A Time and Place for Life Settlements

Sales of existing life insurance policies to third parties—often referred to as "life settlements"—have grown exponentially in recent years, and that trend appears likely to continue, according the FINRA.

The FINRA recently issued a notice to brokerage firms and associated persons that life settlements involving variable insurance policies are securities transactions, and firms and associated persons involved in such transactions are subject to applicable FINRA rules.

But what are life settlements? Until recently, the FINRA reports that the owner of a life insurance policy who no longer wanted or could not afford it had two options: to let it lapse or surrender it to the issuer for its cash surrender value. But now, the emergence of a secondary market for existing life insurance policies provides a third alternative: to sell the policy to a third party for less than the net death benefit, but more than the cash surrender value. Such transactions, the FINRA says, are typically referred to as life settlements. The value of a particular life settlement depends on a variety of factors, including the insured's life expectancy and the nature and terms of the policy.

According to the FINRA, the life settlement market emerged as an offshoot of the viatical settlement industry that developed in the 1980s as a source of liquidity for AIDS patients and other terminally ill policyholders with life expectancies of less than two years. Unlike viaticals, however, the FINRA says that life settlements involve policyholders who are not terminally ill, but generally have a life expectancy of between two and 10 years. Life settlements also tend to involve policies when the insured is older and there has been a change in health since the policy was issued. Policies with lower cash values and higher net death benefits seem to draw more interest from investors.

The life settlement market has expanded rapidly in recent years. One recent study, for instance, estimates that existing policies with a collective face value of $5.5 billion were sold by policyholders to investors in 2005, while others suggest that the potential market exceeds $100 billion. Although business models vary, in a typical scenario, an insured sells an existing policy to a life settlement provider, which either holds it to maturity and collects the net death benefit, or sells the policy or interests in multiple, bundled policies to hedge funds or other investors. The insured may contact the life settlement provider directly, or through a financial adviser, or may use a life settlement broker, which solicits bids from multiple life settlement providers on behalf of the insured. It is not uncommon to hold out for a higher bid by not accepting the first bid or by letting the providers bid against each other.

In most states, both life settlement providers and life settlement brokers are subject to licensing and other requirements, the FINRA says.

According to the FINRA, most life settlement providers claim to target only those policyholders who have already made the decision to surrender a policy or allow it to lapse, either because the policy is no longer wanted or needed, or because the policyholder can no longer afford to pay the premiums. However, as more providers enter the life settlement industry, the FINRA reports that there is increasing competition to find policyholders who fall into that relatively narrow category. And this, says the FINRA, has led some life settlement providers to

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aggressively encourage financial service providers, including broker-dealers, to canvass their books of business for seniors or other eligible customers who may be interested in selling their life insurance policies in the secondary market, even if they do not need to or had not previously considered surrendering or allowing their policies to lapse. Significantly, the commissions paid in connection with life settlements are typically quite high—in some cases, up to 30 percent or more of the purchase price.

Accordingly, the FINRA is concerned that aggressive marketing tactics, fueled by high commissions, may lead to inappropriate sales practices in connection with these transactions.

By way of background, the FINRA reports that a variable life insurance policy is a security, and the sale of such a product in the secondary market is a securities transaction subject to FINRA rules. What's more, those involved in selling or buying a variable life settlement should understand fully the issues related to suitability, due diligence, best execution, supervision and training, and compensation in connection with variable insurance contracts.

Generally, the FINRA requires that, before recommending the purchase, sale or exchange of a security, members must have a reasonable basis for believing that the transaction is suitable for the customer.

The FINRA reports being concerned that some of the marketing materials prepared by life settlement companies to encourage financial service providers to recommend life settlements to their customers do not present a fair and balanced view of life settlements, and may encourage broker-dealers to recommend unsuitable transactions.

A variable life settlement may be a valuable option for insured's who otherwise would surrender their policies or allow them to lapse, the FINRA says. But variable life settlements are not for everyone. There can be significant costs associated with such transactions, and FINRA cautions firms that a variable life settlement is not necessarily suitable for a customer simply because the settlement price offered exceeds the policy's surrender value. Other relevant factors may include the customer's continued need for coverage, and, if the customer plans to replace the existing policy with another policy, the availability, adequacy, the underwriting, and cost of comparable coverage. Depending on the circumstances, including the customer's stated financial needs and investment objectives, firms also may need to consider the basic tax and other relevant implications of selling a variable policy. Settlements paid in excess of the cumulative premiums paid on the policy constitute ordinary income to the policy owner, compared to the death benefit which is tax-free. In order for the settlement provider or investment group to receive the death benefit, they must file a claim with the insurance company which requires an original copy of the death certificate.

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