumers and all industry players. The movement of major insurers to enter the life settlement industry is expected to expand in 2008 and should result in a benefit to consumers by increasing capital available to purchase life settlements and by adding efficiency to the market resulting in better prices for selling consumers.

However, there remain numerous issues that require further research, definitions, legislation and regulations. The primary unanswered issues include:

- ❖ legal definition of insurable interests as determined by state law and which varies among states and is not clear in some transactions;

- ❖ measurement of the gross product revenue from all aspects of the life settlement industry, including tax revenue and tax code evaluation (Insurance Studies Institute has proposed and the Treasury Department is receptive to such a study);
- ❖ potential economic loss to consumers and insurers by forcing a five-year holding period;
- ❖ who should control ownership of life insurance: owners? insurers? government?;
- ❖ would a 100% excise tax be fair, knowing it would effectively ban premium finance transactions; and
- ❖ should the insurance industry be controlled at the federal level or left to the states?

These are issues that are being currently debated by insurers, life settlement firms, special interest groups, legislators, insurance commissioners, the NAIC, NCOIL, FINRA, and others, including the media. Meanwhile, better laws and regulations are needed to assure protection of consumer's rights to manage and sell their insurance assets, and to assure protection to the investors who enable the life settlement industry with their capital.

Legislative bills are in process in many states, including District of Columbia, Florida, Kansas, Maine, Massachusetts, New York and Ohio. New legislative bills may also be considered in California, Connecticut, Hawaii, Illinois, Indiana, Kentucky, Maryland, Michigan, Minnesota, Missouri, Pennsylvania and Utah. The major legislative debates are expected to focus on (a) the five-year ban; (b) limitation of STOLI transactions; (c) full compensation disclosure; and (d) certain other proposals deemed overly burdensome by some.

State insurance regulators through the work of NAIC and legislators through the work of NCOIL have recently adopted comprehensive model laws to address problem transactions in the secondary market. Life settlement industry participants are working with legislative committees and legislators to adopt appropriate and tailored solutions to address the issues.

Where an insured has a valid insurable interest and decides to finance the premium through an entity other than an insurance carrier, the existence or absence of third party financing should not, in and of itself, be a barrier to that consumer's ability to purchase a new life insurance policy. Third party premium financiers include in their ranks, for example, AI Credit, a subsidiary of American International Group, which is the largest premium finance company in the United States. Thus, because some investor or stranger initiated insurance programs may be "gaming" insurable interest laws and may be abusing life insurance, a narrowly tailored regulatory approach at the state level should be used to identify these situations and put an end to them. As previously stated, a regressive tax such as a 100% excise tax would ultimately work to eliminate a relatively new and increasing revenue stream that currently flows to the Treasury, states and the economy.

The fear is that the outcome of these debates will be determined by which lobby has the most influence and perhaps not by what is best for the socio-economic welfare of consumers and the balance of revenues. The goal is to fairly weigh the balance of protection among consumers, insurers, life settlement players, investors and government.

The bottom line is, if a policy owner can realize current benefits or value greater than the future benefits from retaining a policy, whether such is measured in hard dollars or intrinsic intangibles, the policy owner should be allowed by law to monetize it.