

## **Informational Hearing**

### **The Growing Life Settlement Industry: Is Anyone Watching Out for Consumers?**

Wednesday February 20, 2008  
1:30 pm, Room 112

#### **Background**

##### Introduction

A life settlement is a complex financial transaction in which a policyholder possessing an life insurance policy sells the policy to a third party for more than the cash value offered by the life insurance company. The purchaser becomes the new beneficiary of the policy at maturation and is responsible for all subsequent premium payments. Capital from hedge funds, investment banks and pension funds in search of higher returns is flowing into the life settlement market. Life settlements are a new market that is growing rapidly, and is largely unregulated in California.

The life insurance industry claims that the buying and selling of life insurance policies in a secondary market distorts the very purpose of life insurance by breaking the “insurable interest” link between an insurer, policyholder and beneficiary. In addition, some argue it undermines the lapse-based pricing structure used by most insurance companies, and could lead to higher prices across the board for life insurance.

The life settlement industry argues that seniors can only benefit by allowing them to capitalize on a previously little used asset that they might otherwise simply let lapse or surrender for substantially less than they would receive in a life settlement when the policy is no longer needed or wanted.

The US Supreme Court established in 1911 in *Grigsby v. Russell* that a life insurance policy is the property of the policyholder and is fully transferable. This opinion placed the ownership rights in a life insurance policy on the same legal footing as more traditional investment property such as stocks and bonds. Notwithstanding the court's ruling, the market for life settlements did not gain much traction, or institutional investors, until the 1980s.

The life settlement industry has grown from just a few billion dollars less than a decade ago, to about \$12-\$15 billion in 2006, and according to some projections, is expected to grow to more than \$150 billion in the next decade. Legislatures nationwide are currently debating enactment of statutes to regulate this new and rapidly growing industry. At least 27 states have already enacted some form of regulation of these complex financial transactions. Model acts have been developed by both the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL).

Despite its growth, few have ever even heard of life settlements outside of life settlement and life insurance industry professionals. Many important public policy issues are touched in the debate over regulation, from the purpose and function of life insurance, to the rights individuals have to maximize all their personal and financial assets. It also raises questions about the potential for the financial abuse of seniors, as they are solicited to sell existing life insurance policies, purchase life insurance policies to sell to investors, or to invest in life settlements with promises of high financial returns.

This hearing is intended to familiarize the members of the Committee and the public with the life settlements industry, its players, some of its implications for the life insurance and financial markets, and with some of the key issues the Legislature will be called upon to consider as it decides whether or how to regulate the industry.

#### How it Started: AIDS and The Viaticals Market

During the 1980s, the so-called viatical settlement market developed in response to the AIDS crisis. These transactions involved the sale of life insurance policies by persons with a catastrophic or life threatening illness or condition (diagnosed as having a life expectancy of 24 months or less) for an amount less than the death benefit, but more than the cash surrender value, in order to raise funds to pay for end-of-life care. The desperate circumstances of the sellers raised the potential for abuse, and the Legislature in 1990 stepped in to regulate viatical sales, defined as a sale of life insurance by a person diagnosed with less than 24 months to live. Anyone transacting viatical settlements in California must be licensed by the Department of Insurance (DOI). Licensees must provide specified disclosures to the seller, including possible alternatives to settlement, the tax consequences of such a settlement (the proceeds are taxable, whereas life insurance proceeds are not), the impact on Medicare or other public assistance programs, and issues relating to the confidentiality of medical information. The statute specifically prohibits any false or misleading advertising or solicitation, and provides an absolute

right of rescission for 15 days after the settlement. The Insurance Commissioner (IC) was given broad powers to regulate the affairs of viatical settlement companies.

The viatical market largely evaporated after medical advances dramatically altered the life expectancy of an AIDS diagnosis. In 2001, the NAIC released a Viatical Settlements Model Act, providing guidance for the regulation of the business of both viatical and life settlements. At the same time, life settlement providers started purchasing policies for their investment portfolio using institutional capital. The arrival of well-funded corporate entities transformed the settlement concept into a wealth management tool, and began driving a rapid market expansion. The life settlement industry has actively targeted wealthy seniors 65 years of age and older with life expectancies of two to 10 years. Seniors now are being solicited with offers to buy new policies or sell existing policies in exchange for “free” insurance or large cash payouts. California has not adopted the model act, or expanded its viatical settlement law beyond those involving policyholders diagnosed with 24 months or less to live. The vast majority of life settlement transactions involving California policyholders are currently not regulated by the DOI. The Department of Corporations provides the purchaser of a life or viatical settlement some protections, including required disclosures about the nature of the risk, under the Corporate Securities Law.

