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Session 32PD
The Evolving Viatical and Life-Settlement Market

Track: Nontraditional Marketing

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Summary: The viatical settlement market, which began in the '80s in connection with AIDS, has now matured and spawned a related, and possibly bigger, life-settlement market.

MS. TRACI J. LILLY: The presenters today are Michael D. Quinn, Gerry H. Goldsholle and me.

Mr. Quinn is currently the founder and president of Estate Trust, Inc., which is a national distribution center providing aftermarket sales of existing life-insurance policies. Mike has a bachelor's degree in business administration and economics from the University of Maryland—College Park, and has a CSA designation. He also has held various CEO and chief operating officer positions since 1976, and founded the Wye Group in 1977, which is one of the largest independent mortgage, banking, insurance, financial and real-estate service organizations on the East Coast.

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I'm an Associate of the Society of Actuaries, and my current responsibilities include traditional life reinsurance pricing at GeneralCologne Re. I also have the opportunity to do some research and risk analysis of the non-traditional developments in the life insurance industry, including life settlements. My background includes asset-liability modeling (ALM) work for Guaranteed Interest Contracts and other institutional products. I am going to give you a walkthrough of a typical deal structure that illustrates the players involved. Then I will discuss some of the implications that these products have for life insurance companies and longevity risk takers.

Gerry Goldsholle currently is the CEO of Advice Company, which sponsors a legal Web site for consumers called freeadvice.com. Mr. Goldsholle started out as a trial lawyer for the SEC, and then held various positions at Metropolitan Life Insurance Co., including president and CEO of Metropolitan Life Marketing Corp. While he was at Metropolitan Life, he created the first accelerated death benefit life insurance policy in North America. Mr. Goldsholle is a graduate of the College of William & Mary, Columbia Law School and the Stanford School of Business Executive Program. In October 2000, Mr. Goldsholle served as chairperson of the First Viatical Academy. Mr. Goldsholle is going to be providing a description of regulatory matters.

MR. MICHAEL D. QUINN: My job is to provide you with a primer on viatical and life settlements. If you do not know much about this business, hopefully, I will be able to build a platform that will help you understand the next two presentations.

Before I get into the basics of the business, I want to make a few brief comments about how the viatical and life settlement business has evolved. I am almost 67 years old, and I have been in the insurance and financial services business my entire career. I came out of the military and went right into that business sector. In my experience over all those years, I've had the pleasure of watching different products evolve and, obviously, was very conscious of the timing it took for different financial services to evolve. Much like everything else today, the evolution of things is a heck of a lot faster than it used to be. That, essentially, is true with what is happening in this business.

In the mid-'80s, there was no such thing. Nobody ever heard of a viatical settlement, much less a life settlement. There's a little friendly dispute about these dates. But in 1988 or 1989, the first commercial transactions (by definition) took place. The one that is most well-known was put together by a company in Albuquerque, New Mexico. It was a general insurance agency operated by the Worley family. So they are generally credited with having developed and closed the first commercial viatical settlement.

The viatical settlement business from that point, '88/89 through mid-1994, was the classic mom-and-pop business. (That includes our company, which was founded in 1990.) Over the years, more and more companies came into the business. But across the United States, from one coast to the other, every one of those firms was small. There was no institutional presence in the viatical settlement business, whatsoever. That was the case until 1994. In 1994, CNA Insurance Companies entered this business through a newly created subsidiary called Viaticus, Inc. That was a definite turning point in this business.

In 2003, the mom-and-pop side of this business still exists, but it exists primarily in the distribution of the business (my side of the business), the side of the business that's involved with the introduction of viatical life settlement. On the provider side—the fund side, the buyer side, if you will—that sector of the business is heavily dominated by institutional fund providers such as insurance companies, Wall Street firms, some domestic banks and quite a few foreign banks.

These funding agencies, in some cases, are portfolio buyers. In most cases, these fund providers actually function as aggregators—often for their own account, but they're still aggregating product, which they wrap in one form or another into a security. Often, as is the case with one of the larger German banks, the product gets wrapped, and then the security that is secured by those assets is sold to that bank's customers. In other cases, other securities are created and sold to institutional investors. So the business started in '88/'89, with mom-and-pop, private investors and no institutional funding. Today, it is dominated by institutional funds.

On the distribution side—the customer side, if you will—there are some changes taking place. In 2003, we will see at least two mergers of distributors in this business. What's going on there is consolidation—companies joining together to create larger platforms that are better equipped to deal not only with their clients, but also with institutional fund providers.

I have just a couple other general evolutionary comments—I would say that the dynamics are in place for a permanent shift of this asset class into a financial product that is routinely rated by rating agencies and sold to institutional buyers. That is not the case today, but I would argue that, that is not far away. The real-estate finance business in this country is national in scope. There's no such thing as local financing; it's all national, it's dominated by Fannie Mae, Freddie Mae, Ginnie Mae, and so forth. In the '60s, that was not the case. In the '60s, residential real-estate finance looked amazingly like the viatical and life settlement business does today. That is to say, it was localized; it may have joined with regional institutional players. Then with the advent of Ginnie Mae securities, almost in the blink of an eye, that business shifted from local to national. I would suggest to you that, that is exactly what will happen to this business.

What is the difference between viatical and life settlements? The difference between the two is their different needs. Life settlements, which are a dominant product today, actually evolved from the viatical settlement business. Again, this is by way of a primer, the viatical settlement (as is a life settlement) is a salable life insurance policy at a discount from its face value or a discount from its net death benefit.

In the case of a viatical settlement, what the fund provider is looking for is a potential seller who has either a terminal or a chronic illness. The original Health Insurance Portability and Accountability Act (HIPAA) made the proceeds of a viatical settlement free from federal income tax, provided the insured person has an illness that reasonably can be expected to result in death in 24 months or less. There is also a caveat that requires that that transaction take place with licensed regulated fund providers, if those regulations are in place in that state. The law also provides for a viatical settlement, so to speak, for the chronically ill. There is some methodology that details this. It's possible for a chronically ill person to sell off, in pieces or in stages, parts of a policy, such that they can collect roughly $64,000 a year, free of federal income tax. As I say, the driving element here, in the case of a viatical settlement, is that the insured person is very sick and has a very short life expectancy.

