

Investor Education Series

Investor Alert

Key Topics:

- Senior
- Life Settlement
- Life Insurance Policy
- > 1035 Exchange
- Viatical Settlements
- Death Benefits

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Seniors Beware:

What You Should Know About Life Settlements

Lately, more and more seniors are hearing about opportunities to sell their existing life insurance for cash in transactions known as life settlements. A life settlement, or senior settlement, as they are sometimes called, involves selling an existing life insurance policy to a third party—a person or an entity other than the company that issued the policy—for more than the policy's cash surrender value, but less than the net death benefit.

Life settlements can be a valuable source of liquidity for people who would otherwise surrender their policies or allow them to lapse—or for people whose life insurance needs have changed. But they are not for everyone. Life settlements can have high transaction costs and unintended consequences. And even if you decide a life settlement is generally right for you, it can be hard to tell whether you are getting a fair price.

If you are considering selling your life insurance policy to a third party, you can help protect yourself by familiarizing yourself with your existing policy so that you fully understand your options, becoming fully informed about life settlements, shopping around for the best offer, and dealing only with licensed buyers and brokers. We are issuing this Alert to highlight the questions you should ask and the factors to consider before entering into a life settlement.

What Is a Life Settlement?

Until fairly recently, if you owned a life insurance policy that you no longer wanted or needed, you had two choices: surrender the policy for its cash value or allow it to lapse. Now, there is a third option: selling your policy (or the right to receive the death benefit) to an entity other than the insurance company that issued the policy in a transaction known as a life settlement.

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, 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 with higher net death benefits than viaticals.

The life settlement market has expanded rapidly in recent years. One recent study 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.

How Do Life Settlements Work?

The purchasers of life settlements, sometimes called life settlement companies or life settlement providers, generally are institutions that either hold the policies to maturity and collect the net death benefits or resell policies—or sell interests in multiple, bundled policies—to hedge funds or other investors. In exchange, you receive a lump sum payment. The amount you will receive in the secondary market depends on a range of factors, including your age, health and the terms and conditions of your policy—but it is generally more than the policy's cash surrender value and less than the net death benefit.

When you sell your life insurance policy, whoever buys it is acquiring a financial interest in your death. In addition to paying you a lump sum for your policy, the buyer agrees to pay any additional premiums that might be required to support the cost of the policy for as long as you live. In exchange, the buyer will receive the death benefit when you die.

Factors to Consider When Deciding to Sell Your Life Insurance Policy

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Alert. Life settlements have proven profitable not only for institutional investors that purchase policies, but also for the providers and brokers who handle these transactions.

As a result, competition among life settlements providers for individuals seeking to sell or otherwise terminate their life insurance policies has become increasingly intense. Because the life settlement industry is relatively new and may target seniors who may be in poor health, it can be prone to aggressive sales tactics and abuse.

That does not mean that you should never consider a life settlement. A life settlement might make sense for you if you no longer want or need your current policy—or if you can no longer afford the expense of paying insurance premiums and are willing to give up or replace the coverage. Even then, however, you should proceed with caution. Here are some of the key factors you should consider:

Ongoing Life Insurance Needs—If you are considering buying a new policy with the proceeds of the life settlement, you will need to determine whether you will be able to get a new policy with equivalent coverage—and at what cost. Your old policy will still be in force and may affect your ability to get additional coverage. Even if you can get a new policy, you may have to pay higher premiums because of your age or changes in your health status. If your goal is to retain coverage but lower the premiums you pay or otherwise obtain different features, you might want to consider options such as reducing your existing amount of policy coverage or making a "1035 Exchange."

1035 Exchanges

If you're thinking of switching from one life insurance policy to another, you should consider whether a "1035 Exchange" would be more beneficial than a life settlement. Depending on your circumstances, if you opt for a life settlement, you may have to pay taxes if the cash surrender value of your policy—or the amount of a life settlement—exceeds the premiums you've paid.

