Life Settlements

A Continuing Education Course
I. FUNDAMENTALS/STRUCTURE

What is Life Settlement (LS)?

A Life Settlement (LS) is the sale of an existing life insurance policy for more than its cash surrender, but less than its death benefit. A Life Settlement (LS) occurs when a life insurance policy is purchased from the owner by a third party in order to make a profit from the difference between the actuarial value of the policy and the death benefit. This assumes, of course, that the death benefit will be greater than the actuarial value of the policy. A secondary market comprised of third parties (typically institutional investors or individual investors pooling their money to invest) are willing to bid on the purchase of a policy, as a result the owner of the policy can receive substantially more than the policy’s cash value. Candidates for life settlements are generally over age 65 with some impaired, but not terminally ill medical condition; older insureds can have no impairment for the program to be beneficial.

Assuming the owner of the policy no longer needs the insurance coverage to provide for loved ones, estate plans or business succession, then a life settlement could be beneficial in the following situations:

**Personal**
- The premium payments are becoming a financial burden
- There is a need to lower the cost of insurance
- Funds are needed for long-term or medical care
- Funds are needed for retirement
- There is a desire to make a current gift to loved ones
- There is a desire to make a current bequest to a favorite charity

**Business**
- No longer need the policy to support a buy/sell agreement
• No longer need a policy to support key-man insurance
• Funds needed due to disability or early retirement
• Funds needed to reduce company debt
• Funds needed for a severance package
• Funds needed for a deferred compensation program

These are not the only situations in which LS may be considered, but they are the most common.

The LS industry creates a secondary market for life insurance policies and products. The LS market has grown significantly as the population ages and policyholders, for one reason or another, see LS as a viable option for them. The secondary market offered through the LS industry enables liquidation of these policies.¹

The Financial Accounting Standards Board (FASB) defines LS as “a transaction between the owner of a life insurance contract (the insured) and a third party (life settlement provider), where the life settlement provider does not have an insurable interest (an interest in the survival of the insured, which is required to support the issuance of an insurance policy) and intends to continue paying the premiums on the insured’s life insurance policy. The scope of the project would include brokered settlement transactions whereby a broker facilitates settlement transactions between insureds and life settlement providers.”²

An LS transaction is made when entities called settlement companies purchase unneeded or unwanted life insurance policies from the original owners in order to receive the death benefit. The LS firm continues paying the premiums to the issuing life company until the death occurs, at which time the third-party investor receives the death benefit. Life

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¹ Bernstein Research Call, p.1, March 4, 2005
² Financial Accounting Standards Board project [http://www.fasb.org/project/life_settlements.shtml#history](http://www.fasb.org/project/life_settlements.shtml#history)
Settlements offer investors an investment that is non-correlated to the rest of their portfolios.³

**Typical LS Scenarios**

Weighed with the **Benefits and Suitability** considerations toward the client and considering the risks involved, the following situations may present circumstances in which a LS transaction may be warranted:

- Policy premiums are no longer affordable
- There is no longer a need for the policy
- A key-man life insurance policy is no longer needed because the company no longer exists or the insured is no longer key to the viability of the business
- The owner has multiple life insurance policies and desires to eliminate extraneous ones
- The owner wishes to replace an individual policy with a survivorship policy, a long term care policy, or to have liquidity for long term care.
- Funds are required to pay medical expenses or for expensive experimental treatments in the case of a terminal illness.
- Funds are needed to maintain the insured’s standard of living in the case of short life expectancy or disability.
- The policy is to be removed from a trust or estate.
- If a policy is lapsing or about to be surrendered. An LS may offer a better alternative in such cases.
- A policy owner’s estate value is reduced so the need for the life insurance policy, which was designed to cover the tax liability for the estate, no longer exists.
- The policy owner wishes to make a charitable donation but lacks the liquidity of funds to do so.

