Article from:

The Actuary

May 1996 – Volume 30, No. 5

The Newsletter

of the Society of Actuaries

Vol. 30, No. 5

May 1996

The Actuary

Regulators, investors put viaticals under microscope

by Linda Heacox
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In Latin, the root of the word "viaticus" means "voyage." In the Christian church, the viaticus is the sacrament of the Lord's Supper given for forgiveness of sins to a person in imminent danger of death. In the world of insurance, it might as well mean "controversy." In the past six years, the $400-$450 million viatical industry has attracted admirers as influential as TV newsmagazine *60 Minutes,* and has also come under scrutiny from regulators and consumers.

The industry is still very small. So far, only two major financial entities have pitched their tents in the viatical camp: CNA Financial Corporation, with its purchase of Viaticus, Inc.; and Transamerica Business Credit Association, as a financier for the capital intensive companies of the viatical industry. Quotes for shares in another viatical company, Dignity Partners, Inc., are now on NASDAQ. Another six or seven companies purchase life insurance policies in quantity. Banks have opened up to the industry and are making loans to the smaller companies, which industry executives hope have removed the speculative character the industry had when it first began.

The humanitarian debate

A viatical settlement occurs when an insured sells his or her life insurance death benefit to a third party, a situation almost always predicated by terminal illness. The insured receives cash, and the buyer pays the premiums until the seller dies, when the investor receives the payout. The return on some viaticals can be high — 15%-25% in some cases — provided the seller dies when expected or earlier. If he or she survives longer, returns diminish.

The moral issues of such settlements are well-known in the insurance industry, which has been debating its own accelerated death benefits issues for years. Because the decision to sell a death benefit is usually extremely emotional, brought about by dire financial straits in the final stages of life, consumer groups in all 50 states have called for regulation of the fledgling industry.

However, life insurance attorneys Edward Blakeslee and Patricia Jackson in their paper, "Viatical Settlements: A Primer," published in the *Association of Life Insurance Counsel Proceedings* (1995, Vol. XXXIII, pps. 187-204), wrote,"It seems that viatical settlements can and do fill a valid need. While medical advances and new treatments have prolonged the lives of the terminally ill, those same advances and treatments are likely to be expensive."

Pers Larson, a financial advisor and advocate for the terminally ill, told a 1995 House Ways and Means Committee hearing on viaticals that they "permit the seriously ill to pay their bills while fighting their illness and maintaining their dignity and

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former way of living," while reducing the need for government funds and charities to pay for their care. Moreover, Larson said viaticals have created a new, tax-paying industry, thus benefiting society.

Viaticals and accelerated benefits

The genesis of viaticals did indeed come about due to need. The anecdotal history is that the AIDS crisis created a cottage industry in viaticals. When investors heard of an investment yielding high returns and backed by the guarantee of a contract with an insurance company, enormous interest was aroused.

The viatical industry believes consumer need remains high, despite the fact that hundreds of U.S. and Canadian life insurers now offer accelerated benefits riders (ADB) with their policies. Upon proof that an insured is terminally ill (usually a 6- to 12-month life expectancy), the insurance company will offer to pay out a percentage of the death benefit, less a relatively small administrative cost. The insured receives a part of the benefit to use during his lifetime, and his beneficiaries are paid out the rest at the time of death. The insured and his beneficiaries, therefore, can recoup nearly all the face value of the policy. A typical viatical, by contrast, pays out between 50%-80% of the face value in a lump sum or annuity.

According to Bill Kelly, executive director of the Viatical Settlement Association of America, one of two trade associations for the industry, viatical companies believe that only 6% of all life insurance policies carry accelerated death benefit riders. Gary Chodes, president of Viaticus, estimates the potential market at $17.3 billion annually. That figure is based on insurance figures ($13 trillion currently in force), population, and terminal illness figures.

Marketing of viaticals is done largely through an education process of professionals, e.g., insurance agents, estate planners, employee benefits departments, or "trusted intermediaries" like social workers. Often, accelerated death benefits can work in conjunction with viaticals. An insured can apply to his insurance company for an ADB and viaticate the remainder.

Regulation

Viatical brokers and consultants of varying degrees of credibility seem to be everywhere, including the Internet, offering potential returns ranging from 15% to 60% on what they term a "humanitarian investment." Now, it appears the too-good-to-be-true factor may have kicked in.

Concerned with protecting both buyers and sellers, the National Association of Insurance Commissioners (NAIC) has produced models of a legislative act and regulations for states to consider when debating how or whether to regulate the viatical industry.

The NAIC models are based on the California Insurance Laws 10113.1-10113.4, enacted in 1990. They are three-pronged and include:

- Mandatory disclosure of important information about viatical settlements, including providing information on alternatives to viaticals, such as accelerated benefits
- Licensing by state insurance commissioners of viatical brokers and providers (fee amounts left up to states)
- Suggested minimum returns to the seller. Following are the suggested minimums:

If life expectancy is:	Suggested minimum % of face value:
Less than 6 mos.	80%
6-12 mos.	70%
12-18 mos.	65%
18-24 mos.	60%
24 mos. or more	50%

According to the NAIC, 14 states regulate the sale of viaticals. Seven adopted legislation last year, and seven already had statutes governing these types of sales. So far, 13 states have some form of regulation:

- Previous statute — California, Kansas, Minnesota, New Mexico, North Carolina, Texas, Utah, Washington
- Based on or similar to the NAIC model — Indiana, Louisiana, New York, North Dakota, Oregon

Two more states, Pennsylvania and Vermont, have statutes pending passage that are based on the NAIC model.

