ETHICAL CONSIDERATIONS IN THE SECONDARY LIFE INSURANCE MARKETPLACE

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I. LIFE INSURANCE SETTLEMENTS

A discussion of the increasing incidence of “plain vanilla” life settlements, the purchase of in-force and unwanted life insurance policies to institutional buyers. A review of the increasing role and obligation of the life insurance agent as an advisor in the process

A. **Life Settlements** Defined

1. Definition - Often referred to as a “**senior settlement**”, a life settlement is the sale of an unwanted life insurance policy to a licensed institutional investor. The qualified policyholder receives a lump sum payout that can be significantly greater than its cash surrender value. The purchaser assumes responsibility for payment of the premiums and becomes the policy's owner and beneficiary.

2. Distinguished from **Viaticals –** The distinction between life settlements and viaticals is one of state law. When a distinction is made, viaticals are usually the secondary sale of a policy where the insured is deemed to have less than two years to live. In these states there may be different licensing requirements for participation in a life settlement and a viatical.

B. The Marketplace – A Brief History, A New Respectability

1. Early days – Settlements, then referred to almost exclusively as viaticals, became common in the late 1980's and early 1990's. They were usually conducted informally, with little regulation, for private buyers. The circumstances often involved an insured with less than two years to live and who was selling the policy to cover medical expenses or some other current economic need.

2. A New Asset Class – There is now a large secondary market where institutional funding from companies such as GE, Merrill Lynch and Berkshire Hathaway, represent a $12 billion dollar pool of available capital to acquire unneeded or unwanted life insurance policies each year for their investment portfolios.

3. Movin' On Up – Insurance carriers today recognize the place of the secondary market in the life insurance world. Many speak favorably of the "plain vanilla" life settlementmarketplace while recognizing:

    a. The need for more transactional and licensing regulation

    b. The likelihood that products will need to be re-priced to account for anticipated reduced lapse ratios

    c. Some quotations:

    "This is a capitals market, free market society we live in . . . If other entrepreneurs come in and find a weakness in our pricing, that is not their fault; it is our fault." David Herzog, AIG (quoted in *The WSJ*, August 9, 2006)

    "The insurance industry is not interested in preventing people from disposing of policies they no longer need." Frank Keating, President and CEO, ACLI (in an article voicing objection to the use of insurance in IOLI plans, *The WSJ*, August 26, 2006)

    "We have no quarrel with traditional, legitimate viatical settlements or life settlements. We understand that policyholders who face extraordinary medical expenses or whose financial protection needs have changed may, after considering the ramifications, decide to sell their policies in the secondary market." Frank Keating, President and CEO, ACLI (at the 12th bi-annual spring meeting, NAIC, New York City)

    "Life settlements today are being packaged into securities and sold to institutional investors. They're held on the books of reputable firms and even offered as traded funds for small investors. A.M. Best, the insurance rating agency, has even come out with best-practices guidelines for packaging life insurance policies into bonds . . ." Holman W. Jenkins, Jr. (column in the Wall Street Journal, August 9, 2006)

C. The Transaction – A Brief Description

1. The parties to the transaction

a. The ***Viator*** – the party (often the owner) selling the policy.

b. The Financial ***Advisor*** – the professional assisting the Viator in the process of the sale, usually an insurance agent.

c. The ***Sales Support Organization*** – the party assisting the Viator and the Advisor in the evaluation of, application for, processing and closing of the transaction.

d. The Life Settlement ***Broker*** – the party who represents the Viator and shops the market to get the highest price available for the contract.

e. The Life Settlement ***Provider*** – the party who represents the Funder and buys policies which meet the specifications of the Funder, for the ***lowest price possible***.

f. The ***Buyer/Funder*** – the party buying the policy for investment purposes.

2. The transactional process

a. Prospect Qualification

1) ***Caveat*** - Managing Expectations

An offer is usually a good opportunity for the owner, given the circumstances, and is usually a very good deal for the funder. The Viator seldom "makes a killing" on a life settlement.

2) Common Guidelines for a Good Prospect – below are the criteria for a policy that typically qualifies for a good settlement offer. Extenuating circumstances, particularly with regard to health, can broaden these parameters.

