



Articles

AAII Journal - May 2006

Individuals' altruistic instincts are being tapped by a life insurance marketing scheme that has been coined "investor-initiated life insurance." Although it may sound intriguing, this is something that you want to avoid

Why You Should Avoid Investor-Initiated Life Insurance

By Peter Katt

Throughout the country wealthy seniors' altruistic instincts are being tapped by a life insurance marketing scheme that the Wall Street Journal's Rachel Emma Silverman has coined "investor-initiated life insurance."

While it may sound intriguing, this is something that you want to avoid, for reasons that will become clear once you understand exactly how it is structured.

The Enticement

Here's how a brochure from one of the firms pushing this scheme describes the arrangement:

"We offer applicants a unique opportunity to make significant donations to their favorite charity. This donation is made with absolutely no cash requirement or expense to applicants or their estates.

"This is accomplished by taking advantage of the potential dollar amount of life insurance that can be written on applicants. Qualifying seniors between ages 75 and 85 can have completely cost-free life insurance for two years. At the end of the two-year period the participating senior has the option of taking over the policy by repaying the first two years' premiums and interest, or allow the premium financier to sell the policy in the flourishing life settlement market. The senior will receive 50% of the net proceeds from the sale of the policy."

Whew! Such a deal.

How It Works

But let's take a look behind the arrangement to see how it really works.

Mr. Smith is an 80-year-old retired real estate developer, in excellent health, with a net worth of more than \$20 million. He has been approached by Acme Charity Funders to allow them to use his high net worth to finance a \$10 million life insurance policy on his life to be used as an investment vehicle.

Mr. Smith has no other life insurance and is not inclined to be covered. However, Mr. Smith is intrigued by Acme Charity Funders' promise that he can provide his favorite charity with a donation of \$350,000 in two years, and nearly \$10 million if he happens to die during the first two years, by simply putting up with the inconveniences of being underwritten for life insurance. Let's examine this proposal to see if it is as benign as Acme Charity Funders represents.

The application for life insurance has been made to ABC Life. ABC Life (and almost every other life insurance company) doesn't approve of their policies being used in this manner. They ask a question in the application about whether any discussions have occurred about the possible sale or assignment of the applied for policy to a life settlement provider.

Mr. Smith correctly answers "yes," followed by this explanation: "The possibility of disposing of this policy in the future was discussed with my insurance agent. He explained that, should I choose not to continue paying the premiums, one of my options was to sell the policy."

Considering that six binding documents associated with the premium financing and subsequent sale of the policy in two years will have to be signed, this explanation is not accurate. However, since the transaction ABC Life wants to prevent will occur after two years when the contestable period has expired, ABC Life's objection to this type of sale may not have any practical effect.

Unknown to Mr. Smith is that state insurance regulators have become increasingly concerned about these schemes.

In December 2005, the New York Insurance Department issued a negative opinion about at least one version of an investor-initiated life insurance scheme because New York ruled there is no insurable interest. If insurance companies can assert that no insurable interest existed, they can attempt to void such contracts.

Presumably this isn't a problem for Mr. Smith, who will have no interest in whether death benefits are actually received if he lives more than two years. But this is of great concern to the end investor.

Acme Charity Funders uses Tricky Capital Company to finance the first two years' premiums at 13% interest. (In fact, Acme Charity Funders and Tricky Capital are essentially partners in all aspects of this scheme.)

Tricky Capital is granted the exclusive right to arrange for the sale of the ABC Life policy for a period of four years if Mr. Smith doesn't buy them out. Repaying the premium and interest costs is highly unlikely because Mr. Smith's interest in doing this in the first place is to make a no-cost contribution to charity.

Tricky Capital is also given a power of attorney regarding the collection and distribution of Mr. Smith's medical records for the purpose of negotiating the sale of the policy. Tricky Capital will have complete control over the sale of the policy.

Who Buys These Policies?

There is a significant difference between the few highly professional life settlement firms that buy policies with institutional monies only, and the many others whose

activities are impossible to track.

Firms buying policies with their own funds must be prudent in calculating purchase prices, and there is very little chance that any individual investor can learn the identity of insureds.

Unfortunately, there are many firms in the life settlement arena that I would not want my life insurance sold to because they repackage policies for sale to firms and individual investors. Such firms are more likely to pay larger amounts for policies because they make their money by doing deals with the end investor taking the risk. And I have noticed that there have been discrepancies in life expectancy data.

A firm selling a policy and claiming a shorter than real life expectancy is exaggerating the expected yield to an investor. This is easy to get away with because investors can't possibly know what the true life expectancies are—they aren't doing any independent underwriting.

The point is that Acme Charity Funders and Tricky Capital have a financial motivation to seek the highest price for Mr. Smith's policy, and it is likely the highest bids will come from firms that will repackage Mr. Smith's policy to investors. This could have dangerous consequences to Mr. Smith.

Three times I have observed that the identities of insureds are known to investors that have purchased policies from certain life settlement firms. In each of the three situations, the life settlement firms involved deny that the identities of insureds are ever known by their investors. Not only is this false, but their denials show that they agree that providing the identities of insureds to investors is dangerous. The return on investment depends on how soon insureds die. Investors knowing who Mr. Smith is can influence the strength of their investment return.