The difference in payouts on these two—viaticals and life settlements—is that in viatical settlements for which the medically diagnosed life expectancy is 24 months or less, the proceeds from that sale are free of federal income tax. They are not necessarily free of the relevant state tax, but certainly free of federal income tax. In real world terms, it's possible—depending upon what fund provider one is dealing with—to get a viatical settlement in a situation for which the life expectancy is something beyond two years. However, in those situations, the likelihood is that the proceeds would be subject to federal income tax. The payouts on those viatical settlements range anywhere from 50 percent to 80 percent, depending upon the life expectancy and pricing appetite of the fund provider.

In the case of life settlements for which there is no requirement for the terminal illness or chronic illness, the life expectancies are quite different than a viatical settlement. (Let us just say it one last time. People that are involved in viatical settlements are very sick and have short life expectancies.) The sellers of insurance policies, who are getting life settlements, often are not even individuals; often they are companies, they're trusts, banks and individuals. The actual owners of those policies are all over the screen. Because life expectancies are typically much longer—five to 15 years—the typical payout on life settlements is much longer. The payout on life settlements is anywhere from 10 percent to 30 percent of the face of the net death benefit.

When you look at a life settlement, you might ask yourself what is going on? The life settlement business is a secondary market for existing life insurance. The situation is now such that it is possible for an owner of a life-insurance policy—if the circumstances with the insured fit the right profile—to have an alternative to a lapse or a surrender of a life-insurance policy. It can be a very important alternative.

Obviously, if an organization or an individual has made a decision to dispose of a life-insurance policy for whatever reason—maybe it's no longer necessary, no longer affordable; they just plain don't want it, don't need it and it's got to go away—surrender or lapse are the classic options. The life settlement is another option, to the extent that one takes advantage of a life settlement. Clearly, you would never do that unless the life settlement was providing more money than was available from the surrender of a policy.

You might wonder who manages to make this happen. I have been in this business since 1990, and I am still astounded at the number of professionals that really know nothing at all about life settlements. This is one of those financial services that is not used every minute of every day. It is often, for one reason or another, not a solution that works for people. But having said that, in certain circumstances, not only can it be useful, but also it can represent a significant, positive difference in money to the sellers.

Insurance professionals, financial planners, CFOs of corporations have become aware of this. As they should, because there is a lot of corporate-owned life insurance in this country—certainly much is owned by attorneys, particularly elder-law attorneys. Bankruptcy attorneys and business consultants also have paid attention to this. A life settlement, unlike a viatical settlement, is event-driven. It is situational.

In the United States, we are in the early stages of some major transfers of wealth. We are talking about the movement of money in the trillions, not the billions. The wealthy or high-net-worth segment of our economy is large and growing a lot faster than nonaffluent households. As a consequence, estate planning needs and the resulting potential tax consequences involved in all of that are affecting more people. There are more people in the United States who are having their personal financial situations reviewed.

I never have actually seen a review that did not at least touch on the life insurance portfolio, or the schedule of life insurance that the client has now. Oftentimes, there are recommendations about reconfiguring life insurance, because of changed circumstances, changed needs, and so forth. When that happens, that is the time when someone will pause for a second and ask whether or not a life settlement might be an option.

The last part of that has to do with American business. Anybody who was ever been involved in a business deal involving a bank or some financing entity knows that, more often than not, life insurance also was involved, because the lender required it. There is just a lot of life insurance in the United States that is business-related. When the need for the insurance has become outdated, then often the life insurance policy is literally unnecessary, and is lapsed or surrendered. It is an opportunity for a life settlement.

What does a typical life settlement look like? If the insured person is male, he certainly is 65 or older. If the insured person is female, she is 70 or older. The average age in this business on life settlements is between 72 and 73 years of age. The average policy that has been involved in a life settlement is around $1.4 million to $1.5 million.

As I said earlier, there are a number of institutional fund providers in this business. They do not all have the same investment appetites. As a consequence, they do not all have the same investment criteria. Sure, the basics are there—the life expectancies, and so forth. But it would be very unusual to submit a qualified case to four institutional fund providers, and have those institutional fund providers, who independently are looking at the same information, come back with identical offers to purchase. That does not happen. Usually, they come back within a range, but there will be a material difference in what they decided that policy would be worth to them if the owner of the policy opted to sell it.

What kind of policies? Almost any kind of life insurance is eligible—universal life, whole life, even term insurance (if it's possible to convert the terms and conditions to make economic sense), joint survivor and certain kinds of group insurance. As far as the ownership, I mentioned earlier that in addition to individuals, there are trusts, companies, corporations, banks and so forth.

There are quite a few variables involved in the consideration of a policy when an institutional organization is looking at an application. The policy structure, obviously, is something that you pay a lot of attention to—the insured person's age, current health condition and how health circumstances have changed since the policy was originally issued. If health circumstances have changed, and if there are attendant problems now that did not exist when the policy was written, that would certainly affect the price. The cost of the insurance, how much the premium is, is certainly an issue. Obviously, if a company buys the policy, they have to start paying the premiums on it. So the amount of premium are very important. The relationship between the premium and the amount of insurance has to be relative. That usually means that the total cost of the insured person should be somewhere between 3 percent and 5 percent of the net death benefit.

