Life Settlements – Understanding the Risks and the Benefits

By Michael L. Frank

What is a life settlement? Simply put, a life settlement is the sale of an unwanted, no longer effective life insurance policy. It may potentially be a better solution with a greater cash settlement than lapsing or surrendering a policy. It is important to understand the benefits and the risks of doing such a transaction.

Insurance Policy Participants

To understand a life settlement, we are providing basic information about the participants in a life insurance policy. For any individual or group insurance policy, we would have individuals (or corporations) defined for each of the covered insured, policy owner, and beneficiary. A typical insurance policy might have an individual as the policy owner and covered insured, with the individual's family as the beneficiaries.

Upon selling a policy (completing a life settlement transaction), the covered insured will typically be the same as before. However, the policy owner and the beneficiaries will most likely be a different party, in the most common case, the company buying the policy (i.e., life settlement company).

Once the policy is sold (and insured is no longer the policy owner), all premium payments and obligations are the duty of the purchaser (the life settlement company).

A life settlement is offered as an alternative to a policy lapse or reduction in coverage, so we should understand what a policy lapse means. A life insurance policy lapses or cancels itself when a policy owner stops paying premiums on it. If you have an insurance policy (e.g., universal life) that has accumulated a cash value, the cash value is reduced (or drained) to pay your premiums until it runs out, and then the policy lapses.

What can an insured do with the money from a settlement? Anything they want, since it's their money. This transaction can have tax implications so a tax advisor should look at the specific benefits and effects on their tax liability.

How does this impact the retail life insurance broker who sold the policy? The sold policy is still in force, therefore the in force broker will still collect renewal commissions on the original life insurance policy. It is important to note that the policy has not lapsed, solely changed ownership. The broker may receive other potential compensation either via a commission or consulting fee as a result of the life settlement transaction, plus any fees when assisting clients in managing their newly acquired funds. However, brokers conducting life settlement business should be aware of the laws and regulations governing their state of jurisdiction.

Who is Eligible for a Life Settlement?

Typically seniors (age 65+) are eligible if their health has become impaired since the original issue of the policy. In addition, individuals should have life expectancy of less than 15 years and a policy face amount above $150,000 since the value of the transaction needs to be large enough to cover the transaction's administrative costs.

In addition, a policy must be assignable (transferable) and outside of the contestable period (cannot be voided). Any type of individual life insurance may be considered (including Convertible Term, Whole, Universal, Variable, Survivorship, Adjustable and Joint First-to-Die policies). The policy does not require a cash value to be eligible.

Second-to-Die policies are also considered for life settlements, especially in cases whereby one of the insureds is deceased. Policies can be individually owned or owned by trusts, foundations, not-for-profit organizations or businesses.

As life changes, so do individual's needs. For this reason, a life insurance policy purchased in the past may not match a policyowner's needs today. The reasons for initial purchase may no longer be valid such as:

- Changes in the client's estate (or estate tax laws) reduce/eliminate the need for insurance;
- The client has outlived the intended beneficiary(ies);
- Premiums have become too expensive;
- The client's needs have changed and would require a different type of policy (i.e. annuity, health insurance or long-term care);
- Insured may want the money for other unforeseen reasons (e.g., just travel).

Businesses often purchase life insurance policies on key people and owners for protection. Examples of cases where this happens and the policies may have "outlived" their usefulness are:

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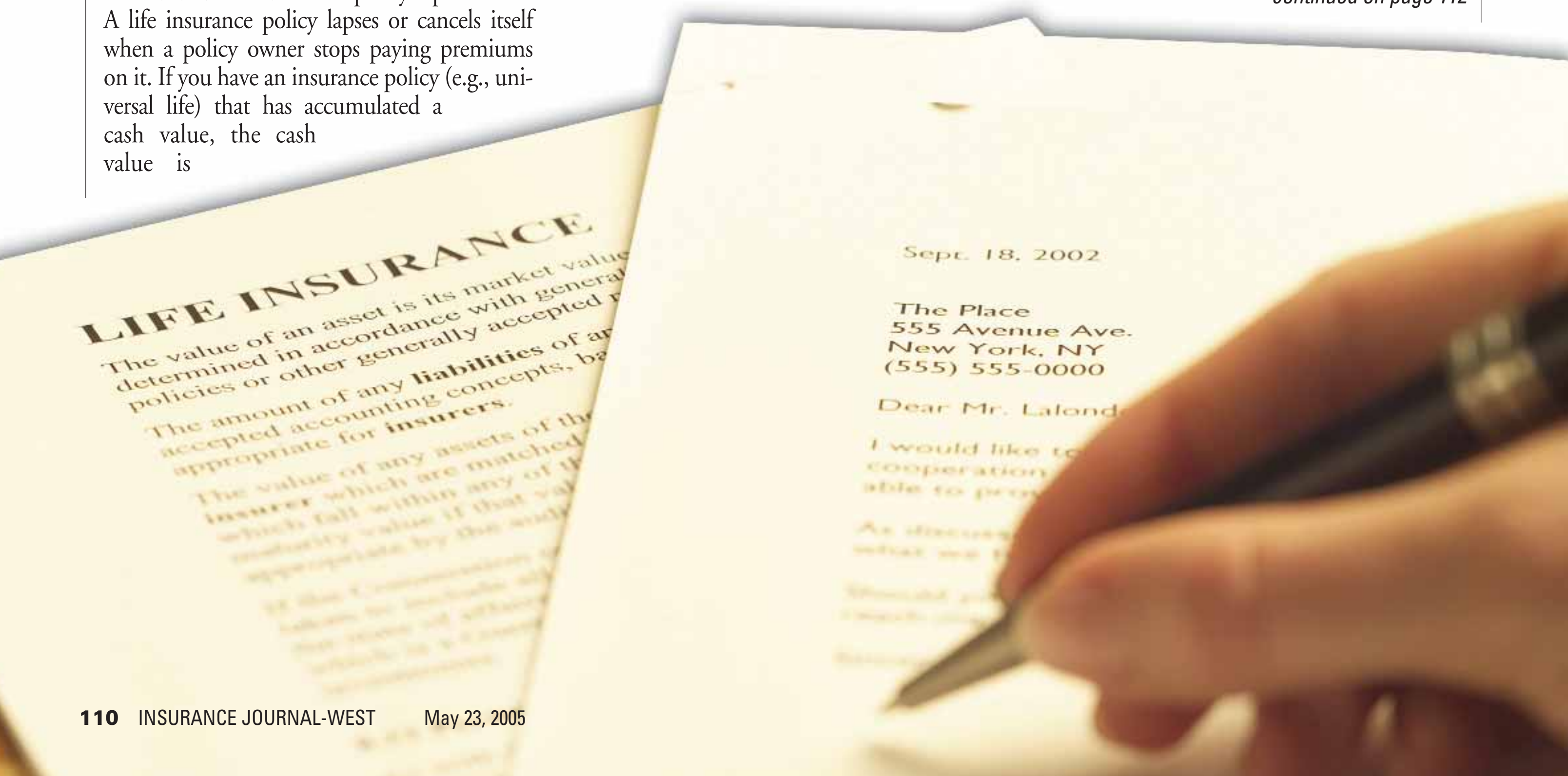

- Buy-sell policies for cases in which the owners have retired or the business is sold;
- Deferred compensation plans when the executive has left the company;
- Key person policies, after the insured has retired, or if key person is no longer key to the organization;
- Policies purchased to cover loans that have since been paid off.

Surrendering an insurance policy may provide some financial value to the insured through a cash value, which will be determined based on an insurance policy and state non-forfeiture laws. A life settlement may result in a larger value depending on an insured's health and open market assessments (valuations).

The Process

Each transaction involves unique variables such as age, life expectancy, type of policy, face amount, surrender value, loans, premiums and changes in health. The application process is streamlined but customized so quote turnaround time is typically 4-6 weeks. Information required includes applications, physician medical records and policy illustrations. Typically, there are no costs to the insured to obtain bids from various life settlement companies.

Similar to traditional life insurance policies, medical underwriting exists for life settlements to develop a life expectancy (LE) and mortality table load factor for pricing purposes. However, the insured does not require any additional medical examinations and/or tests, only consent the release of their current medical records for underwriting review.

Pricing of Life Settlements

Pricing of life settlement transactions are based on a combination of art and science. The science piece reflects the economic calculations based on actuarial principles and financial forecasting. A calculation (similar to the formula used for life insurance reserving) is used to develop the present value of future benefits less the present value of future premiums and other expenses based on actuarial tables and medical underwriting information. We are referring to this as the maximum price for purchasing the policy.

