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Myths And Realities Surrounding The Life Settlement Industry

As clients weigh life settlements as an option in serving long term financial needs, agents and brokers are faced with myriad questions regarding the laws surrounding this evolving industry. In order to answer these questions, it is imperative that life settlement brokers and agents understand the myths and realities surrounding the secondary market. Misconceptions can affect the credibility of the industry and may confuse clients looking to pursue their financial planning goals via life settlements.

Myth: The life settlement industry is not regulated, thus there are extreme variations in how the life settlement companies value a life insurance policy.

Reality: There is substantial institutional funding within the life settlement industry, which requires a high standard of compliance, due diligence and discipline, and an increasing amount of regulation.

Institutional investors, such as banks, insurance companies and hedge funds, continue to drive the life settlement industry. As life settlements become more common, the opportunity for additional life settlement business will increase, as will the institutional investors' appetite for this asset class.

Today, German funds are still in the market, but to a much lesser extent. In the past year, several large European banks and other internationally known companies have become active in the market. In the next few years, the major source of capital will come from term securitization, as investors vie for a piece of what is estimated to be the $9 to $11 billion a year face-value business of life settlements ("Life Insurance—Life Settlements Update—What a Difference a Year Can Make," Bernstein Research, May 19, 2006). In particular, some of the world's largest hedge fund managers are increasingly viewing life settlements as a stable investment and including them in their portfolios.

At present, approximately 39 states have some form of regulation for viatical or life settlements, covering such areas as licensing, more clearly defining life settlement, and counseling an insured being considered for a settlement transaction. For years, leaders in the life settlement industry have worked closely with the National Association of Insurance Commissioners for consistent regulation of life settlements.

Myth: Brokers need not be concerned about regulation in states other than their own.

Reality: Any professional or firm transacting life settlements needs to be aware of regulations for all states in which they conduct business on behalf of their clients. This includes the state of residence/domicile of insureds, sellers of policies, and any trusts involved in the ownership structures. Certain states, such as Florida, have enacted legislation to prevent policyholders considering a structured settlement from changing their state of residence in order to circumvent state laws governing such transactions. There have been recent hearings and legislative reviews across the nation designed to increase consistent regulation and licensing of professionals among the states.

Myth: The life-settlement industry is not as concerned about insurable interest or policy contestability as it should be.

Reality: The life settlement industry is very concerned about insurable interest at the time of policy issue, as well as the contestability period.

Many in the life settlement industry have voiced their support for the Life Insurance Finance Association's recently issued statement that the purchase of life insurance policies should be based only upon an insurable interest in the life of the insured, regardless of whether a consumer chooses to finance the purchase of such policy through a life insurance premium finance transaction. LIFA also opposes the sale or purchase of life insurance policies that violate state insurable interest laws.

The life settlement industry has as much at stake as the life insurance finance industry in regard to these issues. On May 3, 2006, the NAIC held a special public hearing in New York to explore insurable interest issues in connection with both premium financing and life settlement transactions. In addition to insurance regulators, testimony was provided by representatives of life insurance companies, life settlement companies, premium finance companies, and industry professionals from New York as well as other states.

The legal concept of an "insurable interest" is based on the assumption that the policyowner or beneficiary will suffer a loss upon the death of the insured. Insurable interest is not measured by what the policyowner or beneficiary will gain through recovery on the policy. Insurable interest is determined by the relationship between the insured and the original owner and beneficiaries of the policy at the time the policy is issued.

Spouses, dependents and other close family members are presumed to have an insurable interest based on their relationships with the insured. Business entities, even family owned companies or family partnerships, must show that the insured is a "key person" in the operation of a business enterprise and that the loss of that person would have an adverse economic impact on the company. Whether a charitable organization or other third party may be deemed to have an insurable interest in the life of a particular insured depends upon state law at the time the policy is issued.

The policy carrier can assert that lack of an insurable interest renders the policy void, and may be able to raise this defense at any time during the term of the policy, despite expiration of the contestability period or even after death of the insured.

Myth: Life settlements have a negative impact on the life insurance industry.

Reality: The presence of the secondary market for life insurance should increase sales for insurance companies because of the option it provides to policyholders. By providing a financially superior alternative to non-forfeiture and cash-surrender values, the likelihood of clients purchasing life insurance will increase. Bottom line, the availability of the secondary market enhances the value of life insurance in financial and estate plans because it provides flexibility and a fair-market value for this financial asset.

Myth: Financial advisors are not required to disclose a life settlement as an option to eligible clients when formulating a financial planning package.

Reality: According to Bernstein Research issued in 2005, "Specifically, insurance agents and other producers will feel an increasing responsibility to present life settlements as an option to their clients. The alternative today is simply to take the path of least resistance and let customers surrender their policies. It is clear that the overall financial services examples include investigations of life and annuity sales practices. Given that life settlements typically offer payments that exceed cash surrender values, regulators in the future may perceive that it is part of a financial advisor's fiduciary duty to investigate life settlement options on behalf of clients."

Myth: Agents and brokers know how to transact life settlements, but most do not offer them to clients.

Reality: Frequently agents and brokers don't offer life settlements to clients because they lack information on how to conduct a life settlement transaction.

In March 2006, an insurance trade journal published the results of a survey on the life settlement industry that indicated six in 10 agents do not feel they know enough about life settlements. Even agents who have never been involved in a life settlement transaction believe that it would benefit clients as a financial planning tool (71 percent). Nearly half (48 percent) of the surveyed agents who have never offered life settlements say they would need additional training and education before feeling comfortable enough to offer the product. Life settlement companies are increasing educational opportunities through a variety of channels, including web-based training events, workshops at industry conventions and development of continuing education classes. During June 2006, the first ever life settlement awareness month was held to promote general industry awareness. Seminars titled "Life Settlements—The Fundamentals" and "Life Settlements—Advanced Strategies" were broadcast on the Internet.

Life settlement companies are meeting the demand for education—they are a predominate presence at producer conferences throughout the world, and company executives are developing classes for continuing education credit and writing bylined articles which have appeared in most of the industry's major trade publications.

Myth: All life settlement firms are the same.

Reality: There are brokers and providers/funders, and it is important to understand the function of any firm with which you choose to transact life settlements. Further, agents and brokers should perform due diligence by gathering information from several competitive companies. They should then target those with the most experience, best resources and an excellent reputation.

Here are some guidelines that can help in choosing an appropriate life settlement provider for your clients:

- Solicit bids from only those providers that are both experienced and ethical.
- Select a life settlement company that is licensed or otherwise qualified to do business in the state in which the policyholder resides.
- Look for proven industry experience, preferably at least $1 billion in purchased aggregate face value.
- Confirm the company is institutionally funded and will not resell the contract to an individual investor.
- Check with the state attorney general or state insurance department for any complaints or legal actions against the settlement provider.
- Make sure clients consult with professional tax advisors.