# Understanding the Facts and Myths of This Secondary Insurance Product

by Michael L. Frank

Simply put, a life settlement is the sale of an unwanted, no longer effective life insurance policy. It may potentially be a better solution with a greater cash settlement than lapsing or surrendering a policy. It is important to understand the benefits and the risks of conducting such a transaction. The goal of this article is to provide some insight into life settlements

Once a life settlement transaction takes place, the original policy owner has exchanged his/her ownership rights in the policy for "cash," which is simply now his/her money to use as they see fit. A life settlement transaction can have tax implications so a policy owner should discuss such implications with his/her personal attorney, financial planner or tax advisor to look at the specific benefits and effects on tax liability. The payout to the insured could be a lump sum or potentially an annuity stream of payments.

After a life settlement transaction, the original policy owner is no longer responsible for paying premiums—all premium payments and obligations are the duty of the purchaser (the life settlement company).

Interestingly, the policy has not lapsed (only ownership change) so the in-force broker will still collect renewal commissions on the original life insurance policy. The broker may also receive other potential compensation either via a commission or consulting fee as a result of the life settlement transaction, plus potentially additional commissions or fees, if the client needs assistance in managing the newly acquired funds from the life settlement transaction. However, brokers conducting life settlement business should be aware of the laws and regulations governing their state of jurisdiction.

## Who is Eligible for a Life Settlement?

- Typically seniors over the age of 65 (in some cases 60)
- Individual has impaired health since original issue of policy with life expectancy of less than 15 years.
- A policy with a face amount of $150,000 or more
- A policy that is assignable and outside of the contestable period

A reasonably high face amount is required as well as shorter life expectancies, since the value of the transaction needs to be large enough to cover the transaction's administrative costs. Longer life expectancies typically result in lower life settlement transaction amounts. If a policy is not assignable, or still in the incontestability period, ownership cannot be transferred. These guidelines are typically established by the life settlement funding organizations and investors for a life settlement provider, through significant financial modeling and testing of parameters.

## What Type of Life Insurance Policies are Eligible for a Life Settlement?

Virtually any type of individual life insurance may be considered. The policy does not require a cash value to be eligible. Second-to-Die policies are also considered for life settlements, especially in cases whereby one of the insured(s) is deceased. Policies can be individually owned or owned by trusts, foundations, not-for-profit organizations or businesses.

## How Large is the Market?

- 35.9 million individuals age 65 and over (Source: U.S. Census Bureau, 2003)
- There is over $492 billion of insurance in force on insured(s) over age 65 (Source: Conning Insurance Research and Publications, 1999)
- In 1990, the life settlements market was approximately $50 million (Source: On Wall Street, November 1, 2002)
- In 1998, one company, Viaticus, bought policies with a total face amount of $350 million in the senior market (Source: Conning Insurance Research and Publications, 1999)
- In 1999, life settlement funding sources acquired $1 billion worth of insurance. This became $2 billion in 2002 and is projected to reach $15 billion by 2007 (Source: Senior Market Advisor, March 2004).
- Over one period, life settlement providers paid $336.3 million and the cash surrender value was only $93.4 million. (Source: UPENN's Wharton School and Criterion Economics, October 2002)

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**AN ACTUARY WHO PERFORMS ACTUARIAL SERVICES REGARDING SPECIFIC INDIVIDUALS IS FUNCTIONING AS A PERSONAL ACTUARY WITH REGARD TO THOSE SERVICES.**

This is a large and expanding market, which continues to have growing appeal to the investment community. The challenge in gathering data in the life settlements market is that the industry is extremely large and policies are bought multiple times so it is difficult to track the accuracy of market size (mostly estimates).

