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## Articles

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- **Life settlements are an option for high-net-worth life insurance policyholders age 65 or older.**
- **Policyholders incur costs of 10% to 20% of the purchase price when the policies are sold.**
- **Buyers of policies often don't understand the importance of having an accurate assessment of life expectancy.**

## The Pitfalls of Life Settlements

*By Peter Katt*

As the economy and financial markets have seen considerable turmoil, so has the life settlement market with less funding now available for the purchase of policies. Nonetheless, the settlement market still bounces along with great enthusiasm.

Recent experiences I have had suggest this is a good time to update AII members on what to look out for when dealing with life settlements or pitches to invest in life insurance policies.

### What 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 would not 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. In addition, the buyer 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 insurance policies have market values that exceed the cash value offered by the carrier.

The market for the buying and selling of life insurance policies for investment purposes has a rational basis. The original life settlement business plan was to buy unwanted or unneeded policies as an institutional investment from insureds over 65 whose health had deteriorated more than just the passage of time would

account for. This provided the mortality arbitrage needed to make the purchase price higher than the policy's surrender value.

### **Should You Sell Your Policy?**

In reality, it is likely that some 95% of potential policy sellers should retain them. That there are many more policy sales than reality would dictate is a tribute to the tenacity and selling skills of those agents soliciting the sales.

### **Appropriate Scenarios for Selling**

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

- One is when cash is desired and a life settlement offer exceeds the policy's surrender value.
- The other situation is a policy with heavy surrender charges, poor pricing and where the insured is still in good health to replace the offending policy. The settlement value will be substantially higher than the surrender value even when the insured's health has not deteriorated. Prior to the sale, another policy with better pricing should be acquired to replace the policy to be sold. Obviously, this should only occur as long as the client's net worth would justify both policies.

Almost all other possible life settlement situations should result in the policyowner retaining the policy—at least until the policy is near termination.

### **An Alternative to Selling**

Let's say a policyowner named Don wanted to stop paying premiums on his \$1 million universal life policy with \$100,000 cash value. Now 72, and with health problems he did not have when the policy was purchased at 60, Don can sell the policy for around \$275,000. But he doesn't need the cash—he just wants to stop paying premiums. Don's best move would be to keep the policy for another five years without paying premiums. The \$100,000 cash value can pay the internal policy cost-of-insurance charges for this five-year period. (As long as the cash value is large enough to cover the cost of the premiums, the policy would remain in force. Each premium payment diminishes the cash value balance, eventually reducing it effectively to zero.)

There is about a 35% probability Don will die between 72 and 77. After five years, the policy will probably be worth around \$475,000 in the life settlement market because Don's life expectancy will have become shorter. (He would be 77 instead of 72.) Keeping the policy to age 77 allows his beneficiaries to receive \$1 million tax-free if he dies, and Don will very likely improve his situation if he waits and sells at 77.

### **Hidden Costs**

Policyholders incur costs when policies are sold. These costs of 10% to 20% of the purchase price are built into the price offered to the policyholder and, as a result, are essentially hidden.

Understand that this is not something the industry wants you to know. The life settlement industry and their solicitors have created the image that many policyowners come to their own conclusion that they want to sell their life

insurance policies and then contact an agent. Rather, almost always it is the agent soliciting a policyowner to sell his policy because of the very high commissions paid.

In the situation described above, the agent recommending that Don sell his policy for \$275,000 when he is age 72 would be paid around \$55,000. That means the life settlement firm would be paying out \$330,000 for the policy-but Don would not know about the \$55,000 going to the agent.

### **Should You Buy Life Insurance Settlements?**

As you can see, there are pitfalls for policyholders to consider before selling a policy. But what if you are on the other side? Do life settlements make good investments?

The appetite for life settlement transactions has become so great that the industry has convinced itself that life insurance is mispriced and that the policies of insureds in the same health are attractive targets as well. Settlement brokers purchase policies and repackage them to sell to small institutional and individual investors.

Some in the industry refer to this as "dumb money" because they think investors are too ignorant to know how to analyze the investment potential. Mainly, investors don't understand that it is critical to have an accurate assessment of life expectancy, and life expectancy is often fudged by the settlement broker.

For example, a fellow in Texas (Ted) contacted me last year. During 2008, he purchased life insurance policies that insured 10 strangers for \$400,000 from his financial advisor as investments. Some months after buying the policies, it occurred to Ted that he really didn't know much about how the great yields he was promised would be generated. For example, although he had the names of the insureds, he didn't know anything about their health.

His advisor was no help with this, so he called the settlement broker firm that sold the policies. They refused to give him any information and stopped returning his calls. Ted, being a resourceful fellow, tracked down the phone numbers of the insureds and started calling them!

### **Creating Life Settlement Inventory**

Settlement firms and agents have used seminars and dinners to convince wealthy seniors to rent their high net worth and life to become insured for the sole purpose of then selling the life insurance policies in two years. These transactions often involve a third party paying the premiums and providing the wealthy senior a bonus for renting his life (see my May 2006 AAI Journal article, "Why You Should Avoid Investor-Initiated Life Insurance").

