How Life Settlement Brokers are Compensated

Buckeye Life Resources

Brokers and others representing sellers of life insurance in the secondary market generally derive their compensation from the “gross offers” made by buyers, passing some lesser “net” amount to the seller. The difference between the gross and net amounts represents the compensation paid to the broker and any other intermediaries. Accordingly, the seller doesn’t pay the broker directly, but rather indirectly, as the commission is held back from the buyer’s offer, and the buyer remits payment to the broker after the sale is finalized.

The primary compensation models used in the industry to determine how much brokers are paid are as follows:

Percentage of Face Amount

This arrangement compensates the broker with a predetermined percentage of the face amount of the policy to be sold (commonly 8%). In addition to being arbitrary, a potential problem with this approach involves its fixed nature – compensation remains the same even if the broker fails to extract fair market value for the policy. Stated differently, the broker has no incentive to maximize the offer for the seller’s gain after some minimally acceptable amount is received (even if it’s well below the policy’s actual worth).

Percentage of Offer

Here, compensation is calculated as a percentage of the gross offer made by the buyer (typically 30%). This method is potentially flawed, too, because the offer amount incorporates the cash surrender value (CSV) of the policy, if any, which was contributed by and rightfully belongs to the seller. Brokers shouldn’t benefit from that portion of the asset that would have been returned to the seller absent the sale (i.e., the CSV).

Value Creation

The true measure of a life settlement broker is his or her ability to procure fair market value for a policy – to maximize the offer in excess of the CSV of the policy, if any, based on what the market will bear. Hence, the value created by the broker is the difference between the gross offer and the policy’s CSV, and value-added compensation models reward brokers with a prearranged percentage of the excess amount. Only this performance-based approach fully aligns the broker’s and seller’s interests.

The key benefits of value-added compensation are:

- Brokers are incentivized to vigorously market the case, soliciting offers and counteroffers from all prospective buyers until the winning bidder is determined;
- The process ensures the highest offer will be presented to the seller;

- It encourages full transparency and disclosure of the broker's compensation even if not required by state regulations, and
- It diminishes the counterproductive influence buyers may wield over brokers (e.g., to accept below-market offers).

The following example illustrates the fundamental differences between the three compensation models:

Assumptions

Face amount of policy: $1,000,000
Cash surrender value: $50,000

Scenario 1: **$150,000 Gross Offer** *(broker fails to obtain fair market offer)*

	% of Face (8%)	**% of Offer** (30%)	**Value Creation** (25%)
Broker's commission:	$80,000	$45,000 *	$25,000
	$1,000,000 x 8% = $80,000	*$150,000 x 30% = $45,000*	*($150,000 - $50,000) x 25% = $25,000*
Net amount to seller:	$70,000	$105,000	$125,000

Scenario 2: **$300,000 Gross Offer** *(broker obtains fair market offer)*

	% of Face (8%)	**% of Offer** (30%)	**Value Creation** (25%)
Broker's commission:	$80,000 *	$90,000	$62,500
	$1,000,000 x 8% = $80,000	*$300,000 x 30% = $90,000*	*($300,000 - $50,000) x 25% = $62,500*
Net amount to seller:	$220,000	$210,000	$237,500

* *The industry norm is for buyers to pay brokers the lesser of 8% of face or 30% of the gross offer, and this amount is divided between the broker and any other representatives of the seller.*

Regardless of the compensation formula applied to a life settlement transaction, it should be clearly and openly communicated to the seller at the onset of the process to avoid related confusion later in the process.

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