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¹ “65+ in the United States” by Frank B. Hobbs with VbONNIE I. Damon, posted on the US Census Bureau website
² December 1, 2004 Research Report on “Reinitiating Coverage”, published by Taglich Brothers, Inc.
³ Bernstein Research Call, p. 3, March 4, 2005
• The charity receiving the donated policy does not have the funds available to maintain the premium payments.
• The beneficiaries of a policy have died.
• Changes in health status of the insured requires different coverage.

History of LS

The LS market, even though it began as an extension of the existing viatical industry during the mid-1990s, it is dramatically different than its predecessor. The LS market has grown in size to approximately $13 billion. The primary driver for this growth is the aging population. According to the US Census Bureau, there were over 33.2 million Americans over age 65. This number is expected to grow to over 53 million by 2020; this is a rate double that of the general U.S. population (1). It is estimated that there is 150 billion in face amount eligible for life insurance settlement and the annual market is estimated to grow 5 to 8 fold in the next five years (2).

It should be noted that the LS market addresses policyowners above ages 65 in most LS company definitions, distinguishing the LS market from the viatical market. (Other distinctions will be explored under Facts and Stats). The market for LS is expected to grow at a rate three times that of expected population growth over the next 25 years and, at a 90 percent growth rate, will reach approximately $160 billion over the next several years.4 The increasing liquidity of the secondary markets will also add to investors’ comfort level going forward as competition among LS firms and regulatory oversight increases.

Both the viatical and LS markets are relatively new. But the markets for both have grown significantly since the early to mid-1990s and the projected growth of the LS market points to LS sales as a significant industry. Part of this growth is also fueled by greater regulation and more stringent broker licensing requirements adding confidence to the marketplace. Because of the development of more sophisticated underwriting

4 Bernstein p. 2
models, the LS market doesn’t have to depend on policyholders who are terminally ill, as do viaticals. Rather, the LS market focuses on older policyholders:

- Whose health is compromised
- Who can no longer afford policy premiums
- Whose needs regarding the policy have changed

When a policy owner’s life becomes impaired, the policy is also referred to as being ‘impaired.’ What does this mean?

1) The present value of the policy’s death benefit increases since the death is expected to occur sooner
2) The present value of the premiums decreases since the length of time the payments will be made will be shortened.

Both factors **increase the overall actuarial value of the policy**, making it attractive for the secondary market. LS is attractive for insurance companies because securitization of the asset, the life insurance policy, can increase the value of life insurance company stocks by providing liquidity for a formerly illiquid investment.5

**History of Viatical Sales**

According to the National Viatical Association, viatical sales industry evolved from the onset of the AIDS epidemic in the late 1980s as the need for funds rose to purchase medication and to maintain patients’ standard of living with decreased ability to perform their jobs. The first viatical settlement was made by Rob Worley, then an insurance agent in New Mexico. Worley heard a talk show program about a man who discussed his desperate need for cash to pay medical bills. Neither his bank nor the insurance company would buy back his life insurance policy even though he was dying of cancer. Worley

5 Wharton Study, p. 14
eventually started a viatical settlement company and bought his first policy in 1989. Worley has since left the industry.

At that time, settlements primarily involved AIDS patients within the 24 to 44 age range. Initially, patients sold their policies to individual dealers who operated mostly underground in an unregulated environment. Funds were needed quickly and unscrupulous individuals cornered the market, offering AIDS patients no alternative. These early sales were few and offered third parties who repurchased the policies from these unscrupulous individuals few financial safeguards around the transaction resulting from the policyholder’s early death.

So, the market was limited until companies began to form for the purpose of facilitating these transactions. Of course, many of the early companies were slightly questionable as well. These individuals and early companies would purchase the policies from distressed holders at a discount and offer them for resale to investors, promising high returns. This was frowned on for two reasons: the buyers appeared to be taking advantage of terminally ill people who had no other way to liquidate their policies and, since viatical investments did not fall under the SEC’s pure definition of a security, they fell outside the regulatory arm. Because of the unethical dealings by these underground buyers and some of the early viatical companies, the industry developed a shady reputation early on—one that it is still trying hard to shake, although it is making positive inroads.

