UNUSUAL INVESTMENTS: A LOOK AT VIATICAL SETTLEMENTS

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Viatical settlements have received considerable publicity because of high potential returns, but the risks include high return variability due to maturity uncertainty, high transaction costs, and low liquidity. And, you must decide if you can be comfortable with such an investment.

Individual investors are being offered an ever-growing multitude of investment vehicles, many of which are outside of the traditional array of products. Among the many new products available is the viatical settlement.

A viatical settlement is created when an investor makes a payment to a terminally ill individual in exchange for being named the beneficiary of his life insurance policy. The policyholder benefits by converting an illiquid asset (the policy) into cash, often at a time when cash is desperately needed to pay medical costs and living expenses. The investor receives the policy's proceeds when the insured passes away.

To read the marketing literature from viatical brokers, one would come to believe that viatical settlements are both the safest and the highest-returning investment opportunities available. This is, of course, highly misleading, despite favorable press reports, including a positive segment on the CBS television program, "60 Minutes." Viatical settlements can offer potentially high returns as well as safety from one kind of risk—default risk. But the high return potential comes at a cost of high return variability due to maturity uncertainty, high transaction costs, and low liquidity. They are also difficult and time-consuming for investors to properly analyze.

HOW THEY WORK

Viatical settlements were developed in response to the AIDS crisis. Many AIDS patients were young and single, without large savings or home equity, and often without disability insurance. Many, however, held life insurance through their employers.

One way for an insured to quickly raise funds from a policy is to sell it to an investor, by naming the investor as the beneficiary of the policy in return for a cash payment. This process is known as a viatical settlement, and it does not involve any interaction with or decision by the insurer, other than filing the paperwork required to assign a new policy beneficiary.

In 1989, the first two firms opened for business to specifically target individuals with advanced cases of AIDS for viatical settlements; by 1994, the industry had grown to some 60 firms. According to estimates by the Viatical Association of America, between $420 million and $450 million in policies were viaticated between 1995 and 1997.

In general, the process works like this: a potential viator (the insured who wishes to sell a policy) signs up with a viatical settlement brokerage firm, which will solicit offers from investors. The viator provides information about the policy, including its type (whole, term, etc.), issuing company, premium schedule (if any), and cash value (if any). The viator also provides a personal medical history, including information about his or her illness, current physical condition, and life expectancy. Although the industry formed in response to AIDS, certain cancers and other terminal illnesses have also become commonly associated with viatical settlements.

Once a brokerage has a policy available, it offers that policy to a variety of potential investors, including viatical funders (firms specializing in the pur-

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chase of life insurance policies), individuals, and some institutional investors.

From the viator's point of view, the only detail of the transaction that matters is the cash payment received upon designating a new policy beneficiary. After that cash is received, the viator no longer cares what happens to the policy. The broker is supported by a commission which typically is paid by the investor.

From an investor's viewpoint, there are a number of financial factors that need to be considered, which will be covered in the next section. However, investors also must consider whether they are comfortable with the nature of the investment. Descriptions of the investment process may sound somewhat ghoulish, and indeed, some accounts of the viatical settlement industry have used precisely this term. On the one hand, the viator wants and, quite often, *needs* cash (for food, shelter, and other expenses) and is anxious to receive it as quickly as possible. In some cases, if the policy is not viaticated quickly, it will lapse because the viator is no longer able to make the premium payments. Barring the possibility of a viatical settlement, a viator with no dependents properly regards life insurance premiums as a needless drain on limited income and will *rationally* allow a policy to lapse. On the other hand, an investor is clearly better off financially the sooner the insured passes on and the policy is paid out; investors must make sure they can handle being confronted with that dilemma.

Once the investor develops an interest in purchasing the policy, a cash offer is made. If it is accepted by the viator, the offer price is deposited in a fully insured escrow account. The policy beneficiary is irrevocably changed. Once any "right to cancel" period has passed, the funds are transferred from the escrow account to the viator and to the broker. At that point, the viator has no further interest in the policy—unless only a portion of the benefits were assigned, as may be required in some states, or when a viator has dependents. In some cases, the investor is responsible for making future premium payments, if any. Indeed, the investor will want to make these payments, as the policy would lapse otherwise and, without the policy, the investment is worthless. However, if the investment is made through a viatical funder, the funder will administer premium payments and monitor the viator on an ongoing basis.

