

LIFE PARTNERS HOLDINGS, INC., et al., Case No. 15-40289-rfn-11

Basic Overview of Life Insurance

Relative to The LPI Portfolio of Policies

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The proposed purpose of this document is to help each position holder gain an understanding of the different types of policies and the risks that may be associated with each - now and in the future. This document is meant to provide only a basic overview of these types of policies. For a more in-depth understanding you are encouraged to consult other financial and insurance professionals and sources.

The Life Partners portfolio consists primarily of **whole life, universal life, and term life insurance policies**. In addition to these **individual** life insurance policies, LPI also purchased hundreds of **group** life insurance policies, which are typically policies issued by an insured's employer. How do these policies differ? In very broad terms, whole life and universal life insurance policies provide permanent coverage and generally have a cash fund component (like a bank account), while term life insurance policies provide coverage for a certain period of time and typically do not have a cash value component. We will first discuss the different types of individual life insurance and then we will discuss group life insurance policies.

Whole Life Insurance Policies

Whole life insurance policies are somewhat rigidly constructed and require, as specified in the policy, that a level premium (same amount each year) be paid each year until the death claim is filed or until the policy maturity date, whichever occurs first.

Each whole life policy has a specified policy **maturity date**. At the policy maturity date, the policy will either become paid-up, endow or it may continue until the demise of the insured (if premiums continue to be paid). A **paid-up** policy is one in which no further premium payments will be necessary, but the coverage will remain in effect until the death of the insured.

If the policy **endows** at the maturity date, that means the carrier will pay the death benefit, at that time, even if the insured is still living.

Whole life policies can either be participating or non-participating. Participating policies often pay dividends, as declared by the carrier (but are not guaranteed) in which case the owner of the policy designates the way the dividend should be paid. Dividends can be paid in cash to the policy owner, used to offset premium expense, used to purchase paid-up-additions (additional coverage), or allowed to accumulate within the policy.

As previously discussed, a whole life policy is a permanent type of insurance and therefore, has a cash account. The **cash value** within a whole life policy is typically guaranteed and specified in the policy contract. As cash value builds in the cash account, it may be withdrawn in the form of a loan; with interest rates that vary by insurance company, market conditions and as specified in the policy contract. **Net cash value** refers to the cash value, less any loans and accrued loan interest, plus any value (if applicable) held in dividend accumulations or additions. This is the amount that would be paid by the insurance carrier if the policy were surrendered, which is why net cash value is sometimes referred to as **cash surrender value**.

Whole life policies also allow the policy owner to select one of several options in the event they have cash in the policy and premium payments are discontinued. These include: surrender of the policy in exchange for receipt of the net cash value, issuance of a paid-up policy with a reduced face amount, or purchase of an extended term policy.

The premium obligations for whole life policies are clearly outlined in the policy and are not flexible, so the amount of premiums due each year will not change (unless a dividend is applied toward the premium or a loan is taken on the policy).

The primary **risks** associated with owning (investing in) whole life policies are less significant than other types of policies because premiums and death benefit are well defined in

the policy and remain level. However, they by their very nature, are more expensive to maintain than UL policies.

Universal Life Insurance Policies

Universal life (“UL”) insurance policies offer more flexibility with respect to premium payments than whole life policies. For example, the policy owner may choose how much premium to pay and how often they want to pay – as long as there are sufficient funds in the policy account each month when the insurance carrier deducts the cost of insurance and related fees.

The funds in the cash account within a UL policy are often referred to the **account value**, which is the sum of premiums paid plus interest credited, less premium/sales expense charges and policy costs (which include costs of insurance, policy fees, and carrier administrative charges) as well as any reductions due to cash withdrawals from the policy. **Cash surrender value** is the account value less applicable surrender charges and outstanding loans (plus accrued loan interest). This is also the amount that the policy owner would receive if the policy were surrendered.

