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The Facts And Myths Of Life Settlements

What Is a Life Settlement?

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 doing such a transaction. The goal of this article is to provide some insight into the market of life settlements.

Insurance policy participants. To understand a life settlement, we are providing basic information about the participants in a life insurance policy. For any individual or group insurance policy, we would have individuals (or corporations) defined for each of the covered insured, policyowner and beneficiary. A typical insurance policy might have an individual as the policyowner and covered insured, with the individual's family as the beneficiaries.

Upon selling a policy (completing a life settlement transaction), the covered insured will typically be the same as before. However, the policyowner and the beneficiaries will most likely be a different party—in the most common case, the company buying the policy (i.e., life settlement company). Once the policy is sold (and the insured is no longer the policyowner), all premium payments and obligations are the duty of the purchaser (the life settlement company).

Definition of policy lapse. A life settlement is offered as an alternative to a policy lapse or reduction in coverage, so we should understand what a policy lapse means. A

life insurance policy lapses or cancels itself when a policyowner stops paying premiums on it. If you have an insurance policy (e.g., universal life) that has accumulated a cash value, the cash value is reduced (or drained) to pay your premiums until it runs out, and then the policy lapses.

What can an insured do with the money from a settlement? Anything he wants, since it is his own money. This transaction can have tax implications, so a tax advisor should look at the specific benefits and effects on tax liability.

How does this impact the retail life insurance broker (i.e., the individual who sold the insured the policy)? The sold policy is still in force; therefore the inforce broker will still collect renewal commissions on the original life insurance policy. It is important to note that the policy has not lapsed, but only changed ownership. The broker may receive other potential compensation, either via a commission or consulting fee as a result of the life settlement transaction, plus any fees when assisting clients in managing their newly acquired funds. 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 age 65) are eligible if their health has become impaired since the original issue of the policy. In addition, an individual should have a life expectancy of less than 15 years and a policy face amount

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above \$150,000, since the value of the transaction needs to be large enough to cover the transaction's administrative costs.

Also, a policy must be assignable (transferable) and outside of the contestable period (cannot be voided). Any type of individual life insurance may be considered (including convertible term, whole, universal, variable, survivorship, adjustable and joint first-to-die policies). A policy does not require a cash value to be eligible. Second-to-die policies are also considered for life settlements, especially in cases where one of the insureds is deceased. Policies can be individually owned or owned by trusts, foundations, not-for-profit organizations or businesses.

Why and When Would a Life Settlement Be Appropriate?

As life changes, so do individual needs. For this reason, a life insurance policy purchased in the past may not match a policyowner's needs today. The following reasons for the initial purchase may no longer be valid.

- Changes in the client's estate (or estate tax laws) that reduce or 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 would require a different type of policy (i.e., annuity, health insurance or long term care).

- The insured may want the money for other unforeseen reasons (e.g., travel).

Businesses often purchase life insurance policies on key people and owners for protection. Examples of cases where this happens and the policies may have "outlived" their usefulness include 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 the key person is no longer key to the organization; and policies purchased to cover loans that have since been paid off.

Surrendering an insurance policy may provide some financial value to the insured through a cash value, which will be determined based on an insurance policy and state non-forfeiture laws. A life settlement may result in a larger value, depending on an insured's health and

open market assessments (valuations).

The Process

Each transaction involves unique variables such as age, life expectancy, type of policy, face amount, surrender value, loans, premiums and changes in health. The application process is streamlined but customized so quote turnaround time is typically four to six weeks. Information required includes applications, physician medical records and policy illustrations. Typically there are no costs to the insured to obtain bids from various life settlement companies.

Similar to traditional life insurance policies, medical underwriting exists for life settlements to develop a life expectancy (LE) and mortality table load factor for pricing purposes. However, the insured does not require any additional medical examinations and/or tests and must only consent to the release of his current medical records for underwriting review.

How Large Is the Market?

