Life Settlements

Putting the Pieces Together

BY LYNN VINCENT

Tough economic times are prompting some agents and their clients to explore life settlements as a way to gain access to much-needed funds. Permanent life insurance policies in danger of lapsing may present senior policyholders with an opportunity to replenish their retirement accounts that have been decimated in the recent market downturn. Advisors with institutional and nonprofit clients who are suffering from a cash-flow crunch may also be able to help those clients convert donated policies into current liquidity. And advisors with business clients carrying keyman policies that are nearing the end of their usefulness may, through life settlements, create a source of "found money."

BEFORE YOU AND YOUR CLIENTS START EXPLORING WAYS TO BENEFIT FROM LIFE SETTLEMENTS, HERE ARE A FEW ISSUES YOU NEED TO ADDRESS.

But life settlements are complex financial instruments and before you and your clients start exploring ways to benefit from them, you need to understand them thoroughly and know what you are getting into. ▷

Life settlements defined

In its simplest terms, a life settlement occurs when the owner of an unneeded or unwanted life insurance policy sells the policy, usually via a financial-services professional, to a third party, often for more than the cash-surrender value offered by the carrier. The purchaser (or investor) becomes the policy's new owner and beneficiary and must keep the policy in force by making continued premium payments. High-net-worth policy owners age 65 or older can be good candidates for life settlements, as well as seniors with a life expectancy of more than 24 months and who own a permanent life insurance policy (usually $250,000 face value or more), which they no longer need, or on which they don't want to—or can't—pay the premiums.

A 2007 Conning Research study estimated that $6.1 billion in policy face values were sold to investors in 2006, up from $5.5 billion in 2005. Conning expects the industry to grow by about $1 billion a year into the future. Still, a 2008 study conducted by Agent Media and Life Insurance Settlement Association (LISA) showed that though 42 percent of agents said they believed life settlements could provide them with substantial revenue, nearly two-thirds said they had never transacted one because they don't know enough about it. *Advisor Today* spoke with several life-settlement specialists to help shed light on the pitfalls—and opportunities—of this growing niche.

POINTS TO PONDER

- Fiduciary responsibility to the policyholder
- Licensing requirements
- Medical privacy
- Extensive education for policyholders
- Staying abreast of anti-STOLI legislation
- Carrier relationships

Fiduciary responsibility

Every expert *AT* spoke with emphasized the fiduciary responsibility of the advisor to the policyholder. For one thing, that means the advisor has an obligation to inform the policy seller that the transaction carries potential tax consequences, and that the client should seek advice from a qualified tax professional. Fiduciary responsibility also means that the advisor, either directly or through a broker, must shop the client's policy to enough different life-settlement providers to ensure that the seller receives the most competitive bid.

A broker who failed to do that was a claimant in litigation handled by William Berger, an attorney who heads the life-settlements division at Greenspoon Marder, a Florida firm specializing in commercial law.

The broker "got the insured, an elderly person, to sign a document agreeing that if the broker was able to get the insured $2.5 million for the policy, the broker could keep anything over that," Berger says.

Before the transaction became final, though, the insured learned that an investor had agreed to pay the broker $4 million, which would leave the broker with a $1.5 million commission. "The insured was scratching his head and thinking, 'This broker is taking advantage of me,'" Berger says. Working with Berger and a different broker, the insured was able to get $5.5 million for the policy from another buyer, while paying a brokerage fee of only $200,000. Incredibly, the original broker sued the insured for breach of contract. But he lost.

"We were able to show that this person took advantage of the insured because the law in Florida is transparency. The broker has a fiduciary responsibility to the 'viator,' the owner of the policy," Berger says. In a life-settlement transaction, the financial professional "is supposed to look out for the best interests of the viator, not his own pocket, or the investor's."

Much of the public-policy debate surrounding life settlements centers on the issue of hidden fees. But Steve Orr says that argument is fading as competition mounts and increasing regulation and professionalism have resulted in greater transparency. These days, brokers who don't disclose their fees "are more your old-school agents who grew up in the life insurance industry when you didn't disclose commissions," says Orr, a former Maryland insurance commissioner, and now president of Life Settlement Providers in Baltimore. "I don't think it's nefarious, for the most part. Their philosophy is that it's no one else's business."

