

# LIFE SETTLEMENTS

A LOOK AT THE IMPLICATIONS

*The secondary market for life insurance is reshaping the landscape within the entire financial services industry.*

*This rapidly growing market imposes new duties on financial advisors. Life insurance policies now have a fair market value.*

## A Free Market for Life Insurance

Do your clients know the fair market value of their life insurance policies? 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. It was 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 to fund new, more cost-efficient insurance. The new policy had a face value of \$4.4 million and significantly lower ongoing premiums.

Such life settlement cases are an everyday occurrence now that the secondary market for life insurance has transformed the financial planning landscape.

Life insurance provides financial solutions to meet various needs of businesses and families. Over time, however, needs change. Loans are repaid; key executives retire; estates become smaller; businesses are sold; estate taxes are reduced-or better yet, no longer exist. Or, perhaps with interest rates down, the policy may just be too expensive. According to Millman and Roberston, a leading actuarial consulting firm, 88% of all universal life policies never result in a death claim.

In other words, the policies are surrendered or permitted to lapse. A surrender or lapse is, essentially, a sale of the policy back to the insurance company for the cash value. But, if the insured's health has declined, the insured is no longer insurable in the same rate class; in that case the policy may be worth considerably more than the surrender value.

Until several years ago, these individuals were facing a monopsony, a market situation in which a seller can only sell to one buyer. 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 it has existed for life insurance policyowners. For many years, policyowners have had only one buyer for their policies—the life insurers. The advent of a secondary market has lessened the monopsony power to value their insurance.

### **New Options. New Responsibilities.**

A recent article entitled, *The Benefits of a Secondary Market for Life Insurance Policies*, published by the American Bar Association (*Real Property, Probate & Trust Journal*), concludes that the secondary market for life insurance is both pro-competitive and pro-consumer. By allowing companies to compete for underperforming or unneeded policies, the secondary market has generated greater consumer choice and favorable valuations for consumers.

Before the advent of the secondary market, life insurance policies could not readily be sold, and it would have made little sense to speak of a policy's fair market value. By its very existence, this new and growing secondary market for life insurance bestows on every policy a fair market value like the owner's other financial assets. A robust secondary market changes what financial advisors must know and do to help their clients make the most of their policies. The possibility that a client's insurance policy will have a market value well above its surrender value has at least three major consequences:

- ❑ When estate planners inventory the market value of a client's assets, they'll need to know the fair market value not only of stocks, bonds, and real estate, but of life insurance policies as well.
- ❑ In estimating death taxes, advisors need to consider whether the Internal Revenue Service will value any life insurance policies on other's lives at their fair market value.
- ❑ In advising clients how to exit from an unwanted insurance policy, planners need to consider whether a life settlement at fair market value is the most suitable choice.

In short, the professional or fiduciary obligations of financial advisors now include the need to treat life insurance policies as a fully evolved property on par with the client's other financial assets. In many cases that means a bank or trust company serving as a trustee must consider a life settlement.

### **Due Diligence**

Because the policyowner receives cash and has no ongoing financial commitment to pay premiums, it might seem that the only relevant feature of the transaction is the amount. But there are other aspects that a financial advisor will want to consider.

There is the question of institutional capital. Not only does institutional backing provide a secure funding source, it also provides the highest degree of consumer protection with regard to privacy and confidentiality. At no point should a client's policy, or the personal information associated with it, ever be in the hands of an individual investor.

Security is also important. It is critical that the funding company places the settlement funds in an escrow account to assure they are available *before* the policyowner approves the transfer of the policy. (In ascertaining that institutional funds are being used, the financial advisor should not mistake an institutional escrow agent for an institutional source of funds.)

### **Ideal Candidates**

High net worth clients age 65 and over with:

- ❑ A life insurance policy with a face amount of at least \$250,000.
- ❑ A change in insurability since the policy was issued.
- ❑ Life expectancy of 15 years or less.

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 over have a fair market value in excess of their cash surrender value.

