Using Life Settlements

by John Martin
Click here to learn more about John Martin

A life settlement may be an ideal way to free up extra cash to help the elderly remain in the home, to pay for medical and long term care expenses or to pay bills. Here is a description of what a life settlement is and how it works.

What is a life settlement?

A life settlement enables older individuals, businesses and other organizations to sell life insurance policies they currently own – but no longer want or need – for an amount greater than the cash surrender value. In some cases the value can be 2-3 times the cash surrender value. Even some term life insurance policies with a conversion option to permanent coverage can qualify for a life settlement.

Do you know the fair market value of your life insurance? In a recent case, a 77-year-old man had a $3.9 million policy that was not performing up to expectations. His advisor recommended that the policy be appraised. A life settlement provider determined that the market value of his policy was $740,000 – four times its cash surrender value. The client decided to sell the policy and use the proceeds for current needs instead of benefiting his estate.

Background

An active marketplace for the sale and purchase of in-force life insurance policies had its beginning about 1990. Funding sources interested in utilizing the death benefits as a source of investment return began soliciting the purchase of policies, mostly from the terminally ill, who could no longer afford the premium payments that were required to keep the policy in force.

These early viatical settlements, defined now in many states as transactions involving a terminally ill insured, often involved AIDS patients in extremely reduced economic circumstances. Offers were often from non-institutional funders. Competitive bids were uncommon in this underdeveloped marketplace. There was little or no confidentiality regarding the identity of the insureds whose policies were sold.

The unacceptable conditions and environment of the formative life settlement market has, understandably, left a bad impression in the minds of many within the life insurance planning industry. However, this dappled history of viatical sales should not predispose a person to avoid a thorough examination and understanding of the current, rapidly expanding market for life insurance contracts. Today's life settlement transactions bear little or no resemblance to the viatical sales of yore.

Two Ways to Benefit from Coverage

Owners of an insurance contract can realize value from the asset in two ways. They can collect the proceeds payable under the contract upon the death of the insured, or they can sell the policy for its current market value. Until recently, there was only one market where a policy could be sold during the life of the insured, and that was back to the carrier that had issued the contract. The "resale price" was the surrender value of the policy. Term insurance coverage had no surrender value and, hence, no fair market or resale value.

If the health of the insured had not declined since the time the policy was issued, or if there had been no significant increase in how the industry priced comparable risks, then the surrender value would represent the reasonable market value of the contract. However, if the insured had experienced a moderate decline in health (or if industry pricing had increased) then the premiums established at the time of purchase were less than what was actuarially required to support the risk element of the death benefit. Consequently, the policy was a better "deal". Viewed as an investment with the death benefit representing a return, the policy was worth more than its surrender value. Certainly a policyholder who wanted to sell the contract would prefer a sales price that more accurately reflected the true worth of the policy in light of the insured's change in life expectancy. Such a sales price was impossible to determine or attain as long as the only potential buyer was the issuing carrier whose offer was the surrender value.

In most other markets, such a situation would not be tolerated. Imagine if a homeowner, after living in the home for many years, was told that instead of being permitted to sell the home to any willing buyer, he or she could only sell it back to the original builder at the price determined by the builder. Clearly no one would tolerate such a situation for homeowners, but that situation is exactly what has existed in the life insurance market. The advent of a secondary market has lessened this monopsony power of life insurers and created a free market for policy owners to value their life insurance.

A market that generates fair and reasonable offers for existing policies is advantageous for owners who intend to lapse or surrender policies because coverage is no longer needed, or because the product no longer serves current planning goals, or because coverage has become unaffordable. Outliving a need for coverage is a common occurrence. By definition, "term" insurance is designed to address those situations where protection is required for a defined period of time. Some examples would include coverage against buy-sell obligations at death, key-person coverage on an employee until retirement, or security on an existing debt. The previous disposition of policies in these situations that resulted in little or no cash may now command significant funds that can be used to fund a lifetime buyout, pay nonqualified benefits to a retiring employee, or liquidate loan obligations sooner than expected.