As far as the transaction itself, it is a very straightforward process. As I mentioned earlier, usually an intermediary—be that an insurance agent, a financial planner or an attorney—discusses this option with the client. The client opts to find out what the policy is worth, and an application is generated. The application form always is made available by the institutional fund provider, either directly or through their representatives. The application is completed and submitted to the fund provider or the fund provider's agent, along with some other information. Such additional information might include a copy of the policy, an illustration of the policy, authorization forms to secure verification of the details, the economic details of the policy, legal details of the policy and a release that allows complete access to medical records for the last couple of years. I should mention that, as far as I know, no medical exam is required; it is a review of medical records without a medical exam.

At the conclusion of that review, if the institutional fund provider is interested, they will make an offer to purchase the policy. That usually is done by phone. That call is followed up by a formal letter with an offer to purchase. If the seller accepts the offer, that usually requires written acceptance. Shortly thereafter, there is a closing package that is not dissimilar from what you would see if you refinanced your house. It is a contract to sell the policy. Those papers are signed and returned to the fund provider. At that point, the funds that have been offered to the seller are deposited in an escrow account. Then the forms are submitted to the insurance carrier, requesting a change in beneficiary and ownership. Once those changes have been made, there is a transfer of title, and the funds are released in escrow and wired to the seller's bank account. That completes the transaction. There is always a period of recission available in these transactions.

Just a couple of comments about the results of the transaction—confidentiality always has been a primary concern, and significant assurances have been made to the consumer and the professionals that represent them that confidentiality will be observed and protected. Obviously, this year, with the changes in HIPAA, now confidentiality is mandated, so one does not have any choice. For those of you who are familiar with the Medical Information Bureau, that group is not involved in these transactions, at all.

I have just a couple of comments about the industry players. There are institutional scale providers in this business. One of the largest is Coventry First of Fort Washington, Pa.

The environment for this business is somewhat regulated and getting more regulated by the minute. The momentum for regulation is there. It is rolling. Unfortunately, it is a hodgepodge. Every state has its own version of how the business should be regulated. Some states regulate viatical settlements and life settlements. Some states just regulate viatical settlements. Some states do not regulate. For example, Maryland has no law yet, whatsoever.

There is another observation that I would make. A family member or good friend might ask your opinion about life settlements. Please caution them that if someone gets involved in one of these transactions, they should make sure that they are working through an institutional channel. If the companies are in distribution, they should be talking to companies that represent and work only with institutional fund providers. They shouldn't have just anyone looking at their policy, coming up with valuations, and so forth, but only legitimate institutional fund providers. In other words, this is not a business in which one should be involved with other private people. There is potential trouble there. This is a business in which you want to deal with large organizations, because therein lies the safety.

Just one last comment on tax status—I mentioned earlier that under HIPAA, with viatical settlements, the proceeds are free of federal income tax if the life expectancy is 24 months or less. On the life settlement, you do not have that provision. The federal tax-free benefit is limited to viatical settlements. No such benefit exists in the case of life settlement.

What happens in a life settlement? Chart 1, at the end of this manuscript, shows an example of a case in which the insurance policy is a $1 million policy. The cost basis of the policy at the point when it was sold was $50,000 dollars, and the cash-surrender value (CSV) of the policy was $60,000. The $1 million policy was sold for $200,000 in cash. What are the tax consequences of that? Of the $200,000, the first $50,000—in other words, up to basis—is tax-free. The difference between $50,000 and $60,000, which is the cash-surrender value net if it were deducted on the tax basis, is taxed at ordinary income rates. The difference between the $60,000 and $200,000, or $140,000, is taxed at capital-gain rates. Most tax advisors would wrap that in the tax return as a long-term capital-gain tax.

That is a super-fast, fly-by primer on viaticals and life settlements. It is a fairly complex business.

FROM THE FLOOR: You mentioned the words 24 months, but I have also heard "reasonably expected to result with a death in 24 months." Does the phrase "reasonably expected" translate in your mind to life expectancy?

MR. QUINN: When the regulations were written, nobody, not even the federal government, was prepared to play God. So they came up with this language. It is a little mushy, but what they are saying to the medical practitioner is, "We're not asking you to play God. All we're asking is that, in your professional opinion, can you state if there's a reasonable expectation that your patient will pass away in 24 months." That should be secured in writing. It does not get sent to the IRS.

MS. LILLY: I am going to expand somewhat on some of the points discussed thus far. In doing that, I am going to give you another brief overview of viatical and life settlements. Then I am going to describe a typical deal structure, and look at the different players that are involved. I am going to describe the implications that these products have had for life insurance companies. Then I will move on to how life insurance companies have reacted or could react to this business. Finally, we will look at the involvement of the longevity risk taker, and what concerns that particular player might have.

Whether you are talking about viaticals or life settlements, you are talking about a policyholder that has, usually, a whole life or universal life policy. Whole life and universal life are probably more common, because they do not expire. However, there are some deals that are made with term policies. The risk, of course, is that the term policy would expire, and then the settlement company that's holding the policy must pay the annual renewable term premium, which will just keep going on.

The settlement company can lessen that risk by only buying longer-term policies, like 20-year or 30-year term policies, or anything for which the remaining level term period is longer than the person's life expectancy. Or you could alternatively use a convertible term policy.

The issue here is that this policyholder most likely was issued standard or possibly even preferred insurance, but later on became somewhat impaired or chronically ill, to the point at which the present value of the death benefit is greater than the cash surrender value of the policy.

There was a point in the industry much earlier on, when some of the smaller mom-and-pop companies were getting burned. People would get a policy issued, knowing that they were impaired. They managed to get standard risk insurance, and then turned around and sold it immediately to a settlement company. More recently, settlement companies have been getting around this occurrence by refusing to buy anything within the contestable period.

The policyholder sells the policy to the settlement company, and receives the present value of the death benefit, less whatever the settlement company's expenses are. At that point, the settlement company owns the policy and pays the future premiums to keep the policy in force, and then collects the death benefit upon the demise of the insured.

I just want to touch a little bit on the target markets for viatical and life settlements. In viatical settlements, you are talking about people that are terminally ill, and this has historically been AIDS patients or people with certain types of cancer for which life expectancies are usually less than 24 months. However, it can be somewhat longer than that. But regardless, this would be a very limited market, since you are just talking about a small subset of potential impairments.