Over 30 states currently have regulatory requirements that govern both viatical companies and their brokers.

**A viatical broker** is an individual or company that negotiates offers with a variety of viatical providers or funders on behalf of their viator clients. They are responsible for gathering all paperwork necessary for the eventual transaction. Viatical providers or

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6 Bernstein, p. 12, March 4, 2005
funders are actual purchasers of the policies and issuers of the securities to third-party investors.8

Viatical companies have suffered from medical advances creating more effective treatments for AIDS patients. The ability of AIDS patients to live longer has added uncertainty to their life expectancies, making it difficult to effect viatical sales profitably and limiting the viatical market to policies with a life expectancy of two years or less. With the growth in the number of reputable viatical firms, the secondary market for these policies had grown to between $1.4 billion to $4 billion by 2001 from approximately $50 million in 1990, according to the Viatical Association of America.9

In the early days of the industry, individual policies were purchased by companies and the information on these individuals was readily available. Today, quality viatical firms for diversified pools by aggregating the policies, preventing knowledge of any single former policyowner’s identity.10

Facts and Stats

Below are some facts and statistics on viatical and LS transactions, what they involve, and how they differ:

1. The size of a viatical policy is usually less than $100,000 and most often between $25,000 and $50,000 in face value; LS policies are usually over $100,000 and most often over $250,000 in face value.
2. Viatical settlements usually involved terminally ill patients; LS involve people over age 65 who are infirm or disabled, having ‘impaired’ lives.
3. Viaticals usually apply to AIDS patients age 25 – 44; LS to seniors over 65

8 Viatical Settlement History http://www.viatical-advocate.org/viatical-settlement-Industry.htm
9 Wharton Study p. 3
10 Ibid, p. 2
4. Viatical life expectancies are usually 24 months or less; LS life expectancies typically range from two to 14 years.

5. The LS market has developed a more organized resale market for insurance with its focus on older people with impaired lives, but not terminal cases. Large face amounts of policies allow the spread of administrative and transaction costs over a larger pool of funds.

6. LS grew at a 19 percent compounded annual rate between 1998 and 2002 in a market as large as $100 billion.11

7. The projected market for LS is $160 billion over the next few years, based on projected growth of 90 percent over the next 25 years.12

II FEATURES

- **In a LS, the premiums can be assumed by another party.**
  In the case where older policyowners or charitable organizations can no longer afford policy premiums, liquidity is offered as well as the elimination of a burdensome payment.

- **Unneeded proceeds from an LS can be reinvested by the former policy owner into other investment instruments.**
  Policies that seem not to be performing well can be liquidated and the proceeds reinvested into other securities.

- **Paid-up policies that are underperforming from an investment standpoint can be swapped for a new paid-up policy that performs better.**
  A liquid secondary market can also be made to SWAPP (Settlement with a paid-up policy) policies that are paid up, creating the ability to exchange a poor asset for a better-performing investment. This can be particularly advantageous in a low interest rate environment, can upgrade the credit rating of the insurer, and can offer a more appropriate level of coverage.13

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11 UCONN Deloitte, p. 3
12 Bernstein, p. 2, March 4, 2005
• **LS can facilitate liquidity in a bankruptcy situation.**
  This can apply in a corporate bankruptcy relative to key man policies or in a personal situation.

• **LS can enable charities to unload policies for which they can no longer pay the premiums.**
  Charities can be the recipients of donated life insurance policies. But another ‘gift’ comes along with those policies—the premiums that have to be paid. LS provides a way for charities to liquidate an illiquid asset and eliminate premium payments they can’t afford.

• **LS sales focus on the aging population. The range is ages 55 – 70, depending on the LS company.**
  The largest population segment in history is aging, contributing to the growth prospects for LS.

• **The criteria LS companies use to determine if a policy is desirable for purchase include the age of the policy, the A.M. Best rating, the type of policy, and the face amounts.** Different companies use different criteria.