Types of Policies Considered	All types – Non-convertible Term, VUL or LTD where both insureds are still alive are all more difficult to settle
Minimum Face Amount	$100,000
Age Requirements	70 and above (younger if current health is poor)
Premium to Face Ratio	6% or less (will consider higher depending on case)
Life Expectancy Requirements	2-15 years (will consider longer depending on case)

Carrier Ratings	AM Best A- or above preferred

b. Case Application

The standard life settlement application package should include:

1) Requests for personal and policy information on the Viator and the Insured that is necessary to go forward with the case.
2) Medical Release
3) Insurance Information Release
4) Disclosure with explanations to the Viator regarding settlements
5) Single case exclusionary agreement for an appropriate period of time

c. Case Preparation

1) Medical data collection and underwriting
2) Insurance data collection
    a) Policy
    b) Appropriate in-force illustration
    c) Verification of coverage (VOC) from the carrier
3) Handling advisor (attorney, accountant, etc.) inquires
4) Inventorying misc. documentation (orders of bankruptcy, divorce decrees, etc.)

d. Acquisition of Bids on the Policy

e. Presentation and Acceptance of the Sales Offer

f. Closing the Transaction

1) Documentation (a stack about ½ inch thick)
2) Carrier home office changes and documentation
3) Payment to the Viator – usually received within 72 hours after the home office policy changes take effect

D. Ethical Concerns

1. Disclosure

a. Carrier Responsibility

The Insurance Marketplace Standards Association (IMSA) has as its principles of conduct for member carriers:

Principle #1 – To conduct business according to high standards of honesty and fairness and to render that service to its customers which it would apply to or demand for itself in the same circumstances

Principle #2 – To provide competent and customer-focused sales and service

b. Advisor Responsibility

From the Code of Responsibility of the SFSP (CLU/ChFC)

Rule 1.5 A member shall make and/or implement only recommendations that are appropriate for the client and consistent with the client's goals.

Application 1.5a. Compliance with Rule 1.5 requires the financial service professional to use his/her best efforts to (1) understand the client's/prospect's personal and financial background and experience; (2) understand the client's/prospect's risk tolerance; and (3) ***educate the client about the various options available to meet identified needs and goals. . .*** the financial service professional is cautioned against providing advice if he or she is not properly licensed or authorized to do so.

CANON 2 *Competence -* A member shall continually improve his/her professional knowledge, skill, and competence.

Professionalism starts with technical competence. The knowledge and skills held by a professional are of a high level, difficult to attain, and, therefore, not held by the general public. Competence not only includes the initial acquisition of this specialized knowledge and skill, but also requires continued learning and practice.

Rule 2.1 A member shall maintain and advance his/her knowledge in all areas of financial service in which he/she is engaged and shall participate in continuing education programs throughout his/her career.

c. There is increasing speculation that a legal liability may emerge with regard to discussing the life settlement option with a client considering lapse or surrender of a policy. Developments in this area could track those regarding the responsibility for agents making life insurance presentations to also propose disability insurance.

2. Suitability

For those policy-owners who:

a. No longer need the coverage
b. No longer need the particular policy in force
c. Can no longer afford the coverage

d. Currently need the money that a settlement would bring more than they need the future death benefit in the future

3. The Best Price for the Policy

a. Brokerage Issues

1) ***Caveat*** – The Provider works for the Funder, not the Viator. It is the Provider's job to give the Viator the lowest amount possible for the contract.
2) To assure that the Viator receives the best price for the policy it should be presented with bids from all respectable Providers licensed to do business in the state of sale.
3) With proper disclosure to and permission from the Viator, consideration may be given to presenting the policy to private funders.
4) An effective Broker will leverage the bids off one another to get each Provider to make their highest offer.

b. Compensation Issues

1) Most current limitations on compensation are imposed by the providers offering bids on behalf of the funders.
2) One reasonable standard for advisor compensation for the typical case (one without an excessive purchase price) is 15% of what the client is paid for the policy.

3. Licensing

a. Some states require proper licensing to participate in a life settlement. In most regulated states licensed life insurance agents are only required to submit the proper filing papers with a fee.
b. Georgia requires licensed life insurance agents to file a one-page application with a $50 fee prior to the *recommendation* of a life settlement to a client.

II. LIFE INSURANCE PREMIUM FINANCE ARRANGEMENTS (45 minutes)

An examination of the concept of "investor-owned life insurance" (IOLI). The elements and structure of the most typical plans are discussed along with the concerns that all parties to the transaction have raised as the market grows and changes.

A. Premium Financing Plans

1. **Traditional Plans**

Borrowing money to pay insurance premiums is attractive during periods of low interest rates because the premium payer avoids the need to liquidate income-producing or highly appreciated assets to pay for the coverage.