But in the life settlement market, you are talking about anybody who has become chronically ill or impaired since the issue of his or her policy. The life expectancy could be anywhere from two years to 15 years, or possibly even longer. Typically it has been somewhere in the range of seven or eight years. So obviously, this could be a potentially unlimited market.

Now I will start to build up the overview of a typical life settlements deal structure. You start out with no life settlements involved. You just have your policyholder, your beneficiary and the life insurance company and the cash flows between them. In a basic structure for a life settlement deal, you would have your origination or settlement agent that would be making this cash settlement to the policyholder. This is typically done by establishing a trust. So the cash flow then would go from the settlement agent, through the trust, to the policyholder. In return, the policyholder has the beneficiary sign off on the policy and reassigns that policy to the trust. So the trust then becomes the beneficiary of the policy. Now, to keep that policy in force, the settlement agent then pays premiums through the trust to the life insurance company. In turn, the life insurance company will pay the death benefits back through the trust to the origination agent.

What does this mean for life insurance companies? An insurance company product is going to be priced, based on an assumed lapse rate. To the extent that now we have the settlement contract in place, policies that otherwise might have been surrendered are now going to be kept in force. So to the extent that, that impairs the original surrender assumption, it could result in lower profits for the insurance company; similar to what happened in the "term to 100" market.

What are life insurance companies doing, or might they do about this business? There are several different approaches that could be taken. One would be to decrease the surrender assumption in pricing. This, of course, possibly is going to lead to an increase in product prices, which really would be a non-competitive response, because the policyholder does not gain anything from that.

There is another thing that insurance companies are beginning to do that also could be seen as a noncompetitive response. Some companies are starting to disallow any policy assignment to a trust or to a non-related beneficiary. Another possible response would be to add product features that will compete with life settlements. This, again, will lead to increased product prices, but it is a much more competitive response, because now at least the policyholder is getting something for their increased premium.

Another possibility would be to get agents or producers involved. When this settlement takes place, have the agents talk to the policyholder and get them to use some of the proceeds from the settlement to purchase a critical illness policy or long-term care, or something of that sort.

Finally, there is always the option to do nothing. This only is going to be a viable option if the life settlement business is going to be temporary, which does not seem to be the case.

Going back to our basic life settlements deal structure, it takes a lot of capital to fund all these cash settlements to policyholders. You get outside investors involved.

With outside investors involved, all of the previous players are still the same, except that you have a new player, the outside investors, who are placing the majority of the capital for the cash settlements into the trust. In return for their capital outlay, they receive coupon and principal payments over time. Typically, the settlement agent also makes an equity payment into the trust, so they also have a stake in the risk. Now, the investors can be all in one pool, or they might be divided into several classes, like a collateralized-mortgage obligation (CMO). In that case, the last investor class or tranche would not be paid fully until the last policyholder in that pool is deceased.

Just expanding a little bit on that comparison to a CMO investor—on the CMO side, you have the investor receiving cash flows based on the underlying mortgage principal and interest payments. Of course, the timing of the cash flow is going to depend on what the actual mortgage-prepayment speed turns out to be, versus what was estimated at the beginning. Now, the risk is a prepayment risk that the investor is going to get their principal back too soon. However, there is an upper bound on the timing of the return of principal in that an investor in a CMO knows that they are going to get their principal back at least by the ultimate maturity of the underlying mortgage. So, if 30 years is the longest mortgage in the pool, then they will get their investment or their principal back by then.

On the life settlement side, however, the cash flows are based on the underlying life-insurance policy death proceeds. The timing is going to depend on what the actual life expectancy is, versus what was estimated. Now, of course, there is no upper bound, because the life expectancy could be however many years longer than what was originally estimated. So in this situation, we have the primary risk as longevity risk, rather than prepayment risk.

Settlement companies then look to longevity risk takers, so that they can create an upper bound, a final ultimate maturity, by which all investors will receive back all of their principal. With the longevity risk taker involved, the settlement company can then set a maximum investment horizon. For a life settlement product, that might be something like 10 years. If your underlying life expectancies are in the range of two to 15 years, you might guarantee that everybody is going to get their money back by the end of the 10 years.

The longevity risk taker then receives a risk premium from the trust for taking on this risk. At the end of the investment horizon (that 10-year period), if there are any policies remaining in the trust, the risk taker pays the trust a recovery amount, which would be equal to the face amount of the outstanding policies at that time. The investors receive their final principal payment, and the investment matures.

Now, the risk taker has several options at the end of that investment horizon. They can either maintain that relationship with the trust and the life insurance company by paying the policy premiums through the trust and receiving the death benefits as the policyholders become deceased or they can purchase the remaining policies from the trust and pay policy premiums and receive the death benefits directly from the life insurance company. You would have cash flows going from the longevity risk taker directly to the life insurance company, with the trust out of the picture.

A third option would be to let the policies lapse at that time, and the entire deal would be done.

So what concerns might longevity risk takers have with participating in a deal like this? First of all, there is some debate over what this really is. It seems to be primarily a financial guarantee. I know that settlement companies have looked to reinsurance companies to take on this longevity risk. The biggest problem that reinsurers have is, is this really reinsurance? Because your client, in this case, is not an insurance company. Now, a reinsurance company possibly could get around that by using an insurance company front to deal with the trust. But then, there is still some question as to whether that is really something that should be done.

Another concern is that a lot of times the settlement companies will contract with an independent underwriting firm. In that case, the underwriters are being paid a fee to provide a life-expectancy assessment for the policyholders. In this case, you have this deal that depends very much on the life-expectancy estimate. To the extent that that life expectancy estimate is too low, you are going to increase that longevity risk. On the contrary, looking at it from the life settlement underwriter's perspective, if you are providing a lower life expectancy, you're going to be able to give that policyholder a larger cash settlement. So you are more likely to get that business. This can create a conflict of interest, which is another concern that some of the potential longevity risk takers have had.