The **cost of insurance (“COI”)** that the carrier deducts each month from the policy account is determined by many factors including the insured’s age and the amount of insurance the carrier has at risk (the difference between the face amount and the policy’s cash account). *The COI will increase each year as the insured ages, but may also increase for various other reasons that are unforeseeable at this time, such as unexpected COI increases issued by the insurance carrier.*

The manner in which UL policy premiums, are currently managed by Magna Servicing LLC has been adapted to fit traditional life settlement policy management models. The primary purpose of this change is to ensure that no premium funds are paid to an insurance carrier in excess of what is necessary to keep the policy in force, **because extra funds in the cash value account when the death claim is filed, would be retained by the insurance carrier..** The process for determining the minimum amounts that need to be paid to keep a policy in force is referred to, within the settlement industry, as **premium optimization**, which might be more accurately described as premium *minimization*. Premium optimization will be discussed in greater detail below.

UL policies are also referred to as flexible premium policies because the policy owner helps to define the amount of premium to pay and the frequency at which it is paid (as long as sufficient funds are in the cash account when the insurance company deducts the necessary funds each month). It works like this: as planned and as appropriate, the policy owner pays funds (premiums) into the cash account. The carrier receives those funds, deducts any premium loads (an administrative charge assessed by the insurance company against funds submitted), and applies the balance of the funds to the policy account. Every month, on the “monthiversary” of the policy date (typically the date the policy was issued), the carrier deducts the cost of insurance (including fees – if any) from the cash account in the policy. As long as there are sufficient funds in the account, the policy will remain in force. The policy owner has the option to pay more funds into the cash account than the carrier will deduct each month. These funds do earn interest; however, if the insured passes away and the death benefit is paid, the insurance carrier typically does *not* return to the policy owner, the funds remaining in the cash account (unless the policy was designated an Option II policy at inception, or the funds were paid *after* the death of the insured).

Yes, this can be a very confusing concept, but it's really just a matter of having sufficient funds in the account when the carrier deducts the monthly "premium expense". Think about it like an \$800 mortgage payment being auto drafted each month from your checking account. The mortgage company doesn't care if there is \$800 dollars or \$2800 in your account, as long as the \$800 is there when they are scheduled to get it. Of course, since the extra \$2000 is in *your* account, you keep it. With a UL policy if the insured dies and that extra \$2000 is in the policy's cash account, the carrier will keep it.

This is unique to UL policies; unlike whole life and term policies where the carrier will return "unearned" premium (premiums previously paid that covers the period after the date of death). As mentioned, an exception would be Option II policies, which require the insurance company to pay both the death benefit and existing cash value at death. Policies with the Option II designation, require a higher premium payment, which could be why there are very few Option II policies within the LPI portfolio.

So, how do we determine how much we need to pay into the cash account to keep the policy in force? That's the tricky, and also confusing part. The carrier does not give you this information. That's why we prepare **optimized premium schedules** for UL policies. The most common method of preparing an optimized premium schedule is through the use of one of the industry software services developed for this purpose. To calculate the optimized premium schedule, an illustration ledger provided by the insurance carrier, along with various other pieces of policy information, are analyzed by the software to produce a premium stream projecting the minimum amount necessary to pay each year to keep the policy in force without building an excess of cash in the cash account. Some industry professionals also perform annual premium reviews where these long-term streams are reviewed again to ensure that the projected premium

stream is still at an optimal level. When paying from optimized premium projections, the premiums will increase every year as the policy costs increase.

Case Study 1

Now that we've discussed premium optimization, let's look at a case study of an **actual UL policy within the LPI portfolio** for which position holders were paying a level premium of \$3,833.69 annually for the initial 10-year period following the date LPI purchased the policy. LPI got this amount from the Illustration they received from the carrier (they requested that the carrier prepare an illustration showing a level premium being paid for 10 years). At the end of that first 10 years, LPI requested another new illustration from the carrier that showed the next fourteen years of payments. The amount in the new illustration showed a premium of \$35,951.05 being paid annually. Huge premium increases such as these are huge surprise for many of the position holders, because they assumed the \$3,833.69, would always be the amount of premium that needed to be paid each year. Many other policies in the LPI portfolio have also had huge increases for the same reason.

Remember, with UL policies, we pay funds into the cash account, and the carrier deducts from the cash account, the amount necessary to cover the COI and related expenses each month. So, in reality what was happening when the \$3833.69 was being paid into the cash account, was that more than necessary was being paid in the early years and the excess funds were sitting in the cash account to help offset the COI and fees in later years. In effect, position holders were pre-paying some of the premiums.

Let's look at this case a little closer. The data in the table below is directly from the illustration that LPI has on file and for which it billed investors and scheduled premium payments to the carrier.