THE VALUE OF A VIATICAL

Properly valuing a viatical may in itself discourage many investors from the product. While the equation is relatively straightforward, determining the values of each of the variables can involve a fair amount of work—similar to the effort required to analyze a real estate investment.

However, if you understand some of the concepts of how viaticals should be valued, you will have a better understanding of the inherent risks and difficulties associated with the investment.

The maximum price that an investor should be willing to pay for a viatical settlement is equal to the discounted present value of the life insurance policy's benefit amount, less the discounted present values of the premium payments required to keep the policy in force, less the costs required to create the viatical settlement:

$$\text{Value} = [\text{PV of policy benefit} - \text{sum of PV of all premiums} - \text{transaction costs}]$$

The present values of the policy benefit and premiums are determined by discounting the future values by an appropriate discount rate over the time (T) that the payment occurs; in this equation, time is stated in months, and the length of time for the policy benefit is the life expectancy of the insured, while the time for the individual premium payments is the number of months until they are due:

$$\text{Present Value} = \left[\frac{\text{Future Value}}{(1+\text{Disc Rate}/12)^T}\right]$$

Thus, the variables needed to solve the equation are:

Policy benefit and policy premiums: The policy benefit, which will be paid to the beneficiary upon the death of the insured, and the policy premiums, which must be paid in order to keep the policy in force should be determined precisely from the following sources:

- The policy declarations page provided by the viator or viatical broker.
- The insurance company that issued the policy to verify that the policy is in force and that the policy's premium payments are current. Often investors in viaticals will only offer to purchase policies that have been in force for more than two years. The investor should also determine the amount of any loans that have been made against the policy.
- The investor should also verify that the policy has passed any period of contestability (the period during which the insurer can question the information provided on the original application), and that the policy allows the insured (the viator) to irrevocably change the policy's beneficiary.
- The investor should check the rating of the issuer through A.M. Best or another rating agency that specializes in insurance providers. Only policies issued by A-rated (or better) issuers should be purchased.

Life expectancy: The life expectancy of the viator is the expected maturity of the viatical settlement. As with any fixed-income investment, there is a close relationship between the maturity and the price that an investor is willing to pay—because

the policy benefit is generally fixed, a longer life expectancy for the viator results in a lower value for the viatical settlement.

Determining the life expectancy of the viator is the most difficult step in evaluating a viatical settlement, because of the high level of medical expertise needed to evaluate medical records or perform a physical examination. For some illnesses, a patient's physical condition follows a fairly predictable path, and life expectancy estimates are very accurate. For others, outcomes vary widely. Although the life expectancy cannot be known with certainty, these are some steps that can be taken to assure the most reliable estimate possible:

- Consult the viator's medical records, which should be available from the viator or the viatical broker.
- Obtain an independent evaluation of the viator's medical records by a professional who has significant experience with the viator's illness. The investor may want to employ someone who is not associated with the viator or the viatical broker offering the policy.
- In some cases, require an independent medical examination of the viator, particularly if the viatical broker offering the policy does not have a well-established track record (although it is not a good idea to use such a broker), if the policy is being purchased directly from the viator, or if the independent evaluation of the viator's medical records is inconclusive.
- The investor might be better served by obtaining a range of life expectancies, and then examining the viatical settlement using both best-case and worst-case scenarios.

Transaction costs: A number of fees are associated with evaluating an insurance policy and creating a viatical settlement. As with real estate transactions, these can vary widely across brokers. Further, the amounts may be negotiable. The investor should obtain a list of all fees that will be assessed in writing before proceeding, including:

- The commission that the viatical broker will charge, which is very high relative to more traditional investments.
- The professional fees required to obtain an independent evaluation of the viator's medical records and/or an independent physical examination of the viator.
- Any legal fees needed to create an agreement between the viator, the viatical broker, and the investor or to process the change of beneficiary.
- Any change of beneficiary fee charged by the insurer.
- Any escrow fees required to hold the investor's funds until the beneficiary has been irremovably changed.