• **Companies are either brokers or funders (providers).** Brokers work for the policy owners wishing to sell; funders create the securities for sale to third-party investors which, in turn, support the secondary market.

**Life Settlements and Philanthropic Giving**

A life settlement can enable a donor to make a planned gift in two ways. First, the life settlement can be a charitable gift in which a donor can receive an income tax deduction and avoid taxable consequence on the sale of the policy. Second, if there is no taxable gain in the life settlement sale, the donor may desire to keep the settlement proceeds and give a low basis asset to their favorite charitable organizations.

Oftentimes, high net worth seniors with large policies do not own them—they are owned by a trust. Therefore, such situations would challenge the financial advisor to be creative in restructuring the estate plan so that it would enable the insured to sell the policy and donate the proceeds to his or her favorite charity. The financial advisor may advise the
client to keep the proceeds in the trust and gift a low basis asset to their favorite charitable organization.

Some charities find it cumbersome to deal with donated policies, and up to now, have had only two options: (1) Cash it in for the surrender value, or (2) continue to pay the premiums. Currently, a third option is available which will enable a charity to obtain the maximum fair market value for the policy. When a charitable organization receives a gift of a life insurance policy it has various options: It can continue to make premium payments -- which it may or may not be able to afford. Or, it could cash it in for the surrender value -- which may be nominal. A life settlement could solve the charity's dilemma by giving the charity cash for the policy which, most likely, will be substantially more than the surrender value. Such a situation allows the donor to see the charity put these funds to good use during their lifetime. This sometimes is referred to as “giving while living.”

Most charitable organizations are in need of financial assistance especially during times of poor markets. Life settlements may provide an opportunity for donors to accelerate charitable gifts during their lifetime. This will most likely result in income tax benefits for the donor and a current gift to the charitable organization. Taxable events relating to the proceeds from a life settlement are more likely to occur with policies that have been owned for less than five years since such policies involve less cash basis. The donor receives a charitable income tax deduction for the value of the life settlement sales amount. In addition, if the sales price exceeds premiums paid, the donor would also avoid any tax consequence on the sale of the policy. If the life settlement does not create a taxable gain to the donor, this individual may decide to keep the life settlement proceeds and gift a different (low basis) to charity which makes good tax sense.
The following is a case study\(^\text{14}\) where a life settlement and a charitable remainder trust were used to benefit a charitable organization and eliminated costly insurance premiums while providing a substantial income to the senior client.

**Case Study:** Mrs. X had a Charitable Remainder Trust (CRT) and a large life insurance policy to replace the value of the CRT to her children. She originally set up this strategy to minimize estate taxes without disinheriting her children. The income from the CRT had gone down at the time, due to declining equity markets, but the life insurance premiums remained constant. The client was beginning to feel the economic pinch of maintaining the life insurance policy. One possible solution was a life settlement sale combined with a CRT termination. The economics of this arrangement were impressive and satisfied the client’s needs.

(There have been a number of Private Letter Rulings (PLRs) since 2002 which the IRS has consented in the termination of CRTs.) In essence, the donor receives his or her income interest back-taxed at long-term capital gain rates and the charity receives its interest today.

Mrs. X’s CRT had a fair market value (FMV) of $1M (originally $1.2M), and the policy had a death benefit of $1M (premium commitment of $60K). The life settlement received was $225,000 (not taxable). These proceeds remained in the irrevocable trust and managed in a tax-efficient manner seeking long-term capital appreciation. The termination of the CRT resulted in a $400,000 immediate gift to the named charitable organizations. Mrs. X received $510,000 back after capital gains tax ($600K X .15% = 90K, 600K - 90K = 510K). In addition, she is no longer committed to pay $60,000 in annual premium payments.

### III BENEFITS/ADVANTAGES OF LS

The benefits of LS are diverse. Some have already been mentioned in the definition and history of viatical and life settlements.