The Internal Revenue Service allows you to exchange an insurance policy that you own for a new life insurance policy insuring the same person without paying tax on the investment gains earned on your original contract—which could be a substantial benefit. Because this is governed by Section 1035 of the Internal Revenue Code, these are called "1035 Exchanges." But there are other factors you should consider when deciding whether to exchange your policy, including potential loss of death benefits. For more information and a list of questions to ask, see FINRA's Investor Alert entitled Should You Exchange Your Life Insurance Policy? www.finra.org/investor

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- ➤ Less Costly Alternatives If one of the factors driving your decision is a need for cash, be aware that surrendering your life insurance policy for its cash value or pursuing a life settlement are not your only options—especially if you would ideally like to retain your coverage. For example, you might want to see whether you can borrow against your policy. You might also be eligible for accelerated death benefits, which allow an individual with a long-term, catastrophic, or terminal illness to receive benefits on his or her policy prior to dying. Check with the company that issued your policy before leaping into a life settlement. You may still decide that a life settlement is the best alternative for you, but you should be aware of all of your options before making up your mind.
- ➤ Difficulty Determining Fair Prices One of the hardest things to know when you are selling a life insurance policy is whether you are getting a fair price for your policy. There is no transparent secondary market for life insurance policies. The best way to make sure you are getting a fair price is to shop around. This can mean directly contacting multiple life settlement companies, using a licensed life settlement broker who will shop your policy around on your behalf, or contacting your broker or other financial services provider.
- ➤ Impact on Your Finances A cash payment from a life settlement can have unintended financial consequences, especially if your financial circumstances have changed from when you first bought the policy. For example, if you currently receive state or federal public assistance, such as Medicaid, a life settlement can negatively impact your ability to participate in that program. Before you proceed with a life settlement, be sure you fully understand the financial implications for you and your family. You may want to consult your attorney, accountant, or other legal or financial professional.

How Can I Protect Myself?



Good Idea. If you decide to go forward with a life settlement, here are some questions you should be sure to ask.

- 1. Is the life settlement broker or provider licensed in my state? A growing number of states regulate life settlement companies and life settlement brokers to some degree, and may require that they be licensed. Be sure to ask your state insurance commissioner (www.naic.org) whether the life settlement company or broker you are dealing with is properly licensed—and whether either has a record of complaints. If you are working with a securities broker, FINRA BrokerCheck should be your first resource to learn about his or her professional background, registration/license status and disciplinary history. www.finra.org/brokercheck
- 2. What will happen to my policy? Ask what the life settlement company that is buying your policy will do with it. Will they hold it themselves? Sell it individually? Or package it with other policies and sell interests in the package to other investors? The ultimate buyer of your policy will become responsible for paying the premiums and will collect the death benefit when you die—and, as noted below, any interim and ultimate buyers of your policy will also have access to a great deal of personal information about you, including your health status.
- 3. What information will I have to provide? To whom? For how long? When you sell your life insurance policy, you will have to sign a release authorizing the release of medical and other personal information so that the buyer can determine how much to offer for your policy. You may also have to agree to provide periodic updates about your health. Once the buyer obtains that information, it may be shared with other parties, including lenders or third party investors.

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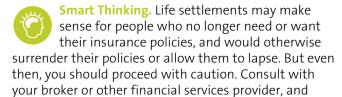
- 4. How can I protect my privacy? Before accepting any offer from a life settlement company, you should carefully read the application, and make sure that the company has procedures in place to protect the confidentiality of your information. If it will be sold, ask to whom, and whether the end buyers will have access to your personal information. If you use a life settlement broker, find out the names of the life settlement companies from whom the broker solicits bids, and ask about the privacy policies of all parties or potential parties to the transaction. In many cases, state regulations govern the handling of confidential information. Contact your state insurance commissioner to find out what regulations apply. (www.naic.org)
- 5. What's the best price I can get for my policy?

 If you are using a life settlement broker, ask what bids were received, and what steps the broker used to make sure you are being offered the most competitive price available. If you are approached by someone soliciting you to sell your life insurance policy, make sure you understand that person's role in the transaction: Is he or she a life settlement broker who represents you, or is the person affiliated with a particular life settlement company? If the answer is the latter, the person may only obtain an offer from that company, making it hard for you to know whether you are being offered a competitive price for your policy.
- 6. What are the transaction costs? Life settlements can have high transaction costs. The commissions paid by life settlement companies to life settlement brokers and other financial professionals involved in the transaction can be as high as 30 percent. Ask your broker or other financial adviser what they are being compensated for their role inthe transaction, and what other parties are receiving commissions. If someone recommends a particular life settlement to you, find out what they are being paid, and by whom.
- 7. What are the tax consequences? The lump sum payment you receive in exchange for your life insurance policy can be taxable, depending on your circumstances. Before entering into a life settlement, check with a tax professional about the tax implications of any transaction you are considering.