Illustration 1

Projection Start Date: 06/26/06

Start Account Value: \$83,224.96

Y R	EOY AGE	Premiums Less Withdrawals	Loa ns	Loan Balance	Account Value	Net Cash Surrender Value	Net Death Benefit
4	76	3,833.69	0	0	85,823	68,421	350,000
5	77	3,833.69	0	0	84,257	67,706	350,000
6	78	3,833.69	0	0	82,235	66,520	350,000
7	79	3,833.69	0	0	77,787	62,895	350,000
8	80	3,833.69	0	0	71,838	57,768	350,000
9	81	3,833.69	0	0	64,837	51,586	350,000
10	82	3,833.69	0	0	54,647	42,215	350,000
11	83	3,833.69	0	0	37,933	26,320	350,000
12	84	3,833.69	0	0	10,791	0	350,000
13	85	0.00	0	0	0	0	350,000

Policy lapses without value in 11/2014, even if payments shown are made as due.

As you can see, each year when LPI paid the \$3,833.69 to the insurance carrier it was deposited into the policy account value, but notice the account value decreases every year regardless. This is because the \$3,833 was never enough to cover fees and COI each year. For example, in policy year 11, the total amount deducted from the policy account value was over \$16,000 – not \$3,833.69 as was paid to the insurance carrier and assumed by most to be the annual cost of maintaining the policy (the “premium”).

There are several other points that could be made regarding this illustration, but these policies and illustrations are very complex, so we are only discussing information here that will be most helpful to the position holders in gaining a basic understanding.

Now let's look at the next illustration ledger LPI requested for this policy (after the first 10-year illustration from which they were paying ended).

Illustration 2

Projection Start Date: 04/26/15

YR	EOY AGE	Premiums Less Withdrawals	Loans	Loan Balance	Account Value	Net Cash Surrender Value	Net Death Benefit
13	85	-	0	0	11,593	1,642	350,000
14	86	35,951.05	0	0	14,188	5,105	350,000
15	87	35,951.05	0	0	16,803	8,655	350,000
16	88	35,951.05	0	0	19,813	12,705	350,000
17	89	35,951.05	0	0	23,280	17,386	350,000
18	90	35,951.05	0	0	27,270	22,857	350,000
19	91	35,951.05	0	0	31,865	29,341	350,000
20	92	35,951.05	0	0	37,154	37,154	350,000
21	93	35,951.05	0	0	41,302	41,302	350,000
22	94	35,951.05	0	0	44,108	44,108	350,000
23	95	35,951.05	0	0	45,349	45,349	350,000
24	96	35,951.05	0	0	44,431	44,431	350,000
25	97	35,951.05	0	0	40,675	40,675	350,000
26	98	35,951.05	0	0	33,230	33,230	350,000
27	99	35,951.05	0	0	20,373	20,373	350,000
28	100	35,951.05	0	0	100	100	350,000
29	101	-	0	0	105	105	350,000
30	102	-	0	0	109	109	350,000

A reasonable assumption when looking at this is that the premium (COI plus fees and expenses) is \$35,951 per year, but again, that is not exactly correct. As the \$35,951 is paid to the insurance carrier, it is deposited into the policy account value from where the insurance carrier deducts the monthly COI (plus

fees and expenses). For example, look at the policy account values for years 16 and 17 and you will see that only the \$35,951 was paid into the account but the policy account value continues to increase. This is because the entire amount was not the *minimum* amount necessary to keep the policy in force. In this illustration, the excess funds paid in will stay in the policy account and cover the expenses of future years.

From this illustration you can also see why optimization is important. If premiums were paid per this illustration ledger, and the insured were to pass away in year 20, you can see that over \$37,000 of cash value would still be sitting in the policy account value – that the insurance carrier would retain.

The current premium management plan for the Portfolio of policies is to pay premiums *not* from these types of illustrations, but from optimized premium streams, which, as stated previously, will mean that the premiums are estimated to be an amount just slightly greater than the amount necessary to keep the policy in force, but not a large amount that would be forfeited to the insurance carrier should a death claim be filed. Please keep in mind that all premium schedules are projections and could vary over the years.