There are two problems with this. First, insureds do not know who will end up owning these policies. Second, as the dumb money dries up, there may be no market for the policy. The lack of a market is not a problem if a non-recourse note has been used. However, if the insured is responsible for paying back the premium financing, he would face a huge debt that will have to be repaid if the policy is terminated because the premiums or loan interest are not affordable.

### **Premium Financing Followed by Life Settlement**

A recent premium financing client of mine is on the hook for \$949,462. Betty is 84 and in good health for a smoker. If she dies within seven years, her \$4 million financed life insurance policy will provide a good financial return for her heirs. If not, the delayed repayment of the debt could nearly consume her estate. The family had no idea what they had gotten into, and the agent did not understand it either. The family is literally in tears over the bad options they face.

The promised life settlement fall-back position has failed to produce an offer much higher than the current cash value. Betty and her family will have several years of agonizing moments deciding what to do.

Table 1 shows the value of this program upon Betty's death. The internal rate of return (IRR) is derived from the return (death benefit) Betty is getting for premiums paid. The IRR is 12% at 90, 2% at 91 and turns negative at age 92.

<b>Table 1. Estimate of Betty's Premium Financing</b>					
Age/Year	Annual Prem Loan (\$)	Annual Loan Cost @ 4.3% (\$)	Cumulative Loan (\$)	Net Death Benefits (\$)	Internal Rate of Return (%)
84/2010	91,132	18,337	2,160,637	2,000,000	10,801
85/2011	217,796	98,826	2,251,769	1,908,868	686
86/2012	154,464	106,191	2,469,565	1,691,072	199
87/2013	154,464	112,833	2,624,029	1,536,608	91
88/2014	154,464	119,475	2,778,493	1,382,144	83
89/2015	154,464	126,117	2,932,957	1,227,680	26
90/2016	154,464	132,759	3,087,421	1,073,216	12
91/2017	154,464	139,401	3,241,885	918,752	2
92/2018	154,464	146,043	3,396,349	764,288	(6.3)
93/2019	154,464	152,685	3,550,813	609,824	-
94/2020	154,464	159,327	3,705,277	455,360	-
95/2021	0	165,969	3,859,741	300,896	-
96/2022	0	172,611	4,014,205	146,432	-
97/2023	0	-	4,169,669	(9,032)	-

Annual Premium Loan = Illustrated premiums that are paid from loans.  
Annual Loan Cost = Amount Betty Pays out-of-pocket cumulative on premium loans.  
Cumulative Loan = Loan principal from ear one of this premium financing program.  
Net Death Benefits = Policy's death benefits less the cumulative loan.

Table 2 shows the cost to terminate the policy if the loan interest costs become too great over Betty's remaining lifetime. I had to prepare these estimates because the firm that sold this wouldn't provide it, and the agent didn't understand what to do.

<b>Table 2. Betty's Net Cost to Terminate</b>			
Age/Year Beginning of Year	Cumulative Loan (\$)	Cash Value (\$)	Net Cost to Terminate (\$)
84/2010	2,160,637	1,211,175	949,462
85/2011	2,251,769	1,288,949	962,820
86/2012	2,469,565	1,368,963	1,100,602

87/2013	2,624,029	1,442,518	1,181,511
88/2014	2,778,493	1,508,991	1,269,502
89/2015	2,932,957	1,568,758	1,364,199
90/2016	3,087,421	1,614,492	1,472,929
91/2017	3,241,885	1,632,647	1,609,238
92/2018	3,396,349	1,592,694	1,803,655
93/2019	3,550,813	1,506,998	2,043,815
94/2020	3,705,277	1,189,187	2,516,090
95/2021	3,859,741	753,633	3,106,108
96/2022	4,014,205	176,435	3,837,770
97/2023	4,169,669	0	4,169,669
Cumulative Loan = Loan principal from ear one of this premium financing program. Cash Value = Illustrated policy cash value. Net Cost to Terminate = Cumulative loan less the cash value.			

If premium financing is continued, the return could be large, but the cost of Betty surviving past the age at which IRR turns negative is probably unacceptable. If this program is continued, it turns negative at age 92, which is Betty's life expectancy. If Betty lives to 92 and this policy is terminated, the cost is estimated to be \$1,803,655 (calculated as cumulative loan balance minus cash value in Table 2).

The current \$949,462 cost to terminate this program is really the delayed cost of providing life insurance coverage for the past six years that has had a net zero cost to date. Unfortunately, Betty and her family had no realization of the enormous costs involved with what is essentially a loan for the life insurance policy. What they wanted was life insurance for nothing (good luck), and the agents wanted to cash a huge commission check.

### **Lawsuit Anyone?**

The wackiest case I have been involved with is that of an agent purchasing \$30 million of life insurance without the insured's knowledge by paying the premiums himself and owning the policies. This came to light when the agent asked the insured to turn over medical records so he could try selling the policies. Litigation resulting from such investor-initiated life settlement is fast becoming a cottage industry.

### **Conclusion**

What started as a worthwhile secondary market for the very few situations when it makes sense to sell a life insurance policy has gotten completely out of control because of huge hidden fees and commissions, and the misplaced belief that policies are a great investment.

Most insureds should not sell their policies until they are about to terminate. It is doubtful anyone should rent their life to be an insured only to try and sell it later, and no individual should become an investor in another's life insurance policy.

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