#### What is an “Insurable Interest”?

In order to purchase a life insurance policy, the purchaser must have an “insurable interest” in the life of the person insured. An individual has an unlimited insurable interest in his or her own life. Individuals related by blood or marriage can also have an insurable interest. An employer can have an insurable interest in the life of its directors, officers or other key personnel, with the consent of the employee. Legislation enacted in 2003 prohibited insurers from issuing policies that insure the lives of rank and file employees and that designate the employer as the beneficiary of the policies

The life insurance industry has objected to many life settlement transactions, particularly those transactions referred to as “stranger originated life insurance” (STOLI) because they claim they violate the requirement for an insurable interest. STOLIs will be discussed more fully below. As defined in the California Insurance Code, “an individual has an unlimited insurable interest in his or her own life, health and bodily safety and may lawfully take out a policy of insurance on his or her own life, health, or bodily safety and have the policy made payable to whomsoever he or she pleases, regardless of whether the beneficiary designated has an insurable interest.” An insurable interest must exist at the time the policy becomes effective, but does not have to exist at the time the loss occurs. An individual can always take out insurance on his or her self, and then transfer the policy to someone else. The question comes down to the intent at the time the policy is purchased. The insurance industry has attempted to partially address the issue by including questions in the policy application that ask whether the purchaser has any intent or agreement to transfer the policy. If the policyholder then transfers the

policy within the two-year contestability period, the insurance company can attempt to void the policy based on fraud in the application.\*

### How Does a Life Settlement Work?

The value of a life settlement is based on the face value of the insurance policy, the medical condition of the policy holder, and the amount of the premium. Typically, the target market for life settlements is high-net-worth policyholders age 65 and older, with a life expectancy of two to 10 years. Life settlements provide the policyholder significantly more cash than the cash surrender value offered by insurers. According a study conducted by the Life Insurance Settlement Association, the average gross offer accepted by brokers was 29% of the death benefit. The offer is not necessarily the same as what is paid to the policyholder. There are significant fees and commissions to the various parties involved. In addition, the settlement payout to the policyholder may be taxable as ordinary income or capital gains.

Life settlements are complicated financial transactions that are generally conducted on behalf of clients by experienced professional advisors, including CPAs, attorneys, financial planners, estate planners, and insurance advisors or brokers. Life settlement providers serve as the purchaser in a life settlement transaction and are responsible for paying the client a cash sum greater than the policy's surrender value. Financial advisors may opt to work through a settlement broker. Brokers, for a fee, will shop a policy to multiple providers. Life settlement investors provide the capital or financing for life settlement transactions, using their own or capital or raising the capital from a range of investors. The life settlement investor is the ultimate funder for the secondary market transaction. In some cases, the settlement provider is also the investor, using its own capital to fund the transaction. In most cases, a life settlement investor must be a qualified institutional buyer as defined in the federal Securities Act of 1933. The purpose of the qualified institutional buyer requirement is to prevent unsophisticated or undercapitalized investors from participating in, and potentially being harmed by, complicated life settlement transactions.

### Who Benefits From a Life Settlement?

According to most statements by the life settlement industry, senior citizens who are already planning to lapse or surrender their life insurance contract are the primary target market for life settlements. They assert that a senior will almost always receive more from a settlement of a life insurance policy than the lapse value the senior could receive from the insurer. Life settlement industry marketing materials, however, suggest many other reasons for seniors to sell their policies, including using the proceeds to purchase a new life insurance contract or long-term care contract, collecting immediate cash, gifting

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\* By statute, a life insurance policy is incontestable after it has been in force for two years except for non-payment of premiums, unless an imposter was used to obtain the policy. The insurance company has two years to identify any undisclosed or misrepresented facts that rise to the level of material misrepresentation that would have kept the policy from being issued as applied for, allowing it to rescind the policy. If the fraud is material and intentional, the insurer may attempt to contest the policy beyond the two year period.

to a family member or charity, creating funds to invest elsewhere, and paying divorce costs. Some brokers believe that a senior should have the unrestricted right to profit from the untapped asset of their advanced age and insurability by obtaining insurance for the purpose of selling it.

