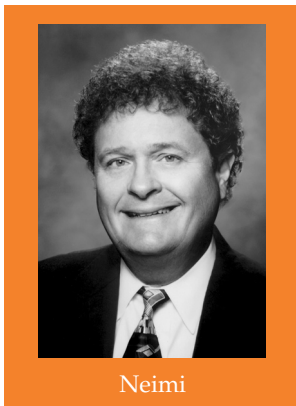


A Q&A WITH LIFE SETTLEMENTS

Wealth Management Business' Exclusive Question & Answer Session with Leading Professionals in the Life Settlement Industry

1. What are the factors that every estate planner should recognize as making it appropriate to discuss a life settlement with the client?

Alan Neimi, Maple Life Financial: Life settlements are a maturing market and



Neimi

should be part of any estate planner's routine advice. A life insurance policy is a saleable asset. The recommendation to sell the asset is up to the estate planner on a

client-by-client basis and depending on their particular financial situation and circumstances. Divorce, death of a beneficiary, underperformance, unaffordable premiums, estate plan changes, liquidity needs, healthcare needs, and business bankruptcy are some of the many factors estate planners should consider for a life settlement discussion.

Craig Seitel, Abacus Settlements: First, only "ultra seniors" (65 and over) qualify for life settlements. If a client falls within this age category then the estate planner should be on the lookout for the following:

- If the owner is going to let his/her policy lapse;
- If the policy was purchased for estate planning purposes and is no longer needed;
- If the owner has a keyman, buy-sell

or business succession plan policy that is no longer needed;

- If the owner's family has achieved financial stability and well being and the policy is no longer needed.

2. What are the questions every estate planner should be asking clients in order to solicit those factors if they exist?

Niemi: Questions include whether the need for a life insurance policy has changed due to personal or financial situations and events including:

- Divorce
- Becoming an empty nester
- Death of a spouse
- Retirement
- Selling a business
- Corporate or personal bankruptcy
- Replacing the policy makes more sense
- Policy has not performed as anticipated

In addition, a client may need access to cash for:

- Medical or long term care
- Charitable donations
- Other gifting opportunities
- Travel
- Other activities

Amy Gavartin, Melville Capital:

- Does the insured have any policies that the planner is not aware of?
- Are they comfortable with the

The Participants:

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John Koeppen, Director of Marketing, GWG Advantage

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amount of current coverage they have?

- Would they be interested in the possibility of keeping the same amount of coverage, but reducing their annual premium expense?

- What factors have changed in their life since taking out these policies?

- Do they have elderly parents they are supporting that may have policies where premium expenses could be utilized better on other products or purposes?

- Do the beneficiaries still require the protection? Etc...

3. Assuming the issue suggesting a life settlement is that there is no further need for the coverage (as opposed to there being insufficient resources to pay further premiums): if it's a "good deal" for an investor to buy the policy, why isn't it a "good deal" for the policy owner to KEEP the policy?

John Koeppen, GWG Advantage: What's a "good deal" is apt to be measured differently by the policy owner than it is by the investor. The policy owner has to be concerned about the insured outliving the policy, so that the life insurance is no longer in force when the insured dies and all the money that has been paid into it has been wasted. Even when keeping a policy, the policy owner will be making premium payments on a portfolio asset, which

is undervalued or underperforming. Settlement offers the option to redirect proceeds into more suitable financial vehicles. But an investor will acquire blocks of policies and is focused on life expectancy and aggregate results. An investor knows the rate of return will turn out to be higher on some policies acquired in the block than on others.

Niemi: The issue for the client is when they wish to derive the economic benefit from their life insurance policy. What a client can derive in their lifetime from a life insurance policy is obviously minimal. Most financial planning professionals including those in the life settlement industry understand the importance of evaluating all available investment options and tailoring a plan that meets individual customer needs. Life settlements are not for everyone and great care should be taken to ensure that proper review of a client's entire financial situation is conducted. Life settlements add to the available planning options and in some cases make the most financial sense for consumers, which is why the secondary life insurance market continues to expand in record numbers each year.

4. How does my client get comfortable with the notion of "strangers" owning life insurance on them and profiting from their demise?

Seitel: This is not a novel concept.



Seitel

Reverse mortgages are not paid until the borrowers pass away. Retirement annuities will be paid as long as the annuity owner is alive. The client needs to understand that

the life settlement investor endeavors to accumulate hundreds of policies as

an investment, based upon longevity risk rather than its typical investment, which is based on credit risk.