Another feature of a UL policy is that it allows for **withdrawals** to be taken from the cash account by the policy owner, if excess funds are available. This withdrawal can be in the form of a partial surrender, which typically reduces the death benefit of the policy, or in the form of a loan, which would require the policy owner to pay interest on the loaned amount. If the loan has not been repaid before the claim is filed, any outstanding loan balance, plus interest accrued, would be deducted from the death benefit when the claim is paid.

The **maturity date** of a UL policy can be very important. The maturity date is the date at which the death benefit becomes payable by death or the date at which the contractual

obligation of the insurance carrier ends. Some UL policies may have extension riders or provisions. With extensions, specified coverage may continue for the insured’s lifetime or a specified length of time and keeps the policy in force beyond the original policy maturity date. Extension options may include an option that will allow the death benefit to be extended to pay only the Basic Sum (as defined in the policy), the full death benefit, or the net account value plus interest. Once a policy extends, premiums and policy charges may stop.

Let’s look at an example of an actual policy within the portfolio. Policy Code LPI54525 is a universal life policy with a total face value of \$15,000,000 (\$7,500,000 in basic coverage and \$7,500,000 in additional coverage) and a current net cash surrender value of \$1,387,316.34. The policy has a maturity date of December 13, 2026. Now, fast forward to the policy’s maturity date, December 13, 2026. For the sake of this example, let’s assume that both the face and net cash surrender values are the same and the insured is still living. The table below provides the amounts that would be paid by the insurance carrier based on the different maturity options.

Illustration 3

Maturity Option	Amount To Be Paid by Insurance Company	When Amount is Paid
Extension for Basic Sum	\$7,500,000.00	When the insured passes away
Extension for Full DB	\$15,000,000.00	When the insured passes away
Extension for NAV + Interest	1,387,316.34 plus interest	When the insured passes away
NAV/NCSV	\$1,387,316.34	December 13, 2026

*Typically if a policy does not have an extension, the amounts to be paid by the insurance company are processed on or near the maturity date.

There is another policy in the portfolio that matures at age 95, and does not have an extension rider, which means the insured is only covered by the insurance policy until age 95. If he/she lives beyond age 95, the policy may not pay any death benefit and will likely only pay the net cash surrender value, resulting in a significant loss to the position holder. Most policies issued in more recent years have maturity dates at later ages, such as 100 or 115.

As mentioned, the UL policies managed by Magna Servicing, LLC now have optimized premium schedules. This means that the premiums will increase every year and possibly be greater than can be projected at this time.

A **survivorship universal life** policy insures two lives, typically a husband and wife, under one life insurance policy and pays a death benefit only when the surviving spouse passes away.

Variable Life and Interest Sensitive Insurance Policies

Variable universal life (“VUL”) policies have securities underlying the value of the contract. A variable universal life insurance policy can be riskier than other forms of insurance because the policyholder chooses the investments from a pool made available by the insurance company, and the policyholder assumes the risk for the performance of these investments. Neither the principal nor the savings portion of the contract is guaranteed, so if the investment does not perform sufficiently, the policyholder must make up any deficit. Typically, the owner will opt for a guaranteed investment option if they purchase a VUL policy to mitigate this risk.

An **interest sensitive whole life policy** is one in which the cash value component may fluctuate based on variations in current interest rates.

Term Life Insurance Policies

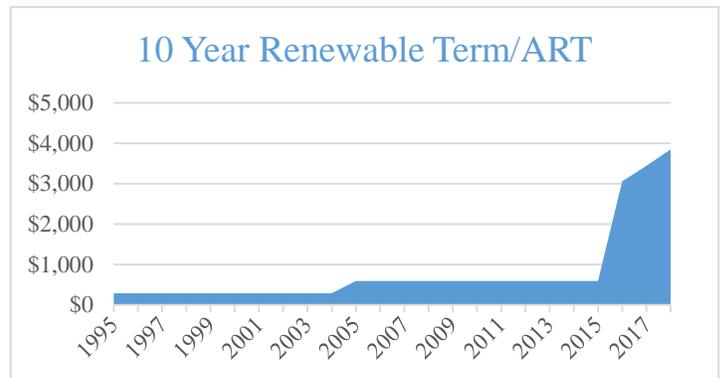
Term life insurance policies have little ongoing flexibility because the death benefit, premium requirement and length of policy are determined when the policy is issued and remain level for a pre-determined period of time. For example, a 10 year-term policy may be issued with a \$1,000 annual premium and \$1,000,000 death benefit. At the end of the tenth year, the