Discount rate: The appropriate discount rate in this equation is an investor's required rate of return, a somewhat amorphous concept to many investors. There are a number of different ways to determine the required return and, depending on the approach taken, the required return for a viatical settlement may vary from one investor to another. The higher the required return, the lower will be the estimated value. An investor should consider the following when setting their minimum required return:

- Opportunity costs: The returns that might be earned from alternative securities. Ideally, these alternative investments will have risk levels and maturities similar to viatical settlements.
- Expected return: The return suggested by the investor's experience, the viator's illness and condition, and the broker's expertise. This is a more subjective measure of required return, but may be necessary in cases where the viatical settlement in question is somewhat unique (e.g., new illness) and the investor has no alternative investments with similar risk and maturity characteristics.
- Historical returns: In theory, the average returns earned by past investments could be used, but in practice, it would be difficult to obtain reliable information on average returns because there simply is not much of a track record. Ideally, returns would be used that matched the proposed viator's illness and life expectancy. Investors should disregard returns earned on particular policies, because these will vary widely from case to case.

THE RISKS

A simple but useful definition of financial risk is "the probability that an investor will receive significantly less than expected from an investment." Using this definition, there are a number of sources of risk specifically associated with viatical settlements, including risk related to investment maturity, fraud, and investor decision-making.

Investment maturity-related risk: It is difficult to determine the approximate life expectancy of a viator (which equals the expected maturity of the viatical settlement) and impossible to do so precisely. Yet, the maturity of an investment, particularly one that will return a fixed dollar amount, is of critical importance. As a simple example, suppose that an investor pays $80,000 for a $100,000 policy and expects it to mature in one year. Clearly, the investor *expects* to earn a 25% return. If, instead, the policy does not mature for two years, the realized return will be only 12.5% or half as much, because the dollar amount received does not change. An investor can mitigate maturity-related risks somewhat by hiring professional expertise to review the viator's medical records and perform a direct physical examination. An investor should also be cautious with regard to very short life expectancies (e.g., less than six months) because there is much risk that the actual

maturity will be longer than expected (and little chance that it will be shorter than expected). In the end, however, an investor must be comfortable taking on maturity-related risk before ever considering an investment in viatical settlements, because maturity of the security will always be unknown.

Fraud-related risk: Because the viatical settlement industry is relatively new and unregulated and each viatical settlement is unique, there is some risk of fraud associated with each transaction. To a greater extent than for most other markets, an investor must understand the concept of *caveat emptor* before purchasing a viatical settlement; do not be misled by hype that promises unusually high returns coupled with little or no risk—this simply does not exist. There are a variety of ways to decrease the likelihood of being the victim of a fraudulent transaction, including:

- Verifying the terms of the policy and the financial health of the issuer;
- Ensuring that the policy issuer cannot contest coverage because of a fraudulent application, unusual or experimental medical treatment, or method of death (e.g., suicide);
- Verifying the illness of the viator and their current health situation;
- Establishing that the viator is mentally competent to assign a new beneficiary;
- Determining whether the viator's likely survivors have waived claims against the life insurance policy. (This may not be possible in the case of minor children.);
- Determining whether the viatical broker is registered (in states where registration is possible), is a member of the Viatical Association of America, and agrees (in writing) to adhere to the ethical standards espoused in model legislation and by VAA;
- Reviewing other viatical settlements created by the viatical broker and checking his or her employment history before and after entering the viatical settlement industry; and,
- Being wary of a viator or a viatical broker who tries to discourage an investor from taking precautionary steps or tries to rush the investor by claiming that the opportunity will disappear soon if not acted upon.

Valuation errors: Investors must understand that their own decision-making process can add significantly to the level of risk undertaken. Failure to understand the terms of the viatical settlement or to obtain the medical opinions necessary to understand the viator's condition and, therefore, the value of the viatical settlement will result in a much lower return than expected. As with any market, an investor must understand the rules of the game before starting to play.

RISK VS. RETURN

Since their introduction in 1989, viatical settlements have offered particularly high returns compared to other types of investments. While high returns could mean that the market is inefficient, a substantial number of viatical funders currently compete to purchase policies, suggesting competitive pricing. In such competitive markets, high returns are typically associated with high levels of risk or other negative characteristics.

Generally, the higher returns realized by viatical settlements appear to be justified given their generally higher risks. The costs of making a viatical settlement on a life insurance policy is higher than the costs of acquiring other investments, with the possible exception of real estate. Further, there are no active secondary markets for viatical settlements and the maturity of the investment is uncertain. Thus an investor is essentially "stuck" with the viatical settlement, regardless of a later desire to liquidate. In addition, because the market for viatical settlements is new, the possibility for fraudulent transactions exists, though a number of states now require registration of viatical brokers and/or funders. Lastly, because the price of each viatical settlement is generally in the tens of thousands of dollars, it is difficult for an individual to develop a well-diversified portfolio of viatical settlements—although some brokers or funders offer shares (parts) of policies to individual investors.

