

# **Stranger-Owned Life Insurance**

**Free insurance? Found money? A good investment? A scam?  
What is it anyway?**

By



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## **Stranger-Owned Life Insurance: Free insurance? Found money? A good investment? A scam? What is it anyway?**

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*Stranger-Owned Life Insurance (SOLI) is best thought of as a "mortality futures" transaction where certain parties have one expectation as to the future value of the article of trade that is the subject of the "futures contract", while other parties have a different expectation as to the future value of that article of trade. In a SOLI transaction, the article of trade that is the subject of the "futures contract" is the life expectancy or mortality of the insured. While current marketing practices suggest SOLI is an easy way to make money with little if any risk and that all parties will profit, SOLI is actually a complicated transaction involving at least six parties to the transaction and where certain parties will profit and certain parties will lose, just like in any "futures contract". As such, we will explore herein the various risks of loss and potential for profit from the perspective of each of these parties to the transaction.*

### **Part I – The Overview**

Stranger-Owned Life Insurance (SOLI) is not a type of life insurance product. It is instead a marketplace term for a transaction that came into being roughly 3 years ago and which makes use of three legitimate but otherwise separate financial markets, namely: 1) the primary market for *new* life insurance products issued by the insurer, 2) the secondary market where *inforce* life insurance products can be sold, and 3) the market of special-purpose lenders who finance life insurance premiums. The basic structure of the transaction is also marketed or referred to as Investor-Owned Life Insurance (IOLI), Charity-Owned Life Insurance (ChOLI) and Speculator-Initiated Life Insurance (SPINLife).

By any name, the transaction (hereafter referred to as SOLI) is defined as an ownership scheme in which a life insurance policy is owned (either initially or ultimately) by an investor group unrelated to the insured, where the insured (or someone with an insurable interest) pays little or nothing for the life insurance, and where someone other than the insured (or someone without an insurable interest) pays for the insurance. Further, in a SOLI transaction the purpose of the insurance is **not** for protection against premature death or as a wealth accumulation vehicle, but rather for a profit on the future trading of a life insurance contract.

The basis for such profit expectations revolves around a single factor – the life expectancy of the insured. For instance, like in any "futures" contract, the different parties to the SOLI transaction have different expectations as to the future value of the life insurance death benefits that are article of trade in this "mortality futures" contract. In other words, on one side of the SOLI transaction, certain parties are calculating life expectancy one way, while certain parties on the other side are calculating life expectancy differently. Whichever party calculates life expectancy most accurately will profit, and whichever party miscalculates life expectancy will lose, as we will see below.

These various parties to a SOLI transaction are:

- 1) An insured
- 2) A life insurance agent/broker (the distributor)
- 3) An investor group (the viator or life settlement market maker)
- 4) A special-purpose lender
- 5) The life insurance company

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6) The IRS because SOLI policies do not qualify for tax exempt treatment afforded to other forms of life insurance

A typical SOLI transaction begins with a life insurance agent/broker proposing to a prospective insured that he or she “owns” a “wasting asset” in the form of their insurability, and that they can make money “selling” this wasting asset by simply consenting to be insured under a SOLI policy. The insured, who does not need life insurance for traditional reasons such as income replacement, family protection, retirement planning, funding a stock redemption agreement or financing estate taxes, consents to being insured in exchange for the promise of either “free insurance” or some cash payment or both.

Insureds generally pay nothing towards SOLI policy premiums, and in some cases, are actually paid up-front cash in exchange for consenting to being underwritten and insured. The investor group serving as market maker for the policy puts up the money to pay premiums (either directly or indirectly through borrowing) and/or to pay the insured this up-front cash (again either directly or indirectly through borrowing), all for the exclusive purpose of earning a profit from the collection of SOLI death benefits, which are expected to be greater than the amount they paid for the policy, plus an expected minimum rate of return on the market maker’s SOLI investment.

Regulatory issues make it impractical for the investor group to own the SOLI policy and pay premiums directly during the first two years. As a result, SOLI transactions involve a finance company during this two-year interim period. These special-purpose-lenders loan funds for the payment of premiums to the insured (or a trust created by the insured) often on a non-recourse basis (i.e., the insured can default on repayment and the lender has no recourse for recovering loaned amounts from the insured) at interest rates as high as Prime-plus-5% or more (for example, 12% to 14% compound annual loan interest).

The typical proposal for a SOLI transaction suggests that, after these first 2 policy years, the market maker will purchase the policy from the insured for its “fair market value”, but the market maker is not generally required to purchase the policy nor is this purchase price guaranteed. While the insured is generally entitled to repay the loan during the first two years and keep the policy, this is unlikely for reasons discussed in “The Insured” section below. Also, while this “fair market value” is presumed to be enough to repay premium loans, pay above-market interest, and pay the insured a profit, this “fair market value” is actually a function of the market makers calculation of the life expectancy of the insured at the that time (i.e., 2 years after the date of the initial policy purchase).

“Fair market value” is, by definition, the price at which a willing seller will sell and a willing buyer will buy. The seller of a SOLI policy is the insured (or the trust of the insured), and the buyer is the viator or investor group formed to make a secondary market for life insurance policies. Both are willing sellers/buyers when they expect a profit. The insured-seller does not generally perceive a need for the life insurance for traditional reasons, and has no investment in the SOLI contract (beyond the tax cost which may or may not be disclosed in the sales process), so the insured is a “willing seller” at almost any price given there are few if any other exit strategies out of the SOLI transaction.

For instance, an insured has only three (3) options under a SOLI policy, namely: 1) continue the policy by repaying the premium loan and accrued above-market interest and start paying above-market premiums, or 2) surrender the policy for its cash value after repaying the premium loan and accrued above-market interest and take the difference as a loss, or 3) sell the policy to the life settlement market maker for an amount presumably greater than the cash surrender value and hopefully also enough to pay off the premium loan, pay accrued above-market interest, pay termination fees (if any), recoup taxes paid and earn the promised profit. Of course, unless the insured decides they need life

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insurance for traditional reasons, the only practical option is to sell the policy to the life settlement market maker, and thus the SOLI insured will generally be a “willing seller” at any price.

On the other hand, for the market maker buyer to be a willing buyer, the purchase price of the SOLI policy must be low enough such that the investor group still profits when death proceeds are collected some number of years in the future. For example, an investor group seeking a 12% return on its investments over a 10 year holding period could pay up to \$370,000 for a \$1 million SOLI policy (ignoring taxes for the moment) provided the life expectancy of the insured was 10 years or less. In other words, a \$370,000 investment earning 12% for 10 years is equal to \$1 million. As such, the maximum price a market-making-buyer will pay for a SOLI policy can be estimated using simple time-value-of-money calculations using the insured’s life expectancy as the holding period ( $n$ ), the “hurdle rate” of the investor group (typically in the 12% to 14% range) as the discount rate ( $i\%$ ), the amount of the death benefits expected in the future as the future value ( $FV$ ), and solving for the present value ( $PV$ ).

Of course, the less a market maker pays for a given policy and the shorter their holding period until they receive SOLI death proceeds, the greater their profit. It is thus important to remember that life settlement market makers are in business to *pay as little as possible* when purchasing SOLI holdings in order to maximize investment returns to their investor group. Also, while life insurers generally reserve the right to change their calculation of life expectancy over time by adjusting the pricing of their life insurance policies to reflect actual mortality experience, life settlement market makers “lock in” their calculation of life expectancy at the time they purchase a SOLI policy, and thus risk either reduced profits or even a loss if they miscalculate life expectancy.

For these reasons, and given the current lack of regulation of the life settlement secondary markets, the amounts these investor groups pay for SOLI policies is often far less than their intrinsic “fair market value” of a given policy as calculated above. In other words, *after* the insured consents to being underwritten and insured under a SOLI policy, the market maker has no obligation and little or no financial incentive to purchase the policy from the insured for an amount that is sufficient to repay premium loans, and pay above-market interest, and pay the insured a profit, and are not required to purchase the policy at all. This is not to say that life settlement market makers won’t deliver on the promise to purchase the SOLI policy and pay an amount sufficient to pay a profit to the insured, but is to say that there are financial forces working against the insured receiving such a profit.

One way investor groups may be able to ensure their profit targets while also paying profits promised to the insured is by selling SOLI holdings to a 3<sup>rd</sup>-Party rather than holding SOLI policies until death benefits are paid. Selling SOLI holdings shortens the holding period of the investor group to something less than the life expectancy, and thereby eliminates the risks associated with different life expectancy calculations. For this reason, certain SOLI investor groups have been seeking to securitize SOLI holdings for sale on Wall Street in the same way real estate developers pooled real estate holdings and sold them as Real Estate Investment Trusts (REITs), and the way mortgage companies bundled mortgage holdings and also sold to the community of public investors.

If SOLI holdings are securitized and sold to the general public, then the number of parties in the SOLI transaction increases to include #7-the investment banking firm that securitizes individual SOLI holdings and sells them to #8-the public market of individual investors. As such, SOLI transactions involves at least six parties, and potentially as many as eight, each involved for the purpose of turning a profit. Each party thus represents a “friction point” whose profit erodes a portion of the economic benefit otherwise available to other parties in the transaction but further down the line.

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While there may be transactions other than SOLI that involve eight or more parties/friction points, few involve a financial product that is generally available in the market usually with only two parties seeking a profit from the transaction (i.e., the life insurance company manufacturing the product and the life insurance agent/broker distributing the product, but not the insured who is actually a consumer who is paying for insurance coverage in a traditional life insurance transaction and not seeking a profit and thus not a friction point). In other words, implied in the SOLI transaction is that there is a sufficiently large profit margin in a non-SOLI transaction that this “excessive” profit can be divided among an additional four to six parties, and all will still profit. As we will see in Part IV below, this is simply not possible.

While certain parties to a SOLI transaction do profit without regard to life expectancy (e.g., the life insurance agent/broker and the investment banking firm if SOLI holdings are securitized), certain other parties will profit while certain other parties must lose depending upon the ultimate accuracy of their respective life expectancy calculations. For instance, if life settlement market makers are correct in their calculations of life expectancy, then these investor groups will profit along with those parties on the same side of the SOLI transaction (e.g., the insured, the special purpose lender, and potentially the public investor), and the life insurance company must lose. On the other hand, if the insurance company is correct in its life expectancy calculations, then the insurer will profit and all other parties on the other side must lose.

To explore the profit potential and risks of loss for each party to the transaction, we must first examine in Part II the underlying economics of the life insurance product at the center of the SOLI transaction, and then delve into the financial meaning of the term “life expectancy” and the different ways that life expectancies are calculated by the different parties to the transaction in Part III. With this understanding of how life insurance products actually work in a SOLI transaction, Part IV walks through the impact of life expectancy on the various parties to the SOLI transaction and considers the long-term viability of the SOLI market.

Finally, whether or not the SOLI market is viable over the long term, SOLI transactions have been and will likely continue to be aggressively marketed for the foreseeable future. As such, to the extent that practitioners are comfortable with the economics of the transactions, and clients are comfortable with the potential risks and social issues, then Part V identifies a list of “top 10” questions that prudence suggests should be asked before either participating in or entering into a SOLI transaction.

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## Part II – Economics of the Life Insurance Product

The economics of all life insurance products is a function of three pricing factors: 1) cost of insurance charges (COIs), 2) policy expenses, and 3) policy interest/earnings, as shown below:

$$\text{Pricing, Performance, and Profitability} = \text{Cost-of-Insurance Charges} + \text{Policy Expenses} - \text{Policy Interest/Earnings \& Death Benefits}$$

Therefore, to understand the profit potential of a given life insurance product, we must examine what the life insurance company expects to charge/collect for 1) cost of insurance charges, plus 2) policy expenses, minus what the insurer expects to credit/pay out for 3) earnings on policy account values and death benefits, as is shown in the below table of hypothetical policy charges and policy values for an “average”<sup>1</sup> life insurance product typically used in SOLI transactions.