Plan features:

a. Longer-term Recourse Loans (5-10 years) – Often collateral is required in addition to the policy, depending on the results of the financial underwriting of the premium payer.

b. Policy ownership for life – The coverage is purchased for the immediate or long-range protection needs of the insured. Repayment of the loan is intended at a future time when either income will be available or the liquidation of assets is more attractive.

c. Program qualification – Loans are made based on the credit-worthiness of the borrower. The emphasis is on financial underwriting.

2. **Non-traditional Plans** in View of the Secondary Market – "This is not your Father's Oldsmobile"

Premium financing is now seen as a way to realize the value of a person's "unneeded insurability". Financed insurance is purchased and then later settled in the secondary market with the hope that the loan can repaid and all parties will make a profit at that time.

Plan features:

a. Short-term Non-recourse Loans (30-36 months) – Only the policy is required as collateral. If the borrower cannot repay the loan upon maturity, they lose the contract and are not responsible for any additional shortfall in repayment. In attempts to create a recourse loan, some financing plans have begun requiring additional obligations from the borrower.

b. Ownership with consideration for a future life settlement – The plans usually assume some scenario that anticipates settlement of the policy shortly after the contestability period, depending on a potential policy value in the secondary market that exceeds obligations created by the loan.

c. Program qualification – Loans are made based on the likelihood that the policy can be settled profitably in the secondary market beyond the contestability period. The emphasis is on the medical underwriting of the original policy versus the life expectancy reports generated on the insured. The economic workability of the plan is generally based on achieving some degree of underwriting arbitrage between the two.

d. Typical arrangements:

For many reasons a family trust, FLP or family LLC is usually the purchaser of the policy and the borrower.

1) Money up front – The borrower enters a financing arrangement and purchases the policy. The interest in the policy is then transferred, directly or indirectly, to the financing entity, or a related party, shortly after the purchase. The borrower is paid a percentage of the death benefit, usually not in excess of 3%.

2) Settlement in the short term – The borrower enters into the financing arrangement and then, shortly after the contestability expires, settles the policy and uses the

purchase price to pay off the loan, keeping any excess. The better financing arrangements do not involve the financer in the settlement except to the extent it is repaid principal, interest and fees on the loan.

3) Borrowed premiums for life – All parties intend that they will hold the coverage for the life of the insured. The financer usually buys a straight life SPIA on the premium payer to contain the cost of future payments. The borrower has the right to a portion of the death benefit that usually reduces over time. Sometimes there are provisions that allow for commutation of all or part of the borrower's benefit at an earlier time.

B. Reservations Relating to Non-traditional Plans

1. Concerns of the Insured

a. What are the philosophical and moral implications of selling unused insurability?

b. What is the likelihood that investor-owned insurance might encourage the premature death of the insured if the investor is in desperate need of improving his or her bottom line?

2. Carrier Concerns

a. How will non-recourse premium financing-type plans affect carrier profitably? Consider:

1) Lapse supported pricing on the policies used.
2) Medical underwriting – applicants taking advantage of business decisions or table-shave programs for reasons other than those intended.

b. Crime-related death claims.

c. Is there an insurable interest question?

1) Is there an insurable interest when the policy is issued and a change of ownership is likely? If not, what are the carrier's obligations when this is discovered or at the time of death?

2) Does the carrier have legal liability if the program is one that ends in a crime-related death caused by someone without an insurable interest?

d. Governmental regulation – Will carriers be viewed more like in vestment companies and taxed accordingly?

3. Governmental Concerns

a. Public safety and public policy – Will the government continue to sanction an activity that could be viewed as an opportunity to bargain in people's lives?

b. Will the government further restrict regulation?

1) Tightening of the insurable interest laws – possibly to include owners other than those at the time of purchase (poss. making exceptions for charitable entities)?
2) Will it extend contestability periods?

c. Tax treatment

1) Will the government remove the tax-advantages currently afforded to coverage (e.g. tax-favored treatment of certain withdrawals, cash reserve buildup and death benefits)?
2) Will the government tax carriers more like investment or securities firms?

4. Agent concerns

a. Is the applicant making full disclosure of his or her intents as required by the carrier being used for coverage (that could result in revocation of the contract for fraud).
b. Is there a full explanation to the client of the loss of access to insurability resulting from the plan.
c. Is there a full examination of the likelihood of the profitability of a plan that is contingent on the future settlement of the contract.