A study by Deloitte Consulting LLP and the University of Connecticut in 2005 examined the economic value of life settlements from the consumer's perspective. \*\* That study identified three options for the policyholder: surrender the policy to the insurance company for its lapse value, sell the policy on the secondary market to a life settlement company, or retain the policy until death, possibly utilizing other resources to pay the premium. According to the study:

- If a policyholder has immediate liquidity needs, the settlement value will always be higher than the lapse value because the lapse value is determined at the time the policy is issued, its value is determined by regulation, and does not change when the policyholder's health changes. Settlements, on the other hand, go up in value when the policyholder's health has deteriorated. The shorter the life expectancy of the policyholder, the more valuable the policy is to the life settlement company.
- A settlement may not be the best economic choice for the policyholder who has other sources of financial liquidity, and would not be the appropriate strategy for a person who is simply looking for investment options, particularly because of the high costs associated with a settlement transaction. A life insurance policy is generally a person's highest yielding asset. Retaining the insurance contract and continuing to pay premiums significantly outperforms the strategy of selling the policy to a life settlement company and reinvesting the proceeds in a variety of investment options.

Life settlements are a great source of profits for many participants in the transaction, adding to the high relative cost of a settlement transaction.\*\*\* Among the costs are broker commissions, seller commissions, origination fees, underwriting fees, servicer fees, and taxes to be paid on the proceeds. So, much like in the mortgage business, there can be stronger incentive to generate and close a deal, or generate a high volume of deals, than to ensure that each transaction is actually in the best interests of the senior or the investor. At least one marketing brochure targeting investment professionals not only touts the potential commissions from life settlements, but also emphasizes that additional revenues can be generated from the seller's purchase of other investment products using the

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\*\* "The Life Settlements Market: An Actuarial Perspective on Consumer Economic Value", Deloitte Consulting LLP and University of Connecticut, 2005

\*\*\* According to the Deloitte study, the transaction costs of a life settlement are approximately 50%-67%, compared to 4%-8% for residential real estate, 0%-5% for mutual funds, 1%-2% for bonds and .01%-1% for stocks

proceeds from the life settlement. Citing industry statistics, the brochure notes that almost half of all life settlement transactions result in the purchase of new life insurance.

### The Problem with STOLI: Wagering on Seniors' Lives?

Various stakeholders in the life insurance and the settlement industries are going to great lengths to distinguish between “legitimate” and “illegitimate” life settlements. STOLIs are generally admitted by most participants to be bad. But as always, the devil is in the details. As defined by the NCOIL Model Act, a STOLI is a practice or plan to initiate a life insurance policy for the benefit of a third party investor who, at the time of policy origination, has no insurable interest in the insured. STOLI practices include, but are not limited to, cases in which life insurance is purchased with money or resources from or through a person or entity who, at the time of policy inception, could not lawfully initiate the policy themselves, and where, at the time of inception, there is an arrangement or agreement, whether verbal or written, to directly or indirectly transfer ownership of the policy and/or policy benefits to a third party. One method used to evade the insurable interest requirement is the creation of a trust to purchase the policy.

Some in the life settlement industry have not just focused on seniors who already have long-standing insurance policies they may need or want to sell. The need for enough policies to satisfy investors has led to widespread solicitation of seniors to take out life insurance for the sole purpose of selling it. In its early days, only high wealth seniors were solicited to take out multi-million dollar policies for the purpose of selling them for a quick profit. For example, TV personality Larry King was involved in the purchase and “flipping” of \$15 million in insurance on his life. He has sued the brokers and other involved in those complex transactions to sell and buy insurance policies on his life, claiming that he did not get a high enough percentage of the value on the policies, that he was not informed of the full extent of the broker commissions and fees, that he did not know the identity of the ultimate holder of the policies on his life, and that he was not informed that he has exhausted his insurability and would be unable to purchase additional insurance for the benefit of his family.

Some advertisements are now targeting even low wealth seniors with promises of free cash, offering a lump sum payout in exchange for having a medical examination and taking out a life insurance policy--using financing provided by the purchaser--who then would be made the beneficiary of the policy. According to one flyer being passed out at senior living centers, “there are investors that want to speculate on your life expectancy...They are also willing to give you up to \$50,000 to spend any way you want to—NOW!” Some investors reportedly have sponsored free cruises for seniors willing to undergo physical exams and apply for life insurance while onboard. Others have invited seniors to expensive meals at exclusive restaurants to entice them into a deal.