On the federal level, interest in viaticals exists because of the tax implications for both buyers and sellers. Currently, the cash received by the sellers is treated as ordinary income to the extent the seller realizes gain on the transaction. Proceeds spent on medical expenses would, of course, be sheltered from taxation. Individual investors who buy viaticals pay capital gains on their profits if they use after tax dollars.

Legislation passed in March by the House of Representatives, H.R. 3103, *The Health Care Coverage and Affordability Act of 1995,* would change Internal Revenue Code 101 to treat amounts paid by a viatical company for any portion of a life insurance policy insuring a terminally ill person as an amount paid by reason of the death of an insured. No cap is proposed on amounts treatable as tax exempt. If the bill is enacted, it would apply to viatical proceeds received after December 31, 1995.

Need for actuaries

Chodes and Bradley Rotter, chairman of Dignity Partners, Inc., both said they employ no staff actuaries. With the industry in its infancy, their firms are just starting to collect the body of data necessary for real analysis. Rotter said his firm has conducted about 2,000 transactions since 1993 on about $100 million of policies. Viaticus, however, relies on consulting actuarial firms and CNA's staff actuaries to help develop new products, do risk analysis, and analyze portfolios of policies. Chodes and Rotter said they

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Life Practice Area faces strategic issues

by John Palmer
SOA Vice President

In the next few months, the leaders in the SOA Life Insurance Practice Area will be wrestling with some big picture issues that we believe are important in setting the strategic direction for our efforts. We are interested in your feedback on these issues, no matter which area you practice in.

Experience studies

Experience studies are critical in helping our members fulfill their practice requirements. They also represent a key service the SOA performs for its publics, including insurance companies and regulators. Improving the timely and effective delivery of experience studies continues to be a challenge.

A committee headed by Esther Milnes conducted a survey in April on the value of experience studies among several SOA, American Academy of Actuaries, and Canadian Institute of Actuaries committees, as well as related industry groups. Results should be available by the end of May.

Regulatory overload

The quickening pace of regulatory activity shows no sign of abating. We will be increasingly challenged to bring the necessary resources to bear for an appropriate and timely response. Specific challenges include:

- How can actuaries mesh sound actuarial practice with public policy mandates (e.g., the Model Illustration Regulation)?
- How do actuaries take advantage of changes in the regulatory climate to apply appropriate actuarial principles (e.g., the nonforfeiture report)?
- How do we cope with regulatory overload: the sheer volume of changes and the array of local regulatory variations?

Please let me or anyone on the Life Practice Committee know your thoughts on these issues.

Risk classification restrictions

The advent of genetic testing has triggered the discussion on the appropriateness of risk classification. The U.K.'s Institute of Actuaries is facing a parliamentary mandate to the British insurance industry to respond to this issue within one year.

The Society of Actuaries faces the challenge of separating its research from a political advocacy position. However, because appropriate risk classification is fundamental to our profession and to our business, the actuarial profession clearly has a role in this public policy debate. Where do you think the profession should stand on this issue and, more specifically, how should the SOA (distinct from the Academy) respond?

Viability of the actuarial profession

This issue is not unique to the Life Insurance Practice Area. It is being keenly felt by all SOA members. The stagnation of U.S. and Canadian traditional life insurance businesses and the shrinking number of employers have narrowed the scope for traditional employment. Some solutions may come from increased interrelationships with allied professions, such as economists and investment professionals, and from internationalization and improved visibility from publicity on the unique abilities of actuaries. On which initiatives do you believe we should concentrate our efforts?

Perhaps you're wondering if your opinion is really valued. Sometimes it only takes a handful of people speaking up with innovative and well-reasoned approaches to influence the leadership's directions. We want to hear from you.

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hope to continually improve the sophistication of the underwriting being done.

Currently, each company submits policies to scrutiny by a physician and underwriter or a team of underwriters. Chodes said, "As we get more sophisticated, we'll be able to apply more actuarial techniques and models to what we do. Certainly a critical component to success in this business is to get a handle on how long people will live," said Chodes, whose company has entered into settlements with people who have as long as a seven-year life expectancy.

Future of viaticals

Chodes expressed confidence in the industry's future, saying that the infusion of capital in his firm, through the purchase by CNA, and in Dignity Partners, through securitization, allows viatical companies to have stable access to capital and varied portfolios. By all accounts, three-year-old San Francisco-based Dignity Partners astonished Wall Street with its aggressive securitization strategy a year ago, with $35 million worth of policies followed by another $15 million. In the process, it won the *Investment Dealer's Digest* "Deal of the Year Award." The firm went public in February 1996, with an initial public offering of $21.7 million. Another securitization will probably take place within the year.