Pol Year	Age EoY	(1) Account Value BoY	(2) Planned Annual Premium	(3) Premium Loads	(4) Fixed Admin Expenses	(5) Cost of Insurance Charges	(6) Cash Value Fees	(7) Net Policy Earnings	(8) Account Value EoY	(9) Net Death Benefit
1	76	0	409,581	30,719	15,687	42,973	0	20,843	341,045	10,000,000
2	77	341,045	409,581	30,719	15,687	58,848	0	40,795	686,167	10,000,000
3	78	686,167	409,581	30,719	15,687	75,879	0	60,954	1,034,417	10,000,000
4	79	1,034,417	409,581	30,719	15,687	89,254	0	81,418	1,389,756	10,000,000
5	80	1,389,756	409,581	30,719	15,687	107,561	0	102,149	1,747,518	10,000,000
6	81	1,747,518	409,581	30,719	15,687	127,152	0	122,984	2,106,525	10,000,000
7	82	2,106,525	409,581	30,719	15,687	147,316	0	143,875	2,466,259	10,000,000
8	83	2,466,259	409,581	30,719	15,687	171,302	0	164,687	2,822,819	10,000,000
9	84	2,822,819	409,581	30,719	15,687	191,909	0	185,417	3,179,503	10,000,000
10	85	3,179,503	409,581	30,719	15,687	211,183	0	206,198	3,537,693	10,000,000
11	86	3,537,693	409,581	30,719	15,687	231,368	0	227,040	3,896,540	10,000,000
12	87	3,896,540	409,581	30,719	15,687	251,519	0	247,922	4,256,118	10,000,000
13	88	4,256,118	409,581	30,719	15,687	267,859	0	268,969	4,620,403	10,000,000
14	89	4,620,403	409,581	30,719	15,687	301,369	0	289,752	4,971,961	10,000,000
15	90	4,971,961	409,581	30,719	15,687	337,961	0	309,674	5,306,849	10,000,000
16	91	5,306,849	409,581	30,719	15,687	403,935	0	327,669	5,593,758	10,000,000
17	92	5,593,758	409,581	30,719	15,687	427,184	0	344,143	5,873,892	10,000,000
18	93	5,873,892	409,581	30,719	15,687	434,621	0	360,712	6,163,157	10,000,000
19	94	6,163,157	409,581	30,719	15,687	417,918	0	378,587	6,487,002	10,000,000
20	95	6,487,002	409,581	30,719	15,687	380,593	0	399,186	6,868,770	10,000,000
21	96	6,868,770	409,581	30,719	15,687	351,582	0	422,993	7,303,356	10,000,000
22	97	7,303,356	409,581	30,719	15,687	310,284	0	450,349	7,806,597	10,000,000
23	98	7,806,597	409,581	30,719	15,687	251,421	0	482,369	8,400,720	10,000,000
24	99	8,400,720	409,581	30,719	15,687	167,508	0	520,615	9,117,002	10,000,000
25	100	9,117,002	409,581	30,719	15,687	47,479	0	567,302	10,000,000	10,000,000

Because SOLI transactions are generally marketed to high-net-worth individuals between ages 70 and 80, we will examine the pricing of an institutionally-priced \$10 million traditional life insurance product insuring a 75 year old female non-tobacco-user considered to be in standard health, and where COIs and policy expenses are based on industry benchmarks<sup>1</sup> and

<sup>1</sup> Based on TheInsuranceAdvisor.com (TIA) benchmarks derived from industry standard mortality tables (see Society of Actuaries 75-80 Basic Select & Ultimate Gender Distinct Mortality Tables at [www.soa.org](http://www.soa.org)), industry aggregate expense ratios (see Society of Actuaries Generally Recognized Expense Table for 2001 also at [www.soa.org](http://www.soa.org)), generally accepted actuarial principles, and continual study of an increasingly larger sample population of actual products to include both inforce policies as well as new products currently available for sale/purchase. Like other benchmarking systems, these benchmarks do not reflect the mathematical average of all products, but instead illustrate example policy pricing and performance intended as representative of an “average product”. In other words, because TIA Benchmarks were designed by actuaries to be intentionally average, based on “average” cost of insurance charges (COIs), “average” fixed administration expenses (FAEs), and “average” cash-value-based “wrap-fees” (e.g., M&Es), and “average” premium loads, certain products available in the market will charge lower COIs, and/or lower FAEs, and/or lower wrap fees, and/or lower premium loads, while certain other products will charge higher COIs, and/or FAEs, and/or wrap fees, and/or premium loads.

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policy interest/earnings are based on the long-term historical rates of return for the assets classes into which policy cash values are required by regulations to be invested. Each of these is explained below.

**Cost of Insurance Charges (COIs)** – COIs are by far the largest cost component in a life insurance product. Whether disclosed or not, all policy issues are priced for expected cost of insurance charges to cover anticipated payments by the insurer for death claims. As with most types of insurance, claims are, and arguably should be, the largest single cost factor of any insurance policy. COIs typically account for about 75% or more of the total charges collected by the insurance company, and, as expected, the higher the claims, the higher the COIs and the shorter the life expectancy of the insured in the pool for a given product.

COI charges are calculated year-by-year as the result of multiplying policy death benefits (see net amount at risk in the illustration above) times a COI rate specific to each age corresponding to each policy year for the product. These deductions are much like term life insurance premiums because they are mainly for claims paid during a given period (typically 1 year). For this reason, COIs are frequently referred to as the pure "risk" portion of the premium, which the insurance company collects to pay the death benefits. As the number of deaths increases with age, so do the COIs.

Assume an insurance company provides permanent life insurance for a group of 1,000 policyholders all of whom are insured for \$100,000. Three insureds out of the group of 1,000 die in a given year. The insurance company pays \$300,000 to the beneficiaries of those three insureds. The insurance company must collect \$300 from each policy owner over the course of the period in order to pay this \$300,000 in claims (i.e., 1,000 policyholders times \$300=\$300,000 in death claims paid). In this case, the COI rate would equal \$3.00 per \$1,000 of death benefit (each insured paid \$3.00 multiplied times 100 for each \$1,000 of death benefit).

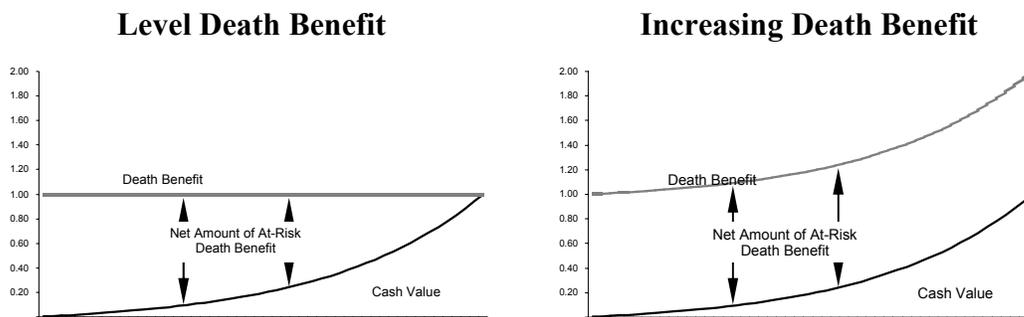
As the average age of the population of 1,000 in the group ages, the risk of more deaths increases. For example, in the next year, all insureds are a year older. Because the probability of death increases with age, we assume that four insureds out of population of 1,000 will die in this next year (for simplicity sake, we will assume that the insurance company sold three new \$100,000 policies to replace the three \$100,000 policies removed from our pool by the three deaths in the prior year). The insurance company will pay \$400,000 to the beneficiaries of those four insureds. It must collect \$400 from each policy owner over the course of the period in order to pay this \$400,000 in claims (i.e. 1,000 policyholders times \$400=\$400,000 in death claims paid/to be paid). In this case, the COI Rate would equal \$4.00 per \$1,000 of death benefit (i.e. each insured paid \$4.00 multiplied times 100 for each \$1,000 of death benefit).

This example also assumes that the insurance company collects only the exact amount necessary to pay these claims. However, the insurance company must also collect a profit to remain in business. Actual COIs in this example would be slightly higher to cover anticipated claims, and also to provide a profit to the insurance company. Some insurers also "load" the COIs to cover other policy expenses that are not disclosed elsewhere. For example, some policies marketed as "no-load" or "low-load" policies do not disclose certain policy expenses or loads. For instance, while a no-load product does not charge a premium load, the insurer must still pay state premium taxes and federal deferred acquisition costs (DAC) taxes which are nonetheless calculated as a

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percent of premium. As such, even "no-load" or "low-load" policies will charge for state premium taxes, federal DAC taxes, and even sales loads, but such "loads" are "hidden" inside either "loaded" COIs or other policy charges.

In all cases, these COIs are calculated each policy year as the result of the policy "net amount at risk" death benefit multiplied times a COI rate provided by the insurance company for each age corresponding to each policy year for each product. This "net amount at risk" death benefit is that portion of the total death benefit in excess of any policy cash value and is thus the inverse of the cash value (e.g., the higher the cash value of the policy, the lower the net at risk amount of death benefit to the insurer). To the extent that policy cash values increase over time, this net-amount-at-risk death benefit will decline from year to year in a level-death-benefit policy design, or will remain level in an increasing-death-benefit policy design, as shown in the charts below.



While different policies can calculate the "net at risk" death benefit differently, this Net Amount at Risk (NAR) in any given year can be generally calculated by the following equation:

$$\text{Net Amount at Risk} = \text{Policy Death Benefit} - \text{Policy Cash Value}$$

Because COIs are calculated on the NAR, and because they increase geometrically, the NAR is a significant factor for the pricing and performance of any SOLI holding. COI charges are minimized when cash values are nearly equal to the policy death benefit even at the older ages when COI rates are at their highest. However, because policy cash values are used by the insurer to pay a part of the death benefit, any COI cost savings associated with high cash values and a corresponding low NAR must be measured against the "cost" of forfeiting policy cash values.

Either way, payment of death claims are the insurer's largest expense and thus COIs collected to amortize the payment of such death claims over the life of the policy are the largest single policy expense. Because COIs can vary widely from year to year and from product to product the [illustration](#) of hypothetical policy values above uses benchmark<sup>2</sup> COIs published by [www.TheInsuranceAdvisor.com](http://www.TheInsuranceAdvisor.com) (TIA) as a representative of average year-by-year COIs for all

<sup>2</sup> TIA benchmark cost of insurance charges (COIs) are derived from industry standard mortality tables (see Society of Actuaries 75-80 Basic Select & Ultimate Gender-Distinct Age-Nearest Mortality Tables at [www.soa.org](http://www.soa.org)), generally-accepted actuarial principles, and continual study of an increasingly larger sample population of actual products to include both inforce policies as well as new products currently available for sale/purchase. As such, TIA Benchmark COIs do not reflect COIs for an actual product available for sale, nor the mathematical average COIs for all products, but instead is representative of COIs found in an "average product".

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institutionally-priced individual permanent life insurance products insuring a female non-tobacco-user age 75 considered to be in standard health.

**Policy Expenses** – In addition to COIs, most policy issues are priced for expected expenses related to actuarial design, sales and marketing, underwriting and new business processing, state and federal taxes, and service and administration. Insurers charge for these policy expenses in only three ways: premium-loads shown in column 3 of the [illustration](#) of hypothetical policy values, fixed administration expenses (FAEs) shown in column 4, and cash-value-based “wrap fees” shown in column 6, each of which is explained below:

- a. **Premium-Loads:** Premium loads are charged to policyholders as a percent of premiums paid in a given year and typically range between 0% and 35%. Premium-based charges customarily cover state premium taxes that average 2.5%, DAC taxes averaging 1.5%, and sales loads/expenses ranging between 0% and 30%. While state premium taxes and DAC taxes generally are calculated by the respective government agencies as a percent of premium, and while insurance companies must certainly pay these taxes, insurance companies are not required to assess the charge as a percent of premium. As a result, some insurance companies charge no premium charges, and collect state and federal taxes from other charges within the policy (usually COIs).

Premium-based charges also can vary depending on either the policy year in which a premium is paid or the level of the premium paid into a given policy. For example, a higher premium load may be assessed in the early policy years to recover up-front expenses related to underwriting, issue and distribution of a given policy. After these up-front expenses have been amortized (frequently over a period of 10 policy years), premium loads are often reduced to cover the relatively lower policy owner service and policy administration expenses.

A higher premium load may be charged on actual premiums paid up to a "base policy premium" or "target premium" level, while a lower premium load may be charged on actual premiums paid in excess of this "base policy premium" or "target premium" amount. This "base policy premium" or "target premium" is generally the premium which, if paid every policy year, would endow or mature the policy for its originally issued face amount based on either guaranteed or expected policy pricing assumptions as to COIs, expenses and earnings.

Insurance company actuaries calculate “base policy premium” or “target premium” by basing expenses upon actuarial expectations. These calculations also assume that the policy cash values produced earnings consistent with historical performance for the asset classes underlying policy cash values. Further, if the policy owner paid the "base policy premium" or "target premium" every year, then the policy would mature the death benefit regardless of the insured’s age of death. This "base policy premium" or "target premium" is, therefore, analogous to the "insurance premium" (i.e. that premium typically paid to maintain insurance coverage).

We can view the premium amounts paid into the policy in excess of this "base policy premium" or "target premium" as "excess premium" above and beyond that required to

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support an insurance death benefit. A policy owner may decide to pay this “excess premium” to create a cash value reserve that can be used to pay future COIs and policy expenses from within the policy, effectively pre-paying future premiums or accumulating wealth in the form of policy cash values that benefit from preferred federal income tax treatment and special protection from the claims of creditors under state law.

Premiums paid up to the “insurance premium” are generally subjected to “insurance loads” to cover policy expenses unique to the insurance component of the policy. Premiums paid in excess of the “insurance premium” are generally subjected to a lower level of loads on those monies intended to accumulate the cash value the “investment” component of the policy. Because premium loads can vary widely from year to year and from product to product, the [illustration](#) of hypothetical policy values uses benchmark premium loads<sup>3</sup> published by [www.TheInsuranceAdvisor.com](http://www.TheInsuranceAdvisor.com) (TIA) as representative of average premium loads for all institutionally-priced individual permanent life insurance products insuring a female non-tobacco-user age 75 considered to be in standard health, as shown in column 3 in the illustration.

- b. Fixed Administration Expense (FAE) – FAEs are charged to policyholders as some fixed amount calculated and set at the time of policy. They are issued either as a flat monthly charge (for example, \$10.00 a month), or in relation to the originally issued policy face amount (for example, \$1.00 per \$1,000 of policy face amount). While the amount of this charge is fixed when the policy is issued, it can vary from year to year by a predetermined schedule. Because of this variability, the [illustration](#) of hypothetical policy values uses benchmark FAEs<sup>3</sup> published by [www.TheInsuranceAdvisor.com](http://www.TheInsuranceAdvisor.com) (TIA) as representative of FAEs for all institutionally-priced individual permanent life insurance products insuring a female non-tobacco-user age 75 considered to be in standard health, as shown in column 4.