A lapse due to a change in product suitability may occur when a product with improved features or guarantees is needed. A common situation involves the surrender of a single life contract when a second-to-die policy is purchased to more economically fund against anticipated estate tax liability. Funds from the sale of the original policy can be used to jump-start the new contract. This is especially advantageous when there are no tax advantages to exchanging the policy under IRC 1035.

The most difficult situation involving the surrender of a policy is when the cost of coverage becomes prohibitive. The circumstances are usually problematic because the decline in health that makes a life settlement attractive may be severe enough that the need for coverage is now more urgent. In such cases the industry has proven self-correcting in extreme cases where death is imminent and the need for cash desperate. With increasing frequency, carriers are providing policyholders with accelerated death benefits (ADB) that allow for prepayment of the death benefit upon evidence of the likelihood of death or the existence of certain medical conditions. The requirements vary with carrier or policy. The proliferation of the availability of ADBs may ultimately eliminate the need for a secondary market for true viatical sales.

The most analysis is needed in situations where mortality is measurable but not imminent (usually cases involving life expectancy between 3-15 years) and the insured either needs the money or simply cannot afford future premiums. A life settlement may

be advisable in those situations where the policyholder either has no heirs to benefit from coverage or where he or she believes they can make better investment use of the life insurance settlement amount over the time remaining than would result if a death benefit were paid.

New Territory in the Financial Landscape

The increase in investment interest in unwanted policies is understandable because age and life expectancy are such predictable demographics when large numbers are involved. Institutional investors have come to realize that big blocks of properly underwritten policies acquired through life settlements can form a very predicable, very conservative and very profitable source of income. Increasingly, large and reputable financial institutions, some with major life insurance departments, approach providers who will purchase policies that meet certain criteria designed to complement a particular investment portfolio where the insurance will be held in a blind trust. Depending on the state of residence of the owner of the policy, there may be over 20 different providers competing for business and resulting in much higher offers to the policy owner. The financial size of the funder, the anonymity of the insured, and this competition are hallmarks of the current secondary market. The small, unkown buyers are not part of the current life settlement market. Discomfort over an emotionally disinterested third party holding a contract on your life should be no greater than that caused by a carrier who issued an immediate annuity with a lifetime payout having an economic interest in your early death.

A potential seller can assure getting the highest bid for a life settlement by working through a broker who shops and negotiates the most valuable contract among the various providers available. Going directly to a provider results only in getting that provider's bid and removes the competitive aspect from the process. In addition, a broker is aware which providers have particular needs based on the policy criteria received from particular funders. It is not uncommon for a broker to agree to shop a case only under some condition of exclusivity. First, this protects the time and expense involved in finding a buyer. The average life settlement case requires approximately 30-60 days to close. Second, and more important to the client, it serves notice to providers that they must make their best offer to the exclusive broker because they will not have an opportunity to bid through another source.

A properly advised life settlement, rather than bringing an end to the insurance plan, can be valuable to the continuation and improvement of the plan. In most cases a life settlement represents the proper and profitable disposition of an unneeded asset that provides funds for a need or another financial vehicle that better suits the current position of the client. Studies show that in the majority of the life settlements involving policies over $1 million in death benefit, the funds are used to buy another financial planning product.

Indeed, life insurance policies can help address a wide range of financial goals from paying estate taxes to protecting against various business risks to covering survivor needs. Over time circumstances can change and policies may become outdated, inefficient or unneeded. Rather than surrendering a policy for its cash value or letting it lapse, first consider a life settlement.

JE McGowan Consulting estimates the potential secondary market for life insurance policies exceeds $18 billion annually. The growth in the secondary market for life insurance has soared over the last decade.

- In 1990, only six companies made an active secondary market. They purchased about 500 policies with a face value of between $40 million and $50 million.

- Today, the Federal Trade Commission estimates that $500 million in life insurance policies are sold annually on the secondary market. With companies entering and leaving the market, it's difficult to estimate the number of active participants.
- Actuarial data suggest that 40% of all policies on people age 65 and older will not be held to maturity.
- The National Association of Insurance Commissioners estimates that in 1996 nearly $1.5 trillion face amount of life insurance policies expired, lapsed or was cancelled by policyholders; each policy was a potential source of wealth had the owner sold it on the secondary market.