## Why and When Would a Life Settlement Be Appropriate?

A life insurance policy purchased in the past may not match a policy owner's needs today. The reasons for initial purchase may no longer be valid such as:

- Changes in the client's estate (or estate tax laws) reduce/eliminate the need for insurance
- The client has outlived the intended beneficiary(ies).
- Premiums have become too expensive
- The client's needs have changed and require a different type of policy (i.e., annuity, health insurance or long-term care)
- Insured may want the money for other unforeseen reasons

Businesses often purchase life insurance policies on key people and owners for protection. Examples of cases where this happens are:

- Buy-sell policies for cases in which the owners have retired or the business is sold
- Deferred compensation plans when the executive has left the company
- Key person policies, after the insured has retired, or if key person is no longer key to the organization
- Policies purchased to cover loans that have since been paid off

Surrendering an insurance policy may provide some financial value to the insured through its cash value. Cash values do not reflect an individual's health and are based on local non-forfeiture laws, so there is limited latitude in cash value calculations. A life settlement, on the other hand, may result in a larger value depending on an individual insured's health and open market assessments (valuations).

## The Process

Each life settlement transaction involves unique variables such as age, life expectancy, type of policy, face amount, surrender value, loans, premiums and changes in health.

To obtain a life settlements quote:

- Complete an application which includes policy information and release forms for medical information and insurance illustrations
- Gather secondary information including medical information from insured's physician(s). Note that a medical exam is typically not required.
- Obtain policy illustration information
- Evaluate the policy and medical underwriting
- Develop a proposed price

The overall process could take four to six weeks depending on the ease of obtaining necessary information and data. Typically, there are no costs to the insured to obtain bids from various life settlement companies.

## Who are the Participants in the Life Settlement Market?

A ***life settlements broker's*** function is to help a client and the client's insurance broker (if involved) in obtaining quotes from potential life settlement companies. The broker works on behalf of the client (policy owner) and is typically paid a fee by the life settlements purchasing company.

A ***life settlements provider*** is an organization formed to purchase policies with third party (institutional or private equity) funds. The provider assumes responsibility for managing of the sales process, gathering data, coordinating with medical underwriting, pricing the transaction and handling the legal agreement and ownership transfer.

In addition, the provider will be responsible for the ongoing tracking and maintenance of the policy including payment of premium and collecting of death benefits. The life settlements provider will also assume responsibility for licensing and complying with insurance regulations and local jurisdictions (this may include being bonded or putting up capital to meet local requirements).

***Life settlement funders*** are organizations or individuals that provide the working capital to providers interested in buying policies. These organizations can be insurance entities and non-insurance entities such as investment bankers, hedge funds and other financial institutions. Providers will market the names of its funders where possible, since it would receive a competitive advantage to have a large institution or insurance company as its financial backer or "funder."

Certain providers are interested in buying portfolios or large blocks of business, while some are interested in buying policies at one or two at a time.

Some of the major providers include Coventry First, Legacy Benefits, Lifeline Programs, Neuma, Peachtree and Vespers. These organizations are financially backed by financial institutions (some even have insurance company partners) or private equity market or a combination of both. The investor community is both in the domestic (North American) market and the international market.

Several major providers have exited the marketplace over the past several years (e.g., Centre Life Finance Limited, Viaticus), while others are temporarily on hold from buying policies until they secure new funding. Additional providers have exited due to legal (or illegal) practices. New providers continue to enter this field and I would anticipate a significant number of new entrants due to perceived profits in this industry.

For a listing of some of the companies in the industry, visit the Viatical & Life Settlement Association of America (VLSSA) Web site at *www.viatical.org*. The Web site also includes information and updates in the industry, including regulations and definitions.

## Reinsurance

Life settlement providers may buy reinsurance to mitigate their exposure of life extension risk or limit volatility risk for smaller portfolios. Life extension risk is guessing too low of the life expectancy projections resulting in longer and greater payouts in premium in addition to a delay in the payout of life insurance benefits.

The largest reinsurer of life settlements was Gowshawk syndicate at Lloyds of London. However, Gowshawk is no longer offering this reinsurance coverage to the marketplace. Therefore, many of the current providers are using other means for managing their exposure (e.g., revised underwriting guidelines).


## Medical Underwriting

Similar to traditional life insurance policies, medical underwriting exists for life settlements. However, the insured does not require any additional medical examinations and/or tests; only consent to release current medical records for underwriting review is necessary. Life settlement companies contract on a case-by-case basis with medical underwriting firms to develop some of the factors used for their pricing models. Even if the life settlements provider underwrites internally, they will often employ third party or outside underwriting for peer review to ensure proper underwriting discipline.