FAEs can also include contingent or back-end policy surrender charges that are deducted from the policy cash account value upon surrender or cancellation/termination of the policy. These surrender charges are calculated in relation to the initially issued policy face amount and can be as much as 100% or more of the planned annual premium for policy issues available to the general public at large, commonly referred to as “Retail Policies.” They can be less or even 0% for policies purchased in larger volumes, frequently referred to as “Institutionally-Priced Policies.” In either case, this surrender charge typically remains level for an initial period of years and then reduces to \$0 over a following period of years, but is not applicable here because SOLI policies are held either until the death claim is paid, at which time any surrender charges are waived, or until policy maturity after surrender charges have already been reduced to \$0.

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<sup>3</sup> TIA benchmark policy expenses are derived from industry standard industry aggregate expense ratios (see Society of Actuaries Generally Recognized Expense Table for 2001 also at [www.soa.org](http://www.soa.org)), generally-accepted actuarial principles, and continual study of an increasingly larger sample population of actual products to include both inforce policies as well as new products currently available for sale/purchase. As such, TIA Benchmark COIs do not reflect policy expenses for an actual product available for sale, nor the mathematical average of policy expenses for all products, but instead is representative of policy expenses found in an “average product”.

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- c. Cash-Value-Based “Wrap Fees” – These are insurance fees charged to policyholders as a percent of policy account values. They are similar to FMEs found in mutual funds or variable products where investment managers charge an investment management fee based on a percent of assets under management. However, these cash-value-based *insurance fees* are specific to the policy and are generally collected at the policy level. They are separate from and in addition to the *investment fees* also charged as a percent of policy account values, but which are specific to the investment fund and collected at the fund level.

Fund-level or fund-specific charges relate specifically to the investment portfolio or separate accounts funds upon which the cash value is based. They typically range from 25 basis points, or 0.25% for an index fund, to 200 basis points, or 2.0%, for international or emerging markets type funds. Fund-level or fund-specific charges are often referred to as FMEs, and generally include, but are not limited to, charges at the investment fund or portfolio level for investment management fees, investment advisory fees, and fund operating expenses. These charges may or may not be disclosed depending upon the type of policy.

Because fund-level or fund-specific charges are a function of the underlying investment portfolio or separate account funds, these charges are more of an “investment expense” than an “insurance expense”, and should generally be considered only when comparing investment options or separate account fund selections, and not when comparing policy costs.

On the other hand, policy-level or policy-specific charges relate specifically to the policy itself, without regard to underlying portfolio investments or separate account fund selections, and typically range from 0 to 100 basis points, or 1.0%. They can vary from year to year and are based on the policy account value. The most common policy-level or policy-specific cash-value-based charge is the Mortality and Expense Risk (M&E) charge found in variable life products. This M&E charge is intended to cover the risks assumed by the insurance company that the actual cost of insurance charges will be greater than expected (i.e. insureds live less time than anticipated resulting in increased claims) and/or that actual expenses will be greater than expected.

Some products also include policy-level or policy-specific cash-value-based charge in addition to the M&E charge, both of which can vary depending on the year of the policy (e.g., 1.0% of cash values during the first 10 policy years, and 0.5% of cash values thereafter). Because these policy-level or policy-specific cash-value-based charges are specific to the policy, without regard to the underlying investment portfolio or separate account fund selections, they truly are a policy cost to be considered when comparing one policy to another.

Because SOLI transactions typically use traditional life insurance products, which are typically not priced to include cash-value-based “wrap fees” such as M&Es found in variable products, the [illustration](#) of hypothetical policy values on page does not include cash-value-based “wrap fees.”

The manner in which these premium-loads, fixed administration expenses, and cash-value-based “wrap fees” are constructed and calculated determines the suitability of a given product to a

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given situation. For instance, products with low COIs and low FAEs perform optimally in defined-death benefit, minimum premium situations even if premium loads and cash-value-based fees are relatively high. That is because these expenses are calculated as a percent of a minimum premium and minimum cash values, and thus have less influence on the degree to which premiums can be minimized. On the other hand, products with low premium loads and low cash-value-based fees perform optimally in defined-contribution, maximum-accumulation situations even if COIs and FAEs are relatively high. That is because maximizing premiums and cash values reduces the Net Amount at Risk (NAR discussed above), which in turn minimizes COIs, and means COIs have less influence on cash value accumulations.

The SOLI transaction is by definition a defined-death benefit, minimum-premium type plan design. However, because premium-finance lenders typically take assignment of the policy as collateral, and because such lenders generally seek as much collateral as possible, SOLI transactions often use products with higher premiums and greater cash values to satisfy the lender's collateral requirements. As a result, products most suitable in SOLI transactions often are those that report both low COIs and low FAEs, as well as low cash-value-based fees and low premium-loads. Because such policy expenses can vary widely from year to year and from product to product, the following analysis uses benchmark expenses<sup>3</sup> published by [www.TheInsuranceAdvisor.com](http://www.TheInsuranceAdvisor.com) (TIA) as representative of average policy expenses for all institutionally-priced individual permanent life insurance products insuring a female non-tobacco-user age 75 considered to be in standard health as shown in columns 3, 4 and 6 of the [illustration](#) of hypothetical policy values.

**Interest/Earnings** – After the insurance company deducts COIs, premium loads, FAEs and cash-value-based “wrap fees” (M&Es), premiums paid in excess of these policy charges are credited with some form of policy interest or earnings based on product type and the allocation of invested assets underlying policy cash values. For instance, regulations require that “fixed products,” such as universal life and whole life most often used in SOLI transactions invest assets underlying policy cash values predominantly in high-grade corporate bonds and government-backed mortgages<sup>4</sup>.

The policy interest crediting rate for universal life products and the dividend interest crediting rate for whole life products generally will correlate with the 6% historical rate of return on high-grade government and corporate bonds and government-backed mortgages over time. These are higher for insurers with superior investment performance or whose general account portfolio may be comprised of fixed-income securities with longer-term maturities, and lower for insurers with inferior investment performance or whose general account portfolio may be comprised of shorter-term fixed-income maturities.

While life insurance policy pricing and performance projection systems often allow for a wide range of interest and investment earnings assumptions in calculating hypothetical policy values,

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<sup>4</sup> While regulations do not specifically require assets underlying universal life and whole life cash values to be invested in high-grade corporate and government bonds and government-backed mortgages, regulations involving risk-based capital requirements do allow insurers to maintain lower levels of capital for safer investments and/or do require insurers to retain higher levels of capital for riskier investments (e.g., high-yield bonds). Because the amount of capital that must be retained has a direct impact on an insurer's profitability and ability to grow (i.e., the lower the capital requirement the higher the profitability and faster they can grow, and vice-versa), the effect of risk-based capital requirements regulations causes invested assets underlying universal life and whole life cash values to be invested in high-grade corporate and government bonds and government-backed mortgages.

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actual policy performance ultimately is a function of the actual performance of invested assets underlying policy cash values (unless policy interest/earnings are subsidized by excessive expenses charged elsewhere in the policy).

In periods of low interest rates, insurers may declare policy interest crediting rates on fixed products that are commensurate with low prevailing interest rates (in much the same way as banks declare an interest rate on Certificates of Deposit that are generally consistent with prevailing interest rates). Similarly, in periods of high interest rates, insurers have declared policy interest crediting rates that are commensurate with high prevailing interest rates without regard to the historical rate of return for the invested assets underlying policy cash values.

Also, some insurers declare higher interest crediting rates for new policy issues than that credited to renewing policy issues (e.g., 5.5% interest for new policy issues while inforce policy issues are credited with 5%). Others may declare a market interest rate at issue with a “bonus interest crediting rate” after some period of time.

Either way, because these declared rates are generally guaranteed for one year or less (considerably less than the expected holding period for SOLI policies), and because insurers routinely change declared interest rates both to follow movements in prevailing interest rates and to correlate declared rates with the interest earnings in their portfolio of invested assets underlying policy cash values, we will ignore prevailing policy crediting rates. Instead, we will use the 6% long-term historical rate of return on the asset classes in which invested assets underlying policy cash values are required by regulation to be invested.

Altogether, the profit potential of any given life insurance product is a function of what the insurer expects to charge/collect for 1) cost of insurance charges, plus 2) policy expenses, minus what the insurer expects to credit/pay out for 3) earnings on policy account values and death benefits. As such, we can use this formula to calculate the earliest point in time at which an insurer can pay a death claim and still generate a profit. In other words, we can use this formula to calculate life expectancy inherent within the pricing of any given product, as discussed in Part III below.

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### **Part III – Life Expectancy**

As discussed in Part I, the various and different calculations of life expectancy are at the center of the SOLI transaction where certain parties have one expectation as to the future value of the “mortality futures” contract, and while other parties have a different expectation as to the future value of that same “mortality futures” contract. As such, to understand the SOLI transaction, we must also understand both the financial meaning of the term “life expectancy” and its use by both the investor group and the life insurance company.

The definition of “life expectancy” according to *Merriam-Webster's Dictionary of Law*, © 2002 *Merriam-Webster, Inc.* is “an expected number of years of life based on statistical probability.” Under this definition, investor groups calculate the purchase price of a given SOLI policy using this life expectancy value as the number of years they expect to hold the SOLI policy until death proceeds are paid. Investor groups, therefore, begin with a life expectancy value derived from a generally-accepted life expectancy table, and then calculate the price they are willing to pay for a SOLI policy from that life expectancy.

For instance, one generally-accepted life expectancy table reports a 12 year life expectancy for a 75 year female who does not use tobacco and who is considered to be in standard health. As such, a life settlement market maker would use 12 years as the holding period in our example here when calculating the present value of expected future death benefits. As discussed on page 3 of Part I, this present value amount of expected future death benefits represents the maximum amount a life settlement investor group would be willing to pay for a given SOLI policy. The shorter the life expectancy, the shorter the holding period of the investor group (i.e., the sooner they can expect receipt of SOLI death proceeds), and the more they are able to pay to purchase a SOLI policy and still generate a profit on the receipt of SOLI death proceeds.

Life insurance companies approach life expectancy from the *opposite* end of the equation. Insurers calculate life expectancy starting first with year-by-year mortality experience, and then calculate the amount of time over which they must collect cost of insurance charges (COIs), policy expenses, and an interest spread so that the sum of COIs, policy charges and earnings collected over this duration is sufficient to pay policy death claims, cover overhead expenses, and earn a profit. The point of time at which the life insurer had sufficient time to reach target profitability is the life expectancy of the pool of insureds for that given product.

In other words, the life expectancy inherent in the pricing of any product is simply a function of what the insurer expects to charge/collect for 1) cost of insurance charges (COIs), plus 2) policy expenses, minus what the insurer expects to credit/pay out for 3) earnings on policy account values and death benefits. For instance, in our example SOLI policy on page 5 of Part II, it takes 16 years for the insurer to collect \$4,226,608<sup>5</sup> in COIs and policy expenses, plus earn interest on

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<sup>5</sup> Comprised of \$3,017,388 in COIs, \$491,504 in premium loads, \$250,992 in FAEs and \$466,724 cash-value-based “wrap fees”, which in the case of a typical SOLI policy are not disclosed, but which have been estimated here.

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those amounts collected over time, and then be able to be able pay \$4,406,242 in net-at-risk policy death benefits<sup>6</sup>, and generate a profit.

Life expectancy is thus a function of these three factors, and not the other way around. The life expectancy of a given pool of insureds, therefore, **cannot** be calculated without knowing year-by-year mortality (i.e., cost of insurance charges), year-by-year operating expenses, and year-by-year margin on invested assets. Of course, the life insurance company pays death claims before this break-even point on certain policies, but then also collects COIs, policy expenses, and an interest spread beyond this break-even point on other policies, and then averages these number of years of life based on statistical probability.

A simplified definition of “life expectancy” from the perspective of the life insurance company is, therefore, the point in time where 50% of the death claims for insureds of a given age within the pool have been paid out, and where they continue to collect COIs, policy expenses, and an interest spread on the other 50%. For the insurance company, life expectancy is, therefore, the **result** in their profit equation, which can and does change over time as the variables to their profit equation may change. This is in contrast to the definition of life expectancy used by life settlement investor groups where life expectancy is one of the **givens** in their profit equation upon which the result is derived.

The differences between the life expectancy calculations used by insurance companies and the life expectancy calculations derived from generally-accepted life expectancy tables and used by life settlement market makers may be explained by the effect of underwriting on mortality rates and thus life expectancy tables. For example, while the life expectancy of all 75 year old females may be 12 years according to one generally-accepted life expectancy table, the process of underwriting and selecting risks results in lower mortality rates. This extends the life expectancy of the insured population underwritten by the life insurers beyond that of the general population on which certain generally-accepted life expectancy table are based.

It is also worth mentioning here that the pricing reflected in the illustration of hypothetical policy values on page 5 is representative of average life insurance policy pricing. The calculation of life expectancy based on this average pricing is therefore an average life expectancy for all policies. It is fair to say that roughly half of the products in the market available for use in SOLI transactions will have lower COI and/or policy expenses, and thus reflect a longer life expectancy (i.e., the lower the COIs and policy expenses, the longer the break-even, thus the longer the life insurance company’s calculation of life expectancy) than that shown here.