Gavartin: It is very important for obvious



Gavartin

reasons that policies should only be sold to large institutional investors building large portfolios versus private investors. Because these institutional buyers

are holding hundreds, if not thousands, of policies, the return made or lost from one policy is not going to sway the overall return of the portfolio (portfolio theory). Legitimate institutional investors will utilize the service of a third party escrow company, hold the policies in blind trusts, have a contract with a rescission period, utilize HIPAA compliant forms and require next of kin approval. If these guidelines are followed, one could say it is not a "stranger" owning the policy, but a large institution making an investment into an asset non-correlated to more traditional investments (i.e., stocks, bonds).

5. How does one find out the best way to offer an existing life policy for sale? Are there brokers? How does one choose a "straight shoot-

The wealth management professional should approach several providers for quotes. LISA is the national trade association for settlements.

er"? Is there an independent governing body, such as the state insurance commission? And what state's law applies to these transactions?

Niemi: One would be best directed to select a life settlement broker and life settlement provider that are licensed or otherwise qualified to do business in the state where the policy owner lives. Today, over 27 states have adopted life settlement legislation and require a broker license in order to participate in a life settlement transaction. Choosing an experienced life settlement broker and an institutionally owned and funded provider is crucial. To learn more, visit the Life Insurance Settlement Association (LISA) at www.lisassociation.org.

Seitel: The wealth management professional should approach several providers for quotes. LISA is the national trade association for settlements. My recommendation is to contact this organization (or refer to their Web site — www.lisassociation.org) to confirm that the vendor is a current member. Today, 28 state insurance commissioners have life settlement regulations. Within 24 months, I believe that all states will be regulated for consumer protection purposes. We very much promote these developments.

6. How does one find out whether he or she has been offered the best price? Must brokers disclose their commissions? Can they "hide" that by buying it themselves (or by an

The NAIC Model Life Settlement Act creates a restriction on traditional life settlements but not an absolute restriction. The Act is unprecedented in its effect of limiting one's ability to sell an asset.

entity they control) without a commission and then reselling for a profit equal to the commission?

Gavartin: It is not industry rule to disclose commissions and currently commission levels are governed by the funder/provider. The funder/provider also dictates whether or not commissions require "full disclosure". A reputable broker will have no problem offering transparency on all transactions regardless if the funder/provider is offering it. Regarding if a broker can "hide" commissions and buy a policy themselves and then resell for a profit; sure, anything is possible, but a reputable broker would not partake in such practices!

Seitel: Currently, most states do not require the broker to disclose their commissions. Many investors, however, in an effort to control broker commissions, are requiring that the brokers disclose their compensation. In any event, my suggestion is that the seller get at least three offers from reputable providers and, if a broker is involved, require that the broker disclose commissions.

7. There are some ethical issues with respect to obtaining a life expectancy assessment on a client. Do you make that information available to the policy owner in due course of the transaction, or only when specifically requested? How do you counsel brokers to handle this delicate information?

Niemi: Sellers of life insurance policies are the client of their broker and not

the provider. In a typical life settlement transaction the life settlement provider does not have direct access to communication with the seller of the life insurance policy. Thus, a seller would be directed to their broker if such a request were made. In any event, the provider would be guided by the various federal and state privacy laws and regulations regarding disclosure of confidential medical information when dealing with such a request from a policy owner.

Gavartin: In order to obtain a life expectancy (LE) report, a broker needs to have a HIPAA disclosure form granting them permission to receive such privileged and confidential information. Traditionally, this information is not shared with the insured or policy owner and only with the financial representative if they are named on a HIPAA as well. Financial representatives are reminded that this information is confidential. If the insured insisted on receiving their LE results, the advisor should deliver the answer delicately. Additionally, they should explain that it is just an opinion based primarily on government generated actuarial tables.

8. If mortality improves by 10 percent, what will be the impact on the funders? If mortality improves by 20 percent, what will be the impact on the funders?

Seitel: It is difficult to say what the precise effects of life expectancy extension on investors will be. Needless to say it will have an increasingly negative

impact. Most funders, in their pricing models, do build in stress case scenarios such that their investment portfolio should be able to withstand a 20 percent extension and still have a positive return.

Niemi: Funding always takes into account longer life expectancies. Because of the time value of money, longer life expectancies naturally mean lower priced offers.

9. What are the income estate and gift tax effects of such a sale? Does it matter whether the policy is owned by a trust? Should that trust be a grantor trust for income tax purposes or not?