## Pricing of Life Settlements

Life settlement transactions are based on a combination of art and science.

Pricing of policies requires detailed modeling and analysis, so the science piece reflects the economic calculations based on actuarial principles and financial forecasting. A calculation—similar to the formula used for life insurance reserving—is used to develop the present value of future benefits less the present value of future premiums and other expenses. This becomes the maximum price for purchasing the policy.

These present values are determined based on the actuarial tables used by the life settlement company, and the underwriting scores (mortality loads or life expectancy calculations) determined through medical underwriting. Life settlement companies set prices based on each individual's assessment and underwriting of each policy.

Administrative expenses would include ongoing life settlement provider costs plus transaction fees (e.g., brokerage commissions, underwriting fees, reinsurance premium). Typically, brokers

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receive a commission of approximately 4-6 percent of death benefit (face amount). Other fees might include fees for the financing facility, internal business expenses (e.g., payroll, office rent) and other compliance fees (e.g., bonding, licensing).

The purchaser of policies and their investors evaluate both individual policies and the portfolios based on the return on investment (capital). Since the maximum price is determined based on individual characteristics—which are based on an open market valuation including the individual's health—there can be significant value in a life settlement. Individuals with substandard or medically impaired risks could receive especially high values for life settlement transactions.

The **art** of the calculation is that the purchase price of the policy needs to be between the maximum price and the cash value, if any for the policy. The price needs to be high enough to be attractive to the current policy owner and yet low enough to provide profit to the purchaser. The marketing and distribution for a life settlements company will have a significant impact in this area.

## Who are the Life Settlement Companies Marketing

The answer would be anyone who is a senior citizen or provides a service to senior citizens including:

- Life settlement brokers
- Individual insurance brokers and general agencies
- Financial planners and advisors
- Law firms, especially estate planners and bankruptcy
- Health care providers and caregivers focused in the geriatric care business
- Corporations with financial problems or on the verge of bankruptcy (corporations typically think of insurance policies as a liability due to premium payment and not an asset)
- Pension administrators
- Accounting firms and auditors
- Organizations and charities that receive endowments such as insurance policies.

As you can see, sales can come from a variety of sources with a significant number of "middle men" or intermediaries involved creating expense cost and growth opportunities.

## What are the Risks in Doing a Life Settlement Transaction?

Each party to the transaction incurs some form of risk. For the policy owner, the risk is selling his/her rights to the policy:

- **A company collects a benefit when you die.** Not all life settlement companies are reputable, so policy owners need to know whom they are dealing with.
- **The company that you sell your policy to may not keep it for the life of the policy.** It could be sold one or more times. The insured has no control once he/she sells his/her policy to a life settlements company.
- **Life settlements have less regulation.** The insurance industry has significant regulations to protect consumers. This is not true with life settlements, which is why much of the marketing materials for life settlements solely focus on the pros of doing a transaction. For life settlements there are no federal regulations and each state varies its own legislation. Even within a state, these regulations can be confusing and inconsistent.
- **Are the original reasons for buying the policy still valid?** For example, does the insured still want to leave a life insurance benefit to their beneficiaries? Does the insured have other vehicles or protections in place for estate planning for their beneficiaries?
- **Are there other solutions or alternatives?**

For insurance brokers, some of the critical areas for consideration are as follows:

- Are there any regulatory issues to in your respective state of jurisdiction?
- Is there a moral obligation to provide your clients with the pros/cons of doing a life settlement transaction?
- Does your professional liability or errors & omissions insurance cover any liabilities resulting from life settlement suits?

- Will your life settlements provider cover you and the entire transaction for a life settlement under their professional liability/E&O policy?

- Have you done your homework on life settlements and the potential companies that you are dealing with before endorsing them to your clients?

As an investor or funder in the life settlements business, some of the key considerations are as follows:

- Are the promised returns "too good" to be true?
- Does your own personal business plan want to earn profits based on maturities (deaths)? Greater returns occur when death claims incur sooner than projected.
- Are there any unanticipated liabilities or extra-contractual exposure that could materially impair your investment? This could result from lawsuits for covered insured or compliance issues.
- What is your exit strategy for liquidating your investment (typical for all types of investment vehicles not just life settlement company investments)?