Because the profit of the investor group is a function of the difference in calculations of life expectancies, investor groups typically will use products that offer pricing that is more attractive than that shown in the illustration of “average” hypothetical policy pricing and values on page 5 of Part II and used here. In other words, investor groups are “betting” that life insurance companies have become too aggressive in their underwriting and pricing, and as a result, that their calculations of life expectancy are too long (remember the insurance company makes more profit when the average life expectancy for a pool of insured is longer). Investor groups make

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<sup>6</sup> Net-At-Risk Death Benefit is equal to the total policy death benefit of \$10,000,000 less accumulated policy cash value of \$5,593,758 at the end of policy year 16, and is defined on page 6 of Part II.

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the most profit when the life insurance company calculates a longer life expectancy than shown here, presuming of course that life expectancy calculations by the investor group are correct.

Whatever the reason, the practice of calculating life expectancies differently and using these calculations differently gives rise to a number of potential problems with the SOLI transaction since *there is only one “correct” answer to the life expectancy calculation for each pool of insureds*. For example, unless life expectancies used by the investor group is derived from the same death claims experience as that realized by the insurer, then life expectancy calculations of the life settlement market maker will differ from actual mortality experience. Similarly, to the extent insurers over-charge for COIs to accelerate their break-even point, or under-charge COIs to gain market share, then their life expectancy calculations will also differ from the actual mortality experience.

Of course, regardless of how life expectancy is calculated by each, there is ultimately *only one “correct” answer* to the life expectancy calculation for each pool of insureds. If the life expectancy used by the life settlement market maker in calculating their purchase price of a given SOLI holding does not prove accurate, then the life settlement market maker will be the likely loser along with those on the same side of the SOLI transaction. Conversely, if a life insurer is overly optimistic in calculating life expectancy *and does not or cannot change their mortality rates to adjust their miscalculations*, then they will be the likely losers.

In addition, because mortality experience for a given pool of insureds changes over time (e.g., mortality rates for a 75-year-old today is different from that of a 75-year-old 10 years ago), and because life expectancies are a function of the mortality experience, then life expectancy is also a dynamic value. For this reason, life insurers generally reserve the right to change their pricing in SOLI policies to adjust to changes in life expectancies. Conversely, life settlement investor groups “lock in” their life expectancy calculation at the time of SOLI policy purchase.

So even if the life settlement market maker is correct in its initial calculations of life expectancy, because life expectancies are a “moving number,” it is possible the insurer will change cost of insurance charges (COIs) to reflect changes in life expectancies for a particular pool of insureds. This in turn changes the holding period for the investor group, and alters the economics and the profit equation of the investor group over time. As such, Part IV explores the profit potential for each party to the SOLI transaction using both:

- A) Life expectancy calculations derived from generally-accepted life expectancy tables and used by the life settlement market markers, and
- B) Life expectancy calculations inherent in the pricing of our example SOLI policy from the perspective of the insurer.

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### **Part IV – The SOLI Profit/Loss Equation**

In Part II, we examined how a life insurance company charges/collects COIs and policy expenses and pays policy earnings and policy death benefits, and how a given policy could contribute toward total profitability in each given year. In Part III, we explored the financial meaning of the term “life expectancy” and how it is calculated in different ways by different parties to the SOLI transaction. Now, let’s examine the risks and profit potential of the SOLI transaction from the perspective of each party to the transaction.

#### **1. The Life Insurance Company/Product**

Life insurance companies are in the business of collecting premiums from a large group of insureds, paying death claims to small group of decedents/claimants, and earning a profit on the difference between the two. This is similar to how banks earn a profit on the spread between interest paid on deposits taken in and interest earned on loans made.

However, while banks earn a profit on the spread between deposit-interest paid and loan-interest earned *in the same period*, life insurers earn a profit on the spread in the timing difference between when premiums are collected and when death proceeds are paid out. Also, because of the considerable timing difference between policy issuance and life expectancy, the accounting for a life insurance product is somewhat more involved than that used for bank products.

To account for the difference in timing and amounts of death benefits paid versus premiums collected, life insurers amortize expected death benefit payments (as well as other policy expenses) over the duration of the policy contract. The insurer charges each policyholder a cost of insurance (COI) charge for “their share” of death benefits paid out each year along with a policy expense charge for “their share” of policy expenses incurred each year. Over time, the insurer expects to collect enough COIs and expenses to pay policy death benefits, cover operating expenses, and earn a profit.

Of course, the insurance company pays some death claims before sufficient COIs and expenses have been collected for that policy to be profitable, but it also collects COIs and expenses beyond the break-even point on other policies. By design, this break-even point is that point in time when the insurance company expects to have collected sufficient COIs and expenses from a given policy to pay a death claim and earn a profit on the policy. It also represents the insurance company’s calculation of life expectancy for the insured under that policy, as discussed above in Part III.

To the extent that the life insurance company accurately calculates life expectancy, it is able to earn a profit by collecting cost of insurance charges and policy expenses and accumulating both at interest such that the total of COIs plus expenses plus interest earned thereon is greater than policy death benefits. Conversely, if the insurance company miscalculates life expectancy, and is thus *not* able to collect cost of insurance charges, policy expenses, and interest in amounts sufficient to policy death benefits, then the company realizes a loss on that product.

For example, as discussed on page 13 of Part III above, the life expectancy inherent in the pricing of our example SOLI policy shown on page 5 of Part II is 16 years. In other words, for

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the insurance company to generate a profit on our example SOLI policy, the population of 75 year old females who don't use tobacco, who are considered to be in standard health, and who are insured under our example SOLI policy must live an average of 16 years or longer such that the insurer ...

1. Can collect the \$4,226,608<sup>4</sup> in COIs and policy expenses over the first 16 policy years, as shown in they illustration of hypothetical policy values on page 5 of Part II,
2. Plus earn interest on COI and expense amounts collected over those 16 years (which, after paying operating expenses, can be reasonably estimated to be in the \$1,500,000 range, but which is generally not disclosed and can vary widely between life insurance companies), to then be able to ...
3. Pay the \$4,406,242 in net-at-risk policy death benefits<sup>5</sup> calculated as the difference between policy death benefits less policy cash values in policy year 16 of the illustration of hypothetical policy values on page 5 of Part II.

To the extent that #1 plus #2 together is greater than #3, then the product generates a profit to the insurance company. This doesn't mean that all 75 year old female standard-risk non-tobacco-users must live 16 years for the product to be profitable to the insurer. However, it does man that half of the population insured under this product must survive at least 16 years for this product to be profitable to the insurer. To the extent that the life insurance company miscalculates life expectancy, and more than half of the population insured under this product predecease the 16-year life expectancy, then the insurance company must either change their pricing of COIs and expenses, or accept a loss.

For instance, rather than calculating the break-even point for this policy by backing into the insurer's calculation of life expectancy (i.e., 16 years), we will instead calculate insurer profitability based on the 12-year life expectancy derived from a generally-accepted life expectancy table used by the investor group below. Based on the exact same policy pricing, but instead using only a 12 year life expectancy, the insurer is only able to ...

1. Collect \$2,530,561<sup>7</sup> in COIs and policy expenses over the first 12 policy years, again illustration of hypothetical policy values on page 5 of Part II,
2. And only able to earn interest on these lesser COI and expense amounts for a shorter period of time (which, after paying operating expenses, can be reasonably estimated to be less than \$500,000, but which is generally not disclosed and can vary widely between life insurance companies), but still must ...
3. Pay \$5,743,882 in net-at-risk policy death benefits<sup>8</sup> calculated as the difference between policy death benefits less policy cash values in policy year 12 of the illustration of hypothetical policy values on page 5 of Part II.

As such, to the extent actual life expectancy proves to average only 12 years, then the amounts charged/collected by the insurance company in #1 and #2 together are not sufficient to pay

<sup>7</sup> Comprised of \$1,706,264 in COIs, \$368,628 in premium loads, \$188,244 in FAEs and \$267,380 cash-value-based "wrap fees", which in the case of a typical SOLI policy are not disclosed, but which have been estimated here.

<sup>8</sup> Net-At-Risk Death Benefit is equal to the total policy death benefit of \$10,000,000 less accumulated policy cash value of \$4,256,118 at the end of policy year 12, and is defined on page 6 of Part II.

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amounts due in #3, and the insurer for our example SOLI product realizes a **\$2.5+ Million loss** on each and every policy insuring 75 year old females who don't use tobacco and who are considered to be in standard health.

Of course, when an insurer begins to experience such losses, they will certainly adjust their pricing to increase COIs to reflect this shorter life expectancy and correspondingly higher mortality rates. If such increases are possible (e.g., certain guaranteed products do not allow for increases to either COIs or policy expenses) and practical (e.g., COIs and policy expenses would have to more than double), this could lead to the cancellation of policies otherwise insuring healthy individuals who surrender their policies in response to such price increases. This would leave the insurer with a population of high-risk insureds, and further increase mortality rates and further shorten the overall life expectancy of the insured population, a market force the actuaries call "adverse selection."

As such, if the life insurance company miscalculates life expectancy, and does not or cannot change pricing to correct their miscalculation, then they will be the loser in the SOLI transaction. On the other hand, because the life insurer is in business to make a profit, to the extent they do miscalculate life expectancy, and to the extent they can change policy pricing, then they will change policy pricing to ensure their profitability.

## **2. The Investment Group (i.e., the Viator/Life Settlement Market Maker)**

At the other end of the life-expectancy spectrum are the investor groups who purchase SOLI policies in their role as life settlement market makers. These life settlement market makers promoting the SOLI transaction differ from the more traditional life settlement market maker in a couple of ways. While both are in business to profit from the difference between what is paid for a policy on the life settlement secondary market and what the market maker collects in death benefits at some point in the future, the economics of their transactions are considerably different.

For instance, traditional life settlement market makers generally purchase inforce life insurance policies that were issued some time ago (e.g., at least 5 years old, and usually 10 or more years old) and are based on the health profile at that time (e.g., preferred health), and thus priced for the life expectancy corresponding to that health profile at that time, which often has changed since the policy was originally issued. Thus, traditional life settlement market makers agree to a purchase price at the time of the transaction and profit from the difference between what they pay for the inforce policies *based on the life expectancy calculated at the time of issue* and what they collect in death benefits at some point in the future *based on the now different life expectancy calculated at the time of purchase on the life settlement secondary market*.

This is in contrast to the SOLI transaction where the proposed purchase of the SOLI policy and the proposed life settlement sale of that SOLI policy are contemplated *at the same time* and thus are based on the same health profile and the same life expectancy (even though the life insurer and the life settlement market maker may calculate life expectancy differently). As such, the investor groups behind SOLI transactions profit from the difference between what they pay for SOLI policies again based on the life expectancy calculated at the time of issue and what they collect in death benefits at some point in the future based on life expectancy calculations *that*

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*may or may not be any different than the life expectancy calculated at the time of issue.* To the extent there is no difference between the life expectancy calculated at the time of issue and life expectancy calculated at the time of purchase on the life settlement secondary market, there is no opportunity for profit. This is why investor groups behind the SOLI transactions generally do not guarantee at the time the SOLI policy is issued neither the purchase of the SOLI policy nor the purchase price.

In either case, the investor group is most profitable when actual life expectancies are shorter than that calculated at the time they purchase the policy, while life insurers are most profitable when actual life expectancies are longer than those calculated at the time they underwrite an insured and issue a policy. In other words, insurers generally profit when insureds live at least as long as or longer than the life expectancy inherently calculated at the time the policy is issued whereas investor groups profit when death rates are equal to or greater than the life expectancies calculated at the time they purchase the SOLI policy.

If underwriters and actuaries for the investor groups calculate life expectancies more accurately than the underwriters and actuaries for the life insurers, then the investor group profits and the insurer loses. Conversely, if underwriters and actuaries for the life insurer calculate life expectancy more accurately than the underwriters and actuaries for the investor groups, then the insurer profits and the investor group loses. In both cases, each has certain but different advantages in calculating life expectancy.

While the insurer has only one opportunity to calculate the life expectancy of a given insured (i.e., at the time the policy is issued), insurers generally reserve the right to effectively change their calculation of life expectancy for a given pool of insureds by increasing cost of insurance charges if death rates are higher than originally expected. On the other hand, investor groups get two (2) opportunities to calculate life expectancy (i.e., once at the time the SOLI policy is sold but before they purchase it and then again two years later when they actually purchase the policy, if they purchase the policy, for reasons explained below).

However, if the investor group does decide to purchase the SOLI policy on the life settlement secondary market two (2) years after it was originally issued, their life expectancy calculation is locked in from that point forward. Because of this, and because insurers generally can change/increase their pricing at any time (to the extent justified by actual mortality experience), which in turn increases the carrying cost of the SOLI policy to the investor groups, investor groups seek out SOLI policies with the shortest possible holding period (i.e., life expectancy), and pay as little as possible for those they do purchase, and do not purchase SOLI policies that do not fit this criteria, without regard to whether the insured entered into the SOLI transaction for the exclusive purpose of eventually selling the policy to this investor group.

When investor groups do purchase SOLI policies, they typically purchase policies that have been in force for at least two (2) years. This is due (at least in part) to contractual language generally included in life insurance contracts that gives the life insurance company the right to cancel the contract and deny payment of a death claim during the first two policy years if the policy was based on false information provided by the insured or the policy owner, or if the cause of death was suicide. Certain insurers have also filed suit to seek recession of SOLI policy contracts even beyond this 2-year contestability period based on a lack of insurable interest, which is an

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essential legal element to all life insurance contracts, and without which the insurers assert the life insurance contract was never in effect. For this reason, it is rumored that insurers are seeking regulatory changes to extend the contestability up to five (5) years in certain situations.

