By M. Bryan Freeman

Life settlements: then & now

ONCE A TOOL OF LAST RESORT, THE LIFE SETTLEMENT HAS BECOME A MAINSTREAM PLANNING OPTION

Imagine that you just bought a beautiful new car for $50,000. After three years, you decide that you no longer want the car or can afford the payments. What if you were told that your only option was to sell the car back to the manufacturer, for nothing or for a small fraction of the car's actual value? You would be upset, and justifiably so. »

With very limited exceptions, that is exactly the situation that has existed for life insurance policies for more than a century. Historically, there was only one potential purchaser for a life insurance policy: the issuing life carrier. Because there was no competition for the repurchase of policies, there was no reason for insurers to offer more. When a client took his policy back to the "dealer," the only possible "purchase price" was the policy's cash surrender value (CSV).

"With a secondary market for the purchase of a life insurance policy virtually non-existent, a vast number of policies were lapsed every year, with the result that owners received little, if any, of the economic value for their asset," says R. Larry Warnock FSA, MAAA, an actuarial consultant who, through his Atlanta firm, Value Life Corp., regularly consults with the life settlement industry. "Incredibly, it is estimated that 93 percent of all policies issued lapse before paying a claim."

With such an uneven playing field, it was almost certain that free-market innovation would develop an alternative to the artificially low CSV repurchase price.

Today, that alternative is a reality. The secondary market gives policies liquidity similar to more familiar tradable commodities, like residential mortgages, stocks and even cars. Now, market forces ensure that a large percentage of life policies are worth significantly more than their CSV. It is possible for a policy owner to receive anywhere from one and one-half times to more than 1,000 times the amount of the CSV of the policy (depending on the type of policy and the amount of CSV, if any, accrued in the policy).

"Many [universal life] policyholders have underfunded their policies, and many of those policies are in danger of lapsing if they don't see a significant increase of premium dollars," Warnock says. "In such cases, I have seen settlement amounts exceed CSV by tens of thousands or hundreds of thousands of dollars. For example, one case literally had $150 CSV and the settlement paid was $250,000. That is 1,666 times CSV."

Life settlement providers can pay more than CSV in at least 80 percent of the cases presented. One reason the percentage is so high is that life agents and others often bring cases forward for consideration; in a sense, prequalifying the cases.

It is likely becoming clear why the emergence of a secondary market for life insurance was a historical inevitability. For many Americans, a life insurance policy is one of the most valuable assets they will ever own. And free markets will always eliminate artificial restraints on trade. Thus, the ability to receive maximum value for a life insurance policy was a rational and necessary response to an issuer-dominated market that deprived policy owners of the fair value of their policies.

A BIT OF HISTORY

The modern life settlement industry has origins in the viatical settlement transactions that occurred in the late 1980s and 1990s. This was a time when a large group of terminally ill individuals found themselves in desperate circumstances because of the AIDS pandemic. Fortunately, a few entrepreneurial minds had the vision and creativity to realize that the value in life insurance policies could be tapped to offer some relief.

In a sense, the life settlement industry that exists today is the great-grandchild of those viatical settlement transactions. As in a viatical settlement, a life insurance policy is sold in the secondary market. However, just as families change over generations, the current life settlement market bears little resemblance to its forbearer that existed 15 years ago.

Any discussion of the history of settlements must touch on the fact that, like any emerging business, the settlement industry had some bad actors who became involved when the industry was still focused on viaticals.

The damage done to the reputation and credibility of the industry by a few

Case scenario

MANY ADVISORS RELY ON analogies to explain complicated concepts to clients. If you're looking for a way to clearly explain the value of a life settlement, the car analogy noted in this article should help your clients understand the once "trapped" nature of life insurance policies. However, that analogy compares a depreciating asset to a financial asset. So, to be clear, consider the following comparison:

Suppose you invest $10,000 in a 20-year bond that pays you 8 percent interest each year. Holding the bond for the full 20-year term to get back your $10,000 investment is kind of like holding your universal life policy until it matures at death, at which time your beneficiaries receive the face amount.

In the case of the 20-year bond, there is a secondary market in which bond values are influenced by dynamic forces after you make your investment. These forces include changes in prevailing interest rates. So, if one year after you bought your 8 percent bond, market interest rates drop to 6 percent, your $10,000 bond would be worth approximately $11,625.

A similar thing happens with the market value of a life settlement. The market value is impacted not only by market investment yields (required by investors), but also by declines in the insured's health condition and arbitrage between what insurers charge for coverage on old policies and current realistic assessments of those costs.

Unlike the bond analogy, where market values may go up or down, the life settlement market value is almost always significantly greater than the insurer's formula cash surrender value.