Orr's firm supports uniform disclosure of broker compensation, and the life-settlement industry is moving in that direction. Forty-four states and Puerto Rico have enacted legislation or administrative regulations concerning life settlements. This year, as many as 20 states will consider further life-settlement and anti-STOLI

(stranger-originated life insurance) legislation, according to LISA. "If we're having this conversation about hidden fees a year or two from now, I'll be surprised," Orr says.

Licensing

It's critical that advisors considering entering the life-settlement market be aware of two licensing issues: State requirements for advisors acting on behalf of policy sellers, and the requirement to deal with licensed life-settlement brokers and providers. Some states require life insurance agents to get special licensing to engage in life-settlement transactions; in other states, just being a life insurance agent is enough.

And while any advisor worth his salt would check into his own licensing requirements before entering new territory, "some advisors don't realize they must also deal with licensed brokers and providers," according to Bryan Freeman, president of Habersham Funding in Atlanta. Check with your state's insurance commissioner to learn about life-settlement professionals in your state.

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Medical privacy

In November 2008, spurred by 60 consumer complaints collected over a three-year span, the New York Insurance Department held hearings on life settlements. A press release announcing the hearings warned consumers of "the transfer of highly personal information on the insured individual's life and health to unknown people."

Orr says he cannot think of a single case in which medical information was inappropriately disclosed in a life-settlement arrangement. But medical privacy is a common concern, and the key for advisors is, again, transparency. Advisors should ensure that a policyholder knows that his medical information is part and parcel of a policy sale.

"If I bought your life policy today, I would have your medical information and my investor, the person who is funding me, would also have that information," Orr says. "If my investor then sells your policy on the tertiary market, then the new buyer and other parties to the transaction will have the information, too."

Certain policyholders can be vigilant about medical privacy, such as celebrity clients or sellers with conditions they'd prefer other people not know. "If your client is very concerned about the privacy of his or her medical information, that may make them think twice about the decision to sell," Orr says.

Advisors deciding whether to get into life settlements may picture dealing mostly with individual policyholders. But transactions involving institutions are both a growing market and one that is ripe for advisors willing to educate potential new clients. "Virtually all the charities and institutions we have spoken with are unfamiliar with the planning opportunities that are offered by the emerging life-settlement market," says Joe Young, director of Veris Settlement Partners in Rockville, Md.

Often, benefactors donate life insurance policies to institutions such as universities and charities. But sometimes, either the institution or the donor has no interest in maintaining the premiums. The latter was the case when The George Washington University in Washington, D.C., began exploring the sale of a $500,000 universal life insurance policy donated

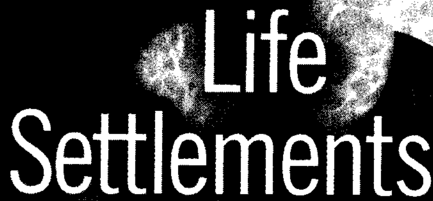
Where NAIFA Stands

NAIFA does not oppose legitimate life settlements, such as those in which the policy was initially purchased with the intent of protecting family members or a small business from the risk of a premature death, according to Gary Sanders, vice president for securities and state government relations for NAIFA, and Roland Panneton, FLMI, senior counsel for law and government relations for NAIFA.

"But NAIFA does not represent its members in life-settlement activities, but in their insurance interests," points out Sanders. "We do oppose life settlements that are used to facilitate STOLI," he explains, referring to stranger-originated life insurance arrangements where investors fund and ultimately own life insurance policies on the lives of people they don't know.

"We do not oppose life settlements," adds Panneton. "Basically, our position is you've got to look at what is in the best interest of the policyholder. Life settlements can be good and they can be not good for the policyholder. Each policyholder must evaluate his or her individual situation and determine if a life settlement is appropriate under their particular set of circumstances."

Panneton recommends that NAIFA members check with the carriers they represent and with state regulators for any guidelines on life settlements. They should also check their errors and omissions policies, as coverage for problems related to life-settlement activities may or may not be covered.



