The Will & The Way

How to "Settle" For More: Creating Excess Value with Life Settlements

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Many people would agree that you should not settle for less, but how do you settle for more on a life insurance policy? Imagine that a client presents you with the following situation: "Now that I am selling my company, I no longer need key person coverage. The business appraisal states that the policy has minimal cash value, but what is the policy's fair market value? Can I sell this policy for more than cash value?"

Selling a policy is an exit strategy that is not widely known, and industry experts estimate that billions of dollars in unrecovered life insurance asset value is left on the table each year. ***Every policy should be appraised before it runs out or is cancelled.***

What is a life settlement?

A life settlement is a financial transaction in which a willing buyer (a third party) purchases an already existing life insurance policy from a willing seller (the policyowner)—in other words, an asset sale. The buyer pays more than the policy's cash value but less than the death benefit. At the end of the process, the buyer becomes the new policyowner, assumes all premium-paying responsibility, and is entitled to the death benefit. The seller transfers all policy ownership rights in exchange for immediate cash.

When selling a car, you know that private party value is higher than trade-in value. Likewise, selling a life insurance policy in the secondary market may provide more than the insurance carrier's cash value.

How does this differ from viatical settlements?

Life settlement prospects have life expectancies between three and fifteen years, whereas viatical settlement prospects are expected to live less than two years.

Viaticals came about as a result of the AIDS epidemic in the 1980s. This enabled terminally ill policyowners to liquidate their life insurance assets for immediate cash. Viaticals are in essence an acceleration of death benefit, and in this regard, viatical proceeds are tax-free.

When should I consider a life settlement?

Primary reasons for selling a policy:

- The policy is no longer wanted.
- The insured is living longer than expected.
- The policyowner no longer wants to or can pay the premium.
- The policyowner's need for a living benefit outweighs the need for death benefit.

Typical Client Profile:

- The insured is age 70 or older and has declined in health since the policy was implemented.
- The insured is younger than age 70 and has a health impairment that reduces life expectancy.
- Premiums are one to three percent of the death benefit.
- The policy has a relatively small cash value compared to the death benefit.

Who are the buyers?

Life insurance buyers in today's market largely consist of institutional investors, including well-known companies such as Apollo, BlackRock, Blackstone, and Berkshire Hathaway, as well as pension funds and even entities funded by life insurance carriers.

These buyers view life insurance as an alternative asset class for portfolio diversification, since policies are non-correlated with conventional assets (equities, real estate, bonds) but are diverse in product type and insureds.

If a buyer wants to purchase my policy, why shouldn't I just keep it?

If a family has sufficient resources to pay premiums, it can make sense to keep the coverage. Well-designed and well-maintained life insurance plans can yield reasonable rates of return at death, particularly given the tax-free nature of the death benefit.

Buyers of life settlements possess two advantages that an individual policyowner does not have. First is ready access to capital, as paying the annual premium is easily accomplished. Second is the law of large numbers, a theorem stating that, as the sample size increases, the actual value grows closer to the expected value, thus mitigating risk. Fund managers pool together thousands of policies worth $100 million to $1 billion to create what is, in effect, a synthetic indeterminate maturity bond. The fund may be wrong on its life expectancy prognostication for any particular policy but is priced to be accurate in the aggregate.

In contrast, keeping the policy requires a policyowner to manage longevity risk on *one* life, or two lives in the case of second-to-die insurance. Families may start wondering when their relative will pass away and how long they will have to pay premiums. This can create a stressful planning environment that life settlements can help to alleviate.

How much would a policy sell for, and what are the fees?

Unfortunately, this is impossible to answer without both policy and client health information; however, ***on average, life settlement proceeds are between 10% to 30% of death benefit.*** Policies where the insured has a significantly reduced life expectancy may have value in the range of 40% to 60% of death benefit.

Life insurance companies value policies based on cash reserves, whereas life settlement buyers determine value based on the ultimate receipt of the death benefit. These different vantage points put the policyowner at a distinct advantage, sometimes resulting in life settlement proceeds far exceeding cash values.

Fees include hard costs for medical records and life expectancy reports, as well as broker compensation.