Another one, especially from the viewpoint of a reinsurer that might be considering becoming a longevity risk taker, is potential negative reaction from life insurance companies. If you, as a reinsurer, are dealing with this particular life insurance company as a traditional business client, it may be seen negatively if you are helping settlement companies.

Finally, although it is not so much an issue as it used to be, but the viatical and life settlement industry still does receive some negative press.

Although reinsurers have been hesitant to get involved in this business as longevity risk takers, one way that reinsurers can get involved is by providing underwriting services to life settlement companies. Many reinsurers have expertise in underwriting impaired lives. Reinsurers can also get involved on the product development side, working with the development of critical illness products or long-term care insurance to help direct companies compete with the life settlements market.

In summary then, we talked about what viaticals and life settlements are. We walked through a typical deal structure, and looked at some of the different players that are involved. We looked at the implications that life settlements are having for life insurance companies, some of the ways that life insurance companies can react or have been reacting, and some of the concerns for longevity risk takers.

FROM THE FLOOR: You puzzled me a bit when you talked about losses of profits. Of the profits, you gave the example of "term to 100." "Term to 100," of course, is very heavily lapse-supported. I agree with you there. But in a more run-of-the-mill UL or whole life policy, the fundamental dynamic still is that low lapses help you. Is it the more theoretical problem that you have got to take more mortality deterioration into account because of the greater potential for anti-selection? Isn't the problem with the mortality deterioration assumption, rather than the lapse assumption?

MS. LILLY: Yes, because in this situation you have a life that has become impaired after the original issue date. If this person is going to be selling the policy to a settlement company, it usually is done because they need the cash for something. A lot of times, it is done to use the cash for medical bills. Or in the case of elder settlements, these life settlements might be used to enhance retirement income, different things like that. It is a situation in which the policyholder probably does not have the means to continue paying the premium, and their health has been impaired. So by continuing the policy, you are now going to have a sooner claim than what you originally had anticipated; it might have been a lapse otherwise. These impaired people who are persisting are possibly degrading the mortality of the overall pool, and that possibility works to decrease profits.

FROM THE FLOOR: For the longevity risk taker, is there any standardized way in which they reserve for that obligation of recovery payment?

MS. LILLY: I don't know of any standardized ways for reserving for the recovery payment. However, there are a number of different theoretical ways of looking at it. I think that some companies have been doing some stochastic analysis to determine what the recovery payment might be. But remember, purchasing the policies is only one of the options the longevity risk taker has. Whether the longevity risk taker must establish a reserve would probably depend on the option that the risk taker wanted to take at the end of that investment horizon. If they plan to just let the policies lapse at that point then reserving for a recovery payment is probably not necessary.

FROM THE FLOOR: I was just wondering if they were holding reserves, or if they were handling them on a pay-as-you-go basis.

MR. GERRY H. GOLDSHOLLE: First, I want to make a disclosure. I do not represent any viatical brokers or settlement companies, nor do I get involved with insurance companies, in terms of helping them with the viatical problems that they may encounter and have encountered. I am looking at this semi-academically, from the perspective of a lawyer for nearly 40 years and a strategic planner and business executive for 23 years. Let me simply suggest that viatical and life settlements are not something small. This is major. Huge dollars are involved, and increasing dollars will be involved. In testimony before Congress, the Florida Insurance Commission reported that between 1996 and 2000, in Florida alone, 14,000-plus life policies, with a face value of nearly $3 billion were sold. In fact, the viators were paid nearly $1 billion. A Grand Jury in Florida found that there was fraudulent intent involved in approximately half of the transactions that it had investigated.

An Ohio State Federal Task Force began work in 1999. The group found that 3,000 investors were defrauded of $100 million, 32 viators fraudulently purchased five or more policies, 85 life-insurance companies were defrauded. Now, life settlements are the hot item. Insurance industry people are trying to recruit agents to settle viatical settlements, and trying to get lawyers to push viatical settlements to their clients. They are becoming a very hot item. I am talking about life settlements, primarily.

As a strategist, I have a concern. If I have a concern, you should have a fear, because what if use of viaticals and life settlements grows? I see it as a zero-sum game. I see new financial market fund providers coming in that are very sophisticated. What they make, somebody else loses. The losers, as I view it, are either individual policyholders, who the life insurance companies are trying to serve; the corporate policyholders, who the life insurance companies are trying to serve; or the life insurance companies themselves.

There are potential systemic impacts for the public, the industry and the financial markets that are involved with viatical and life settlements. I ask you whether or not what we need are changes in life product design, in the terms and the pricing. I look at certain things such as waiver of premium provisions, group policy conversions and the notice that must be given at the various times of a transfer. I look at the persistency lapse assumptions that are built into the product. I look at the cost of fraud, and I do not think you can underestimate that cost.

Part of the problem is the impact of asymmetric information. When I apply for a policy, I know certain things about myself that I hope the insurance company will never find out, no matter how many medical exams they give me, blood tests they give me, attending physician's statements they obtain. I can think of two examples.

One was a policy on a basketball player, who turned out to have AIDS. The brokers convinced us, almost, that he did not need to be examined, because every American could see him play on the court every day. We said, "No, take a blood test." Needless to say, he did not get the policy.

The second was a policy involving a very famous magazine publisher. His application came in on a Friday. He died on Saturday. We did not issue, and it was not bound. But there is asymmetric information that is out there, and genetic testing that binds the insurers, but not the applicants. Even if insurers could go out and get genetic testing, there are practical cost-competitive considerations.

There are post-issue persistency questions, as well. Because if you ever talked about adverse selection, this is a circumstance in which you don't surrender a policy until you make sure that there really is no value. Then you surrender only if you are convinced that you cannot get much of anything for it.