– R. Larry Warnock, FSA, MAAA

unscrupulous people continues to this day. However, the benefits that the settlement industry brings to those who wish to sell their policies far outweigh the actions of those who, in the past, sought to manipulate settlements at the expense of others. For instance, the widespread emergence of accelerated death benefits is a response by life insurance carriers to the fact that seriously ill insureds have a new market for their previously unsalable policies.

Additionally, life insurance companies are offering many new products that are a direct outgrowth of the competition created by the life settlement market, such as hybrid policies that combine long term care, stated disease, disability coverage and other product innovations into one policy.

While some life insurance companies complain that the sale of policies into the secondary market is unfair and harms their financial bottom line, the very existence of the secondary market has increased the value of life insurance, which in turn drives demand for the issuance of new policies. The quiet entry of a few life insurance companies — including Gen Re (a Berkshire Hathaway company) and CNA — into the life settlement market is a strong statement that even insurers acknowledge the value of this new and exciting asset class.

"The fact that a policy holder may have the ability to sell their policy later if they need or want to — especially when their circumstances have changed — adds tremendous value to life insurance policies," says Fritz Milner, president of Milner Atlanta Brokerage Service Inc. "This is a great sales point that agents should never overlook."

LEGISLATION LEGITIMATION

Another factor that has fueled the explosive growth of the life settlement industry is the viatical and life settlement legislation enacted by the U.S. Congress and state legislatures. There are 36 states that regulate viaticals (typically, transactions where the insured

Consider the circumstances

Fritz Milner, president of Milner Atlanta Brokerage Service Inc., encourages agents to look at their portfolio of clients and review the many scenarios in which a life settlement is applicable. Some of the scenarios he encourages agents to look for include:

- Circumstances in which a replacement policy is considered or warranted, whether or not it is accomplished through a 1035 exchange.
- Escalating premiums make the policy unaffordable, or at least not the best investment, dollar-for-dollar, at that time.
- A policy is in danger of lapsing.
- A policy simply is not performing as desired or needed.
- The insured or owner could benefit from a different type of coverage. For instance, when circumstances change and it would be advantageous to own or hold the policy in a different way.
- Wealth accumulation obviates the need for the policy.
- Wealth accumulation necessitates a new or different policy.
- The insured's health changes.
- Changes in estate or tax laws.
- Changes in personal circumstances, such as divorce or retirement.
- Changes in business circumstances, such as the sale or purchase of a business, bankruptcy or a decreased need for a key-person policy.

has less than 24 months to live), life settlements (typically, the insured is older than 65 with a life expectancy of more than 24 months), or both. Many other states are considering such legislation, according to James W. Maxson, general counsel for Habersham Funding LLC.

Regulation of the industry is a positive endorsement of the settlement concept. Many state laws and the current NAIC model regulation recognize that, by virtue of holding a life license, insurance professionals are uniquely qualified to conduct life settlement business.

"Regulation has brought the life settlement market into the mainstream and ensures that all parties — owners, insureds, financing entities, settlement brokers and settlement providers — are protected," Maxson says.

BIG NUMBERS

The potential size of the life settlement market is extraordinary. According to Conning & Co. and the Viatical and Life Settlement Association of America, the estimated face value of policies settled in 2001 was between $1.8 billion and $4 billion. It is fair to say that this number has increased 20 percent to 25 percent every year since.

"Perhaps the most amazing fact is that these settlement numbers are taking place in an environment in which the overwhelming majority of legal, financial and insurance professionals practicing in America today still have not been adequately educated about the value created by the secondary market for policies," says Milner.

In 1999, the last year for which solid data are available, Conning and Co. estimated that the total value of life insurance policies held by senior citizens was more than $490 billion. Even if it were assumed that there was no growth in the industry since 1999, and only 15 percent to 20 percent of eligible policies were appropriate for settlement, the potential market would be larger than $100 billion. Quite obviously, the delta of at least $96 billion represents an exceptional opportunity for policyholders.

"In addition to these facts," Milner says, "we see particular opportunities in the Southeast because it has tended to be a 'following market,' so there are more untapped opportunities here. That means there is a lot of settlement business waiting to be discovered by savvy agents."

Today, life settlements are most often undertaken for reasons of estate and financial planning. These sellers are not in distress; rather, they know they can find new value in policies that have become too expensive to maintain, that are not performing up to expectations or for which the original need no longer exists.

From its origins as a last resort for the terminally ill, the life settlement industry has emerged as one of the most dynamic asset classes to come into existence since the secondary market for residential mortgages.

"As more and more specialty mutual funds purchase life settlements as their sole investment," says Maxson, "this institutional interest recognizes that life insurance policies sold into the secondary market are on the verge of becoming an investment-grade asset class."

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Founder & President,
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