Case Study: $9,000 Cash Value vs. $900,000 Life Settlement Value

A client was trustee and beneficiary of a $5 million second-to-die Universal Life policy insuring an older relative (the spouse was deceased). The policy was underfunded and needed premiums of $325,000 per year to continue. Neither the insured nor the beneficiaries wanted to make future gifts to support the policy, but forfeiting all benefits by lapsing the policy was a disturbing alternative to the trustee.

In brief, the trustee sold the policy to a third-party buyer and received net proceeds of $900,000 for the trust versus the $9,000 that would have been received upon surrendering the policy. The trustee no longer felt the weight of managing a policy with rapidly declining values and the beneficiaries were pleased to preserve a portion of the benefits instead of a complete loss.

Policy:	Second-to-Die Universal Life
Death Benefit:	$5,000,000
Insureds:	Male age 77, female deceased
Premiums:	$325,000 per year
Cash Value:	$9,000
Settlement Value:	$900,000

Who receives the money?

Life settlement proceeds are paid to the seller (policyowner), not the beneficiaries. In a trust environment, proceeds are paid to the trust, and the trust assets will be distributed according to the terms of the trust agreement. The grantor may or may not have access to the life settlement proceeds.

What is the process, and what if I change my mind?

From start to finish, the process can take two to four months on average. The life settlement broker conducts an informal review and provides a range of potential outcomes. If the preliminary estimate is compelling, the broker is engaged in a formal evaluation process (no exam or bloodwork required) to narrow the range of potential outcomes. Ideally, the broker will work with multiple buyers in the bidding process, and if the seller accepts the highest bid, the involved parties complete closing documents. The seller is paid once the policy ownership is transferred to the buyer. There is a ten business day rescission period in North Carolina.

Planning Tip: A life settlement broker has a fiduciary duty to represent the seller's best interest rather than the buyer. Furthermore, a broker who works with multiple buyers versus a single buyer can create a competitive negotiating environment to yield better returns to sellers. Jon B. Mendelsohn, CEO of Ashar Group, a national life settlement broker, said, "It's all about competitive bidding and transparency. This is a market-based valuation with qualified licensed buyers driving up the offer to the client."

How are life settlement proceeds taxed?

The Tax Cuts and Jobs Act improved tax treatment for sellers. Settlement proceeds are taxed as follows:

- Tax-free up to cost basis.
- Ordinary income rates on the difference between cash value and cost basis.
- Capital gains rates on amounts exceeding the greater of cash value or cost basis.

Tax calculation examples on Cash Value vs. Life Settlement Value assuming federal tax rates of 40% on ordinary income and 20% on capital gains.

Scenario	1	2	3
Cost Basis	$800	$400	$400
Cash Value	100	100	500
Life Settlement Value	500	500	700
Ordinary Income Tax Due	0	0	40
Net Cash Value Proceeds	**$100**	**$100**	**$460**
Ordinary Income Tax Due	0	0	40
Capital Gains Tax Due	0	20	40
Net Life Settlement Proceeds	**$500**	**$480**	**$620**

Planning Tip: In the event of a taxable gain, some buyers may or may not produce a Form 1099. Clients should work with their tax advisors to assess any taxes that may be due.

What regulations are in place?

The life settlement industry is well-regulated. All parties are required to adhere to HIPAA and privacy protocols, and forty-five states, including North Carolina, have enacted regulations to provide consumer protections and transparency. This includes state-approved forms and licensing requirements for both the insurance advisor and life settlement broker.

The best life settlement brokers deal exclusively with licensed buyers that represent institutional funds as opposed to individual investors and fractionalized purchasers. Large institutional funds often engage major banks, such as Wells Fargo, Bank of New York, and Bank of Utah, to trustee the policies post sale; this additional layer enforces privacy barriers among parties to protect the confidential nature of the life insurance and the insured.

What are potential downsides?

- The most obvious downside is the loss of the death benefit to the seller. The seller accepts the risk of not collecting the death benefit if the insured dies sooner than expected. On the other hand, the buyer accepts the risk of paying increasing premiums if the insured lives longer than expected.