### 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. However, some insurance companies including reinsurers have had an interest in life settlements for the perceived returns and have participated as a life settlement funder.

Other discussions involve 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 settlements have occurred 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 doing a life settlement may have an adverse impact to insurance companies since policies will more likely payout a death benefit.

On the other hand, 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.

It will be interesting to see how this debate will evolve over time as the industry obtains empirical data in the future.

### What Does the Future Hold?

This is a difficult question since the marketplace is constantly evolving. Some of my own opinions are as follows:

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## PIMA Announces New Award

The Professional Insurance Marketing Association (PIMA) has established a new award called the Product and Process Innovative Marketing Award—or P$^2$IMA. PIMA's Product and Process Innovative Marketing Award competition, which is co-sponsored by SOA's Nontraditional Marketing Section, is open to all PIMA and SOA Nontraditional Marketing Section members. Entries will be judged equally on three critical elements: originality, salability and profitability. The product must have been introduced on or after January 1, 2001, and have involved a member of PIMA or the SOA in its development. Both insurance products and processes that facilitate insurance sales are eligible.

The entry fee is $95. Entrants must be either PIMA members or SOA Nontraditional Marketing Section members. Members of the SOA who are not Nontraditional Marketing Section members may join the section by completing the application form that can be found on the SOA Web site at *http://www.soa.org/ccm/content/areas-of-practice/special-interest-sections/.*

Membership in the Nontraditional Marketing Section costs $20. The winner will receive an invitation to the PIMA conference in February 2005, a trophy and publicity within both PIMA and the SOA.

More information is available at the Nontraditional Marketing page of the SOA Web site at *http://www.soa.org/ccm/content/?categoryID=340001* or by calling PIMA at 817-569-PIMA.

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- **Consumer advocacy—**We expect the life settlements industry to be more closely regulated.
- **New entrants—**With the perceived returns (the market still does not have a historical track record to refute), we should expect more life settlement companies (providers and funders) to enter the market. This will be interesting to monitor as the industry will soon see portfolios maturing, which will provide empirical data.
- **Market conduct—**We expect that we will continue to see some unethical market conduct sales practices.
- **More actuarial analytics—**Currently a limited number of actuaries have both experience and expertise in this market and we would anticipate this number to increase significantly.
- **Potential reinsurance markets—**We would envision new reinsurance player(s) entering the market. These reinsurance arrangements may slightly vary, possibly resulting in a higher stop loss deductible.

If you have any questions or wish to discuss in more detail, please contact Michael L. Frank, ASA, MAAA, a principal and co-founder of Aquarius Life Solutions. Michael would like to thank Alyssa Adelson, principal, Aquarius Life Solutions, and David Weinsier, F.S.A., M.A.A.A., consulting actuary, Towers Perrin for their contributions to this article.

# Meet The New Kids

The Younger Actuaries section got the nod of approval at the Board of Governors June 2004 meeting. The new section was created out of the need to establish a stronger link to recently qualified and future actuaries. Led primarily by younger actuaries, the section will work to advance the actuarial profession by addressing the needs of actuaries who are in the earlier part of their careers. Among other activities, the section will serve as a venue for identification and development of future SOA leaders, will educate its members about and give them a voice in SOA activities, increase the sense of belonging to the profession, and will develop various programs targeted at professional advancement of younger actuaries. There is no age or credential requirement to join the section. Senior members are encouraged to join to stay in touch with the ideas and needs of the next generation of actuaries and to serve as mentors to the younger actuaries.

Candidates and those early in their career are encouraged to join to link to the profession and benefit from section programs and activities that will further their professional and personal development. In order to ratify the section, 200 SOA members must sign-up. Please support this cause, sign-up today at: www.soa.org/ccm/cms-service/stream/asset/?asset_id=4993043&g11n.enc=UTF-8

For more information, please contact Valentina Isakina, SOA Finance Practice Area Actuary at (847) 706-3584 or *visakina@soa.org.*