Now, I am not talking about differences only in degree. Life policies, historically, are paid on death, but at least the applicant's motivation to mislead, to take advantage, that has always existed, was sort of altruistic. The deception benefited his or her survivors, charities or company. The insurer's underwriting practices and standards that have always been applied increasingly are being restricted now.

Viaticals create greater incentives to deceive. I suggest that they are more significant than the incentives to deceive with disability insurance or health insurance. We had this problem 15 years ago, when we created the first policy that paid benefits upon diagnosis of a critical condition that typically would result in death.

We copied this policy from the South African model in which these policies were the mainstream policies, except there is a big difference of which we were unaware. In South Africa, the policy is incontestable forever. It is not incontestable in the U.S. Typically, it is contestable for two years.

Should we be concerned, because owners always had the right to assign their policies? There was income-tax treatment if there was a sale, which has been very well explained. There were always some private sales. But they were relatively rare, and they fell under the radar screen. It was not until the AIDS outbreak that there was a real need. You had individuals with very short life expectancies that wanted cash. Often, the prime target, initially, was the gay community, gay men with no dependents to protect. Insurers made some compassionate efforts. I think Ron Barbaro of Prudential Canada, at the time, deserves a medal for having come up with a compassionate program to advance portions of the death proceeds. We did the same at Metropolitan Life shortly thereafter, with partial payments of death proceeds.

But between the bureaucracy, the inertia, and the overflowing legal and tax worries, things were slow. Private industry, in the form of mom-and-pop viatical companies, were fast. A whole industry emerged. It was mom-and-pop, and it became more sophisticated. It had the appearance of a sure thing.

In 1996, there was an initial public offering of a viatical company. Its timing was terrible. Later that year, the protease inhibitors were announced. They significantly extend lives, and most of the companies went insolvent.

Now, we have a migration to the life settlement business or the senior settlement business. We are targeting insureds in that business with relatively high mortality. The buyers engage in reverse underwriting, which is akin to what they do on substandard annuities. Of course, there are significant medical privacy concerns, notwithstanding HIPAA and other laws and promises to protect confidentiality. But significant funds are needed to buy and carry policies, particularly those of younger people, people who aren't going to die within two years. Even in the viatical business, significant amounts of money were needed.

Where did the money come from? Typically, it came from unsophisticated individual investors. How did the unsophisticated investors part with the money? There were very aggressive sales guys that we used to prosecute when I was with the SEC. They would sell these as investments to unsophisticated investors. They would not bother disclosing the risk. They would say, "It's a sure thing. It is guaranteed. You are going to get your money. It is backed by solid companies."

The buyers' risks, of course, were the longevity, cost of capital, validity of the transfer and policy, and solvency. This was a very inefficient marketplace. If you own 100 shares of InsWeb, you can try to find a market to sell it at—the NESD, the NASDAQ, the unlisted stock market. You sell it on the counter. You know what the pricing is. There is no such marketplace when it comes viatical settlements or life settlements. There is lack of transparency in volume, in the terms being offered and the pricing. There is a dramatic contrast with other flexible markets that this country has thrived under.

In the beginning, there were high—in fact to call them high is an understatement—there were exorbitant fees for the solicitors, for the brokers and the agents that were involved. Of course, they would argue that there was difficulty in locating, educating and convincing policyholders to sell, and convincing investors to invest. Initially, there were very few specific laws or regulations.

If you learn nothing else from my talk today, I want to give you "Law and Legislation 101." Laws are not God-given. They do not result from somebody coming down from on high with 10 tablets. The legislation that we have, in almost every instance, is reactive. Legislators solve problems of the past just as the French generals built the Maginot line in France to protect against another French warfare circumstance of World War I.

The legislators' primary focus is their constituents, their investors, the investors to the policyholders, the beneficiaries. Life insurance companies and agents have influence, but it is secondary. It is as employers and contributors. If you have ever seen legislation made, it is not a pretty sight. I think Otto von Bismark described it as: There are two things that you do not want to view, the making of sausages and the making of legislation.

I suggest that if you are sitting in your insurance company chair or in your consulting chair, one of the best things that you can do is think, "What would I want the law to be to prevent the problems that may befall society and my company?" Existing laws can be changed, notwithstanding your lobbyists, who do not want to do the work, particularly if they are in-house lobbyists and they are not paid more for doing it. New laws can be enacted, and laws are far too important to be the domain solely of the lawyers. They have business consequences, and it's about time business people paid attention to them.

What have been the legislative and regulatory responses, and the industry responses? I am going to cover those quickly. Much of this leads to the viatical business, which was a different business than the life settlement business. One problem is whether they were buying old policies that were out there or were generating new policies. It is very hard to find old policies if you are in the viatical business, and sometimes even if you are in the life settlement business. It is far easier for people, particularly if people are corrupt, to create new policies that would qualify for a quick buck. So they engaged in clean-sheeting.

The Africans lied about their medical history. They relied on the jet issue of non-medical process. Some of the companies even warehoused the policies. They held them for two years until it became incontestable. Impostors took the examinations, examiners were bribed, fraudulent medical records were presented, coverage was purchased with a pure intent to viaticate. There was no insurance purpose. It was buy it, sell it. In fact, the people who bought the policies very often were paid a percentage of the face amount of the policy for being the applicant of convenience. Trusts were used, as they make it easier to disguise what's going on.

There are questions as to whether there is insurable interest. The premium was paid by the agents and the brokers in many cases. There was also fraud on the viators and the policyholders. They were misled as to available alternatives. If you look at some of the history, the cash surrender values in some cases exceeded the amounts that they were paid. They could have done policy loans. The companies were offering accelerated-benefit provisions. Sometimes they wanted to get rid of a policy, because they could not afford the premium, even though they were disabled and there was a waiver of premium policy rider built into their program.

The sales charges and fees, in some cases, were unconscionable. Pennies on the dollar for viatical settlements, particularly to old people. The commission all too often exceeded the amount that was given to the policyholder. There were other games that were played.