Young helped a retiring 68-year-old business executive do just that, converting a $500,000 keyman term policy to a universal policy for a conversion premium of $10,870. The new policy was then sold to an investor for $64,400, netting the executive about $54,000 in "found money."

As with institutional transactions, the key is education. Many business owners are not aware of this life-settlement option, providing advisors with an opportunity both to educate and earn.

CERTAIN POLICYHOLDERS CAN BE VIGILANT ABOUT MEDICAL PRIVACY.

by an 82-year-old former trustee of the university. The policy's surrender value was about $80,000, and the donor's annual premium payments to maintain the policy totaled nearly $40,000. University officials contacted Veris, which then acted as an agent in offering the policy to potential buyers. The school accepted the highest offer, $210,000, resulting in a $130,000 gain for the school—proceeds that will fund development at a university art gallery.

Young brokered a similar transaction for Mount St. Mary's University, the oldest independent Catholic university in the U.S., securing for the school $348,949 on a $1 million policy. When Young originally contacted the school's development office, it had already committed to surrendering the policy for $286,000 to fund a current construction project. By selling the policy on the secondary market instead, the university netted $62,000 in "found" money.

Keyman transactions

Superfluous keyman policies can help businesses "find" money, too. Traditionally, business owners buy term coverage to manage the cost of protecting against the loss of a principal partner. When the policies are no longer needed, one partner retires, for example, the premiums paid to date are viewed as a sunk cost. But Young points out a better option: In some cases, policy owners can convert their policies from term insurance to universal life insurance and sell the policy on the secondary market.

Caveats

But earn with integrity, says Habersham Funding's Freeman. In 2005, the National Association of Insurance Commissioners initiated hearings into stranger-originated life insurance. In a STOLI transaction, a third-party investor or hedge fund with no relationship to an individual initiates the purchase of a life insurance policy, arranges financing for the premiums, and later buys the policy in order to profit from the death of the insured. STOLI transactions violate insurable interest laws, which are supposed to make sure that the owner of the policy has an interest in the insured's continued life rather than his early death.

"As an association, LISA from day one was dead set against this," Freeman says. For advisors, the key is: "If you're originating life insurance and you have someone besides the insured standing on the sideline waiting to pay money for the policy from which you will earn a commission, that's a situation that's too good to be true. They're buying unused insurability on someone else's life. If that's the situation in which you find yourself, you've got to ask yourself: Is something wrong with this?"

NAIFA against STOLI

NAIFA has been at the forefront of efforts to prohibit STOLI transactions. It worked closely with NAIC and the National Conference of Insurance Legislators as these groups developed amendments to their model settlement statutes, which were designed to restrict and stop STOLI. Also, NAIFA state associations were key players in the 13 states that have enacted legislation aimed at protecting seniors and putting an end to STOLI.

"We are anticipating another busy year for anti-STOLI legislation in 2009," says Bill Anderson, NAIFA's senior vice president for state government relations. "And we could be working to enact laws in more than 20 states this year."

A second caveat for advisors looking to get into life settlements is if the decision to do so will impact their relationships with key carriers. In the old days, if insureds wanted to surrender their policies, they could do so only to the originating carrier. Then along came life settlements, providing an option for an insured to get cash on the secondary market that can surpass his policy's cash-surrender value.

Not all insurers are happy about that. Certainly, when policyholders sell to investors, investors then provide to carriers continued revenue streams on policies that often would have lapsed had they not been sold. Still, says Greenspoon Marder's Berger, some carriers "are not very happy with life insurance agents competing with them in the settlement market."

Also, some carriers are upset with double-dipping by agents, Berger says, referring to agents who counsel their clients to sell older policies and buy a new, more affordable policy. The agent makes money on both ends of the deal, sharing in the brokerage fees on the old policy and commissions on the new one.

Over the long term, as the life-settlement industry grows, that could cut into carriers' profitability as fewer policies lapse, forcing insurers to pay more death benefits. Berger suggests that captive agents, or those who deal mainly with a handful of carriers, check those companies' attitudes toward agents' involvement with life settlements.

"There's money to be made," he says. "But there's also risk."☐

Lynn Vincent is a frequent contributor to Advisor Today.