policy may terminate (known as the initial expiry date). However, there is typically an option to keep the policy in force by paying an increased premium amount. This premium generally increases annually, which is why these new premiums are often referred to as Annually Renewal Term premiums or ARTs. For example, one policy within the portfolio originated as a 10-year renewable term at its issue and then eventually renewed as an ART. In this case study, the initial 10-year term had a set premium, as specified in the policy contract, of \$290 annually. Subsequently, the policy had an option to renew for another 10-year period at an annual premium of \$595. However, at the end of the second ten year term the renewal option changed to an ART and the premiums necessary to keep the policy inforce increased significantly and will continue to increase each year.

Illustration 4

Projection Start Date: 01/05/1995

Policy Years	Annual Planned Premium
1-10	\$291
11-20	\$595
21	\$3,059
22	\$3,444
23	\$3,848

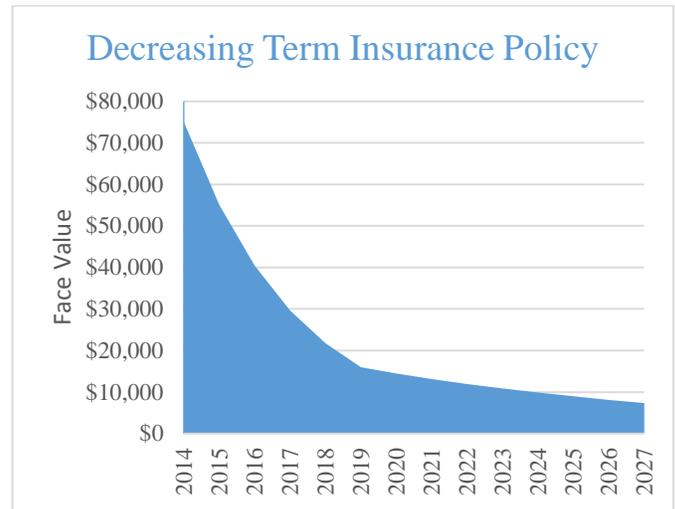


Decreasing term policies refer to a type of term insurance in which a death benefit decreases (at predetermined rates and at predetermined times) over the life the policy. For instance, a policy within the portfolio had a face value of 75,000 for the first 20 years, at year 21 (2015), the policy’s face value decreased and will steadily continue to decrease each year until the policy reaches maturity. In the illustration below, you are able to see how much the policy is

scheduled to decrease each year, resulting in a decrease of approximately 90% over the life of the policy.

Illustration 5

Policy Year	Face Amount
2014	\$75,000
2015	\$55,050
2016	\$40,425
2017	\$29,625
2018	\$21,750
2019	\$15,975
2020	\$14,475
2021	\$13,125
2022	\$11,925
2023	\$10,875
2024	\$9,900
2025	\$9,000
2026	\$8,100
2027	\$7,350



Another option to prevent the loss of a term policy, when available, is the option to convert it to permanent insurance, such as a universal or whole life insurance policy. Each policy/carrier has different qualifications and restrictions regarding conversions. Most pressing is the maximum age restriction for conversion, which differs by insurance company and policy, but is typically around age 65, 70 or 75. The conversion expiration date (or age) refers to the date at which the conversion privilege ends. If a term policy is not converted by the conversion expiration date, there is no longer an opportunity to convert the policy to a permanent policy. Consequently, the maturity date is the date at which coverage ceases. However, often times and if possible, it is more advantageous to convert the policy at some point prior to the policy maturity date, therefore many policies will not reach their maturity date and will, instead, be converted.

Because of the nature of these policies, there are many for which it is not possible to determine the annual premium obligation into the future. For example, many insurance carriers do not provide a premium schedule after the initial term period, or they provide a schedule of the *maximum* amount that can be charged, but typically charge significantly less.

As discussed, one of the *risks* to consider with regard to a term policy is the inability to predict future premiums. When these policies come to the end of their term of coverage, (if the policy cannot be converted to a permanent policy) the premiums will likely increase significantly each year. Many times the insurance carrier does not provide detail about the future premiums that will be charged. For example, there is one policy in the portfolio now for which LPI previously did not exercise the option to convert, resulting in the premium increasing drastically each year. The premium is currently at an annual rate of approximately 47% of the face amount of the policy, which destroys the value of the investment. The likelihood of the premiums increasing over the amounts currently being paid is significant.