According to an in-depth investigation first reported in the SF Weekly, some unscrupulous actors have solicited seniors age 72-85, offering them \$1,000 if they fill out a notarized “health survey” detailing their private medical and financial information, and including a durable power of attorney granting access to medical records and, ultimately,

the senior's death certificate.\*\*\*\* Some life insurance agents' pitches for the survey reportedly have included references to "longevity transactions" based on "mortality" and verbal offers of up to \$30,000 to \$50,000 in additional free cash if the agent is able to find an insurance company willing to issue a policy based on the information obtained. The agents pitching the survey reportedly get \$100 for each completed survey form, but could stand to collect significantly more if they were able to initiate a life insurance policy. The senior would be enticed to sign the policy application with a promise of the additional "free" cash. Similar scams have been reported throughout the state, including at least three involving one agent in the Sacramento region. The survey company apparently has terminated its relationship with some of the agents that have been exposed trying to solicit seniors for insurance in these scams.

Because of the two year contestability period, frequently the terms of the deal are complex. If the senior dies within the two years, the proceeds fronted by the person who solicited the sale would likely be treated as a loan that would have to be paid off (with interest, high fees and possibly a percentage of the death benefit) and the remaining death benefit proceeds would go to the senior's estate—assuming it is not challenged by the insurance company for fraud. So the trick is to find a senior who is likely to live two-10 years to maximize the profit derived from the policy. Such schemes appear to be multiplying, and several examples of the sales materials are attached.

### The Role of Investors and the Secondary Market

Life settlements are being packaged into securities and sold to institutional investors. Capital from hedge funds, investment banks and pension funds in search of higher returns is flowing into the secondary life settlement market. Even some major life insurers have jumped into the life settlement market. Life settlement investments are held on the books of many reputable Wall Street investment firms and offered as traded funds for small investors. The U.S. life settlement market has also attracted investment funds from around the world, fueling the rapid projected growth. German banks and investment funds were major early investors in the U.S. life settlement market because of the tax free nature of this kind of investment at the time in Germany, reportedly providing more than \$1 billion in financing for the industry to purchase and bundle policies for investments in its early stages. The German government recently began taxing life settlement investment funds, but the potential returns are still drawing German investors. Institutional investors burned by the current meltdown in the credit and equity markets also may be looking to expand into life settlements. AM Best, the insurance rating agency, has developed best practices guidelines for packaging life insurance policies into bonds, including: make sure no single life represents more than 3.33% of the value and

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\*\*\*\* The "health survey" itself is a legitimate research tool by a well-established insurance research and underwriting firm to obtain information to develop longevity and mortality tables for use by insurers, settlement companies, and other interested parties such as pension funds. HIPAA rules apply to the use of the information, which once aggregated is non-subject specific and all identifying information is removed. The survey is a complex legal document, however, and requires the senior to continue to provide medical information to the company periodically, up to death.

make sure many diseases are represented so that a miracle cure for one won't devastate bond holders.

The problem of inaccurate life expectancy projections is a major unresolved issue for this relatively new industry, and the performance of mainstream investor funds remains to be tested over the long term. There is a direct connection between life expectancy and yield to investors. Much like shopping for an appraisal that best suits the needs of the deal, settlement intermediaries could pick the life expectancy estimate that supports the best projected yield. So far the market has been driven by a relatively few number of high value insurance policies—with an average of about \$2 million per policy. An expansion into larger numbers of lower yield policies, as some smaller providers and investors are targeting, may throw more uncertainty into the market.

In addition to life expectancy issues, a life settlement is not a liquid investment. You can't cash in your principal if you change your mind. There is no return on the investment until the insured dies and the death benefit is paid, but premiums must continue to be paid on the policy to keep it in force. To deal with some of these problems, policies are being bundled into groups, with many policies of similar life expectancy. That bundle could then have a more predictable rate of return balanced by the performance of the group—if one policyholder lives longer than the projection, another may die sooner, but it would be unlikely that all would live longer than projected.

Investments in life settlements are generally regulated under securities laws, and in California by the state Department of Corporations. Generally, persons selling interests in life settlements as investments are required to hold a securities broker license. However, under current California law, the sale of a fractional interest in a viatical or life settlement contract is exempt from the securities law if the product is sold to sophisticated purchasers, high net worth individuals or accredited investors. Regulation and oversight has been slim, and many investors have been victims of fraudulent transactions promising high returns with little to no risk. Federal charges were brought against perpetrators of a life settlement ponzi scheme involving hundreds of senior investor clients in northern California last year who were persuaded to purchase interests in life insurance policies. According to prosecutors in that case, investors were given fake life expectancies for the policyholders, and were told that the investments were guaranteed by a bonding firm that would pay off if the policyholders lived longer than expected. The scheme collapsed when many of the policyholders lived longer than expected, the organizers could not afford to keep up the premium payments, and the bonds turned out to be bogus.