- 8. What if I change my mind? Always remember that you do not have to accept an offer to purchase your life insurance policy, even if you shopped around for the best price. If you do accept an offer and later reconsider, be aware that some states have laws that allow you to change your mind within a certain amount of time.
- 9. Is the life settlement in my interest or my investment professional's? At least one marketing brochure targeted at investment professionals not only touts the potential commissions from life settlements, but also emphasizes that additional revenues can be generated from the seller's purchase of other investment products using the proceeds from the life settlement. Citing industry statistics, the brochure notes that almost half of all life settlement transactions result in the purchase of new life insurance. In other words, your investment professional stands to make two commissions off of a life settlement transaction. And you may end up replacing a perfectly good policy with a costly new one.

Reminders

make sure that you:



- are dealing with properly licensed entities;
- are aware of the confidentiality policies of the parties involved;
- > are getting a fair price; and
- understand the tax and other implications of the transaction.

Where to Turn for Help

Life settlements can involve almost any kind of insurance policy, including variable policies. However, because only variable insurance products are securities, FINRA only has jurisdiction over life settlements involving variable policies.

If you have questions or wish to file a complaint about a life settlement, be sure to call or write your state insurance commissioner (www.naic.org).

If your complaint concerns a variable life insurance policy, you may also file a complaint with FINRA.

Here's how:

Online:

File a Complaint (for you) www.finra.org/complaint

Send a Tip (for others) www.finra.org/RegulatoryEnforcement/FileaTip

Mail or Fax:

FINRA Complaints and Tips 9509 Key West Avenue Rockville, MD 20850 Fax: (866) 397-3290

Glossary of Terms: Life Settlements

Accelerated Death Benefits.

Also known as "living benefits," accelerated death benefits provide payments to policy holders who have a long-term, catastrophic, or terminal illness—payments that ordinarily would not be available prior to the policy holder's death. Rules concerning accelerated death benefits vary from company to company and from policy to policy. In some cases, depending on the term of the policy or contract, the beneficiaries of the policy may be entitled to a reduced death benefit.

Cash Surrender Value.

The cash surrender value of a life insurance policy is the amount you can collect if you cancel (or "surrender") the policy before it matures or before you die. The amount is typically based on the cash you've built up in the policy over time (your tax-deferred savings) minus any surrender charges or outstanding loan balances.

Lapse.

Lapse refers to the termination of an insurance policy when an individual fails to pay his or her premiums on time. If you allow a policy to lapse, you typically cannot collect any cash surrender value that would otherwise be available.

Net Death Benefit.

A death benefit is the amount an insurance company pays to a policy holder's beneficiary when the policy holder dies. Not all life insurance policies or annuity contracts provide for this sort of benefit, and not all death benefits are calculated the same way. The net death benefit is the amount specified in the insurance policy or annuity contract, minus any unpaid premiums that are due and outstanding loan balances or other withdrawals. In the case of variable life insurance or variable annuities, investment gains and losses can impact the amount of the death benefit.

More Information

- ➤ Notice to Members 06-38 (which discusses concerns about, and member firm obligations in the context of, sales of existing variable life insurance policies to third parties)
- Selling Your Life Insurance Policy: Understanding Viatical Settlements (NAIC alert)
- Viatical Settlements: Buying Viaticals as Investments (NAIC alert)
- NASAA Alert Concerning Viatical Settlements
- Should You Exchange Your Life Insurance Policy? (FINRA alert)

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- Fund Analyzer
- Smart Bond Investing
- Smart 401(k) Investing
- Financial Calculators

Website: www.finra.org/investor Phone: (202) 728-6964

FINRA Market Data — Data on equities, options, mutual funds and a wide range of bonds, including real-time corporate bond prices and FINRA-Bloomberg Bond Indices.

Website: www.finra.org/marketdata

FINRA BrokerCheck—Check the background of a broker or brokerage firm

Website: www.finra.org/brokercheck

Toll-free: (800) 289-9999

FINRA Investor Complaint Center—If you feel you've been treated unfairly.

FINRA Investor Complaint Center 9509 Key West Avenue Rockville, MD 20850-3329

Website: www.finra.org/complaint

Fax: (866) 397-3290

FINRA Dispute Resolution—If you seek to recover damages.

FINRA Dispute Resolution One Liberty Plaza 165 Broadway, 27th Floor New York, NY 10006

Website: www.finra.org/ArbitrationMediation

Phone: (212) 858-4400 Fax: (212) 858-4429

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FINRA, the Financial Industry Regulatory Authority, is an independent regulatory organization empowered by the federal government to ensure that America's 90 million investors are protected. Our independent regulation plays a critical role in America's financial system—at no cost to taxpayers. We register brokers and brokerage firms, write and enforce rules governing their activities, examine firms for compliance, and foster market transparency and educate investors. For more information, visit www.finra.org.