On the positive side, viatical settlements are generally free of default risk, as long as the underlying insurance policy was issued by a safe insurer (one with a high rating). Further, changes in the market prices of other investments do not affect the actual returns received from the viatical settlement.

OTHER CONCERNS

There are several other areas of particular importance to potential investors, including recent trends toward expanding the lists of illnesses for which viatical settlements are made, changes in the tax status of viatical settlements for viators and investors, changes in legislation and regulation, and medical advances for the treatment of terminal illnesses.

- **Other illnesses:** In recent years, policy holders suffering from illnesses other than AIDS—particularly many forms of cancer—have begun to viaticate policies. Potential investors must use caution when offering to purchase a life insurance policy from a person who is suffering from an illness not historically associated with viatical settlements. The investor must have the expertise (or be able to hire the expertise) necessary to determine life expectancy and, further, develop some measure of the risk (uncertainty) associated with that life expectancy. In addition, a required return that is appropriate to value a viatical settlement

associated with AIDS may not be large enough to reward the risks taken when purchasing a policy associated with another illness.

- **Tax status**: 1996's Health Insurance Portability and Accountability Act (HIPAA), which affects payments made to viators and accelerated death benefits paid to policy holders after December 31, 1996, declared such payments tax-free. Prior to that time, viatical settlement payments were taxed as ordinary income. However, some conditions must be met in order for this legislation to apply. First, the viator must have a life expectancy of 24 months or less. Second, the purchasing company must be licensed by the state in which the viator resides. If the state in which the viator resides does not license viatical funders (at the end of 1997, only 20 states did so), the viatical settlement is tax-free if the purchasing company can certify that it complies with the requirements of the Viatical Settlement Model Act and Model Regulations adopted by the National Association of Insurance Commissioners. Although HIPAA's licensing requirements were intended to reduce fraud in viatical settlements, they also appear to place individual investors at a disadvantage to licensed viatical funders. Oddly, industry and regulatory sources have not commented on the taxable status of the payment made to the investor at the death of the viator. These payments appear to be covered by section 101(a) of the federal tax code, which states that "gross [taxable] income does not include amounts received under a life insurance contract, if such amounts 'are paid by reason of death of the insured.'" This language suggests that the investors' return is tax-free, though a tax specialist should clearly be consulted before relying on this analysis.
- **Regulation:** The National Association of Insurance Commissioners has adopted Viatical Settlement Model Act and Model Regulations. By the end of 1997, 20 states had adopted legislation or regulation regarding viatical settlements, most of which require viatical funders and/or viatical brokers to obtain licenses. These new rules, which were strongly advocated by the Viatical Association of America (the industry's largest trade organization and lobbyist), will help to protect viators by reducing the opportunities for fraud in viatical settlements. However, they will also reduce competition, by providing market power entrenched funders and brokers—particularly if licensing requirements for new entrants become onerous. In addition, it is important to bear in mind that insurance regulation occurs predominately at the state level. Thirty states have not yet acted to regulate viatical settlements, nor is it certain that they will adopt the model legislation when they do act. As examples, Utah, New Mexico, and Texas have adopted laws and regulations that do not fully conform to the NAIC models. It is important for an investor in viatical settlements to follow legislative and regulatory activity at the state level.
- **Medical advances:** An investor must always bear in mind that their investment is intimately connected to the particular illness of the viator, and therefore, the expected return on their investment will change drastically with advances in medical treatments for that illness. Essentially, an investor in a viatical settlement must either become, or purchase the services of, an expert with particular knowledge of the illness.

CONCLUSION

Viatical settlements can offer investors the potential for high returns. But these high returns are associated with a number of risks, including: a high maturity uncertainty that can substantially lower returns, high transaction costs, and low liquidity, plus a somewhat higher-than-average potential for fraud.

It is also clear that viatical settlements are quite difficult for individuals to properly analyze, much more so than for most other investments. An investor must carefully study the viatical settlement industry and understand each of the unique risks it poses before making any investment decision.

For investors who are willing to take the time to understand and accept the risks associated with viatical settlement investing, more information can be obtained from the following sources:

- National Viatical Association: 800/741-9465;
- Viatical Association of America: 800/842-9811; www.viatical.org/viatical. ◆