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Life Settlements A Cottage Industry No More

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In just over five years, the life settlement industry has evolved from a cottage industry offering a boutique product, to an industry that is transforming the financial services market and penetrating the international investment banking community. As 19th century writer Victor Hugo once observed, "There is one thing stronger than all the armies in the world, and that is an idea whose time has come." Many wealth management and estate planning professionals now embrace life settlements. They are discovering that a life settlement may benefit high net worth seniors and gives brokers and producers opportunities for additional income.

The life-settlement industry should continue to grow in all areas of the financial services marketplace based on the positive trends we see emerging:

- An increase in broker-dealer firms offering life settlements to their senior clients.
- Seniors purchasing replacement policies and other financial products with the proceeds from a life settlement.
- The incorporation of life settlements into mainstream investment banking.
- A growing connection between charitable giving and life settlements.
- An increasingly pro-consumer attitude toward life settlements in regulatory and legal circles.

Broker-Dealers are Establishing Life Settlement Practices

One of the areas we are seeing movement in the needle is the acceptance of life settlements among broker-dealer firms. Recent legal articles have supported life settlements as pro-consumer and have cautioned legal



and financial advisors about overlooking life settlements as an estate planning option. In light of this, some broker-dealer firms that prefer to err on the side of caution are building a life-settlement practice into their financial services product line.

Brookstreet Securities Corp. in Irvine is one such national brokerage house. Scott Whitten, director, insurance division at Brookstreet said, "...We strongly believe in...counseling our clients about this new opportunity to tap into an asset that was formerly ignored or perceived as 'untappable...With 480 registered reps throughout the country serving thousands...of clients, we want to mitigate any potential liability that can occur merely by failing to mention to the client the life settlement option. So, we decided to make life settlements a focal point of our product offering to high net worth seniors who may be potential candidates for a life settlement."

Although a life settlement is not considered a securities transaction, financial professionals – particularly broker-dealers and registered representatives – are mindful of the spirit of the NASD "suitability rule" (Conduct Rule 2310) in their approach to life settlement transactions. Under the suitability rule, a member shall have reasonable grounds for believing that the recommended transaction is "suitable" for the customer based on the client's entire financial profile and investment goals.

A fiduciary concern might arise in a scenario in which a senior policyholder is paying high premiums on an unwanted, under-performing life insurance policy. The senior might think it makes sense to accept the cash-surrender value and deposit the proceeds into an investment fund recommended by his or her broker. However, if the senior accepts a life settlement offer that is three times the cash-surrender value, the client could possibly increase the sum invested and purchase replacement coverage at significantly lower annual premiums. If the broker is unaware of this liquidity option or overlooks informing the client about it, there could be huge financial losses, which would certainly not be in the client's best interests.

Replacement Policies — A Growing Trend

With new mortality rates expected to reduce premiums from 10% to 30%, it makes sense for seniors to consider purchasing replacement coverage. Providing life insurance for active seniors has become an expanding market as older Americans maintain longer, healthier lifestyles.

Insurers are reaching out to seniors by offering lower prices and relaxed underwriting. It enables seniors to purchase less

expensive and better performing policies than the ones they took out years ago. Over the past three years, carriers have introduced sliding scale rates with relaxed underwriting standards for people over 70. As carriers continue this trend, senior clients who purchased policies before the new standards were set can benefit. In all likelihood, they would qualify for a combination transaction in which life settlement proceeds are used to purchase a more cost-effective policy, assuming there has been no significant change in health.

Just as it has made sense for many of us homeowners to take advantage of the lower mortgage rates saving us thousands of dollars by refinancing our home loans, it also makes sense for seniors to consider purchasing replacement policies with the proceeds from life settlements.

Replacement Coverage Through Annuity Arbitrage

Many insurance producers have at least heard of, if not implemented, some kind of annuity arbitrage arrangement. In this situation, the cash value in an existing life-insurance policy is used in a 1035 exchange to fund a single premium immediate annuity (SPIA). The after-tax payout is used to purchase a replacement life insurance policy. The new life insurance policy has better guarantees, and/or higher death benefits, and ideally, lower premiums.

The latest variation on this theme is when life settlement proceeds are used to purchase a SPIA. Since the proceeds are substantially higher than the cash-surrender value of the policy, the payout is higher and the client can purchase more death benefit or even reduce the premium outlay. However, it does not work in every situation. The agent must run the concept comparing a 1035 exchange to a life settlement to see which scenario is best for the client.