The End Results: Litigation

Now, I don't believe that Acme Charity Funders or Tricky Capital have any intention of putting Mr. Smith in harm's way, but I believe they are ignoring the very bad possibilities that can occur when this type of events-chain is put into motion.

Acme Charity Funders and Tricky Capital simply want to maximize their revenues. But here's what can happen: A life settlement firm wanting to make this purchase pays too much. To make their profit and Mr. Smith's policy appear attractive to investors, the life settlement firm fudges the life expectancy, making it possible to represent that the expected yield is, say, 16%, when in fact it may be closer to zero.

The end investor with knowledge of who the insured is could see his investment return falling below the promised 16% with each passing year that Mr. Smith is alive. Let's say this investor is hit with a financial crisis. His way out is Mr. Smith's death.

I am not claiming this chain of events is likely to lead to murder, although it is certainly plausible. Far more likely, however, is that these deals will result in litigation. The very foundation of these proposals rests on very shaky financial calculations. It is possible end investors will ultimately discover that they have been taken and the legal papers will start to fly, with Mr. Smith a possible defendant due to his profiting from the transaction (even though he contributed to a charity) and his deep-pockets.

I speculate that litigation is most likely to involve hedge funds who I believe are becoming heavy investors in life insurance policies, if calls I have received from funds are a good guide. Conversations I have had with hedge funds suggests they

are very naive regarding the investment potential of acquired life insurance policies, mostly because they are accepting the life expectancy claims of the life settlement firms.

My firm evaluated the pricing for the ABC Life policy to come up with possible life settlement purchase prices depending on Mr. Smith's life expectancy in two years.

Table 1 shows the amount a life settlement firm could pay and earn a 9.5% pre-tax target yield at various life expectancies. To put this into context, if Mr. Smith's health remains the same, his life expectancy will be nine years in 2008 when his policy will be sold.

Table 1. Possible Purchase Prices	
Life Expectancy in	2008 Policy Purchase Price (\$)
4 years	4,530,000
5 years	3,731,000
6 years	2,933,000
7 years	2,343,000
8 years	1,773,000
9 years	1,200,000
10 years	680,000

Not shown are the premium payments needed that we have assumed are the minimum amount required, and go up each year.

Acme Charity Funders and Tricky Capital must sell the policy for at least \$2,291,530 to recoup their premiums and interest plus \$700,000 in order to pay Mr. Smith the promised \$350,000 for his charity (recall that Acme Charity Funders has promised Mr. Smith 50% of the proceeds in excess of premium and interest expenses).

You can see that if Mr. Smith's health holds up and his life expectancy is nine years when the policy is shopped, no legitimate life settlement firm will pay anything close to the \$2,291,530 needed.

In that event, one result could be that the policy will be sold to a firm willing to pay at least \$2,291,530 in order to repackage it and sell it to an investor for, say, \$2,933,000 claiming a much shorter life expectancy in order to represent a robust expected yield. How will investors know differently? Alternatively, Acme Charity Funders and Tricky Capital may sell the policy to one of the life settlement firms prudently buying policies for their own investment for a much lower amount that would deny Mr. Smith any funds for his charity because the price wouldn't cover the premium and interest expenses. In this event, Mr. Smith will have gone through this whole procedure for nothing.

Who Pays the Price?

What do Acme Charity Funders and Tricky Capital expect to make for convincing Mr. Smith to allow them to use his life as an investment? That's the final piece of information you need to fully understand investor-initiated life insurance.

Table 2 shows the various components of what they expect to receive.

Table 2. Expected Revenues	
Commissions on sale of ABC Life policy	\$631,803
Commissions on sale of policy to life settlement firm*	458,306
Net proceeds from sale of policy to life settlement firm	350,000
Interest on premium financing in excess of market interest**	128,000
Total	\$1,568,109
* Assumes a sale price for the policy of \$2,291,530 to repay the premium financing note of \$1,591,530 and an additional \$700,000 to provide Mr. Smith with his \$350,000 share.	
**Difference between a more market-friendly interest rate of 7% and the charged 13%.	

Acme Charity Funders and Tricky Capital have a net loss after two years of about \$831,000 (premiums plus interest minus commissions). Even if they limit bidders to the highest-quality life settlement firms and are only able to sell Mr. Smith's policy for \$1.2 million after two years, they will make another \$240,000 in commissions on the sale (not reflected in the \$1.2 million), leaving them with net revenues of around \$600,000.

So if Mr. Smith's health stays the same:

Either Acme Charity Funders and Tricky Capital will do the honorable thing and sell to a legitimate life settlement firm for, say, \$1.2 million, with Mr. Smith receiving nothing; or

The policy will be sold for much more than it is worth, leaving the end investor in jeopardy. Mr. Smith's concern is how the end investor will respond to this circumstance.

Peddling charitable donations by wealthy seniors "...with absolutely no cash requirement or expense to applicants or their estates..." is a really lucrative and complicated life insurance sale with plenty of intrigue for Mr. Smith.

Such sales can only occur by lying to insurance companies, dodging concerned insurance regulators and exposing Mr. Smith to dangers he has no knowledge exist.

Reprinted with permission by the AAIJ Journal, May 2006. www.aaij.com

Peter Katt, CFP, LIC, sole proprietor of Katt & Co., is a fee-only life insurance adviser located in Kalamazoo, Michigan (269.372.3497).
