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Is your old policy worth more than its surrender value? That's what the life settlement market would have many older policyholders believe. But usually the transactions make little sense--unless you are the agent earning an enormous commission. Why it pays to be wary.

The Unsettled State of the Life Settlement Market

By Peter Katt

Is your old, tired life insurance policy actually worth something more than simply its surrender value?

That's what the life settlement market, as it has evolved, would have many older insurance policyholders believe.

At first glance, it would appear that the development of a secondary market for insurance policies would offer policyowners a competitive alternative for raising cash rather than simply cashing out their insurance policies at the policy's surrender value.

For a very few policyholders, the fair market value of their policies may indeed be worth more than surrender value.

But for the vast majority, the transactions make very little sense—unless, that is, you happen to be the agent involved in the sale, earning an enormous commission.

And it is those commissions that are currently driving this market. If you own a policy that could be targeted for this market, or you are approached with a life settlement offer, it pays to be wary—for the reasons outlined below.

A Little Background

What, exactly, is a "life settlement"?

A life settlement is the sale of a life insurance policy by the policyowner to a third party. The policyowner typically receives cash for the sale in an amount greater than the surrender value (or there wouldn't be any reason to go through the life

settlement process). The buyer assumes ownership and pays premiums it deems necessary to keep the policy solvent and receives the death benefit upon the death of the insured.

Generally speaking, life settlements are an option for high-net-worth policyowners age 65 or older. Independent estimates report that among this group, 20% of policies have a market value that exceeds the cash value offered by the carrier.

The market for the buying and selling of life insurance policies for investment purposes had a rational basis in the beginning.

The original life settlement business plan was to buy unwanted or unneeded policies from insureds over age 65 whose health had deteriorated by more than just the passage of time would account for, and whose policies therefore had a theoretical market value that would be greater than the cash value offered by the insurer.

This provided an arbitrage possibility on the part of purchasers—they could buy the policy at a purchase price higher than the policy's surrender value, and receive the entire death benefit upon the death of the insured.

Institutions Enter the Picture

The major player in this business has been Coventry First, a firm that has a strong financial relationship with AIG. It is my understanding that Coventry buys policies for institutional investors, typically in a "bundled" form. In other words, the institutions are investing in a whole package of policies; they are not investing in individual policies in which the investors know the identity of the insured. In fact, Coventry has stated they have a traveling covenant that protects insureds from becoming known to individual investors. Needless to say, this protects those who are insured by policies that have been purchased by Coventry.

Another settlement firm with major institutional financial support is Maple Life Financial, although they may not feature the traveling covenant to protect insureds, as is Coventry's claim.

The entry of players such as Coventry and Maple, who claim major institutional support, means that offers for life insurance policies should be in line with the life settlement market's current expected yields.

Their offers are probably most accurate and likely lower than may be made by settlement brokers who package policies and sell them to smaller financial institutions and to individual investors.

Should You Sell?

But the fact that there are fair purchasers doesn't mean that you should run off and price out your policy. In fact, it is likely that some 95% of potential policy sellers should retain them.

There are only two situations where selling a policy is the best choice:

- One is an insured who wants cash;
- The other situation is a policy with heavy surrender charges and poor

pricing.

As an example of the latter, a \$5 million policy we are dealing with right now has poor pricing with combined premiums paid of \$225,000, but only \$25,000 of surrender value. It is in the client's best interest to replace it with a legitimately better-priced policy. A legitimate life settlement offer for this policy will be around \$125,000, and this will make up for some of the surrender charge loss, with the client ending up with a much better policy.

In almost all other possible life settlement situations, a proper evaluation would result in the policyowner retaining the policy—at least until the policy will terminate.

Let's say a policyowner named Don wanted to stop paying premiums on his \$1 million universal life policy that has a cash value of \$100,000.

Now 72 years old and with health problems he didn't have when the policy was purchased at 60, Don can sell the policy for \$275,000. But he doesn't need the cash—he just wants to stop paying premiums.

The best move is to keep the policy for another five years using the \$100,000 cash values to pay the cost-of-insurance.

After five years, the policy would be worth around \$475,000 in the life settlement market (Don's life expectancy is getting shorter), and there is about a 35% probability that Don will die in the next five years. Keeping the policy allows his beneficiaries to receive \$1 million tax-free if he dies but even if he doesn't, Don will very likely improve his situation if he waits and sells in five years.

High Fees

Unfortunately, the life settlement business has evolved into transactions where the main purpose is to procure obscenely high fees and commissions.

The life settlement industry and their solicitors have created the image that many policyowners often come to the rational conclusion they want to sell their life insurance policies and then contact an agent.

This is a false picture. Almost always, it is the agent soliciting policyowners to sell their policies because of the very high commissions they are paid.

In the situation described above, the agent recommending the sale for \$275,000 would be paid around \$55,000. That means the life settlement firm would have paid out \$330,000 for the policy—but Don would not have known about the \$55,000 going to the agent.

Don't Invest in Policies!

The appetite for life settlement transactions has become very large, due to the grossly high fees and commissions, and due to the entry into the field of many smaller buying firms and settlement brokers that claim to cull through all of the offers. In fact, the need for available policies is so great that the industry no longer is satisfied having only conventionally purchased life insurance policies as possible purchase targets.

Instead, some big-shooter agents solicit wealthy seniors to actually “rent” their high net worth and life to become insured for the sole purpose of then selling the life insurance policies.

These transactions involve a third party paying the premiums and paying the wealthy senior a bonus for “renting” his life.

As my May 2006 AAI Journal column, [Why You Should Avoid Investor-Initiated Life Insurance](#), shows, there is little rational math involved in these representations, and the end investor will lose a lot of money.

I believe the main trick being used is to represent a shorter life expectancy than is in fact the case, and this substantially increases the expected yield—which will attract individual and small institutional investors—including, I believe, newer hedge funds.

Regulators and ethical life insurance companies are doing battle with the developers of this horrid practice of investor-initiated life insurance.

My advice: Stay away from investments in life insurance policies!

I know of three situations involving smaller settlement firms that resell their policy buys in which individual investors in these kinds of policies were sent complete information about the insured, the insurance company and the policy they have invested in or bought. In each situation, the settlement company that sold this investment denies they ever give out the names of insureds—which I believe is a lie.

If the sellers of life insurance policies knew their policy could end up “in Tony Soprano’s IRA”—as a popular characterization in the industry goes—they would be more cautious about who they sell to.

And from these investors’ standpoints, the information they are being provided is simply incorrect. In one of the above situations in which the insured’s name was revealed, an estate planning attorney had invested \$50,000 in a life settlement policy based on the representation (according to the investor who contacted me) that the settlement company had a 15-year track record of providing investors with average 16% yields. But life settlements haven’t been around 15 years, and the yields are nowhere near 16%.

The most egregious situation I have seen is an agent that caused \$30 million of life insurance to be placed without the client’s knowledge by paying the premiums himself and owning the policies (see www.peterkatt.com/newsletters/ATI_v7n6.html). This came to light when he tried to get the insured to agree to turn over medical records so the agent could begin selling policies. Now there is cross-litigation going on.

I hope regulators have the wisdom and courage to put the life settlement genie back in its bottle and return us to where it began.

There is a nice secondary market for the very few situations that it makes sense to sell a life insurance policy. But it pays to be very wary in the current life settlement environment.

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