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Some seniors are raising eyebrows as they raise cash by selling insurance policies
Life & death issues
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A controversial, but rapidly growing practice in which senior citizens raise cash by selling their life insurance policies to investors who will profit when they die could soon be subject to more government scrutiny.

The multi-billion dollar life settlements business has evolved to a point where investment banks are packaging these life insurance policies as bonds and reselling them in the secondary market, similar to the way mortgage-backed securities are traded.

"At present, there is little transparency with respect to this market," wrote Sen. Herb Kohl, chairman of the Senate Special Committee on Aging in a recent letter to the Securities and Exchange Commission.

In the midst of a financial crisis blamed on a lack of oversight and regulation, federal lawmakers and securities regulators are concerned about the Wild West nature of the life settlement industry and the fact that there is no national sheriff watching out for individuals who sell and investors who buy.

Spurred by the growth of the practice from about $2 billion in 2002 to $12 billion in 2007, the SEC recently announced a special task force to consider how federal securities law applies to life settlements and to create guidelines for trading them as securities.

It used to be that someone with a life insurance policy who no longer needed it or could no longer afford it had only two choices: surrender the policy for its cash value -- if any -- or stop paying the premiums and let it lapse.

Now policyholders who need cash can sell their policies to third-party investors for a cash lump sum in exchange for transferring ownership of the policy to the investor -- usually a financial institution -- who continues to pay the insurance premium and becomes the beneficiary.

"Personally, I think there is concern about the moral hazard issue," said Scott Gilbert, chairman of Gilbert LLP, a Washington, D.C, law firm that specializes in insurance. "There's something that is troubling to many who look at this, about the notion that investors only do better the more quickly people die."

While there's no national watchdog over the practice, there is regulation on the state level.

Since 2003, Pennsylvania insurance law has regulated the viatical settlements industry, which preceded life settlements for seniors. Viatical settlements, which were born in the 1980s in response to the AIDS epidemic, involve people of any age who are terminally ill. While the marketplace has evolved, the state law covers both types of settlements.

There is no hard data for the number of life insurance policies that have changed hands in Pennsylvania but state insurance officials say there are several open investigations involving viatical settlement providers and brokers, which mainly involve failure to make proper disclosures and operating without licenses.

The state's consumer services division has records of 10 consumer complaints in 2008 and four this year regarding viatical and life settlements.

"We have the third highest elderly population in the U.S. and we know that life settlements are a potentially very lucrative transaction in Pennsylvania," said Brad Harker, director of the life insurance bureau of the Pennsylvania Insurance Department.

Mr. Harker said the state has strong language in its laws regarding disclosure by life settlement brokers and agents. Sellers also can rescind transactions within 15 days of receiving the money or within 30 days of signing the agreement. If a seller dies within the rescinding period, his original beneficiaries can collect the face value of the policy.

Regardless of what securities regulators and federal authorities do, Mr. Gilbert predicts there will be legal challenges at the state level nationwide. "Fundamentally, at a gut level, this bothers people," he said, "which is why ultimately you'll see litigation challenges and maybe business repercussions."

Ken Stanger, vice president of Longfellow Benefits, an employee benefits consultant in Boston, said he has a 70-year-old client recovering from lung cancer who wants to sell his $400,000 life insurance policy. The client expects to receive a settlement of $100,000 to $150,000.

"You can argue this all day, but as long as someone goes into this contract with eyes wide open, they are making the decision and it's their morality on the line," Mr. Stanger said. "It's between the client and his conscience."

Life settlements may be a way for seniors to access the value in life insurance policies they previously could not tap. But there are disadvantages.

For seniors receiving Medicaid or income assistance, selling a policy may provide income that makes them ineligible.

If the cash payout is more than the premiums they've paid in, the tax man could be calling. And once someone sells a life insurance policy, he can't buy more insurance than his current net worth.

Investors also have the right to periodically contact the insured to make sure they are still alive, although there are limits in Pennsylvania law as to the number of times that can happen, Mr. Harker said. If the person is terminally ill with less than two years left to live, investors can contact him every three months. Otherwise, the investors are limited to contacting seniors every six months.

Also, sellers must provide the agent or broker with all current medical records, including those they might be embarrassed about. Crucial records like notes to therapists, psychologists or psychiatrists must be disclosed, said Frank N. Darras, managing partner at Shernoff, Bidart, Darras & Echeverria, LLP in Claremont, Calif., a national law firm that represents insurance policy holders.

"If someone is old and really sick and in poor health, are they really equipped to make good judgments selling their life insurance policy?" he asked. "The reason there's a spotlight on this is there aren't any real regulations with any teeth out there to protect senior citizens."

Mr. Darras said the average payout on a life settlement is 8 percent to 20 percent of the policy's face value. But that amount could go up or down based on the person's age or health history.

"The sicker they are, the closer to death and the longer their medical history, the more value the policy has," Mr. Darras said. "If I'm an investor, I don't want to wait around 20 years. I'd like you to be knocking on death's door.

I'm making the premium payments and waiting for you to die so I can get a great return on investment."

Meanwhile, the insurance industry is wrestling with how to respond to these transactions. Some insurance providers have changed policy application forms to ask whether the insurance is being purchased for resale to investors and some have started writing provisions that give the company the first right to buy back the policy.

Life settlement deals have the potential to damage the bottom line for insurance companies because they often count on a large percentage of customers allowing policies to lapse.

Since investors will be less likely to let policies lapse, payouts will increase, resulting in a likely rise in premiums.

M. Bryan Freeman, president of Habersham Funding LLC in Atlanta and a pioneer in the life settlement industry, said turning life settlement contracts into Wall Street bonds is a new development in the industry that became necessary to raise the large amounts of capital needed to buy the policies.

He dismisses the idea that unregulated life settlement bonds have the same potential to rattle the economy as mortgage-backed bonds did. "There's no such thing as a subprime policy," Mr. Freeman said.

While life settlements are only a sliver of the colossal life insurance industry, Mr. Freeman said it has set the two against each other.

There is some anecdotal evidence to suggest that use of life settlements has peaked and is on the decline.

Scott Witt, an actuary and fee-only insurance adviser in New Berlin, Wisc., said the number of deals he did fell off dramatically in the past year, partly due to less attractive offers and fewer offers being made to purchase his client's policies. Life settlement firms are telling him the mortality tables have changed, people are living longer and policies are worth less.

"Business for life settlements has really dried up," Mr. Witt said. "I've seen a lot of cases where clients would have been aggressively offered in the past and we can't even get an offer. The market is righting itself."

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