Life Settlements 101

Buckeye Life Resources

Introduction

The purpose of this document is to provide an overview of life settlements in hopes of either introducing the reader to an unfamiliar financial concept or enhancing his or her existing understanding of it. What follows is not intended to be an all-encompassing review of life settlements, rather a starting point for anyone interested in exploring the topic. In this vein the reader is encouraged to solicit the help of a financial advisor, insurance professional, certified public accountant, attorney and/or other relevant experts before engaging in a life settlement transaction.

Life settlements overview

A life settlement is the sale of an existing life insurance policy to a third party for an amount greater than its cash surrender value, if any, but less than its face amount. The seller transfers ownership of the policy to the buyer in exchange for an immediate cash payment (at times, the seller may also retain a portion of the death benefit). In turn, the buyer of the policy pays all future premiums to keep coverage in force and then receives the net death benefit when the insured passes away.

The life settlement industry (or secondary market for life insurance) dates back more than a century in the United States, at which time the Supreme Court concluded life insurance is personal property that may be sold or assigned not unlike other assets. Even though the legal basis for life settlements was determined long ago, the industry has taken shape only during the past two decades.

Typical of many nascent industries with limited regulatory oversight at the onset, the life settlement trade earned a well-deserved reputation for fraud and self-dealing during its early years that it struggles to shake to this day (the morbid nature of the investment does little to help matters). More rigorous and widespread regulation in favor of consumers, however, as well as the influx of institutional investors (instead of individual buyers), have steadily improved the industry’s reputational footing. Along the way consumers have become more knowledgeable about and receptive to the concept. The life settlement industry now flourishes as a result.

Life settlements are not a panacea, but they may be the ideal financial solution for policy owners under the right circumstances, and they should at least be considered among competing options if and when warranted.

Reasons to sell

Life insurance is an important financial tool that serves many purposes, affording its owners and their dependents invaluable peace of mind in the event the unexpected happens. Common reasons for buying life insurance involve these obligations: replacing family income, paying a home mortgage, funding higher education, buying out one's share of a business and transferring wealth in excess of estate tax exemptions.

By the time most people reach the age of 70, however, the original reason that motivated them to purchase life insurance no longer exists. Moreover, the cost of life insurance only climbs as we age to reflect our increased mortality, making premium payments increasingly burdensome through the years. This may explain in part why the vast majority of life insurance policies never pay a claim – most owners eventually surrender their policies or simply allow them to lapse.

In lieu of forfeiting one's life insurance policy to the issuing carrier for comparatively little or nothing in return, a life settlement may enable the policy owner to extract considerably more value for his or her asset and use the sale proceeds in unlimited ways.

Common Uses of Sale Proceeds

Income	Supplement retirement income with a lump-sum payment or annuity
Investment	Invest more productively elsewhere
Gifts	Support family members (e.g., grandkids' education)
Philanthropy	Assist charitable organizations
Long term care	Improve the quality of long term care
Bucket list	Fulfill a lifelong goal or dream

All else equal, life insurance should be maintained for its original and intended purpose, especially if the death benefit remains critical to the financial well-being of the beneficiaries of the policy. Circumstances change over time, though, and a life settlement may best suit policy owners who no longer want, need or can justify the expense of their coverage.

Reasons to keep

Life settlement transactions are not without drawbacks that must be factored by policy owners. Chief among them are the following:

Nature of the investment: Life settlements are inherently morbid in that a buyer of a life insurance policy has a vested interest in the demise of the insured after the sale is finalized – the sooner the insured passes away, the sooner the buyer receives the death benefit payout and the greater the return on investment. The very concept of life settlements is understandably off-putting to many, but in reality they're not unlike many types of annuities, pensions or long-term-care insurance policies, whereby those paying the proceeds usually fare better economically when the recipients of the proceeds die sooner versus later.

While this is a legitimate consideration, it may help to know that life settlement buyers are institutional investors (e.g., hedge and pension funds, private equity groups or similar financing entities that comply with the Securities Act of 1933). As such, they afford ample size, capitalization and diversification in their portfolios of policies not to rely on the outcome of any one investment for overall success. Many institutional buyers even hedge or insure against the risk of investment losses.

Policy owners are wise to insist on the exclusive use of licensed and reputable institutional buyers when considering a life settlement (and avoid individual or private investors).

Privacy and confidentiality: As part of a life settlement, it's necessary for prospective buyers and various stakeholders to review the insured's medical records and other personal information for underwriting purposes, including third-party estimates of his or her life expectancy. Moreover, after a sale is complete, the new policy owner may contact the insured or other designees for basic updates (not more than quarterly).

In addition to privacy laws that protect sellers, however, life settlement intermediaries have universally established policies and procedures designed to safeguard insureds' confidential information. Sellers may take comfort in reviewing the formal privacy guidelines of the parties to their transactions.