The first benefit involves the creation of a secondary market for life insurance which was not readily available in the past. Previously, there was no way to liquidate the asset if funds were needed for medical care. If the premiums were too expensive and were allowed to lapse, the insured simply lost his or her investment above the Cash Surrender Value (CSV) as well as any future benefit. If a life policy was not performing well because of low interest rates or other factors, there was no choice but to hold the policy until the death of the insured.

Other benefits include:

- **Provides liquidity to a non-liquid asset.** The larger the secondary market grows, the more liquid it will become, spurring growth in a new financial services sector and offering buyers and sellers more options.

- **Offers significantly higher resale values for insurance policies of people with impaired lives compared to existing Cash Surrender Value (CSV).** Policy owners who need liquidity are able to get more value for their policies than the CSV. The more active a secondary market for these policies exists, the greater the resale value will be. Competition fosters better pricing and offers policy owners multiple bids for their policies.

- **Economic improvement simply by the establishment of another secondary market in the financial services industry.**\(^{15}\) An active secondary market lifts the value of all policies, improving the economic well-being of policyholders by increasing demand.

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\(^{15}\) UCONN Deloitte p. 3
• **Prevents premium lapse, improving cash flow quality of the investment.** A dependable cash flow attracts investors and increases the value of the policies. Lapse rates are a key factor in pricing of other insurance products, like variable annuities. Lapse rates, interest rates, and mortality rates are the three primary factors influencing insurance product pricing. Of these, lapse rates are the least predictable since they are directly tied to human behavior.\(^{16}\)

• **Increase in likelihood of individuals to purchase cash value life policies instead of term.** People normally tend to buy term life policies because they are cheaper than variable or universal life policies. Locking in a stream of high premiums and policy charges tied to more non-traditional insurance may not look as attractive. But an active secondary market makes these policies more valuable in terms of overall growth rates and profitability, attracting institutional and other investors.\(^{17}\)

• **Could increase institutional interest in the life insurance market, adding further liquidity through the secondary market.** Institutional investors constantly look for new ways to enhance return; life insurance policies are considered non-correlated to their other investments, increasing their attractiveness through diversification and return properties, enhanced by a buoyant secondary market.

• **May provide life policy issuers another option for serving clients by enabling them to roll cash proceeds of the settlement into payout annuities.**\(^{18}\) Life policy issuers, called incumbents, may begin offering settlements to policy owners in order to capture business that might go elsewhere. They do this by allowing the policyholder to roll the policy over into a stream of annuity payments.

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\(^{16}\) Bernstein, p. 9, March 4, 2005  
\(^{17}\) Bernstein, p. 12, March 4, 2005  
\(^{18}\) Ibid.
The effort by incumbents to discredit the value of the secondary market is led by the assertion that the increase in value of consumer life policies raises costs for consumers wishing to take out such policies. It also stems from the notion that the secondary market causes issuers to lose money. In fact, this only occurs when the carrier uses a practice called ‘lapse-support pricing,’ meaning the carrier’s policies are intentionally undervalued in the expectation that a high number of profitable lapses will occur. This practice has been officially banned, but insurers still have such policies left over from before the ban was enacted.

However, a robust secondary market has been shown to increase the valuation of life insurance policies and an active and efficient secondary market to improve liquidity of an asset, thus increasing the value of the benefit to consumers. This increase may, in turn, increase the valuation for life insurance and subsequent increase life insurance premiums, negating any temporary ill effects for life insurance issuers.

Case Studies

A 76-year-old man wanted to reduce the size of his estate and was planning on gifting a $750,000 policy to his favorite charity. The charity would take on the premium obligation, but receive the death benefit upon the man's passing. The man would be able to write-off his current CSV (cash surrender value) of $142,189. His financial planner informed him about a life settlement and how this might be a good alternative. Upon review of the insured's policy, an offer of $225,000 was made and accepted by the policyowner. The charity received the cash immediately and was not burdened with any future premium obligations. The insured was able to write off an additional $82,811 for his gift.19