- When a policy is sold, the coverage still exists, just under new ownership. Should the insured wish to purchase additional coverage in the future, he or she would need to requalify medically and financially. The policy that was sold absorbs a portion of the insured's insurance capacity.
- Since buyers don't have direct relationships with the insureds, the seller designates a family member or friend who can confirm the insured's living status in the future. As part of their portfolio management, buyers periodically update medical records and life expectancy studies behind the scenes.

What types of policies are attractive to buyers?

Logic may suggest that high cash values are always desirable; but for buyers, the opposite is true. If you can surrender a policy for more than what a buyer is willing to pay, then you would simply surrender the policy for its cash value. High cash values increase the hurdle that buyers must overcome to purchase the policy. There are exceptions, but a general rule of thumb is that low cash value policies are more attractive to buyers than high cash value policies.

Whole Life policies were structured to provide ever-increasing cash values that are undesirable to buyers. With the advent of Universal Life policies, cash values can be on the high- or low-end of the spectrum. In the case of low cash value, life settlements could prove a valuable option.

Convertible term policies are commonly let go at the end of the level term period, usually 10, 15, or 20 years. You may be surprised to know that these policies can be very desirable to buyers. When term policies naturally run out without cash value, life settlements can provide excess value, which is a great way to "settle for more."

Case Study: Partial Term Conversion

A 75-year-old client had a $1.65 million trust-owned convertible term policy. She intended to convert $650,000 of the death benefit to a permanent policy and drop the remaining coverage. The unwanted $1 million portion was sold for $105,000. The trust used the proceeds to pay premiums on the coverage that it retained. The client and trustee never imagined this was possible, and they were pleased to capture value that would have otherwise been lost.

Policy:	Convertible Term
Death Benefit:	$1,000,000
Insureds:	Female age 75
Cash Value:	$0
Settlement Value:	$105,000

Why are life settlements particularly attractive today?

- People are living longer, healthier lives. With over twenty million individuals in the Silent Generation and more than seventy million Baby Boomers, families are facing a need for living benefits over death benefits. Selling a policy can provide funds to care for aging loved ones.
- The estate tax exemption increased from $1 million in 2002 to now being $11.4 million per individual or $22.8 million for a married couple. Now that most families fall beneath the exemption, many policies that were implemented to fund estate taxes are no longer needed.
- In the ongoing low interest rate environment, fewer old life insurance policies are performing as originally intended. In the early 1980s, some insurance carriers were crediting 12% to 15% on policies, and the projected premiums were relatively low. As interest rates have gone down and stayed down, carriers have responded by reducing policy interest crediting rates, which produces the undesirable effect of increased premiums.
- Tax reform not only provided favorable tax treatment for the seller, it also simplified the tax calculation. Prior to 2018, the calculation of gain for life settlement purposes required historical mortality charges that are not readily available. Today, advisors can easily calculate any taxable gain on settlements in order to compare cash value to net after tax settlement proceeds.
- Years ago, the buying and selling of policies was something of a "Wild West" environment with little to no regulation. As the market has matured and states have adopted regulations surrounding life settlements, the market has normalized considerably.

Is a policy ever too small for life settlement?

Yes, high-end buyers most often purchase policies with at least $100,000 of death benefit. At that amount, it is possible to create a competitive bidding environment among multiple buyers. Under that amount, the broker compensation and hard costs represent a relatively large portion of the sale price, thus resulting in little value created for the client.

Case Study: $1,000,000 of Additional Value Created for a CEO

Policy:	Universal Life
Death Benefit:	$20,000,000
Insureds:	Male age 80
Cash Value:	$7,000,000
Settlement Value:	$8,000,000
Value Created:	$1,000,000

Even if clients are happy with taking the policy cash value, a life settlement may create additional value. A family office was considering surrendering a $20 million policy insuring their 80-year-old CEO. The policy was funded under a split dollar arrangement, and the family was going to cancel the policy and return the cash value to the company. Instead of surrendering the policy for $7 million of cash value, the clients sold the policy for $8 million, creating $1 million of additional value.

What is the key takeaway?

Never terminate, surrender, or lapse a policy without first having it evaluated for life settlement. When client circumstances change, life settlements may give clients the opportunity to settle for more and provide greater value for their unwanted policies.

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