### Implications for the Life Insurance Industry

Life insurance has long been priced based on the fact that a large percentage of life insurance policies lapse because the customer could no longer afford the premiums or no longer needed the coverage. Generally, the policyholder's only options were to let the policy lapse or surrender it to the insurer for its cash value—usually 1%-5% of the face value of the policy. Policies that are sold to investors who continue to pay the premiums

are guaranteed to pay the full death benefit. The insurance industry has argued that if the life settlement market expands dramatically, the overall cost of life insurance will go up, particularly for older purchasers.

The life settlement industry has quoted statistics that indicate that up to 88% of life insurance policies lapse and never pay a death benefit, and that the insurance industry is unduly profiting. This figure may be inflated, however, because it does not appear to take into account the type of life insurance. For example, term insurance was developed as a less expensive alternative to whole life insurance for those with short-term protection needs and low annual costs in the early policy years. Term life policyholders may decide to let a term policy lapse once the need for the policy has diminished. Frequently older term policies are replaced with newer and often less expensive policies. For universal and whole life insurance policies—the primary targets of life settlements—approximately 35% of all policies will lapse by the fifth policy year. For policyholders age 65 and older, the five-year lapse percentage drops to less than 20%.

Mortality risk and life expectancy are key life insurance pricing assumptions. The life settlement industry develops its own pricing models based on medical information that is more current than that used by the life insurer when issuing the policy (assuming it is not a STOLI). If an insured's health has deteriorated since issuance, the policy is clearly more valuable to the settlement market. The life settlement company can therefore offer a higher payout and still make a profit. The insurer, however, cannot raise its premiums on individual policyholders if health deteriorates.

### Steps Toward Filling the Regulatory Void

Currently, there appears to be nothing illegal in the solicitation of California seniors described above. Offers for “free” insurance and large cash payouts are multiplying around the state. The life settlement industry argues that these practices do violate existing rebating, insurable interest and consumer protection laws, and that regulators should be taking action against the perpetrators.

Both the NAIC and NCOIL have approved model acts to regulate the business of life settlements, and at least 30 states so far have passed some degree of regulation, and many more states are considering such legislation this year. All interested parties appear to agree that a regulatory framework should include disclosure of fees and commissions, tax implications, and impact on the senior's government program eligibility, and restrictions on marketing and advertising to prevent fraud. Many of the largest life settlement companies have developed their own best practices, including full disclosure to the policyholder of broker fees and commissions and of all bids received from providers.

The most contentious issue remains how to address the issue of STOLI. The NAIC Model Act, with the support of the life insurance industry, proposes a five-year waiting period before new life insurance policies could be settled, with certain exceptions for situations where the policyholder's personal situation had changed, such as the loss of a job or death of a spouse. The life settlement industry has vigorously opposed such a ban,

believing that the current two-year contestability period is sufficient and that a five-year ban would interfere with the rights of policyholders to profit from a valuable asset. They believe that life insurance policies are personal property and that the owner should have an unfettered right to sell their policy if and when they so choose. They argue that it is up to the insurance industry to properly underwrite and price life insurance policies, based on the assumption that all policies will pay a benefit.

The STOLI issue is complicated by the use of non-recourse premium financing in the purchase of life insurance policies. In non-recourse financing, the insured uses a loan to purchase a life insurance policy and pay the premiums, and the policy is the sole collateral for repayment of the loan. Although normally the insured has an option to repay the loan at the end of the two year contestability period, some reports suggest that some lenders have structured their programs to discourage loan repayment through use of high exit fees and other costs, so that at the end of the two year contestability period ownership of the policy will be transferred to the lenders in satisfaction of the loan or sold to investors or a settlement company. Alternatively, the policyholder may have been promised a percentage of the net profits of the sale of the policy or some other benefit as an inducement to take out the “free” insurance.

How to ensure that non-recourse premium financing is available to individuals as a legitimate method to purchase needed life insurance, while prohibiting the use of non-recourse financing as part of a STOLI transaction, remains the crux of the debate currently underway between the life insurance and life settlement industries. Another issue to be resolved includes which participants in these transactions should be licensed by the state of California prior to engaging in life settlement transactions involving California residents.