In response to these legal and/or legislative actions, investor groups may delay purchasing SOLI holdings even longer than two (2) years. The longer the period of time between the date the SOLI policy is issued by the insurer and the date the life settlement market maker purchases the SOLI policy on the secondary market, the greater the risk to those parties whose profit depends on the higher SOLI purchase price calculated using the investor group's life expectancy, namely the special purpose lender and the insured. For instance, with more time, there is greater risk that investor groups will find their life expectancy calculations were not correct and thus will pay less for SOLI policies or not purchase them at all, or that insurers will change/increase SOLI policy pricing causing in market makers paying more to carry the policy and thus pay less to purchase the policy or not purchase it at all, or that legislative changes will prohibit SOLI transactions preventing market makers from purchasing SOLI policies as expected, or that investor groups move on to other investment opportunities and leave existing SOLI policies to their own devices.

However, for the purposes of our example here, we will nonetheless assume the investor group purchases the SOLI policy two (2) years after initial policy issuance on the open market. As such, the SOLI policy originally issued to a 75 year old female is assumed to be purchased by a life settlement market maker when she is age 77, and where her life expectancy at the time of purchase by the investor group is two (2) years less than it was at policy issuance. As discussed on page 3 in Part I, the amount up to which an investor group could pay to purchase a SOLI policy can be determined using simple time-value-of-money calculations where the insured's life expectancy is the holding period ( $n$ ), the "hurdle rate" of the investor group is the discount rate ( $i\%$ ), the amount of the death benefits expected in the future is the future value ( $FV$ ), the premiums paid to maintain the policy is the carry-cost ( $PMT$ ) and then solving for the present value ( $PV$ ). For example, an investor group seeking a 12% return from the purchase of our example \$10M SOLI policy would pay no more than \$2,097,000 using a 10-year holding period (i.e., the 12-year life expectancy at policy issue less the 2 year contestability period), and assuming the investor group pays only COIs and policy expenses as the minimum possible carry-cost instead of the full annual premium.

In other words, an investor group who pays up to \$2,097,000 to purchase our example SOLI policy, and who then also pays \$2,068,503<sup>9</sup> in COIs and policy expenses over the remaining 10 years of life expectancy according to the generally-accepted life expectancy table, would have a total investment of \$4,165,503 in the SOLI transaction. Provided their calculations are correct, and the \$10,000,000 in SOLI death proceeds are received (after paying income taxes discuss in greater detail below) within the 12-year life expectancy from original policy issuance on the open market, and thus within their 10-year holding period from their purchase on the secondary market, then the investor group would earn at least a 12% rate of return. Of course, the less a market maker pays for a given policy and the shorter their holding period until they receive SOLI death proceeds, the greater their profit.

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<sup>9</sup> Comprised of \$1,604,443 in cost of insurance charges (COIs), \$307,190 in premium loads, and \$156,870 in fixed administration expenses (FAEs) for policy years 1 through 12 as shown in the illustration of hypothetical policy values on page 4 in Part II.

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Conversely, the more a market maker pays for a given policy and the longer their holding period until they receive SOLI death proceeds, the lower their profit and/or the greater their risk of loss. In fact, to the extent that generally-accepted life expectancy tables used by market makers do not accurately reflect actual life expectancy, and that life insurer calculations of life expectancy are instead a more accurate reflection of actual life expectancy, then investor groups will have to *both* pay more to carry the policy for more years *and* wait longer to receive SOLI death benefits, thereby doubling the adverse impact to the investor group of miscalculating life expectancies.

For instance, if an investor group were to pay \$2,097,000 to purchase our example SOLI policy based on a 10-year holding period (i.e., the 12-year life expectancy at policy issue less the 2 year contestability period), but subsequently determines that the 16-year life expectancy calculated by the life insurer at policy issues is actually correct, then the holding period for the investor group is extended from 10 years to 14 years. In such a case where an investor group concludes that their calculations of life expectancy based on generally-accepted life expectancy tables is *not* correct, and that life insurer calculations of life expectancy *are* correct, the investor group would have to pay COIs and expenses for an additional four (4) years *and* would have to wait four (4) years longer to receive SOLI death benefits.

Because COIs increase geometrically over time, the total investment by the investor group would thus increase disproportionately to \$5,662,251<sup>10</sup>. Similarly, the future value of SOLI death benefits expected by the investor group also decreases disproportionate due to the natural financial forces of the time-value-of-money and compound interest. Taken together, the SOLI policy that was to produce a 12% return based on the life expectancy initially used by the investor group will actually cause a sizable loss (relative to the hurdle rate of the investor group) if life expectancy calculations by the life insurance company hold true.

While the investor group would receive more in SOLI death benefits than they paid for and into the SOLI policy even when using the 14-year holding period corresponding to the 16-year life expectancy calculated by the life insurance company, the cash-on-cash return would be only in the 5.0% range (roughly the equivalent to the historical rate of return on high-grade government and corporate long-term bonds and government-backed mortgages, but with considerably more risk). Of course, this is well below their opportunity rate on other investments, on which they would have otherwise earned an additional \$7,578,024 (i.e., the investor group loses \$7,578,024 on just this one SOLI policy relative to the other investment opportunities available to high-net-worth individuals).

Given this risk of loss, and because the holding periods for most of these investor groups appear to be considerably less than the life expectancy calculated by the life insurance company, investor groups will likely be all the more interested in an earlier exit-strategy if/when it becomes apparent that the generally-accepted life expectancy table used in the calculation of the purchase price is incorrect. More on this in “Section 7. The Securitization” below.

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<sup>10</sup> Comprised of the \$2,097,000 purchase price, plus \$2,915,567 in cost of insurance charges (COIs), \$430,066 in premium loads, and \$219,618 in fixed administration expenses (FAEs) for policy years 1 through 16 as shown in the illustration of hypothetical policy values on page 4 in Part II.

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### **3. The Special-Purpose Lender**

In between the issuance of the policy by the life insurance company and the purchase of the policy by the investor group is the special-purpose lender. As discussed, regulations make it impractical for the investor groups to own the SOLI policy and pay premiums during the first two policy years. As a result, SOLI transactions involve a finance company which loans funds to the insured or the insured's trust to pay the premiums. These premium loans have typically been made on a non-recourse basis where the insured can default on repayment and the lender has no recourse for recovering loaned amounts beyond life insurance policy cash values serving as the only collateral. While prevailing interest rates on short-term loans have been around 6%, these interest rates on these special-purpose loans have been as high as 12% to 14%, usually justified by the non-recourse nature of the loan.

More recently, and in response to questions about whether such non-recourse loans are truly "arms-length" (i.e., Why would a lender make a loan knowing the only collateral is insufficient for repayment and without any other recourse for repayment?), these premium loans are taking the form of either "semi-non-recourse" or full-recourse financing where the special purpose lender can recover from the insured any difference between the outstanding loan balance and the SOLI policy cash value, or can recover this difference for some period of time or in certain circumstances. In the case of full-recourse or "semi-non-recourse" financing, interest rates can be less than that for true non-recourse financing, but are still often higher than the 6% rate charged on similar short-term loans (perhaps due to the fact that the interest is accrued and prevailing marketing practices suggest that the insured will never have to pay the interest).

In our example SOLI transaction, the special-purpose lender would, therefore, loan to the insured/the insured's trust \$409,581 each year for the first 2 policy years to pay premiums shown in Column 2 of the illustration of hypothetical policy values on page 5 of Part II. In addition, the terms of these premium-finance notes generally allow for interest to be accrued and added to the balance of the note. Using a 12% loan interest rate, this adds \$49,150 at the end of the first policy year, plus interest of \$104,197 at the end of the second policy year, for a total \$972,509 loan balance at the end of the 2-year Contestability Period.

If the insured dies during the first two policy years, and the insurer does not deny the claim, the lender is repaid from policy death benefits and the balance is paid to the insured's trust. However, if the life insurance company denies the death claim during the first two policy years due to misrepresentations by the insured, or because of suicide, then the life insurance company generally will refund either cumulative premiums paid, or premiums paid accumulated at some prevailing rate of interest, or policy cash values if higher. Either way, at best, because the special-purpose lender is charging an above-market rate of interest that is certainly greater than the crediting rate on the SOLI policy, and because of up-front expenses charged within the SOLI policy, it is not likely that the special-purpose lender will be repaid in full if the life insurance company denies payment of the death claim.

If the insured survives the first two policy years, the lender is either 1) repaid by the insured, or 2) repaid with proceeds from the investor group who purchases the SOLI policy from the insured (or the insured's trust) for its "fair market value", or 3) again runs the risk that the loan is not repaid in full (unless cash values are sufficient to fully collateralize the loan, which is usually not

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the case, or the lender has some form of recourse for recovery from the insured). While SOLI transactions typically provide the insured with a contractual right to repay the lender and assume full rights to the policy, repayment of loan proceeds by the insured is unlikely. First, SOLI transactions are marketed on the basis of profiting from “monetizing” the wasting asset that is the insurability of the insured, and not because the insured needs or wants insurance. As such, most SOLI transactions are entered into without the expectation that the insured will repay the loan and assume the right to the policy. Second, if the insured does need life insurance for traditional life insurance planning purposes, there are generally more cost-effective means of purchasing life insurance than through a SOLI transaction.

Even if the SOLI transaction provides the insured with the contractual right to repay the special-purpose lender and a first-right-of-refusal on the purchase of the SOLI policy after two years, it is simply not practical for the insured to repay the lender for premiums that are usually higher than what the insured would have otherwise paid for a traditional estate-planning policy and for interest at rates higher than rates otherwise available. Because it make no sense for an insured to intentionally pay more in premium and more for interest than necessary, the intent of the insured in a SOLI transaction is clearly not to purchase life insurance, but rather to profit on the “trading” of their life expectancy, whether such intention is acknowledged or not. As such, the insured typically lapses their first-right-of-refusal on the purchase of the SOLI policy after two years, leaving only the investor group, who is presumably standing ready to purchase the policy for its “fair market value”, as the only practical source of loan repayment.

For example, to the extent that the life settlement market maker calculates “fair market value” as described on pages 18 and 19 of Part IV Section 2, and using a 10-year holding period (i.e., based on the 12-year life expectancy at policy issue from a generally-accepted life expectancy table), then this \$2,097,000 purchase price for our example SOLI policy is more than enough to repay the \$972,509 loan balance outstanding at the end of the second policy year. Of course, the less a market maker pays for a given SOLI policy, the greater their profit, so there is no guarantee that the investor group will pay a purchase price that is sufficient to repay the outstanding loan balance.

In addition, should life settlement market makers change the way they calculate “fair market value” to instead use a 14-year holding period based on the 16-year life expectancy calculated by the life insurance company at policy issue, then the investor group could pay only a *maximum* of \$546,000 for the very same SOLI policy (i.e., the present value of the \$10,000,000 SOLI death benefit less applicable taxes discussed in Section 5 below and less the expected carry-cost of \$3,565,251<sup>11</sup> and using a 12% discount rate over the 14 years of remaining life expectancy is only \$546,000). In other words, if after two (2) years of premium loans and two (2) years of above market interest, the investor group changes the life expectancy used in their calculation “fair market value”, then the life settlement market makers may not be able to pay enough for the SOLI policy to repay the premium loan in full.

While current SOLI marketing practices presume the “fair market value” of the SOLI policy will be sufficient to fully repay premium loans, pay above-market loan interest, and pay the insured a

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<sup>11</sup> Comprised of \$2,915,567 in cost of insurance charges (COIs), \$430,066 in premium loads, and \$219,618 in fixed administration expenses (FAEs) for policy years 1 through 16 as shown in the illustration of hypothetical policy values on page 4 in Part II.

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profit, this may or may not be the case. As we can see above, depending on the “fair market value” at that time, and the life expectancy calculation used to determine “fair market value” at that time, there may not be enough “excess profit” to repay loan principal, not to mention loan interest nor a profit to the insured. Because such premium loans are generally non-recourse, the special-purpose lender has no recourse for recovery from the borrower/insured, and thus is in a position where they generally would have to forgive the debt and write-off the remaining \$426,123 loan balance otherwise due.

As such, even relatively small differences in the calculation of life expectancy can substantially change the profit equation for the lender, as shown here where there is only a four (4) year difference between the 10-year life expectancy of a 77 year old female based on the generally-accepted life expectancy table used by the investor group, versus the 14-year life expectancy remaining from the 16-year life expectancy originally calculated by the insurer for a 75 year old female non-tobacco-user considered to be in standard health, and who is now 2 years older. However, this difference in life expectancy calculations may be considerably greater in actual practice. The greater this difference, the greater the risk that the amount the investor group will be willing to pay two years after the original sales proposal to the insured will not be sufficient to repay the lender.

### **4. The Insured**

The insured is at least fourth and maybe fifth or sixth in line for their chance at a profit on the SOLI transaction. The insured in a SOLI transaction is a party to the transaction not for traditional risk management purposes, but instead for a profit. As such, the SOLI transaction transforms the insured from a consumer of the product, into a profit-seeking party to the transaction. In so doing, the insured is transformed from an end-user recipient of the product, into a friction point in the value chain.

Of course, if the life expectancy calculations used by the investor groups marketing these SOLI transactions prove correct, then the \$2,097,000 purchase price that the investor group could pay for our example SOLI policy is more than enough to repay the \$972,509 loan balance outstanding at the end of the second policy year and then also pay the insured a handsome profit of \$1,124,491. On the other hand, if the life insurer’s calculations of life expectancy prove to be correct, then the same investor group would only pay \$546,000 for this very same SOLI policy. In either case, if the investor group does in fact purchase the SOLI policy after 2 years as proposed, this amount the investor group will pay for the SOLI policy is **not** known at the time the SOLI policy is issued.