Tax consequences: Life settlements are taxable transactions for sellers, whereas the death benefit proceeds of life insurance do not subject beneficiaries to taxes in most instances. The proceeds from life settlements are generally treated as follows:

Tax free	The portion of the sale proceeds up to the total amount of premiums paid (inception to date) does not trigger federal income tax.
Ordinary income	The amount in excess of the noted cost basis, but less than the cash surrender value of the policy, if any, is taxed as ordinary income.
Capital gain	That which exceeds the cash surrender value is typically treated as a long-term capital gain.

A comprehensive review of tax-related issues is beyond the scope of this document, but policy owners should be cognizant of the potential tax implications of life settlements and consult a professional tax advisor for related guidance.

Other shortcomings apply to life settlements beyond what is noted immediately above, so policy owners are prudent to fully investigate such matters as part of their due diligence when contemplating a sale.

Attributes of a marketable case

There are no definitive guidelines that dictate whether or not a given case is marketable (industry participants refer to life settlement candidates holistically as “cases”). Many different factors apply, and no two cases are identical. Here are criteria and characteristics that generally render cases more salable, however:

Insured

Age	Above ~ 75 (younger if health issues apply)
Life expectancy	Below ~ 15 years
Health arbitrage	Decline in health since policy issuance

Policy

Type	Universal life & term conversions (primarily)
Death benefit	Above ~ $200,000
Insurance carrier	Financially stable
Cash surrender value	Below ~ 20% of the death benefit
Maturity	Age 100 and beyond
Issue date	More than two years ago

Even if a case violates one or more of the rules of thumb cited above, it may still be appealing to buyers depending on the overall circumstances. Life settlement evaluation is an inexact science, and investors differ from one another along lines of risk tolerance, underwriting criteria and buying preferences.

How pricing is determined

Buyers decide what they're willing to pay for a policy in today's dollars based on what they believe it will cost them to keep the policy in force until they collect the death benefit at some unknown future date. Will the total amount they spend to buy and then fund the policy enable them to realize an acceptable investment return?

The primary drivers of policy value are as follows:

Policy Cost	***Insured's Life Expectancy***
Life insurance policies vary widely in terms of the premium payments required to maintain coverage from year to year. Policies that cost less (so-called "efficient" policies) are usually more appealing to buyers than more costly (and inefficient) ones. A proxy for policy efficiency is the premium-to-face ratio using the annualized and level premiums required to carry a policy to age 100. Generally, ratios below 5% are efficient, and ratios above this figure are not.	How much longer the insured is expected to live is pivotal to a buyer's evaluation because it dictates the duration of the investment and the sum required to keep the policy in good standing after the sale is complete. Buyers and third-party underwriters analyze the insured's preexisting medical records in tandem with actuarial tables to estimate his or her remaining lifespan (expressed in median terms), which drives pricing.
Buyers' Investment Returns	***Competition***
Like most investors, life settlement buyers seek investment returns commensurate with the risk they accept (in this instance, the possibility insureds will outlive their life expectancies or life insurance carriers will impose higher premiums on a post-sale basis). At the same time, buyers are subject to market forces and must be competitive with their rivals, otherwise their capital will remain idle.	Life settlement investors strive to buy low, paying as little as possible for the policies they acquire. As such, it's improbable for sellers to obtain fair market offers for their policies unless multiple bidders compete against one another, thereby driving up offers systematically and positioning sellers to maximize the sale price.

Case examples

The following examples demonstrate the potential value of life settlements:

Coverage No Longer Needed

Insured	76 y/o male
Life expectancy	9 years
Policy type	Universal Life
Death benefit	$5,000,000
Surrender value	$0
Proceeds to seller	$840,000
Value created	$840,000

Originally in place as a key-person policy for an LLC, coverage was no longer needed because one of the insureds, who was the only remaining owner of the company, retired and sold the business.

Unaffordable Premiums

Insured	82 y/o male
Life expectancy	5 years
Policy type	Universal Life
Death benefit	$3,000,000
Surrender value	$25,000
Proceeds to seller	$600,000
Value created	$575,000

The trust that owned this policy lacked the funds necessary to maintain coverage, so the proceeds of the sale were evenly divided between the trust's beneficiaries.

Long Term Care

Insured	91 y/o female
Life expectancy	3 years
Policy type	Universal Life
Death benefit	$1,200,000
Surrender value	$25,000
Proceeds to seller	$355,000
Value created	$330,000

The proceeds of the sale were used to fund ongoing long-term care expenses for the insured in the face of escalating life insurance premiums, which were projected to exceed $400k for the next three years.

Retained Death Benefit (RDB)

Insured	85 y/o female
Life expectancy	8 years
Policy type	Universal Life
Death benefit	$2,000,000
Surrender value	$30,000
Proceeds to seller	$30k cash + $900k RDB
Value created	~$640k *

The owner could no longer justify paying premiums, but still wanted coverage for the beneficiaries of her estate. A retained-death-benefit sale satisfied both objectives.