Group Life Insurance Policies

In addition to individual life insurance policies, LPI purchased hundreds of group life insurance policies, which are policies issued by an insured's employer. **Group life** insurance policies are owned by a company for the benefit of its employees. Each employee has a certain amount of coverage, as detailed on the policy certificate. The amount of coverage may increase or decrease per the policy provisions and due to salary and/or age of the employee while employed by that particular company.

Group policies provide two types of coverage. "Basic" life insurance coverage is paid by the employer; however, if the employee has elected "supplemental" coverage, the employee pays

the premium expense for this portion of the coverage (typically deducted from paycheck). If the premium expense is deducted from an employee's paycheck, a reimbursement for the expense is sent after they provide written proof of the expense (normally a copy of their paystub).

These policies are very laborious to maintain and require special attention. Employment verifications must be performed every 21 days to ensure that the employee is still employed because, in the event of termination or retirement of the employee/insured, the policy must be converted to a permanent policy within 30 days. If the policy is not converted, the coverage may cease.

It is not possible to provide long-term premium streams for group policies for many reasons including, premium obligations not being clearly outlined by the carrier; the policies and carriers are frequently changed by the employer, which results in changing premium obligations; the premium obligations and coverage may increase or decrease due to the insured's age and salary; the policy may be converted from a group policy to an individual policy; a waiver of premium is no longer in effect (described below), and if the premium is deducted from the employee's paycheck, the insured may not provide proof of payment for reimbursement in a timely fashion.

Many of the group policies in the portfolio have riders that cover the premium costs in the event the employee is declared disabled, either for a short or long period of time. These riders are referred to as disability premium waivers (DPW) or waivers of premium (WOP). To qualify for a waiver of premium, the insured must provide proof of his/her disability to the insurance carrier. The carrier will periodically review these documents, along with medical records, to determine if the insured continues to qualify for this waiver of premium. There are many policies in the portfolio for which no premiums are currently being paid because of a disability premium

waiver; however, there is no guarantee that these waivers will continue. Additionally, they may cease when the insured reaches age 65.

“Group” policies carry the most *risk* and uncertainty. As mentioned previously, group policies are actually policies issued to an employee of a company. This means their coverage is linked to their employment and may be reduced or eliminated for various reasons. The coverage may cease by virtue of the insured’s ineligibility to continue participation in the company’s plan due to termination of employment or an involuntary termination of the employer’s group policy. For example, should the insured leave employment for any reason, the policy assignee (or servicer) must convert the policy within 30 days (of the employee’s date of separation) to a permanent policy, or the policy coverage ceases. This means that the servicer or assignee must be in continual contact with the employer to verify the insured’s employment, which is impossible if the employer and insured are uncooperative, and could ultimately result in the servicer’s inability to convert the policy within the 30-day window culminating in a total loss of the coverage.

The insured’s level of coverage may change following an increase or decrease in his or her salary level. For example, if a group policy was purchased with a death benefit of \$100,000, (based on the insured’s salary level at that time), and the employee (insured) changes to part-time employment, earning only \$50,000, the coverage may be decreased to \$50,000. This would result in a 50% reduction of death benefit and thus projected payout. Reductions may also occur when the insured reaches a certain age or a particular date as specified within the contract. These policies are referred to as “group decreasing.”

Another consideration with group policies is the inability to plan for future premium payments. There is often little that can be done to predict future premiums. They may increase

drastically at various times for various reasons. For these reasons, group policies are not found in most life settlement investment portfolios.

This information is in no way meant to provide investment advice nor should it be considered a thorough discussion of life insurance. This is merely an overview of the basics of life insurance relative to the portfolio of policies, and does not provide a complete overview of life insurance policies or life settlements. Information regarding life insurance and life settlements is quite complex and is too voluminous in nature to be covered in this paper. For more information about investing in life settlements, or regarding life insurance in general, further consultation with an expert is highly encouraged. Additionally, many state insurance departments provide information on life insurance. A copy of “Understanding Life Insurance” produced by the Texas Department of Insurance is also available

at: <http://www.tdi.texas.gov/pubs/consumer/cb018.html>.