Gavartin: Premiums paid into the policy are considered "cost basis", less amounts received under the contract (for example, dividends and other prior distributions), IRC Sec. 72(e)(6). However, the tax code is silent as to the cost basis when a third party purchases an existing life insurance contract. Additionally, tax code is silent with the treatment of taxation on the proceeds from a life settlement. All this considered, there was a situation where the Tax Court supported capital gain treatment for the excess of sale price over the higher of the federal income tax basis or CSV; Jules J. Reingold, BTA Memo, 1941-319. In the Reingold case, both the government and court agreed that a life insurance contract is a capital asset. This is now included in the meaning of IRC Sec. 1221.

With all that being said, the majority of tax professionals we work with treat the difference between cost basis and the settlement amount as capital gains. In the rare situation of CSV being higher than cost basis, that difference is treated as ordinary income.

With regards to policies being held in trusts, taxation for a life settlement transaction can be very complicated and should be discussed with a professional tax advisor.

Koeppen: The income tax effect of a life settlement generally is that if the cash value of the policy is less than cumulative premiums paid, the policy owner will realize a capital gain on the difference (if any) between premiums that have been paid into the policy and the amount of the life settlement. But if the policy cash value exceeds premiums paid then that excess will be taxed as ordinary income and the balance of the life settlement proceeds received above the cash value will be capital gain.

Life settlements can be completed whether or not the existing policy is owned by a trust. If the policy that is settled is owned by an irrevocable trust the settlement payment will be made to that trust and no gift should result. The trust could use those proceeds to acquire new coverage if desired.

But if the existing policy is owned by the insured or insured's spouse and new coverage is to be obtained with the settlement proceeds, it likely is still preferable that the new policy be owned by an irrevocable trust. Here a gift could result unless a grantor trust is used. The insured could create a grantor trust and sell the existing policy to it for premiums paid or cash value, whichever is higher, presumably without income tax consequences. The grantor trust could then consummate the life settlement without the occurrence of a gift.

10. In split dollar situations, are policies ever purchased "assuming" the collateral assignment liability?

Niemi: Typically, no.

Gavartin: Traditionally, all collateral assignments need to be released for an ownership change to occur at the carrier level. Hypothetically, an entity that has a collateral assignment against a policy could find a buyer to sell their assignment to, but this is not common or usual industry practice.

Koeppen: This could be done, but I don't know how often it happens. The split dollar agreement would have to be modified because the original sponsor (premium payor) will no longer be paying premiums once the policy is settled. This in itself could well be a "material modification" that could have adverse income tax consequences depending upon the date of the original agreement. An example might be forcing taxation of the economic benefit (death protection) from lower carrier 1-year term rates to table 2001. There are a number of other potential problems, and yet the settlement funder might obtain additional leverage by holding back the portion of the settlement payment equal to the collateral assignment liability until the insured's death. If such a liability assumption were desired, the case would have to be evaluated very carefully.

11. What impact will a law restricting the application for life expectancy (LE) for 5 years from issue of a policy have on the life settlement business?

Seitel: Generally speaking, this 5-year moratorium on life settlements is damaging to the consumer and is a total accommodation to the insurance carriers. Simply put, it restricts the consumer from managing his or her asset portfolio by not allowing them to consider a settlement for 5 years. Typically, states prohibit the sale of a policy for 2 years. The concept was that this is consistent with the contestability period so that the carriers had 2 years to complete any additional due diligence to confirm that, in fact, a policy was valid. The 5-year moratorium was conceived as a way of preventing STOLI (which represent a fraction of the life insurance). This approach is akin to giving a lobotomy to someone who has a headache and is clearly unfair to the general insurance owner.

Gavartin: LE companies issue their reports based on medical information and don't inquire as to why the report is needed or by whom. These reports are used for many facets of the insurance process from new issuance of policies to the sale of existing policies. If there was a moratorium for a 5-year period on LE's based on when a policy was last written on an insured, it would not only effect the settlement community, it would effect the entire insurance community at large.

I think the more important question to ask is 'What impact will a law restricting the sale of existing policies for 5 years from issuance have on the settlement community, insurance carriers and policy owners/insureds?'

Niemi: The NAIC Model Life Settlement Act creates a restriction on traditional life settlements but not an absolute restriction. The Act is unprecedented in its effect of limiting one's ability to sell an asset. However, the limitations are not absolute. There are circumstances where a policy can be sold between 2 and 5 years.

"Five-year bans" are often touted as being necessary to protect against Stranger Originated Life Insurance (STOLI) schemes but this is not always the case. Creating a 5-year ban on entering a life settlement ties up the saleability of an otherwise saleable asset. The better approach is to adopt a reasonable definition of STOLI and to prohibit STOLI within the state life settlement law.

A law restricting a life settlement for 5 years is an inappropriate device to injure the life settlement market. The greatest disservice is to consumers who are faced with an unprecedented limitation on their ability to sell an otherwise saleable asset.