Charitable Gift

Insured	84 y/o female
Life expectancy	7 years
Policy type	Universal Life
Death benefit	$5,500,000
Surrender value	$500,000
Proceeds to seller	$500k cash + $3M RDB
Value created	~$2.2M *

One of multiple policies in place, the owner no longer needed this coverage and elected to gift the retained death benefit component of the sale to a charitable organization (while recouping the cash in the policy).

Lapsing Term Policy

Insured	74 y/o male
Life expectancy	4.5 years
Policy type	Term
Death benefit	$700,000
Surrender value	$0
Proceeds to seller	$110,000
Value created	$110,000

Instead of allowing his term coverage to lapse as planned, the owner converted the policy to a universal life product as part of the sale (and was reimbursed by the buyer for the conversion premium he paid).

The foregoing examples were derived from actual cases, but they are solely intended to illustrate the potential benefits of life settlements in the financial planning process and should not be relied upon as indicators of future results. Not all cases qualify for life settlement.

**Present value of the RDB (at 5% and the life expectancy)*

The life settlement process

As with real estate and other significant assets, selling a life insurance policy in the secondary market is usually a lengthy process because it involves extensive due diligence on behalf of buyers and other parties to the transaction. In effect, investors spend considerable sums of money to buy and then fund an intangible asset in return for a payout at some eventual date, perhaps as distant as fifteen or more years. It’s therefore imperative for buyers to gain assurance from legal and other perspectives that all facets of the transaction are handled properly – from the initial underwriting of the case to the transfer of ownership and beneficial interest of the policy. The new policy owner must feel certain the eventual death benefit claim won’t be contested by the insurance carrier for any reason, else its investment will be a failure.

Here’s a summary of the process, which usually takes from 3-6 months to complete:

PQ *(<2 weeks)*	→	**Development** *(4-12 weeks)*	→	**Auction** *(3-4 weeks)*	→	**Closing** *(4-6 weeks)*	→	**Funding** *(2-4 weeks)*

Prequalification

The first step is for the policy owner to determine who will advise and represent him or her throughout the process. Among other individuals, this may be a financial advisor, life insurance agent, estate planning attorney and/or life settlement broker. Aside from being knowledgeable about and properly licensed for life settlements, whoever is selected should be capable of prequalifying the case from the onset to accurately gauge its marketability and potential value. This matters because it will help to establish realistic expectations and avoid wasted time, effort or money by those involved.

Case development

In order to consider bidding on a case, prospective buyers require various policy- and health-related information for evaluative purposes. The seller's advisor can handle all such matters, but needs written authorization from the policy owner and insured to do so. In-force policy illustrations and other information will be obtained from the carrier, as well as medical records from the insured's health care providers (followed by third-party life expectancy reports). In particular, the medical records and life expectancy reports add notably to the overall duration of the process – possibly up to two or more months – in part because they can't be gathered concurrently.

Auction

Once a complete case is assembled, all pertinent documentation is shared with potential buyers for their analysis and bidding. As referenced above, it's in the seller's best interest to approach only reputable and institutional buyers, and it's crucial to market the case to as many of them as possible in an effort to maximize offers for the policy. A fiduciary-minded advisor's goal during this phase should be to conduct a thorough and systematic auction that isolates the highest bidder.

Closing

Assuming the seller accepts the winning offer, the case then enters the "closing" phase, during which the prospective buyer issues formal contracts and related documentation for review and completion by the seller. Closing is another time-intensive part of the process because the buyer and its representatives scrutinize all aspects of the transaction for accuracy, leaving no unresolved issues that may stand in the way of a proper and legal transfer of ownership. This final and exhaustive analysis by the investor is akin to a real estate transfer, and it's possible unforeseen problems discovered at this time may invalidate the buyer's offer if they aren't remedied.

After the buyer is satisfied with its review, the funds allocated for the purchase are released to third-party escrow, and the escrow agent submits the appropriate forms to the insurance carrier for the changes of ownership and beneficial interest, which may take up to 30 days to process. Of note, the escrow agent (typically a sizable U.S. bank) isn't affiliated with the buyer and serves as a disinterested intermediary to ensure the transaction is consummated as contractually agreed by the buyer and seller.

Finally, the seller must receive the proceeds from the sale within three days of confirmation by the escrow agent that ownership and beneficial interest have transferred as intended. Even then, the seller may still decide against the sale for any reason during a “rescission period” mandated by state regulations (usually 15 days in length).

Conclusion

A life settlement may or may not be in the best interest of a life insurance policy owner depending on the circumstances at hand, but this increasingly popular (albeit often overlooked) option should at least be considered when a policy is no longer wanted, needed or affordable. The next best alternative usually pales in comparison to a life settlement.

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