According to Lori Egaña, CLU, CEP, director of National Insurance Brokerage, LLC, "The annuity arbitrage arrangement with a life settlement is a huge win-win situation for the agent and the client." The client receives a higher death benefit or lower out-of-pocket expense for premiums, and the agent receives compensation for the replacement life insurance sale, the life settlement, and the annuity purchase, she added.

Life Settlements in Mainstream Investment-Banking

We are seeing increased activity in the securitization of investments with the use of life

insurance policies sold on the secondary market. This is good news for the life settlement industry since the nature of investment banking is founded upon the stability of assets and longevity in the realization of returns. With the entry of Moody's and A.M. Best into the life-settlement marketplace, we expect other rating agencies to follow suit.

The secondary market for life insurance policies has become an industry unto itself, earning a place among mainstream investment portfolios. As A.M. Best wire services reported in January 2004, one securities firm was assigned a debt rating of "AA-" in which Class A asset-backed bonds were collateralized with \$195 million in face value of life insurance policies (life settlements) purchased from people with life expectancies ranging from 48 months to 84 months.

In some cases, funders (those who purchase life insurance policies on the secondary market) are buyers who function as aggregators of investment products that are wrapped into a security. This is particularly popular in Germany where banks and investment houses wrap the product and sell the security to institutional investors. U.S. life settlement funds are becoming increasingly popular in Germany where investors purchase life insurance policies from policyholders in the U.S. secondary market. The market carries special tax advantages under the current U.S.-German Double Taxation Treaty.

Some investment banking experts we talked with recently have seen a measurable increase in the "securitization" of life settlements in the past six months. They are getting more calls from interested parties and are seeing the increase in their own deal flow. They are also seeing a lot of product on the market and originators seeking out funds to purchase their product. Of course, that is expected to lead to an increase in the number of funds investing in life settlements.

While a lot of the funds that have invested in life settlement transactions originated in Germany, some of those that are closely involved in the investment banking community have been recently approached by funds outside of Europe. As a result, they predict that we will see an increase in the number and the size of funds investing in these transactions. They also expect to see funds begin to buy larger policies. That segment of the market will grow as well.

Baker & McKenzie, a 50-year-old international law firm, has substantial knowledge in this arena. Boris Ziser of Baker & McKenzie said, "It appears there is a growing acceptance in the capital markets for life-settlement transactions. We expect to see a dramatic increase in transactions in the next six to 12 months." Ziser observed that

the recent participation of a major investment bank and a major rating agency (Moody's) in such a transaction would be of great benefit to the industry. Combined with the growth that is taking place, it will lead other investment banks to get involved in these transactions. In turn, this may lead to the investor base expanding even further and allowing originators greater access to the capital markets, Ziser notes.

Larry Simon, CEO, Life Settlement Solutions, says the industry is just starting to enter the domestic investment-banking arena. One well-known insurance conglomerate is regularly engaged in this activity with one of the nation's largest life settlement providers. "I believe the situation will evolve further over the next three to five years as rating agencies become more comfortable with the idea and as more data points become available. At the present time, the German market is raising the majority of the funds due to the favorable tax structure, but as life settlements continue to gain recognition in the financial industry, I believe the rating agencies will relax their reserves requirements thereby allowing mainstream entry into the marketplace," he said.

Giving While Living

Charitable giving is expected to increase dramatically as wealthy seniors seek their philanthropic legacies. Life settlements give estate planners and financial advisors a new tool to help their clients achieve their charitable giving objectives. Through a life settlement, a senior who is at least 70 can sell a life insurance policy on the secondary market for a far greater amount than the cash-surrender value and receive a tax deduction on donating the proceeds to a favorite charity.

In general, an individual can deduct cash donations made to 501(c)3 charitable organizations as long as the donations total less than 50% of his or her adjusted gross income with a five-year carryover. The higher the federal tax bracket, the lower the donation's after tax cost is. For example, a person in a 38% tax bracket who donates \$1,000 gets a tax savings of \$386; thereby making the net cost of the donation \$614. But, a person who in a 15% tax bracket who makes the same donation saves only \$150, with a net cost of the donation being \$850.

The transaction simplifies the donor's wish to see the contribution immediately benefit a favorite charity. Also, the non-profit organization that would have received the contribution as a donated life insurance policy does not have to contend with premium payments, annual policy reviews, and other administrative activities associated with donated policies. Furthermore, the charity

gets an infusion of cash that can be leveraged immediately and maximized through the organization's investment portfolio.

Unfortunately, some charitable organizations have let policies lapse due to premium maintenance and/or administrative review procedures. Apparently, these organizations do not know that donated policies may qualify for life settlements if the donor is at least 70 years old. With the donor's cooperation and willingness to provide routine medical records, the charitable organization can sell the policy on the secondary market and generate substantial revenue instead of letting it lapse and take a loss.