A study published by Conning and Company, an insurance investment and research firm, found that more than 20% of the policies on insureds age 65 and older have a fair market value in excess of their cash surrender values.

In the past few years, the secondary market for life insurance has exploded onto the financial planning scene. Clearly, the market's basic premise – the consumer's right to sell unwanted or unneeded life insurance – has been validated by the U.S. market's spectacular growth, which is expected to exceed $45 billion in face value by 2007.

Consider the estate planning community. A recent article titled "The Benefit of a Secondary Market for Life Insurance", in the Real Property, Probate & Trust Journal of the American Bar Association concludes that the secondary market for life insurance is both pro-competitive and pro-consumer. By allowing companies to compete for unwanted or unneeded policies, the secondary market has generated greater consumer choice, a wider range of products and favorable valuation for consumers. But the implications don't end there. The article goes on to suggest that the market will enhance the perceived value of life insurance, leading to an expansion of the industry as a whole. It concludes by suggesting that lawmakers design regulations to "encourage participation and investment in this secondary market."

Such regulation is indeed happening. A number of states are in the process of passing provisions that protect the consumer's right to know about the opportunities available in the secondary market. These moves are sending a clear message to financial advisors that the secondary market offerings are now within the limits of their fiduciary responsibility.

Another factor is the sheer magnitude of the opportunity. In the U.S. alone, there is more than $100 billion of life insurance in effect where the market value exceeds surrender value. Not surprisingly, the situation has attracted the attention of the capital markets. High quality institutional capital is pouring into the secondary market. Not only does institutional backing provide a secure funding source for secondary market transactions, it also provides the highest degree of consumer protection with regard to privacy and confidentiality, as well as a solid foundation on which the industry can grow.

Does all this mean that life settlements and other secondary market transactions will be popping up on every street corner? Of course not. For the majority of policy owners, maintaining their current policy will continue to be the best course. But the mere presence of the market gives them the means to evaluate what the policy is worth in empirical terms. This is likely the most important implication of the secondary market. Life insurance is now more than a tool for risk-management. It has become an asset with significant value that should be appraised and considered alongside one's real estate, businesses or equities.

This expanding secondary market is providing new options for policyholders – options that are bringing long-term benefits to every sector of the life insurance industry. Life

insurance is now more flexible, more powerful and more valuable for consumers and the professionals who serve them. Insurance is indeed being redefined. And things may never be the same.

How to Identify the Right Circumstances
Many types of insurance policies qualify for life settlement transactions including whole life, variable or universal life, any type of survivorship life, adjustable life, joint first to die, group (if convertible) and term life with conversion option.

Lifetime settlements are for people without a terminal illness who have a life expectancy of 3 years or more but usually less than 15 years. As a general rule, anyone over the age of 65 could be a good candidate, though those age 70 or 75 will generally get a higher price due to a shorter life expectancy. Sometimes the insured has simply outlived his or her family or beneficiaries. Insureds should also consider selling an unneeded life insurance policy for any of the following reasons:

- Liquefy an otherwise dormant asset – the life insurance policy - and use the funds to supplement income.
- Fund new, more cost-effective life insurance coverage. Policies that are older than 5-7 years often can be replaced at lower premiums providing there have been no adverse changes in health.
- Create funds to make other investments. Using the funds from sale to purchase an annuity, mutual funds or other investments may better meet the insureds current planning needs.
- Fund an outright charitable gift or charitable trust.
- Make cash gifts to other family members
- Estate needs have changed
  1. Estate tax laws have changed
  2. Estate has become more liquid, thus insurance is no longer needed for liquidity.
  3. Estate has diminished in value through gifting or other reasons.
  4. Second-to-die policy or some other type policy may be more appropriate.
  5. New policy should be owned by an Irrevocable Life Insurance Trust.
- Corporations should consider selling unnecessary life insurance policies on employee' lives if
  1. The company has been sold to a third party and the policies' original purpose was to fund a buy/sell agreement on one partner's death.
  2. The insured key person retires or is no longer involved in the business.
  3. The policy is part of litigation among partners
  4. The company must sell assets to raise cash
  5. The policy was purchased to fund deferred compensation or other benefit programs that have now changed.