Another case involved corporate-owned life insurance totaling $10 million, with a total cash surrender value of $800,000. The insured had a prospective buyer for the company

and was not interested in acquiring the policies for estate planning purposes. As such, the policies would have been terminated in conjunction with completion of the sale. Due to the insured's age and change in health (recent bypass surgery,) a life settlement application was made to obtain an offer for the sale of the contracts. The client received a life settlement offer of $3.5 million, representing an increase of $2.7 million above the cash value that would have been received had the policies simply been surrendered.\(^{20}\)

A third case study involved a large broker who recently closed a transaction in which the policyholder received over $800,000 more than the policy's cash surrender value. Here is the scenario: A business realized it was making expensive premium payments on a $5 million policy insuring the life of an executive that had retired several years ago. With the executive's retirement, the policy's original purchase had become outdated, and the high premium payments were in fact a liability to the business. The business was considering cashing in the policy for its cash surrender value.

The business had a valuable source of capital. Regarding the policy itself, it was a split dollar whole life policy with a face value of $5 million. There were, however, loans secured by the policy in excess of $750,000. The net death benefit, after deducting for the loans, was $4.25 million. The cash surrender value of the policy was $1.2 million.

The broker was able to obtain a purchase price for the policyholder of over $2 million, thus giving the business $800,000 more than it would have received had it simply surrendered the policy for its cash value. Further, once the business sold the policy, the business did not have to make any more premium payments on the policy. Therefore, not only did the business receive more cash for the policy, but it also absolved itself of the liability of making the burdensomely high premium payments.\(^{21}\)


\(^{21}\) IBID
A 65-year-old man has a significant decline in health due to a stroke, making his life ‘impaired.’ He owns a $1 million life insurance policy. He has also used all the cash surrender value of the policy to fund his medical treatments and early retirement. His cost of insurance is increasing rapidly due to his ill health, which means his premiums are now increasing. The man would have to borrow against his home to continue paying the premiums, something he clearly does not want to do. To him, the policy has become an albatross; however, he is forgetting the reason he originally purchased the policy. His beneficiaries are well off and would be able to pick up the premium payments, but the man makes an emotional decision and sells the policy, cutting significantly short the eventual value due his estate and thus, the tax-free inheritance to his children.\textsuperscript{22}

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A 50-year-old man is induced to buy life insurance with the idea that, after paying premiums for a couple of years, he can sell the policy in a LS transaction and get a significant return on his investment. He does so, and shortly after selling the first policy, he decides the transaction did indeed prove highly profitable and buys another life insurance policy. The premiums for this policy are slightly higher, but still worth the ‘investment’ in the eyes of the now 53-year-old. He performs this type of transaction another time or two, and by the time he decides to keep a policy in order to protect his family should something happen to him, he finds himself uninsurable and unable to purchase the insurance he would like to have to protect his family and enhance his estate.\textsuperscript{23}

IV SUITABILITY

Because of the questionable beginnings of the viatical settlements industry, the issue of suitability becomes a high profile one. Viatical and LS companies make money from

\textsuperscript{23} IBID
origination, servicing, and underwriting fees that are not considered in determining the actuarial valuation of the policy. When these fees are excessive, the greater return for the policy owner’s beneficiaries could be to simply hold the policy until the owner dies. In cases where premiums have become too burdensome, beneficiaries could be called upon to pay them in order to maintain the greater return probability of holding the policy intact.

In cases of needed liquidity, all possible sources of liquidity must be explored before recommending sale of the life insurance policy.

According to a formula developed by Deloitte Development LLC, the actual benefit to the policyholder should be examined by measuring the Lost Economic Value (LEV) of a policy, which is defined as the difference in the Intrinsic Economic Value (IEV), the value represented to the policy owner if it is held until death, and the Life Settlements Value (LSV), the value the policy owner would receive from the LS company. The IEV is calculated by the following formula:

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\text{IEV} = \text{APV of Future Death Benefits} - \text{APV of Future Premiums}
\]

where APV is Actuarial Present Value

The actuarial formulas used can be found in Deloitte’s “Life Settlement Market” report [2005].