A life settlement can be a good option for a variety of reasons. The client may have outlived the risk insured against; the spouse has passed away; the business partnership has dissolved; or a key employee has retired after a long career.

In other cases, investment projections may have proven unduly optimistic in the current low-interest environment. So-called “vanishing” premiums have not vanished, and the financial plan built around the policy is not being met. In any such case, the owner may want out of his policy, either to move the value into another asset or to buy a more efficient insurance policy.

## 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 proceeds will be taxed as follows:

- The portion up to the policyowner’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.

## Next Steps

To learn more about the benefits and responsibilities of the secondary market for life insurance, call **Tony Steigerwald** at 800-659-1349, ext 113.

## CASE STUDIES

Policy: **Universal Life**

Insured: **Male, age 66**

Face Amount: **\$15,000,000**

Cash Value: **\$900,000**

### Policy Purchased for \$2,000,000

The CEO of a Fortune 500 company was retiring due to declining health. As part of the retirement plan, he was given the choice of keeping his policy or taking its \$900,000 in cash value. Upon consulting with his attorney and accountant, he was advised that he should have survivorship insurance for estate planning purposes.

With the help of his financial advisor, the client received \$2 million through a life settlement. He deposited \$1 million into a 10-year annuity which financed a \$5 million survivorship policy. The remaining \$1 million became an additional retirement benefit for the client. The advisor earned compensation for the life settlement, the annuity and the new life insurance.

Policy: **Term**

Insured: **Male, age 65**

Face Amount: **\$3,000,000**

Cash Value: **\$0**

### Policy Purchased for \$930,000

In this case, the client had a \$3 million term insurance policy that had been taken out several years earlier to cover a business loan for his company. Due to a change in his health, the business was sold and the loan was subsequently repaid. There was no longer a need for the term policy.

The client met with his advisor who suggested a life settlement. Rather than letting the policy lapse, and receiving nothing, he received \$930,000. The advisor received compensation for the life settlement and a commission on the \$3 million term conversion.

# POLICY EVALUATION GUIDE

INSURED: \_\_\_\_\_ FACE AMOUNT: \_\_\_\_\_

We developed this guide to help you in qualifying a prospective settlement candidate. Please rate each category and add the points for a total score. Compare the score with the table to determine settlement probability.

Please be sure the settlement candidate meets the following guidelines:

**Age of Insured:** 65 or older (unless terminally ill)

**Minimum Policy Face Value:** \$250,000 (unless terminally ill)

**Insurance Company Rating:** B+ or better (as determined by A.M. Best)

## AGE & SEX OF INSURED:

- 1 Point Male age 74 or less / Female age 77 or less
- 2 Points Male age 75-78 / Female age 78-81
- 3 Points Male age 79-83 / Female age 82-86
- 4 Points Male age 84+ / Female age 87+

## MEDICAL CONDITION:

- 1 Point Insured is a healthy senior
- 2 Points Insured has one or more minor health problems
- 3 Points Insured's health has changed considerably since the policy was issued
- 4 Points Insured has a terminal illness

## POLICY TYPE:

- 1 Point Whole Life
- 2 Points Term Life
- 3 Points Universal Life or Joint-life (Survivorship)
- 4 Points Joint-life (Survivorship) with one deceased

## CURRENT PREMIUMS AS A PERCENTAGE OF DEATH BENEFITS:

- 1 Point 4.0% +
- 2 Points 3.0% -3.9%
- 3 Points 2.0%-2.9%
- 4 Points 1.0%-1.9%

## OUTSTANDING LOANS AS A PERCENTAGE OF DEATH BENEFIT:

- 1 Point 31% +
- 2 Points 31%-30%
- 3 Points 11%-20%
- 4 Points 0%-10%

\_\_\_\_\_ TOTAL POINTS

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<u>Score</u>	<u>Settlement Probability</u>
5-10	Not Likely
11-16	Please Call Tony Steigerwald at 800-659-1349 x 113
17-20	Good—Complete Confidential Application