Businesses may also benefit from selling a policy in the secondary market to

- Purchase an interest in another enterprise.
- Facilitate the transfer of a business to the next generation.
- Repay debt.
- Buy back stock from a partner or shareholder.

Candidates for Life Settlement – Buyer's Criteria
There are several key factors to be considered when evaluating an insured's option to sell a life insurance policy. Since this is an investment for the buyer, it stands to reason that the lower the cost to carry the policy and the faster the expected payment upon death of the insured, the more attractive an offer a policy is likely to attract. Companies that buy life insurance policies in the life settlement market use these criteria to

determine the price to offer:

- Policy Face Value – Depending on the buyer, the minimum face value is $100,000. There are more buyers in the market when the face value exceeds $250,000. Many policies sold in the market have face values of $1 million or more.
- Insured's age – Minimum age of 65. The older the insured, the higher the offer.
- Health Impairments – the more severe the health impairments, the higher the offer will likely be as long as the insured is not terminally ill and has a life expectancy of 3 or more years but not more than 15 years.
- Existing Policy structure – there are many variations ranging from term policies with conversion option, to universal life policies, whole life, variable life, etc. Differences in policy guarantees, etc. will impact the price offered.
- Existing Policy Value – the greater the death benefit and cash value, the higher the offer is likely to be.
- Existing Policy Premium – The potential buyer uses this to determine the cost of maintaining the policy until it pays off. The lower the premium costs the higher the likely offer.

Transaction Mechanics of a Life Settlement Transaction
Once an insured decides that a life settlement transaction may be of interest, the process begins with the prospective seller/policy owner completing some simple paperwork to initiate a free, no-obligation appraisal of the policy. Here are the usual steps to close the transaction.

- The seller/insured submits to the buyer the necessary paperwork, including an application, a copy of the life insurance policy, an in-force ledger (an annual schedule of policy details) to age 95, an authorization form, a copy of any trust agreement if the policy is trust-owned and the insured's medical records for the past two years. A medical exam is not usually required.
- The buyer extends an offer to buy the policy and the seller accepts.
- A closing occurs with all documents signed.
- The funds are deposited in an escrow account until the change of beneficiary and ownership is recorded.
- When the policy transfer is official, the funds in escrow are wired to the insured.

Payment structures are generally flexible to meet the seller's needs. The most common payment methods include lump sum, installments (to defer taxes) and annuities.

Tax Implications
The sale of a life insurance policy may be a taxable event. Tax experts disagree on the details of taxation, but there is a general consensus that if the cash surrender value of the policy exceeds the premiums paid on it, the life settlement will be taxed as follows:

- The portion of the payment up to the policy owner's investment in the contract will be received tax free.
- The portion exceeding the investment in the contract, but not exceeding the cash surrender value, will be taxed as ordinary income.
- The portion exceeding the cash surrender value will be a gain which, in some circumstances, may be a capital gain.

Where the cash surrender value of the policy is less than the investment in the contract, the IRS may take the position that only the cash surrender value represents a tax-free return of basis – and everything else is gain on the sale of the asset. This stance is not

universally accepted, so professional advice on any particular fact situation is in order. In fact, competent tax advice should be sought in all life settlement transactions.
The Life Settlement market has arrived and is experiencing dramatic growth with sales for 2003 estimated at over $1 billion and growing to an estimated $45 billion in 2007. The maturing market has attracted large and reputable institutional buyers who bring to the life settlement market a greater degree of consumer protection with regard to privacy and confidentiality. With more buyers entering the market it is both pro-competitive and pro-consumer – by generating greater consumer choice, a wider range of products and favorable valuation for consumers. Indeed, life insurance has now become an even more powerful, more flexible and more valuable asset. Insurance is indeed being redefined. And it may never be the same again.