There are 35.9 million individuals age 65 and over (source: U.S. Census Bureau, 2003) and more than \$492 billion in force on insureds 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 2002, policies sold to life settlement providers were in excess of \$242 million in value (\$1.5 billion face amount). Life settlement providers paid \$336.3 million and the cash surrender value was only \$93.4 million (source: Wharton School and Criterion Economics, October 2002).

Who are the participants in the life settlement market? A life settlement broker's function is to help a client and the client's insurance broker (if involved) in obtaining quotes from potential life settlement companies. Similar to the insurance market, the broker works on behalf of the

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client (policyowner) and is paid a fee, typically by the company purchasing the life settlement.

A life settlement provider is an organization formed to purchase policies with third party (institutional or private equity) funds. The provider assumes responsibility for marketing and purchasing the policy, including managing the sales process, gathering data, coordinating with medical underwriting, pricing the transaction, and handling the legal agreement and ownership transfer. They are also responsible for the ongoing tracking and maintenance of the policy, including payment of premium and collection 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—both individual and portfolios. These organizations could be both insurance entities and non-insurance entities such as investment bankers, hedge funds, other financial institutions and private equity market. 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.”

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 incorrect life expectancy projections resulting in longer and greater payouts in premium (additional cost to life settlement providers) as well as delay in payment of life insurance benefits (revenue to life settlement providers).

Pricing of life settlements. Pricing life settlement transactions is based on a combination of art and science. The science part 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 based on actuarial tables and medical underwriting information. We are referring to this as the maximum price for purchasing the policy.

Life settlement companies set prices based on each individual's assessment and underwriting of each policy with a value greater than non-forfeiture laws (cash surrender value) for an insurance policy. Individuals with substandard or medically impaired risks could result in significant values for life settlement transactions.

Administrative expenses are priced into the transaction and would include ongoing facility, banking, internal expenses and life settlement provider fees plus transaction fees (e.g., brokerage commissions, underwriting fees, reinsurance premium). As a result, modeling is more complex to meet the return on investment for funders.

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 policyowner 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.

Are there any risks or pitfalls in doing a life settlement transaction? Now that you have a basic understanding of how a life settlement transaction works, let's review some of the more debatable issues.

An individual should consider the following:

- A company collects a benefit when a policyholder dies. When an individual dies, the life settlement company collects a death benefit. Not all life settlement companies are reputable, so policyowners need to know whom they are dealing with, since life settlements companies have a vested interest in a policy, especially if it matures (pays a death benefit).

- The company that the policy is sold to may not keep it for the life of the policy. It could be sold one or more times, and the insured has no control once it sells its policy.

- Life settlements have less regulation. The insurance industry has significant regulations to protect consumers, including disclosure and advertising requirements. These same restrictions are not defined in life settlements, which is why many of the marketing materials for life settlements solely focus on the pros with little or no focus on the cons of doing a transaction. For life settlements, each state varies its own legislation.

Insurance brokers should be aware of the following:

- Are there any regulatory issues to be concerned about in the 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 and omissions insurance cover any liabilities resulting from life settlement suits? You may want to read your policies

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closely. Will your life settlement provider cover you under its policy?

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

An investor or funder in the life settlements business should consider:

- 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 the investment? This could result from lawsuits for covered insured or compliance issues.
- What is the exit strategy for liquidat-

ing the investment (typical for all types of investment vehicles, not just life settlement company investments)?

The Insurance Company Debate

Among life insurance companies there is an ongoing debate about life settlements. Insurance companies traditionally do not want their sales forces 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 life settlement funders.

Other discussions cover whether or not life settlements will have adverse financial impacts in the life insurance industry. As of today, a very small percentage of life settlements have occurred, so the impact 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 will have an adverse impact on insurance companies, since policies will more likely pay out a death benefit (remember, a policy does not lapse from a life settlement but stays in force).

Alternatively, life insurance policies have increasing premium rates and mortality charges with the insured's age, so policies remaining in force will receive more premium to cover increasing mortality. It will be interesting to see how this debate will change 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:

- **Consumer advocacy.** 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), expect future life settlement companies (providers and funders) to enter the market.
- **Market conduct.** Expect unethical/market conduct and practices with select markets. ☹

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