The lack of regulatory oversight at the outset of the viatical industry and the natural tendency toward greater scrutiny as any industry begins to develop in earnest, command greater education on the part of both client and advisor regarding the true benefits of LS.

**Regarding suitability**, the advisory community should be aware of the following suitability factors:

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1) Each client’s situation is different. The client’s entire financial situation must be considered to determine the viability and overall benefit of a LS transaction relative to the client’s needs.

2) A number of factors need to be examined:
   
a) Client’s real liquidity needs and various options for satisfying them. As stated above, there may be other options for providing the liquidity needed, each with its own benefits and risks. Each should be weighed in light of the best interests of the client.

b) Which will benefit the estate more, selling the policy or holding it and allowing a beneficiary to make the payments? Often, a life insurance policy is the highest-yielding asset in the case of an impaired life. If no alternative sources of liquidity are available, a LS may fulfill the liquidity need suitably.25

c) Performance potential of alternate investments before policy is sold. Policies that are underperforming because of low interest rates or other factors may be sold in favor of reinvesting the proceeds in a different investment. The performance potential of each investment being considered should be weighed before the policy is sold in order to determine the best course of action for the client.

d) The sales charge and other fees the client will be paying in the transaction. Calculations involving the risk free interest rate, the LS expenses, the tax rate on net death benefit proceeds, and the discounting of cash flows should be weighed in light of the overall benefit of the LS.26

3) The client’s age. A life policy’s value increases the shorter the life expectancy. This is why an impaired life policy is more valuable than an unimpaired one. A life policy increases in value in a viatical settlement because the life expectancy from a terminal illness can be quite short, especially as in the early 80s AIDS epidemic.

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26 IBID.
4) The client’s health. Factors such as the client’s age and health are primary determinants of the viability of an LS.

5) The client’s overall portfolio. As stated earlier, the client’s overall portfolio should be considered when weighing the benefits of an LS transaction. The asset value of the policy if held to the insured’s death, the needs of the client, and the returns of various reinvestment possibilities.

6) Time horizons and various pockets of wealth – how they will be affected. Again, the client’s entire investment portfolio, including financial planning, tax, and estate perspectives, should be evaluated when looking to make an LS.

**Client and Advisor Education**

- Clients need to know all the facts
- Advisors need to know all the facts
- Advisors need to know the regulations
- An objective evaluation needs to be conducted to see if a LS is warranted – if it’s the best option
- Advisor must know who the reputable companies are and be familiar with all aspects of their LS offerings

It is the advisor’s responsibility to educate himself or herself and then to be able to educate the client regarding all the facts of LS transactions. The advisor should be familiar with:

- LS companies
- Their requirements for effecting LS transactions
- Sales charges and other fees involved
- The oversight the company has placed itself under
- Offerings of various companies in order to ensure an objective
- Appropriate range of offers for the client
Both advisors and their firms should be aware of the licensing requirements for viatical and LS brokers and should be familiar with the regulatory organizations that exist for LS companies. For example:

1) The National Association of Insurance Commissioners (NAIC) (http://www.naic.org/) assists state regulators in serving the public interest, promoting competitive markets, facilitating fair and equal treatment of consumers, support the reliability, solvency, and financial stability of insurance companies, and support and improve state regulation.

2) The Viatical and Life Settlement Association of America (VLSAA) (http://www.viatical.org/) is a non-profit trade association that exists to promote responsible legislation and regulation of the industry. It sets ethical standards for its members and keeps members apprised of ongoing governmental and public standards as well as activity regarding securities, legislation, and regulation of the business.

V RISKS

There are a variety of risks in the LS marketplace, and one of the biggest is to the insured’s beneficiaries. A policyowner’s beneficiaries can lose substantially in a LS transaction and end up owing significant estate taxes which the life insurance policy was originally designed to pay.