"If they knew life settlements were an option, perhaps development officers would reconsider the practice of letting policies lapse," said David Shufflebarger, senior vice president of Alexander Haas Martin & Partners, a philanthropy consulting firm.

Estate planners and financial advisors are often considered to be the primary gatekeepers of philanthropic giving. As such, they may have an exclusive opportunity to identify the role life settlements can play in charitable giving. High-net-worth seniors rely on the advice of wealth management professionals who have the broader picture of the client's estate planning objectives, tax implications, and charitable giving habits. These professional advisors can help the client maximize planned giving by recommending a life settlement in certain circumstances.

Consider this scenario: A wealthy senior is thinking of lapsing a policy or cashing it in for the surrender value because the policy is no longer needed to help his heirs pay estate taxes upon his death. The estate planner will want to discuss the idea that instead of lapsing the policy, the client consider selling it for its fair market value on the secondary market. The proceeds could then be used to satisfy the client's philanthropic legacy while decreasing his tax burden. Furthermore, the cash from the tax savings could be used to purchase a replacement policy that's more suitable to the client's lifestyle or a policy that more closely parallels his estate planning objectives.

The Projected \$41 Trillion Intergenerational Wealth Transfer

Over the next 50 years, the single largest intergenerational transfer of wealth in the history of our nation will take place, according to a study by Boston College's Social Welfare Research Institute (SWRI). The projection indicates that \$41 trillion would be transferred via the estates of high net worth seniors with \$6 trillion expected to go

to charitable foundations. The prediction was validated in 2003. SWRI director Paul Schervish stated in a press release that confirmation of the projection should come as a great relief to universities and charities across the country that expanded their development offices and overhauled their staff in response to the \$6 trillion prediction.

Since donated life insurance policies comprise a sizable portion of planned giving to charity foundations and universities, financial professionals are examining the role life settlements can play in helping foundation officers maximize planned giving and leverage the proceeds from life settlement transactions.

The SWRI report has had impressive and staggering effect. First, the Council of Economic Advisors officially adopted the report, the Congressional Budget Office incorporated the report in an analysis, and the Bureau of Labor Statistics received the report favorably. Also, the report caused financial firms and estate planners to add intergenerational themes and philanthropy to estate and wealth management services.

Both the life settlement and planned giving industries are expected to grow substantially over the next few decades. Understanding the link between the two will help estate planners determine whether this link can have a positive affect on the estate planning objectives of their high-net-worth senior clients.

It is important to note that planned giving instruments, which can be exceptionally complicated to construct and execute, require the services of attorneys, accountants, and other tax and estate planning professionals who are trusted advisors to the client and are respected by the recipient charitable organization.

Furthermore, charitable organizations have gift acceptance policies that address the types of gift instruments they are willing to execute, so it is important that this information be explored at the outset during discussions with the client about the recipient of their philanthropic legacy. In addition, state laws govern the donation of life insurance policies and life settlement transactions, so it is important for the financial advisor to be well acquainted with the insurable interest rules that apply in the given situation.

Pro-Consumer Attitude in Regulatory and Legal Circles

The newly approved amendment to the Viatical Settlement Model Regulation by a key committee of the National Association of Insurance Commissioners (NAIC) in

March 2004 essentially clears the way for licensed life agents to transact life settlements in their state of licensure. This is viewed as a positive step for insurance agents, consumers, and the life settlement industry as a whole.

The amended Model Regulation is expected to be approved at the NAIC's summer meeting. Except for a few states with life producer licensing to do life settlements, others will be in a position to consider the new Model, once it is approved. At least 21 states have adopted some type of life settlement regulation. It is likely that this list will grow as life settlements gain in acceptance across the country.

In addition to positive regulatory activity, we see it as quite favorable that the American Bar Association's *Real Property, Probate, and Trust Journal* published a study by Univ. of Penn.'s Wharton School, which extols the benefits of a secondary market for life insurance policies. Authors Neil Doherty, professor of insurance risk management at The Wharton School, and Hal Singer, senior vice president of Criterion Economics, conclude that the secondary market for life insurance policies has been "pro-competitive and pro-consumer." The authors urge lawmakers to design regulations that encourage rather than dissuade participation and investment in this secondary market.

The Bottom Line

We expect to see a dramatic increase in life settlement transactions throughout the remainder of this year and next. The life settlement industry is an idea whose time has come. The product has provided a much needed exit strategy for seniors seeking liquidity from unwanted policies and it has become a new source of revenue for brokers and producers. □

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