If the latter is the case, then there will not be sufficient funds to even repay in full the outstanding premium loan of \$972,509, not to mention not sufficient to pay the insured the promised profit. Since these premium loans are generally non-recourse, the special-purpose lender has no recourse for recovery from the borrower/insured, and thus would have to forgive and write-off the remaining \$426,123 loan balance otherwise due. Of course, forgiveness of indebtedness is generally a taxable event and could result in the \$426,123 forgiven loan balance being taxed at ordinary income tax rates, which is often not disclosed at the time of sale.

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As such, if the life insurer's calculations of life expectancy are correct, the insured could receive a 1099 in policy year three for \$426,123 of "phantom income" and could be liable for \$170,449 in income taxes assuming a 40% combined federal and state ordinary income tax rate. In addition, because life settlement market makers are in business to *pay as little as possible* when purchasing SOLI holdings in order to maximize investment returns to their investor group, there is no guarantee that the investor group will pay a purchase price that is sufficient to repay even this amount of the outstanding loan balance, and thus adverse income tax consequences could even be worse than shown here.

In addition, there is no definitive authority or guidance for the proper taxation of the seller (the trust) in SOLI transactions. As such, there are questions as to 1) the trust's basis for the policy, 2) whether the trust must lower its basis (thereby increasing its taxable gain) by the amount of the economic benefit of the "free life insurance" received (measured as either the cost of insurance charges internal to the actual SOLI policy or imputed based on Table 2001-10 rates, which in either case can reduce basis to near \$0 and thus make the entire gain taxable), 3) how much gain will the trust actually realize when it sells the policy to the investor group, 4) how much of that gain will be taxed at ordinary income rates and how much will be taxed at capital gains rates, and 5) is the gain taxable to the trust or to the insured, and if taxable to the trust (the actual seller), will the IRS look through the trust to the insured, in spite of the fact that a non-grantor trust may have been used?

In other words, after the insured consents to being underwritten and insured under a SOLI policy, the market maker generally has no obligation and little or no financial incentive to purchase the policy from the insured for an amount that is sufficient to repay premium loans, and pay above-market interest, and pay the insured an amount sufficient both to cover taxes payable by the insured (which amount is as yet undetermined) and pay the insured the promised profit. This is not to say that life settlement market makers won't deliver on the promise of a profit to the insured, even if they have miscalculated life expectancy, but is to say that there are financial forces working against the insured receiving a profit.

It is also important to note that these computations reflect "average" policy pricing, and thus the "average" life expectancy calculation for all life insurance companies. However, because the investor group profits the most when there is the greatest possible gap between their life expectancy calculations and the life expectancy of the life insurance company, investor groups will often seek out life insurance products with lower the COIs and expenses than the averages shown here. In turn, this means that the life expectancy calculated by the life insurance company will be longer than shown here in many cases, and thus the gap between investor group life expectancy and the life insurer life expectancy will also be greater than shown here.

While there is only a four (4) year difference between the 10-year life expectancy of a 77 year old female used by our investor group at the time of their purchase of the SOLI policy, versus the 14-years remaining in the insurer's calculation of life expectancy, this difference will almost certainly be greater in actual practice. The greater this difference, the greater the risk that the amount the investor group will be willing to pay *two years later* for the SOLI policy will *not* be sufficient to repay the lender. If this is the case, this means that the insured will be less likely to

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receive promised profits and more likely to be confronted with taxable phantom income (i.e., income taxes due on monies never received and thus without monies to pay the tax).

Given the amount of capital flowing is into this market, it could be said that the life settlements market is currently a “sellers market” where a greater amount of investor dollars are “chasing” a relatively smaller number of policies for sale. The law of supply and demand tells us that when demand is greater than supply, the sellers enjoy higher prices paid for the life insurance policies they sell. However, to the extent that this flow of capital subsides, then there will be fewer investor dollars “chasing” a substantially larger number of policies for sale (due in no small part to the substantial increase in SOLI transactions in recent years).

Should private investors behind the investor groups buying SOLI policies moves on to the next market opportunity (and take their capital with them), then the life-settlements-market risks becoming a “buyers market” where the supply of policies is greater than investor demand. Once again, the law of supply and demand tells us that when supply is greater than demand, the sellers must accept lower prices paid for the life insurance policies they sell, and thus reduce their potential for profit and increase their risk of loss in the form of taxable phantom income.

Lastly, in addition to the above economic risks of loss to which the insured is exposed, the insured may also be exposed to additional income tax and gift tax ramifications. Such other potential income tax and gift tax consequences are considered in the discussion of the IRS’ role in the SOLI transaction below “Section 6. The Internal Revenue Service (IRS)”

### **5. The Distributor (Agent, Broker, General Agency, Broker/Dealer)**

As with all life insurance policy sales, SOLI policies are distributed by a licensed agent/broker, who is typically contracted through a general agency, broker/dealer or other intermediary between the agent/broker and the life insurance company. For the purposes of this discussion, we will refer to the agent/broker together with the general agency, broker/dealer or other intermediary as “the distributor.” We will also account for the economic friction of “the distributor” in total without separately identifying how much of the total each member of the distribution system is receiving. Because policy expenses (including those related to distribution expenses) can vary widely from year to year and from product to product, we are using very general assumptions about the rates of commission the life insurance companies pay on a product typically used in a SOLI transaction.

It would not be unusual for a life insurance company to pay commissions totaling 100% of the first year premium to all of the agent/broker, general agency, broker/dealer and/or other intermediaries between the agent/broker and the life insurance company. It also would not be unusual for a life insurance company to pay renewal commissions totaling 4% of the premiums after the first year, again inclusive of all commissions paid to all of the agent/broker, general agency, broker/dealer and/or other intermediary between the agent/broker and the life insurance company. As a result, the cost for a life insurance company to distribute a SOLI policy could be as much as \$409,581 in the first policy year, followed by \$16,383 a year thereafter. This would total \$589,797 over the duration of the policy if investor group life expectancy calculations are correct, or \$655,330 if life insurance calculations of life expectancy are correct.

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Either way, such distribution costs represent at least 37%+/- of the *maximum* “investment value” that the insured/the insured’s trust could reasonably expect to receive (i.e., a 37% “investment commission” if the SOLI investment delivers on promised profits, and potentially a “commission rate” that actually exceeds the total value SOLI transaction value if promised profits do not materialize as proposed). Also, because different insurance companies price different policies for distribution expenses in different ways and because different investor groups fund SOLI policies in different ways, the above distribution costs are not intended to represent actual distribution costs in a particular SOLI policy. Rather, they provide us with a representative means to discuss the relative potential for profit by the insured on a SOLI transaction in relation to a representative cost of distribution of a SOLI policy.

These amounts do not represent “profit” in the same way that the life insurance company or the investor group realizes a profit on the SOLI transaction. However, this cost of distribution is built into the pricing of the SOLI policy, and does represent a “friction point” that consumes a portion of the total overall economic benefit otherwise available to the other parties to the SOLI transaction. For example, while the distributor earns at least \$589,797 without regard to which calculation of life expectancy is correct, the insured may receive a profit of as much as \$1,124,780 if life expectancy calculations used by investor groups are correct, or could realize a loss of -\$170,449 if life expectancy calculations used by the life insurance company is correct.

In fairness to “the distributors” in SOLI transactions, certain agents/brokers are also investors in the investor group, and may contribute their commissions earned in an effort to reduce the amount of premium that would otherwise have to be financed by the special-purpose lender. In other words, by “investing” some portion of the total commission into the SOLI transaction, the amount of friction related to the cost-of-distribution is reduced. If the transaction is structured in such a way that this reduced level of friction results in an reduction in overall economic friction, then this practice of “investing” agent/broker commissions into the SOLI transaction could reduce the insured’s risk of loss and increase their likelihood for profit. If the reduction in distribution costs increases the profit of the investor group, then such a practice would not change the insured’s risk of loss nor potential for profit.

In either case, the question as to whether such a payment of commissions into a SOLI transaction will be considered a “commission-rebate” is as yet unanswered. While commission rebating is illegal and prohibited in most states, does the payment of commissions by an agent/broker into a transaction that simultaneously or subsequently makes a cash payment to the insured equivalent to the agent/broker paying the insured some portion of commissions directly? To the extent this is deemed a prohibited activity, if an agent/broker contributes commissions earned on the sale of a SOLI policy into the SOLI transaction, then the agent/broker, general agent, broker/dealer and/or other intermediary could face fines and/or disciplinary action, and the insured could find themselves in a distasteful situation.

Similarly, certain agents/brokers offer to pay legal fees on behalf of the insured for the due diligence conducted by the insured’s counsel. However, to the extent such legal fees are only paid when the insured actually proceeds with the SOLI transaction, and are not paid if the SOLI transaction does not close, then the payment of legal fees could also be considered an inducement to purchase the SOLI policy, and thus also risks being characterized as a form of

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commission rebate. Once again, to the extent that rebating is prohibited in a given state, then the agent/broker, general agent, broker/dealer and/or other intermediary could face fines and/or disciplinary action, and the insured could be entangled in an unpleasant situation.

### **6. The Internal Revenue Service (IRS)**

Because death benefits from SOLI policies do not qualify for the tax exempt treatment generally afforded all of other uses of life insurance, those parties to the SOLI transaction who are purchasing the policy for investment purposes must pay income taxes on the receipt of SOLI death proceeds (to the extent of gain). In other words, while life insurance death benefits are generally received tax-free by policy beneficiaries, and while SOLI death benefits would generally be received tax-free during the first two (2) policy years, the ultimate investor-owners will pay income taxes on the receipt of SOLI death proceeds that exceed their investment in the SOLI contract.

As a result, the Internal Revenue Service (IRS) is also a friction-point as a “party to the transaction” in a form or fashion. For instance, under well established “transfer for value” rules, regulations call for taxation of death benefits at ordinary income tax rates for policies transferred to a third-party who does not qualify for exception. However, many life settlement companies are taking the position that life settlement transactions are not subject to “transfer for value” rules, and thus should be taxed at capital gains tax rates. If the higher ordinary income tax rates apply on the receipt of SOLI death proceeds in excess of investment in the SOLI contract, then the potential for profit is reduced, and the risk of loss is increased.

Given the position of most life settlement companies that SOLI death proceeds should be taxed at capital gains tax rates, we have used a 15% rate to represent the tax friction applicable to our hypothetical SOLI transaction. However, even if the capital gains tax rate is the appropriate rate at which to tax SOLI transactions, current capital gains tax rates are near their lowest point in recent history. If capital gains tax rates increase, the potential for profit is again reduced, and the risk of loss is again increased.

If the actual tax rates applicable to SOLI death benefits received by the investor group are higher than the current 15% rate, then the future after-tax value of their expected SOLI death benefit will be less. In that case, the amount that the investor group will be willing to pay for this lower after-tax future death benefit will also be less. At a minimum, this means that both the amount and likelihood of profit by the insured is also less, and the risk of loss in the form of taxable phantom income to the insured is greater.

In addition, while certain SOLI transactions are marketed on the basis of “free life insurance”, SOLI death benefits may not be free at all. Under recently issued Split Dollar Regulations, a party who enjoys the benefit of life insurance coverage, but who does not pay anything towards the cost of that life insurance protection, is generally taxed on the economic value of those death benefits provided. As such, while Split Dollar Regulations were issued to address life insurance provided by an employer to an employee, no such employer-employee relationship is required under these new regs.

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To the extent the IRS determines that SOLI transactions meet the definition of Split Dollar as defined under these new regs, then the insured and/or the insured's trust will be taxed on the "economic benefit" of SOLI death benefits less whatever the insured pays toward the cost of the life insurance (which by definition is \$0 in a SOLI transaction). While there are grounds to argue that Split Dollar Regulations do not apply, depending on IRS interpretation, this economic benefit amount could be calculated as either the imputed taxable term insurance cost based on IRS Table 2001-10 rates, or the imputed interest on the amounts loaned to the insured/the insured's trust to pay premiums.

If this is the case, then such "free insurance" marketed to the 75 year old female in our example SOLI transaction would instead come at a cost of almost either \$69,380 if economic benefits are calculated using IRS Table 2001-10 taxable term rates and \$153,347 if economic benefits are calculated by the interest on the amounts loaned the insured/the insured's trust to pay premiums. In both cases, such amounts represent the amount of imputed taxable income and the amount of the imputed taxable gift.

In other words, because SOLI transactions usually title the SOLI policy in the name of an irrevocable trust, the insured and/or the trust will be assessed *both* income taxes based on the imputed income based on the amounts above and then will also be assessed gift taxes on the imputed gift based again on this same amount. With income and give tax rates being what they are for the high-net-worth individuals to which these transactions are being marketed, this means that the "free insurance" in a SOLI transaction will actually costs either almost \$69,380 or almost \$153,347 should the IRS determine SOLI meets the definition of Split Dollar, and in addition to whatever other costs/risks of loss discussed above.

## **7. The Investment Banker/the Securitization**

The investor groups that market SOLI transactions and purchase SOLI policies on the life settlement secondary market are often not the type of investor to buy and hold a single investment for long. In fact, in contrast with "buy-and-hold" investors, the investors behind these life settlement market makers are "traders" who see a market opportunity, invest in that market opportunity, and then sell their position within a relatively short period of time. That is why certain investor groups who are actively marketing SOLI transactions and buying SOLI policies on one hand are also looking to securitize SOLI holdings for sale on Wall Street to the general public on the other.

