



RISK MANAGEMENT

Life, Health, Disability, Casualty & Liability Insurance

Finding the Path to Legitimate Life Settlements



Bill Clark

Much of the confusion about life settlements is caused by erroneously putting life settlements, STOLI, viaticals, and investing in life settlements in the same bucket. This confusion can lead advisors to give the wrong advice to clients or to avoid a legitimate life policy exit strategy that is in the best

interest of the clients. Accurate knowledge is a powerful tool to help mitigate risk.

As the market for life settlements matures and the opportunity for advisors to serve senior clients through legitimate life settlements becomes clearer, more advisors are finding the path to legitimate life settlements.

Life Settlements Defined

Definition: A life settlement is an exit strategy, the sale of an unwanted or underperforming life insurance policy (asset) in the secondary market for its fair market value.

- New wealth is often created for senior clients because a life settlement can produce a lump sum cash payment to the client in excess of the policy's cash surrender value. The financial institution purchasing the policy then owns the asset, pays future premiums, and receives the death benefit.
- A life settlement is an alternative exit strategy for an unwanted or underperforming life policy. Other commonly used policy exit strategies are policy lapse, surrender, 1035 exchange, or change of ownership to charity or family member.
- It is a way to provide your client additional liquidity at a time when raising cash can be very important to maintaining life style.

continued on page 2

Editor's Note: This month's edition focuses on Life Insurance Risk Management from two points of view.

Client-Centric Life Settlements: Bill Clark's article brings you up to date on regulatory changes and "legitimacy" for Life Settlements. Some states have enacted rules to **require** disclosure of Life Settlement options prior to policy surrender. The IRS has given tax guidance. Life Settlements are not in the closet anymore.

Guarantees in Variable Universal Life products: When author Jim Otter, a Canadian member, refers to UL in his article, he really means VUL. In today's interest rate environment, many carriers have withdrawn or repriced their guaranteed products. When the market turns, will VUL with guarantees come out ahead?

IN THIS ISSUE

4

The Expiry Date of Your UL Insurance

6

Risk Management Topics at the Arizona Institute



Finding the Path

continued from page 1

Life Settlement Legitimacy

Legitimate life settlements have been recognized by AALU, ACLI, NAIFA, the Internal Revenue Service, legislators, and some life insurance companies.

- Legitimate life settlements have industry support. Quote from the STOLI Alert—March 2007 published by AALU, ACLI, and NAIFA: “The life insurance community recognizes that many circumstances may lead the owner of a life insurance policy to explore a life insurance settlement. We have always supported and will continue to support legitimate life settlements.”
- Consumer-friendly life settlement legislation recently passed in the states of Washington, Oregon, and Maine that requires life insurance companies to notify policy owners that there are alternatives to the standard policy exit strategies. Similar legislation is pending in several states.
- Some life insurance carriers recognize the role life settlements play in the financial planning process by approving life settlement brokerage firms that agents are permitted to use for legitimate life settlements.
- The Internal Revenue Service recently released two revenue rulings (Rev. Rul. 2009-13 and Rev. Rul. 2009-14) dealing with the sale to and purchase of a life insurance policy involving a third party. These rulings increase the importance of the life settlement discussion as a legitimate and recognized financial service product.

The Confusion

The history of the life settlement industry contributes to confusion for advisors desiring to serve their clients well. Terms are often

used interchangeably when there are distinct differences among the definitions of the terms. A thorough understanding of the differences between life settlements and other products that are confused with life settlements is critical.

Stranger Originated Life Insurance (STOLI): Definition: *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.*

- Much of the confusion about life settlements has been caused by thinking STOLI is synonymous with life settlements. It's not. The “O” in STOLI stands for origination. STOLI is about the creation of a policy and lack of insurable interest before policy issuance. STOLI happens long before policy exit. A life settlement is an exit strategy for an existing life policy.
- Legislation, regulation, scrutiny by carriers, and provider diligence are thwarting STOLI. Both NCOIL (National Conference of Insurance Legislators) and NAIC (National Association of Insurance Commissioners) have proposed different models to deter Stranger Originated Life Insurance.
- STOLI is not a life settlement.

Viaticals: Viatical settlements of the 1990's were controversial and differed from present-day life settlements in several ways:

- Many states consider it a viatical settlement if the insured has a life expectancy of two years or less. Viatical settlements are for the terminally ill. By contrast, life settlements serve senior clients with life expectancies of 25 months to 20 years.
- The viatical market of the 90's sold to pri-

vate investors and had little or no regulation at the time. Most of the controversy was on the purchasing side of the transaction. By contrast, in a majority of states a life settlement involves institutional investors and is highly regulated.

- Viatical settlements are for the terminally ill.

Investing in life settlements: Life settlements as an investment class is one of the fastest growing asset classes. It is a noncorrelated asset with potential for a high rate of return. Many consider life settlements one of the last safe harbor assets available for investment.

- Investing in life settlements happens on the purchasing side of the life settlement transaction. Depending on state regulation, investing in life settlements is offered to private and institutional investors.
- A life settlement on the other hand, happens on the selling side of the transaction when a policyowner sells his policy on the secondary market.
- Investing in life settlements (purchasing side) is not a life settlement (selling side).

Due Diligence

Once you decide that a life settlement is in the best interest of your senior client you will find an unending variety of settlement firms available to offer help. Firms vary in their business models and expertise. You will want to carefully select a firm to partner with that is a good fit with your core values and practices. Your investigation could include questions such as:

Does the life settlement company represent investors vs. the policyowner and advisor? This is probably the most important

question because it reveals who really represents your client.

- Life settlement providers represent the institutions purchasing the life insurance policies. Their business model is to purchase the policy for the least amount and secure the highest internal rate of return for the fund.
- Life settlement brokers represent the owner of the life insurance policy. Their job is to negotiate with all of the providers licensed in the state where the life insurance policy is domiciled to secure the most competitive offer for the client.

Does the settlement company practice transparency, disclosing the entire offer including commissions?

- Lack of transparency has been a major issue in the life settlement market.
- All gross offers should be disclosed to you before completing a transaction.
- Ask for the official sheet the broker receives from the provider.

Have any legal or disciplinary actions been taken against the company or any individual associated with the company?

- It takes years to earn your good reputation. Protect that reputation by knowing who you are working with as a settlement partner.
- Due diligence on your part is essential. Google is a powerful tool!

Is the settlement company licensed in all states that require licensing?

- Ask the life settlement company you are considering for a copy of their license in the state where the policy is domiciled.
- If they cannot produce it, they may be using another firm's license.

continued on page 7

Finding the Path

continued from page 3

- Your client's privacy must be protected by only working directly with a licensed company.

Does the settlement company sell life insurance or any other products that could compete with you?

- Find out if the life settlement partner you are considering has other lines of business. This may or may not be what you are looking for. Why bring a competitor directly to your client?
- It could be very important for you to work with a life settlement company that is focused entirely on the life settlement market without the distraction of other lines of business...they're on top of the life settlement business.

Summary

A life settlement is one of many exit strategies that should be explored when your senior client no longer wants his/her life insurance policy. The secondary market for life insurance is regulated in a majority of states and is supported by institutional funds. As an advisor, it is important to protect your reputation by having a clear understanding of the differences between legitimate life settlements, STOLI, viatical settlements, and investment in life settlements. Confusion surrounding the differences can lead advisors to give the wrong advice to clients or to avoid a legitimate life policy exit strategy that is in the best interest of the clients. Investigate life settlements so you are informed of the potential and can advise and service your clients appropriately. Select a life settlement company that is in position to meet you and your clients' expectations while enhancing your reputation in the financial services market. ●

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