There was also failure to disclose the risks and burdens, and the rights that were being granted to the purchasers of the policy. They didn't discuss the tax consequences and the eligibility for public benefits, creditor's claims, legal obligations to others and—perhaps the scariest, and I don't have anything but antidotal evidence—some of the buyers weren't the type of institutional buyers we've been talking about. The institution may have been the Carlo Gambino crime family.

Then to add insult to injury, some of the folks who bought these policies failed to pay the insured people for the policies. There was fraud on beneficiaries and others, whether it arose out of a divorce settlement in which the person was contractually obligated to maintain the insurance in force, or for child support arrangements, or for business arrangements. There have been valuation and custody issues.

The most visible fraud has been done to those unsophisticated investors who came up with the money for the con man. There were Ponzi Schemes and ordinary theft. The brokers sometimes did not buy the policies. The providers did not buy policies. They raised money from investors to invest in policies and never bought them. They spent the money. They made it the old fashioned way; they stole it. There were false representations. There were guarantees of high yields, totally ignoring risk factors and potential medical discoveries. There were inadequate disclosures to investors, even when there was no fraud involved.

So the investors said, "Help us."

The SEC said, "This is outrageous. We'll try to stop it."

The D.C. Circuit Court of Appeals said, "I'm sorry. This is not what we define to be an investment contract. Even though the SEC can regulate investment contracts, we cannot regulate this. Because once the policy is bought, there's not much to be done afterward."

It is not like operating an orange grove, for which you have to water the plants and harvest and sell.

State "Blue Sky" law is often an alternative. They are very broad, and there have been cases. If anybody is interested, there is a book by Gloria Wolk called *Viatical Litigation: Principles and Practice*. State insurance departments were not very interested in helping. They really focus on the policyholder, not on the investor. In most cases, they are not qualified to focus on the investment aspects. Criminal prosecutions—sure, you can get a D.A. involved, but they have other priorities. Bank robbery is more important to most of them than investor fraud. These are complex cases and they take a lot of prosecutorial resources.

Then private rights of action—very few lawyers knew very much about this. Most people don't want to be charged $375 an hour for an attorney to learn about them. What has been happening on the regulatory scope? The NAIC has come up with model acts. Its initial Viatical Settlements Act was proposed in 1993. It covered a problem of the day, which was viatical settlements with a two-year life expectancy duration. It required licensing providers and brokers.

It is the easiest thing to say, "Get licensed." The reason is, if you do not have a license, it is a prima fascie case. Even a busy prosecutor can handle that one. It established a provider with a basic regulatory framework.

Things were not working. Cases began arising. Pressure was brought to bear. So the NAIC model was significantly expanded—first in 1998, then in 2000/2001. Currently, the NAIC model applies to whatever payment the viator has, if it is less than the expected death benefit. It covers viatical. It covers life settlements. It requires licensing of brokers and providers. You can revoke that license for a whole litany of offenses, including a pattern of unreasonable compensation to the viators.

The Act contains contract disclosure and advertising rules. The contract for the purchase of the policy has to be approved in the states having the law. There are mandatory and timely disclosures to viators. An NAIC model brochure is disclosing what is involved and what the issues are. Commissions have to be disclosed. Identity of the parties has to be disclosed. In addition, there are standard provisions for avoiding deceptive practices, misleading consumers in terms of advertising and other sales literature.

Interestingly enough, from the point of view of an insurance company, there are also provisions that prohibit viatical participants from disparaging life companies as part of the process. There is even potential for requiring all advertising material to be preapproved, notwithstanding the First Amendment. Most interestingly, from the perspective of an insurance company, this Act requires that the viator's life-insurance company be given 20 days notice. Why? So that it can start to investigate whether or not the policy is contestable.

There is a 15-day absolute right of recission that protects the viator. He or she can change his or her mind. If he dies within those 15 days, all bets are off. The full proceeds are paid. It has a prohibition against policies being purchased within the first two years of issue, except there are so many exceptions to that, in my view, it is almost meaningless. If you lose your job, that's waived. In fact, you do not even have to lose your job. You just have to say that you have lost your job.

The NAIC also has a new viatical model regulation that expands on certain of these issues. Viatical brokers have to pass an examination. They have to take continuing education. They have to have errors-and-omissions coverage—a lot of window dressing. Most interestingly, there are provisions for viators to receive reasonable payments. There are two alternatives that the NAIC is going to discuss next month. One of them is mandatory minimum payments. You have to get a certain portion of the net face amount, based upon your life expectancy. The second is, compensation must be reasonable. They define a whole series of factors that must be reviewed in determining whether the compensation going to the viator is reasonable.

There must be reporting by the providers as to the number of policies that are being sold and the details on each purchase. That is how I was able to give you the Florida information. Florida had this law since 1996. It gathered the information. There can be no finder or referral fees except to licensed brokers. No longer can you pay your family member, or the lawyer, or the doctor to encourage the transaction. It also mandates life insurance companies to respond quickly. In addition to other legislative activity, the U.S. House Financial Services Committee is paying increasing attention to viatical settlements, with hearings as recent as this month.

Notwithstanding the NAIC model, remember something. All NAIC models have a fundamental flaw. They have no effect until the states enact them, and that is a very slow process. If you need a chart, I can get you a chart on what the laws are in each state. Twelve states have passed laws based on the new NAIC 2001 model, in most cases, with some variations. A few states have their own decent formats of law. Most states have no real viatical laws or rules, or very old ones that are outdated, outmoded and do not even address life settlements one way or the other. In some cases, they say that they have laws, but they address peripheral issues. That is an issue.

So what can you do if you are a life insurer? For future policies, I assume there must be something you can do. Can you ask about genetic testing on applications? Can you ask about how many other policies the person is applying for? Can you require ongoing disclosure of other policies? Can you add riders restricting the ability to sell or sign a review? Can you examine the group processes that you use and the ability of people, for example, to raise the amount of their insurance at any time, significantly? Might you even think of saying "no, that there's no need for insurance in that case"?