Securitizing an investment for sale to the general public has been done with other types of investments in the past with mixed results. As discussed earlier, real estate developers pooled real estate holdings and sold them as Real Estate Investment Trusts (REITs), some of which provided public investors with the advertised rate of return while others did not. Similarly, mortgage companies bundled mortgage holdings and sold to the general public, some of which were again good for public investors, and some of which were not. Whether or not SOLI investor groups will be successful in securitizing their SOLI holdings and selling them to public investors, and whether this will be good for public investors is largely dependent upon two forces discussed in "Section 8. The Public Investor."

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If private investor groups are successful in securitizing their SOLI holdings for sale to public investors, this adds a seventh party to the SOLI transaction--the investment banking firm. Similar to the insurance agent/broker, the fees charged by the investment banking firm do not represent “profit” in the same way the life insurance company or the investor group realizes a profit on the SOLI transaction. However, these investment banking fees can add as much as one-quarter again the amount of commissions paid to “the distributor”, and conceivably even more given the uniqueness of the “investment holdings” being securitized.

In other words, between investment banking fees and commissions to the life insurance agent/broker (and related parties), the combined “investment commission” paid by the public investor could approach 50% or more of the *maximum* value they could expect to receive. Compared to other investments, this is a relatively high cost of bringing an investment product from the “manufacturer” (i.e., the life insurance company) to the public market. As such, investment banking fees represents another “friction point” that consumes more of the overall economic benefit otherwise be available to other parties further down the line, and which must be over come for investors to actually realize promised profits.

#### **8. The Public Investor**

If private investor groups are successful in securitizing their SOLI holdings for sale to public investors, this adds an eighth party to the SOLI transaction – the public investor. Whether or not a securitized form of SOLI policies will be good for public investors depends both on the different calculations as to life expectancy as well as several other forces. First, to the extent that actual SOLI death claims experience proves that life expectancy calculations by the investor group is accurate, then a group of public investors stepping into the shoes of these private investor groups could present a good investment for public investors, in the same way the SOLI investment calculates out to be a good investment for investor groups if their calculations of life expectancy are correct.

However, in the event that the generally-accepted life expectancy table used by the private investor group does not accurately reflect actual life expectancy, then public investors who invest in securitized SOLI holdings will likely earn rates of return in only the 5.0% range. In other words, if life expectancies calculated by life insurance companies prove correct, or if the life insurers change the pricing of SOLI policies, thereby increasing the carrying cost of SOLI holdings to investors, then the rate of return to such public investors will be less than originally proposed and more like the rate of return expected from an investment in high-grade government and corporate long-term bonds and government-backed mortgages, but with greater risk of loss.

Given the considerable risk surrounding the unknown issue of life expectancy and with the SOLI transaction in general, public investors would certainly seek a higher rate of return than that found from comparatively low-risk investments in high-grade government and corporate long-term bonds and government-backed mortgages. For this reason, securitized SOLI holdings must almost certainly offer the promise of higher rate of returns that are commensurate with rates of return from other similarly risky investments, and thus attractive to the community of public company investors.

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As such, for the securitization to be successful from the perspective of the private investor group, it will have to “sell” the use of generally-accepted life expectancies to the community of public investors. To the extent that such generally-accepted life expectancies prove incorrect, then public investors will not realize “promised” returns. Securitization transfers the life expectancy risk to the community of public investors, and in so doing, also creates other risk factors.

For instance, if actual death claims experience of SOLI policies held by the private investor group does not support the life expectancy table used in calculating their purchase price, then private investor groups may use securitization of their SOLI holdings as a means of realizing their target rate of return, even though SOLI holdings do not support such a return. By taking their target rate of return out of the SOLI transaction early, the private investor group has effectively taken a disproportionate share of overall economic benefits greater than the investment performance to which they are entitled and at the expense of the community of public investors further on down the line.

Similarly, certain investor groups pay only minimum policy carrying costs each year as a means of reducing their investment and thus accelerating their rate of return (i.e., paying only COIs and policy expenses as they may increase from year to year rather than paying a planned annual premium that ensures maturity of policy death benefits). Likewise, certain private investor groups are withdrawing/borrowing all available cash values immediately after purchase again as a means of again accelerating their return on investment. While paying only minimum policy carrying costs in a given year can maximize the rate of return in that year, not paying premiums necessary to reduce long-term policy costs and to ensure future death claims are paid is again tantamount to taking a disproportionate share of overall economic benefits greater than actual investment performance and at the expense of investors further on down the line.

When considered within the context of current marketing practices suggesting all parties can profit from the SOLI transaction, these practices can make the SOLI transaction look a bit like a pyramid scheme where investors early in the scheme receive a payout disproportionate to their share of overall economic benefits, and which is greater than the inherent investment performance to which they are entitled. To the extent early SOLI investors are effectively subsidized by those investing later in the scheme, then by definition, the pyramid scheme must eventually fail as the underlying value of SOLI holdings are consumed by subsidies necessary to support artificially inflated returns taken out by early investors and leaving nothing for investors who are last in line.

Of course, only time will tell whether investor groups will be able to securitize their SOLI holdings for sale to the community of public investors, and if so, whether such short-term strategies for maximizing their short-term returns will have the pyramiding effect on the market of public investors that could be last in line. Either way, with as many as eight (8) parties to a SOLI transaction, SOLI is hardly a simple way to make money with little if any risk.

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### **Part V – Summary**

The SOLI transaction is much like a "mortality futures" transaction where certain parties have one expectation as to the future value of the article of trade that is the subject of the "futures contract", while other parties have a different expectation as to the future value of that article of trade. Of course, the article of trade that is the subject of the "futures contract" SOLI transaction is the life expectancy or mortality of the insured.

Current marketing practices suggest SOLI is an easy way to make money with little if any risk and that all parties will profit. However, as we have seen herein throughout, SOLI is a complicated transaction involving at least six parties, and potentially as many as eight parties to the transaction, all of whom are involved for the exclusive purpose of profiting on the future trading of the SOLI policy.

As we have also seen herein throughout, examining the economics of the transaction makes clear that not everyone is going to profit. Certain parties to the SOLI transaction will profit and certain parties will lose, just like in any "futures contract". Also like any other futures contract, the parties who wins and the parties who loses is a function of the actual future value of that article of trade that is the subject of the futures contract, which in the case of SOLI is the life expectancy of the insured.

If the life insurance company's calculations of life expectancy are correct, then they win, and ...

- ... the investor group loses, or must securitize SOLI holdings and sell to public investors, who then will lose in place of the private investor group.
- ... the special-purpose lender will lose either by not being able to collect interest payments and/or by not being repaid for loaned amounts to pay premiums.
- ... the insured will lose by not profiting as advertised, and at worst getting a 1099 for income taxes due on phantom income.

On the other hand, if life expectancy calculations used by the investor group are correct, *and the life insurance company does not or cannot change the pricing of those products in which they miscalculated life expectancy*, then the life insurance company loses, and ...

- ... the investor group wins by earning its target rate of return or more either through the collection of SOLI death benefits or the securitization and sale of SOLI holdings on Wall Street,
- ... the special-purpose lender wins with a profit from above-market interest payments,
- ... the insured wins by monetizing their insurability for a handsome profit by simply consenting to be examined, underwritten and insured,

If the life expectancy calculations of both the investment group and the life insurance company are wrong, then winners and losers will fall somewhere in between the two scenarios outlined above. Of course, all futures contracts involve winners (i.e., those parties that accurately calculate the future value of the article of trade that is the subject of the futures contract) and losers (i.e., those parties that are mistaken about the future value of the article of trade that is the subject of the futures contract).

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As such, while SOLI has been marketed with the presumption that all parties will win, and while certain parties to the SOLI transaction *do* always win, the math clearly shows that some number of parties to the transaction *must* lose. As demonstrated throughout, when parties on one side of the “mortality futures” transaction win, the parties on the other side must lose, as is the case with all futures contracts. To the extent that this is understood by all parties to the transaction, then the SOLI transaction is much like any other speculative investment where there is potential for great profit and as well as the risk of losing even more than that which is invested.

However, the SOLI transaction has *not* been marketed like a “mortality futures” transaction. Instead, SOLI transactions are generally marketed as an easy way to make money with little if any risk and where all parties will profit. In that this is mathematically impossible, then current marketing practices are knowingly or unwittingly “fooling” certain parties into participation. To the extent that promises of profits, which are not supportable over the long term, are nonetheless paid in order to perpetuate the market, then the SOLI business begins to look similar to the situation found in the Savings and Loan (S&L) crisis several years ago.

S&Ls attracted deposits by promising and initially paying above-market interest rates that were not economically sustainable. Eventually, the entire system collapsed, the Federal Government bailed out the S&L’s, and depositors were made whole (up to the limits of government guarantees). While we cannot yet know whether the SOLI market will follow the same path as the S&L industry, nor whether or not it will reach the same level of crisis, we now know that the SOLI market is operating on a similar promise of above market returns, which are also not supported by underlying economics. We also know that, if it does follow the same path as the S&L industry and reaches the same level of crisis, there is no government agency to bail out the losers who were fooled into participating.

In addition, the current environment of increasing regulation, increasing enforcement, and increasing disciplinary action in the entire financial services industry makes the risks of participation all the greater. For instance, if the SOLI market does go the way of the S&L industry, and without a government agency to bail out those who got “fooled” into participating, and where Elliot Spitzer and the like seek restitution from profiteers without regard to whether laws were broken or rules violated, those who may win early in the SOLI market cycle could conceivably be among the losers at some later date.

Either way, the SOLI transaction is *not* a simple, low-risk way to make money. That being said, the SOLI transaction *does* present certain parties with an opportunity for profit and may be a suitable transaction in some cases. However, prudence suggests that any party contemplating participation in a SOLI transaction should first fully understand the risks involved with the SOLI transaction, and at a minimum, explore the below list of our “top 10” due diligence questions to ask before entering into a SOLI transaction:

- 1. Have the parties applying for life insurance (i.e., the insured/the trustee of the insured’s trust) been complete and accurate in their representations and disclosures?** Most every insurer who has the capacity to write life insurance in the SOLI market has published rules governing their participation in SOLI transactions, and in some cases reinsurance treaties prohibiting their participating in SOLI transactions. As such, most insurers have added questions to their applications to identify and prevent their participation in these transactions.

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As such, before participating in a SOLI transaction, agents, brokers and insureds should request a copy of the insurer's published rules related to SOLI transactions. In addition, while many insureds and advisors leave such paperwork to the agent/broker, because the insured/the insured's trustee are the parties legally applying for the insurance, and making the representations on the application, the insured, their trustee and/or their attorney should review the application to verify it is completed accurately and in its entirety. To the extent that the application is not completed in a manner that reflects the true nature of the transaction, then the insured could be accused by the insurer of misrepresentation and the agent/broker could lose their appointment to sell products for that insurer.

- 2. Does a SOLI policy satisfy the statutory requirement for an "insurable interest" between the policyowner and the insured?** A basic requirement for all types of insurance is that the policyowner must have an "insurable interest" in the subject of the insurance. A policyowner has an "insurable interest" in something when loss or damage to it would cause that person to suffer a financial loss or certain other kinds of losses. In the case of life insurance, everyone is considered to have an insurable interest in their own lives as well as the lives of their spouses and dependents. For this reason, SOLI transactions are generally titled in the name of a trust created by the insured. However, there is considerable debate about whether such trust-owned policy ownership is sufficient to constitute a bonafide insurable interest where the substance of a SOLI transaction intends from inception to provide the bulk of the benefits to an unrelated third-party (i.e., in our example, the investor group receives the \$10,000,000 death benefit if death occurs after the policy is in their hands whereas the insured *either* receives \$1,124,491 if life expectancy calculations by the investor group are correct *or* loses an amount approaching \$426,123 if life insurer calculations of life expectancy are correct and depending on eventual income tax and/or gift tax treatment). In other words, in our example SOLI transaction, the insured receives at most 11% of total SOLI policy benefits (unless the insured predeceases during the first two policy years) whereas the investor group can receive as much as 100% of policy benefits and at the expense of the insured. Given this value allocation, while the insured's trust in fact applies for the policy, there is a question whether the courts and/or state insurance departments will look upon this as if the trustee was acting as agent for the intended owners (i.e., the investment group). In addition, because trust agreements are often authored by the investment group and are typically (purportedly) drafted as non-grantor trusts, there is also a question as to whether a non-grantor trust will have the requisite insurable interest in the appropriate state. Moreover, if non-recourse or semi-non-recourse financing is found to *not* be a bonafide arms-length loan (e.g., because the investor groups are guaranteeing the loan perhaps), the argument could be made that the investor group paid for the policy from the beginning and thus there was never an insurable interest. To the extent no such insurable interest is present, the insurance company can void the contract within at least first two (2) policy years, and perhaps beyond. For instance, certain insurers have asserted that because a basic requirement for all types of insurance is that the policyowner must have an insurable interest, and that because the substance of SOLI transactions lack such insurable interest, then SOLI policy contracts are by definition incomplete and thus never in effect. Of course, without the life insurance contract, there is no SOLI transaction. As such, seeking advice of counsel on the subject of insurable interest at it relates to each specific SOLI transaction can reduce the risk that the SOLI transaction will not work out as proposed.

