



What's Going On In The Life Insurance Business

By Gordon Bess, CLU, FLMI

Regulation Settles In for Life Settlement Industry

"THE FROST IS on the pumpkin, and the hay is in the barn ..." so goes a line from one of my favorite James Taylor songs, "Walking Man." October is harvest time, and not just for the agricultural set. The life settlement industry, our main theme subject this month, is beginning to harvest greater credibility and respect as a member of the financial services community.

The latest evidence of this is the official membership granted in late August to Welcome Life Securities of Boca Raton, Fla., as a specialty broker-dealer by the Financial Industry Regulatory Authority (FINRA). (For those of you who haven't heard yet, the National Association of Securities Dealers merged with the member regulation functions of the New York Stock Exchange to form FINRA in July 2007.) FINRA has granted specific authority to Welcome Life Securities to supervise settlement transactions involving variable life policies.

This establishes a new beachhead of regulatory supervision for the life settlement industry and should open the way to more life settlement activity by broker-dealers. "For years, we've been targeting broker-dealers to educate them and their registered reps and advisers on this business," says John M. Welcom, president and CEO of Welcome Funds Inc., a life settlement brokerage firm he founded in 1998. "From a compliance standpoint, we're now on the same level as any broker-dealer, although we're not authorized to do any business other than variable life settlement transactions."

Welcom began forming the specialty broker-dealer in March 2006, after he was interviewed by the NASD for its research into the life settlement industry. He is well-qualified as an expert on the business,

having worked his entire career in settlements – initially only viaticals in the mid-1990s, and then all types of life settlements. The NASD issued Notice to Members 06-38 in August 2006 to remind its 5,000+ members that variable life settlements are considered securities transactions and must be supervised accordingly.

"We knew that notice was coming, and for quite some time we worked with the NASD to try to become a member," Welcom says. "Our application period lasted more than 300 days, whereas the typical membership application takes about 180 days. It's a new industry for the NASD, and they weren't really sure how to regulate it, particularly commission structure and best execution practices." In the notice, however, the NASD minced no words about the need for supervisory control of transactions. Here's a quote from page two:

"... Some life settlement providers... aggressively encourage financial service providers, including broker-dealers, to canvass their books of business for seniors or other eligible customers who may be interested in selling their life insurance policies in the secondary market, even if they do not need to or had not previously considered surrendering or allowing their policies to lapse ... Accordingly, NASD is concerned that aggressive marketing tactics, fueled by high commissions, may lead to inappropriate sales practices in connection with these transactions."

Welcom estimates that only about 5% of all life settlements completed so far in the industry have involved variable life policies. "I think that number will significantly increase as more and more broker-dealers realize that life settlements need to be a part of their financial planning procedures," he says. "Many broker-dealers

have never really opened their doors to life settlements because of a perceived lack of transparency, lack of disclosure, and uncertainty on regulations and licensing. But within the last year or so, that's changed."

Much work remains to be done, however. For starters, most broker-dealers need to climb the learning curve on the unique nature of settlement transactions. "A typical securities transaction, like the selling of a bond, happens at the push of a button," Welcom says. "In a life settlement, the underwriting process can take up to three months. Then the negotiations can take another 30 days. There's really no other product out there that requires such an extensive time frame just to get a quote that the client can accept or decline."

Also unresolved are the definition and regulation of commission payouts, which typically are much higher than in other securities transactions — another anomaly broker-dealers will have to understand. "Life settlement brokers actually have to invest in a transaction. We have to pay for medical records and for life expectancy reports, and there's no guarantee that we're going to close the deal. That's why brokers, providers, and everyone involved in the industry believe that fair and reasonable compensation is higher than what a typical securities commission would be. Not only is there significant financial risk, and the extended time frame, it's also a very limited marketplace."

Institutional funding is the lifeblood of the settlement industry, and increased supervisory control will be (excuse this adjective) welcome news to the funders. "The goal of these institutions is to securitize these products," Welcom notes. "A major concern of the rating agencies has been the supervision of the origination process. Can you really give a portfolio an 'A' rating if there are no regulatory requirements?"

The settlement industry has come a long way in a relatively short time. Regulators are still playing catch-up, but with help from leaders like John Welcom, the industry's outlook is bright.