For older policies, you are out there. What can you do? Well, you can scrutinize vigorously the requests for transferring assignments. You can report abuses, try to get prosecutors involved, and litigate to deter. Insurance companies do not like to litigate, unless it is going to be worth the money. In this particular case, use deterrence. Litigation itself is deterrence to justify actions. If you stop one improper chain, you will probably stop many more policies. You also can seek new legislation. I just urge you that viatical settlements have great benefits. Life settlements have great benefits for some policyholders. So make sure that you are not being anti-consumer. It does not seem to me that you would be anti-consumer by eliminating the contestable periods if you can prove actual fraud or an impostor.

Then what troubles me the most is why don't the insurance companies themselves consider establishing internal policy buy-back units. If the insurance companies had acted in response to the crisis with the intelligence of Ron Barbaro and some of the other companies that followed, there would be no viatical industry. There would be no people looking for new fields to go into. This problem would not have existed accept in theory.

My conclusions—life settlements pose significant concerns. The current extent of litigation is inadequate, and I think that creative approaches by insurers are essential.

FROM THE FLOOR: Viatical and life settlements would seem to require some administrative expenses for execution, including underwriting the life and the paperwork. Is there any sort of a minimum amount that the market has established that would be able to cover those expenses? A minimum face amount?

MR. QUINN: I do not know that I can answer that. If I understand your question, you are asking about the expenses involved in processing underwriting and application, these functions are performed by the fund provider that is considering making an offer. Perhaps someone from the audience could respond.

FROM THE FLOOR: I will cut it back to a couple of comments. Initially, the comment on growth—we are seeing $820 million of face amount submitted to us a month since the first of the year. Underwriting that is an expensive proposition, if you use outside, independent underwriters, which we are both required to do and we do, quite frankly, to build a knowledge database. So we get three independent medical underwriters and our capital provider has their own underwriters. It may cost $3,000 a case for our administrative and underwriting expenses, if we narrow it down to actual purchased cases.

I thought that Mr. Goldsholle's comments were right on point, and he gave a really good history of the business. But I will comment on three ways in which life insurance companies should benefit from the viatical and life settlement business.

One is—and I've spent 30 years as a life insurance producer—the industry is known to give their products away every December, sometimes at the end of every quarter, because quotas aren't met. Also, underwriting requirements are dramatically expanded, and there is really not very much discipline. I say that as somebody who benefits from that. I say it with a feeling that nothing will happen, because I do not think the carriers can help themselves. That is one way.

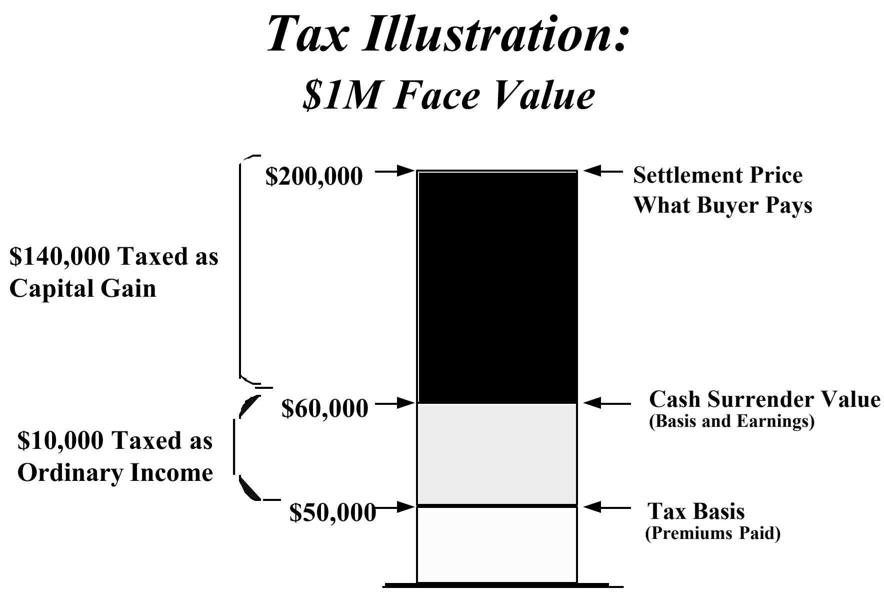
The second is, I think that you missed the most important thing when you talked about the model act. That is the anti-fraud provisions require of fund providers, brokers, or anyone else who has a good-faith belief that there's fraud to report it. We aggressively report it. In fact, when we're not allowed to report it for privacy reasons, if we can't disclose to a carrier that we think they've been defrauded, we'll send a request for medical information to the carrier. We have had very good results as a consequence of that. Long-term, the impact of the law—if it's passed and becomes more universal (ironically, in one state the carriers fought that proposal)—is, by virtue of the way the policy is constructed, that agents virtually are taught to have their clients work around the contestable provision. Over time, maybe you will find that it is not contestable anymore. I think that every carrier would like to know what producers routinely give them bad business. I think that is the most important provision, because I know that we report it every month.

The last thing is, there are far more transactions that are consummated as a consequence of life-settlement inquiries that never develop into a life settlement, than there are life settlements. The point being, you are providing a consumer-oriented benefit. You are letting the consumer know what the value of an asset is. You are going to have an opportunity to do a variety of things.

The last thing that I would say is you missed the most important question, from my point of view, of what was said at the Florida hearing. That was, since 1996, less than 12 consumers, policy owners, had made complaints to the department.

MR. GOLDSHOLLE: The only reason I did not mention the obligatory reporting of suspected fraud was that there are so many. People with good faith will do this. They now must do it. People with bad faith can hide behind enough weasel language inserted in there that can get them out of it. But good people do report.

Chart 1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Settlement Price
What Buyer Pays
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Capital Gain
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Ordinary Income
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