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- 3. Is non-recourse premium financing truly non-recourse? And should it be?** The non-recourse nature of premium financing used in many in SOLI transactions is one of the most appealing characteristics to insureds/investors (i.e., only because of non-recourse financing can promoters pitch that insureds/investors pay nothing into the transaction and thus have nothing to lose), and at the same time is the cause of the greatest concern among life insurance companies (i.e., non-recourse premium financing is one of the most asked questions on life insurance applications in an effort to filter out SOLI transactions). Ironically, while non-recourse financing appears to reduce the risk of loss to the insured on one hand, non-recourse financing also increases the risk that the insured/insured's trust will be seen as only the nominal purchaser, while the investor group will be seen as the actual policyowner, and because the investor group lacks the necessary insurable interest, the transaction could be rescinded. On the other hand, while full-recourse or semi-non-recourse financing adds credibility to the claim that the insured/insured's trust was the real initial owner of the policy because they have more "skin in the game", it also makes the SOLI transaction less/un-marketable because the insured becomes liable for the difference between the loan balance and the policy cash value serving as collateral (i.e., the program can no longer be marketed as "free insurance"). For this reason, certain SOLI transactions are using full-recourse or semi-non-recourse premium financing together with offshore guarantees and/or other assurances that minimize or eliminate the recourse risk otherwise included in the loan documents. As such, to the extent that the insured/investor is contemplating a SOLI transaction based on representations of non-recourse premium financing (or any variation that represents to minimize or eliminate the recourse risk), then loan documents (and any related documents) should be reviewed by counsel to ensure that loan terms are truly non-recourse (i.e., to ensure loan documents are non-recourse throughout and that non-recourse language is not undone later in the document by an indemnification clause or other clause that is too broad or in the proverbial "fine print"). On the other hand, because life insurance companies generally refuse to issue life insurance contracts where non-recourse financing is used to pay premiums, but are generally willing to issue life insurance contracts where the source of premiums may be some form of recourse financing, desired results may be best achieved through some form of recourse financing thereby eliminating risks of material misrepresentation, omission, or fraud on application as well as the risk of litigation at claim time and/or questions surrounding insurable interest.
- 4. What is the life expectancy value used by each of A) the life settlement market maker and B) the life insurance company?** In that SOLI operates much like a "mortality futures" transaction where the life settlement market maker has one calculation as to the future value of life expectancy, and where the life insurance company has a different calculation as to the future value that same life expectancy, the risks of participating in a SOLI transaction can be largely quantified by knowing the life expectancy value being used by each party, and knowing whether such life expectancy values can be changed. For instance, the insured, the life settlement market maker, and the special-purpose lender can limit their risk to some degree through the use of a life insurance product in which pricing is guaranteed, and thus the life expectancy inherent in that pricing is also effectively guaranteed. Similarly, insureds can further mitigate their risk of participation by asking life settlement market makers to guarantee the life expectancy used in their present value calculations of the SOLI policy purchase price on the life settlement secondary market. While few (if any) investor groups have offered such guarantees to date, this is certainly a reasonable request given that profits

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to the promoters of SOLI transactions are largely taken out up front and thus effectively guaranteed to them.

- 5. What are the income tax and gift tax consequences as calculated using *both* A) the life expectancy value used by the life settlement market maker and B) the life expectancy value used by the life insurance company?** As discussed herein, if the life expectancy value used by the life settlement market maker is correct, and the life insurance company does not adjust the pricing of the SOLI policy to change their life expectancy inherent in that SOLI policy, then the insured will receive a handsome profit. This profit will, of course, be taxable, which certainly seems to be an acceptable income tax consequence whether taxed at capital gain rates or ordinary income rates. However, should the life expectancy value used by the life settlement market maker prove wrong, then the insured could be faced with phantom taxable income, and the income tax consequences are not so clear due to a lack of clean opinions and clean statutory guidance. For instance, would cancellation of debt rules apply under bankruptcy/insolvency statutes? Or would income taxes instead be calculated on the taxable gain? And if taxes are to be calculated on the taxable gain, is the basis in the contract equal to premiums paid? Or is basis equal premiums paid less economic benefits received, which can result in basis being nearly \$0, and thus the taxable gain being equal to almost the full amount of the loan? And are gift tax consequences determined in similar form and fashion as income tax consequences? Or are gift tax consequences determined another way? For instance, in that SOLI transactions are often marketed as "monetizing the wasting asset that is the insurable interest of the insured", should gift tax consequences be determined instead by the value of such insurable interest? And if so, how should that value be determined? Is the proper value of a gift of an insurable interest to a trust based on the purchase price paid to the trust by the life settlement market maker? If so, and with income and gift tax rates being what they are for the high-net-worth individuals to which these transactions are marketed, it is possible for income and gift taxes together to consume the entire profit otherwise payable to the insured/insured's trust even if life expectancies from generally-accepted life expectancy tables used by investor groups prove correct. And would such gift taxes be due at the time the insured first "gifts" their insurable interest to the trust? Or at some later date? Given this lack of clean opinions and clean statutory guidance, insureds contemplating a SOLI transaction should seek the advice of counsel to fully understand the income tax and gift tax treatment of the SOLI transaction based on both A) the life expectancy value used by the life settlement market maker and B) the life expectancy value inherent in the SOLI product and used by the life insurance company.
- 6. Could SOLI transactions be subject to new Split-Dollar Regulations, reporting requirements and taxation?** While Split-Dollar Regulations include language that could arguably exclude SOLI transactions from the definition of a Split Dollar Arrangement, if SOLI is seen by authorities as abusive, it is conceivable the IRS could determine that SOLI transactions do meet the definition of a split dollar arrangement (as discussed on pages 25 and 26 in Part IV Section 6), or modify the definition of a Split Dollar Arrangement to include all transactions whereby the insured party enjoys the benefit of life insurance protection at no cost while another party is paying policy premiums. If the IRS determines (even if in hindsight) that SOLI transactions *do* meet the definition of a split dollar arrangement, then the insured could be presented with additional adverse income tax and/or gift tax consequences. As such, insureds considering a SOLI transaction should both seek

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advice of counsel as to the possible applicability of Split-Dollar Regulations to a proposed SOLI transaction, and then also determine who will be responsible for reporting any imputed taxable income (failure to report taxable income can result in the tax return remaining open to IRS scrutiny both as it relates to this transaction, and as it relates to anything else in the return that they may want to question with the benefit of hindsight).

- 7. Could SOLI transactions be considered a Reportable Transaction as defined under the American Jobs Creation Act of 2004 and IRS Circular 230?** The American Jobs Creation Act added a new concept of Reportable Transactions that imposes new penalties for a failure to disclose certain reportable transactions in the tax return of a taxpayer. While such legislation and related IRS regulations may appear intended to apply only to those taxpayers (and their tax advisors) who are involved in large tax shelter transactions or transactions involving large corporations, revised regulations also impose new obligations on tax professionals and taxpayers engaged in any kind of tax avoidance transaction. Whether the IRS would consider “free insurance” without paying tax on the corresponding economic benefit of that insurance, or non-recourse forgiveness of debt to be “any kind of tax avoidance”, a defining characteristic of a Reportable Transaction is one in which the taxpayer and/or any independent tax professionals are required to sign a non-disclosure agreement in order to receive the details of the proposed transaction. Given that SOLI transactions often require such non-disclosure agreements, and that failure to disclose a Reportable Transaction can result in penalties of between \$10,000 and \$100,000 for individual taxpayers and of \$50,000 to \$200,000 for all other taxpayers *in addition to any other penalties that may be imposed (e.g., 20% penalty on any underpayment of tax)*, insureds should certainly seek the advice of counsel to determine whether a SOLI transaction under consideration would also be considered a Reportable Transaction. In addition, because these rules also impose new reporting requirements and penalties on lawyers, CPAs, financial advisors and/or other “material advisors” providing material aid, assistance or advice with respect to organizing, managing, promoting, selling, implementing, insuring or carrying out any reportable transaction, all parties and advisors to a SOLI transaction would be well-advised to understand the Reportable Transaction rules as it relates to the SOLI transaction.
- 8. Could SOLI transactions be considered a “security” as defined in the Securities Act of 1933?** The Securities Act of 1933 defines the term "security" to mean “any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities...”. While the term "security" does not include any insurance or endowment policy or fixed annuity contract, the SOLI transaction combines through a series of steps a life insurance policy together with a note and a participation in a profit-sharing agreement. In addition, insurance is defined by the Merriam-Webster Online Dictionary as “coverage by contract whereby one party undertakes to indemnify or guarantee another against loss” whereas an investment is defined as “to commit [something of value] in order to earn a financial return”. Clearly, prevailing marketing practices advertising the profit potential of the SOLI transaction is closer to the definition of an investment than it is an insurance contract. To the extent the SEC/NASD

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were to collapse these steps of the SOLI transaction into a single “investment contract”, then insureds who buy a SOLI transaction could be found to have purchased an unregistered security, and distributors who sell SOLI transactions could be found to have engaged in the sale of unregistered securities. If this is the case, then the insured risks losing whatever profit they would have otherwise earned (to the extent such profits would have materialized), and the distributors risk penalties, sanctions, loss of licensure, and should authorities find SOLI transactions to be abusive, potentially even charges of fraud. As such, both insureds and distributors should seek the advise of counsel to determine whether the SOLI transaction could be considered a “security” by the SEC/NASD at some point in the future even if that is not their position today.

**9. Does the life settlement market maker have a published confidentiality policy and privacy statement?** Given the obvious risk to the insured of a life insurance policy "falling into the wrong hands", the insured under a SOLI transaction should A) request copies of the Confidentiality Policies and Privacy Statements for the life settlement market maker and the life settlement broker involved in the transaction, B) have such Confidentiality Policies and Privacy Statements reviewed by counsel, and C) consider such Confidentiality Policies and Privacy Statements in selecting the Life Settlement Market Maker and the Life Settlement Broker. This is all the more important where states do *not* require that life settlement providers/brokers have confidentiality policies nor privacy statements to protect the identity and the medical records of the insured. To the extent the life settlement broker and/or life settlement market maker(s) selected for a given SOLI transaction does have published confidentiality policies and/or privacy statements, then such confidentiality policies and/or privacy statements should be made part of the permanent transaction file should future enforcement become necessary.

**10. Ask the promoter of the SOLI transaction for references to insureds who have actually received the promised profit? And/or if the promoter will guarantee some minimum level of profit to the insured and/or indemnify the insured against adverse tax consequences?** The earliest SOLI transactions were entered into between two (2) and three (3) years ago. As such, the first life insurance policies issued pursuant to these early SOLI transactions have now satisfied their 2-year contestability period, and are now available for purchase by the life settlement market makers under the terms of the typical SOLI proposal. Given the substantial amounts of SOLI reportedly written in the past two (2) years, promoters should have a list of insureds from whom they have already purchased SOLI policies, who should have already received the promised profit, and thus should be happy to provide a reference. In the even a promoter is unable to provide references (understandably due to the private nature of high-net-worth individuals and/or the constraints of formal confidentiality agreements), promoters should nonetheless have some “track record” of paying promised profits, and thus should be able to guarantee some minimum level of profit to insureds, or at a minimum agree to indemnify them against adverse tax consequences. Certain promoters have already made a practice of paying profits to the insured up-front and others have paid legal fees on behalf of the insured for due diligence on the SOLI transaction. As such, guaranteeing the insured some minimum level of profit and/or agreeing to indemnify the insured against adverse tax consequences is consistent with these previously established market practices. However, while guaranteeing some minimum level of profit and/or indemnifying against potential adverse tax consequences is good for the insured, such

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guarantees/indemnification raised the question of illegal rebating and could make insurers all the more opposed to the SOLI transaction. As such, even if promoters are willing to offer minimum profit guarantees and/or indemnification against potential adverse tax consequences, insureds and distributors should nonetheless seek the advice of counsel to ensure both complete and accurate representations and disclosures, and compliance with state rebating laws.

We hope you found this discussion to be a balanced view of the pros and cons, the potential for profit, and the risks of loss in the SOLI transaction from the perspective of each party to the transaction. We would also like to acknowledge the below individuals (in alphabetical order), without whom this discussion would have been impossible:

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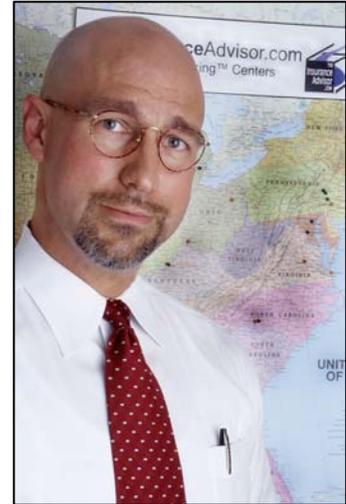
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Barry Flagg is founder of TheInsuranceAdvisor.com (TIA), the leading provider of life insurance product ratings and research. TIA is the natural outgrowth of his need to measure pricing and performance in managing portfolios of insurance products for affluent individuals and growth companies, which consistently ranks him in the top ¼% of all practitioners.

Mr. Flagg was the youngest CFP® in the history of the College for Financial Planning, as well as a Chartered Life Underwriter and Chartered Financial Consultant. He has since been an Adjunct Faculty Member of the College for Financial Planning, and is a frequent speaker to industry groups and workshops for regional and national law and accounting firms, most recently speaking at the HSBC Bank/Wealth & Tax Advisory Annual Conference, the Grant Thornton Family Wealth Planning Annual Conference, and the National Financial Partners Semi-Annual Marketing/Continuing Education Conference.



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