Life settlement companies set prices based on each individual's assessment and underwriting of each policy with a value greater than non-forfeiture laws (cash surrender value) for an insurance policy. Individuals with substandard or medically-impaired risks could result in significant values for life settlement transactions.

Administrative expenses are priced into the transaction and would include ongoing facility, banking, internal expenses and life settlement provider fees plus transaction fees (e.g., brokerage commissions, underwriting fees, reinsurance premium). As a result, modeling is more complex to meet the return on investment (capital) for funders.

The art of the calculation is that the purchase price of the policy needs to be between the maximum price and the cash value, if any for the policy. The price needs to be high enough to be attractive to the current policy owner and yet low enough to provide profit to the purchaser. The marketing and distribution for a life settlements company will have a significant impact in this area.

Risks and Pitfalls

Now that you have a basic understanding of how a life settlement transaction works, let's review some of the more debatable issues. They do provide an alternative solution where a solution may not exist. However, an individual should consider the following:

A company collects a benefit if you die. When an individual dies, the life settlement company collects a death benefit. Not all life settlement companies are reputable, so policy owners need to know whom they are dealing with since life settlements companies have a vested interest on your policy, especially if it matures (pays a death benefit).

The company that you sell your policy to may not keep it for the life of the policy. It could be sold one or more times and the insured has no control once it sells its policy.

Life settlements have less regulation. The insurance industry has significant regulations to protect consumers including disclosure and advertising requirements. These same restrictions are not defined in life settlements, which is why many of the marketing material for life settlements solely focus on the pros with little or no focus on the cons of doing a transaction. For life settlements, each state varies its own legislation.

Are the original reasons for buying the policy still valid? For example, does the insured still want to leave a life insurance benefit to their beneficiaries? Does the insured have other vehicles or protections in place for estate planning for their beneficiaries?

In addition, insurance brokers should be aware of the following:

- Are there any regulatory issues to be concerned about in your respective state of jurisdiction?
- Is there a moral obligation to provide your

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clients with the pros/cons of doing a life settlement transaction?

- Does your professional liability or errors & omissions insurance cover any liabilities resulting from life settlement suits? You may want to read your policies closely. Will your life settlement provider cover you under their policy?
- Have you done your homework on life settlements and the potential companies that you are dealing with before endorsing them to your clients?

As an investor or funder in the life settlements business, some of the key considerations are as follows:

- Are the promised returns "too good" to be true?
- Does your own personal business plan want to earn profits based on maturities (deaths)? Greater returns occur when death claims incur sooner than projected.
- Are there any unanticipated liabilities or extra-contractual exposure that could materially impair your investment? This could result from lawsuits for covered insured or compliance issues.
- What is your exit strategy for liquidating your investment (typical for all types of investment vehicles not just life settlement company investments)?

Insurance Company Debate

Among life insurance companies, there is an ongoing debate about life settlements. Insurance companies traditionally do not want their sales force to be involved in life settlements. However, some insurance companies including reinsurers have had an interest in life settlements for the perceived returns and have participated as a life settlement funder.

Other discussions cover whether or not life settlements will have an adverse financial impact in the life insurance industry. As of today, a very small percentage of life settlements have occurred so the impact today is probably minimal.

However, as the life settlement market grows, one concern is that life insurance policies are lapse-supported so doing a life settlement (remember a policy does not lapse from a life settlement but stays in force) will have an adverse impact to insurance companies since policies will more likely payout a death benefit.

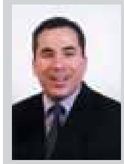
On the other hand, life insurance policies (e.g., increasing term) have increasing premium rates and mortality charges with the insured's age so policies remaining in force will receive more premium to cover increasing mortality.

It will be interesting to see how this debate will change over time as the industry obtains empirical data in the future.

What Does the Future Hold?

This is a difficult question since the marketplace is constantly evolving. But for the most part, you can anticipate changes in consumer advocacy—expect the life settlements industry to be more closely regulated.

It's also likely that there will be new entrants to the market—with the perceived returns (the market still does not have a historical track record to refute), expect future life settlement companies (providers and funders) to enter the market. Finally, expect unethical/market conduct and practices with select markets. IJ



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