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Small life settlements trouble regulators

Customers could end up worse off after a transaction, some fear

By **Darla Mercado**
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Regulators and attorneys are worried that the expansion of the life settlement business into the world of small life insurance policies could harm some policyholders.

Life settlement customers could end up both cash-poor and coverage-poor if they sell their small-face-value life insurance, said Sandy Praeger, Kansas insurance commissioner and president of the Kansas City, Mo.-based National Association of Insurance Commissioners. The concept makes her feel "uncomfortable" — a sentiment many in the financial services industry share.

"These are folks who may be using up all their ability to buy $100,000 in insurance," Ms. Praeger said. "They sell it for cash, go through the money and then later realize they may not be able to get insurance to function the way it should."

In a life settlement transaction, insured individuals sell their policies to third parties for more than the surrender value. The third party pays the premiums and becomes the beneficiary. While life settlement providers have been buying larger policies for more than two decades — and packaging them for institutional investors who generally would not consider buying a policy under $500,000 — only recently have life settlement providers gone after smaller policies.

"When you get to very small policies, below $250,000 in death benefit, there is occasional competition, but most of the industry finds it difficult to make those transactions profitable because of the amount of work," said Scott Willkomm, chief executive of mortality-linked products for J.G. Wentworth LLC.

Last month, 22 states granted life settlement provider licenses to J.G. Wentworth Life Settlements LLC and J.G. Wentworth Life Settlements (DE) LLC, subsidiaries of Bryn Mawr, Pa.-based J.G. Wentworth. The specialty finance company is seeking to purchase policies with face values between $50,000 and $500,000, a market that it describes as "underserved."

Providing holders of small policies with the opportunity to sell them to the secondary market would "democratize the life settlements business," Mr. Willkomm said.

BUILT ON VOLUME

Sandy Praeger: *She's uneasy about the effects of small life settlements*

"There are solid institutional bidders in hot pursuit of qualified life settlements for upward of $500,000," said Michael D. Quinn, vice president of Cielo Life Settlement of Baltimore. That pool may be as large as 20 to 25 institutions, he estimated.

But only about a half dozen companies are interested in small policies, Mr. Quinn said. The time and cost to process a life settlement application, along with any commission due a participating broker, make smaller policies unappealing to most providers, he added.

But a combination of large demand, in the form of many aging boomers with small policies, and streamlined marketing and processing capabilities, could make Wentworth's venture profitable, said Mr. Willkomm.

"Our profit model is built on volume, so unlike our competitors, who are satisfied with doing 200 transactions per year, we like to do multiple hundreds in smaller amounts," he added.

J.G. Wentworth, Cielo and others process applications electronically, reducing a transaction's paperwork and costs. Offers can be made in as little as five to 10 business days of receipt at Cielo, as less time is spent on collecting medical records and underwriting for small-face-value policies.

Also, J.G. Wentworth uses a direct-to-consumer retail approach for this market, reaching policyholders through television ads and eliminating brokers and their commission.

"The cost of getting the customer in the door and engaged in a transaction is manifested in the broker market by the commissions you pay," Mr. Willkomm said. The company purchases these policies for itself, rather than on the behalf of investors.

GETTING FAIR VALUE

But it's this very approach that makes attorneys and regulators nervous about the target audience.

Average people lack the sophistication to shop their policies around or to seek help from a broker, attorneys said.

In an environment with few competitors and complicated transactions, these clients will have a tough time getting fair value for their policies, according to attorneys.

"People with big policies will be well advised and will get the fair value, but senior citizens who aren't represented won't," said Bernard A. Krooks, a managing partner in Littman Krooks LLP in New York, White Plains, N.Y., and Fishkill, N.Y.

Additional long-term complications may arise for these clients, including the possibility that they may not be able to buy more life insurance.

For instance, the difference be-tween the discounted price and the cash surrender value of the policy could be treated as a transfer for less than fair market value, possibly creating a sanction period if the client or a spouse applies for Medicaid within five years of the settlement's date, according to Charles W. Beinhauer, an attorney with Pfalzgraf Beinhauer & Menzies LLP of Buffalo, N.Y.

Individuals who sell their policies to get out of a cash crunch are probably the ones who will need Medicaid, Mr. Beinhauer said.

"It's the elderly couple that's desperate, so they're willing to take this lump sum," he said.

There is little recourse for clients who don't get a good deal on their policy.

"You're presumed to be a competent adult able to engage in the transaction, so if you make a bad deal, you can't get your money back," warned Mr. Krooks.

Regulators aren't putting limits on the small-face-value secondary market yet, and no complaints are on their radar.

"As long as they meet state requirements, I can't say arbitrarily that they can't do business," said Ms. Praeger. Her state has cleared J.G. Wentworth's life settlement subsidiaries.

"We'll watch these transactions closely and ask for additional authority to regulate if needed," Ms. Praeger said. NAIC will be watching for higher premiums and will administer market conduct exams to curtail abusive practices, she said.

In a recent note to member firms, the Financial Industry Regulatory Authority Inc. of Washington and New York said it would examine the life settlements industry, particularly to learn whether the transactions are done with the intent of getting the consumer to use the proceeds on high-commission products such as variable annuities.

On the other hand, industry groups such as the Life Insurance Settlements Association worry that small-face-value policies will inspire "excessive" oversight to prevent stranger-oriented life insurance practices.

"I don't want state laws and regulatory burdens to be such that it's impossible to do these kinds of transactions," said Doug Head, executive director of the Orlando, Fla.-based LISA.

"The cost of getting into the business will be so onerous, it will keep modest consumers from accessing this market."

Nevertheless, attorneys are keeping a close eye on these life settlement providers, fearing that seniors will get meager bids for their policies and then blow through the cash.

"Those two issues are the major areas I'd be concerned with," said Mr. Beinhauer. "It's such a new product; I think it's an issue that will grow over time."

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