Life insurance policies are also purchased often with the original intention of increasing the value of the estate in a tax-free manner. This estate advantage is, of course, completely negated if the policy is sold before the death of the insured.

Other risks are as follows:

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There are also unscrupulous companies that may encourage people who currently do not own life insurance policies to purchase them with the idea that they can sell them at a huge profit later, rather than for the originally intended purpose of buying life insurance, which is to provide for beneficiaries if something happens to the insured.

Suitability is a big risk as many wealthy senior consumers will be ‘sold’ a transaction they really do not need. This particularly applies when unscrupulous insurance agents encourage consumers to buy insurance with the purpose of effecting a LS transaction after a couple of years (the usual policy age minimum requirement for LS companies), eventually making the policy owner uninsurable if the transaction occurs a few times.

There is also the concern that if Congress begins to view LS transactions as creating securities, making insurance policies similar to other investments, the tax-free status of insurance will be rescinded.

Unscrupulous insurance agents encourage elderly consumers to buy a policy, sell it, buy another one in two years, sell it, and so on. This damages the consumer’s insurable interest, making it more difficult for them to obtain insurance in the future.

Another risk involves that of incumbent companies to try to corner the market by trying to raise barriers to entry for the secondary market and effectively boycotting LS companies in an effort to corner the market and limit consumers’ access to the secondary market for impaired policies.

VI REGULATION/REGULATORY REQUIREMENTS

To protect consumers from the types of risks listed above, each state has its own legislation regarding LS transactions. There is also general regulatory information that can be found through the NAIC website (http://www.naic.org/state_web_map.htm), the

**State By State Update (As of November 2005)**

The following chart indicates states with life settlement law¹, states with viatical settlement law², states without life or viatical settlement law, and states with life settlement legislation currently being considered.²⁸

<table>
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<th>State</th>
<th>States with life settlement law</th>
<th>States without life settlement law</th>
<th>States with life settlement legislation pending</th>
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<tbody>
<tr>
<td>Alabama</td>
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¹ Life Settlement: Lump sum cash settlement paid to an insurance policyholder in exchange for contract ownership rights.

² Viatical Settlement: Lump sum cash settlement paid to an insurance policyholder in exchange for contract ownership rights, where the insured has a chronic or life threatening illness with a life expectancy of two years or less.

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**Regulations and Disclosures**

Currently, there are 23 states with Life Settlements laws, but no uniform regulation has been implemented for the Life Settlements industry. Both the National Conference of Insurance Legislators (NCOIL) and (as mentioned above) the National Association of Insurance Commissioners (NAIC) have model regulations currently in place.

The NCOIL Life Settlements Model Act was amended in July 2004 to include:

1. A provision requiring separate licensure to act as Life Settlements investment agent for those agents who recommend or sell Life Settlements
2. A requirement for Life Settlements brokers to complete 24 hours of pre-licensing education in life insurance, Life Settlements, and ethics, as well as continuing education on a biennium basis
3. A requirement that insurers disclose to policyholders the option of Life Settlements under certain circumstances
4. A provision prohibiting persons to enter into a sales contract if the policy were obtained by false, deceptive, or misleading means.

Amendments were made in July 2004 to the NAIC Viatical Settlements Model Regulation to incorporate the following provisions:

1. Extending the existing regulation on Viaticals to include all sales of life insurance policies where the proceeds are less than the face amount
2. The verification of coverage form and a new consumer brochure
3. Allow licensed life insurance agents to serve as Life Settlements brokers without an additional license
4. Standards for the evaluation of reasonable payments to policyholders involved in a Life Settlements sale

**The need for regulation to curtail these abuses is being avidly supported by top firms in the industry.**

In 2002, a database was begun by the Life Settlement Institute to share information about abusive or unscrupulous activity. Regulatory interest is improving, simply from the due diligence performed on the company by prominent, large investors such as Warren Buffet. The more institutional interest in the LS secondary market, the greater regulation will inherently develop. If LS firms do not meet the investment criteria of institutional investors, they will fail to attract the capital they need.

End.