

## Assessing Clients' Life Settlement Offers

by Peter C. Katt, CFP, LIC

"Be Your Own Beneficiary" is the catch phrase heading a life settlement firm's Web site. Life settlement refers to the purchase of unneeded life insurance policies. This column will examine whether life settlements are likely to be of value to your clients.

Selling an existing life insurance policy may not be as isolated a recommendation as you might think if the past year is any evidence. I have had several clients solicited, seen many life settlement advertisements directed at financial planners to solicit the purchase of policies, and read articles claiming a new professional responsibility to obtain life-settlement quotes for their clients' policies as a measurement of their true surrender value. In short, there seems to be something of a full-court-press on to convince affluent policy owners to wise up and Be Your Own Beneficiary.

The reason for this is because life settlement firms claim their net return is 12 percent to 15 percent, and they are paying insurance agents and others willing to solicit such purchases 10 to 15 percent of the purchase price as a commission. Add to this the possible repeal of the estate tax, which would make more and more policies available for purchase, and there may be more agents buying policies than selling them.

### Life Settlement Profile

There are three necessary insured characteristics for a life settlement firm to consider purchasing a life insurance policy:

1. Over age 65
2. Life expectancy of 2 to 13 years
3. Significant decline in health since the policy was purchased so that the policy underwriting rating is considerably better than the insured's current health

Many who don't fit this profile go through a lot of wasted motion because solicitors are diddling them with the idea of buying their policies at great profit in an attempt to establish a relationship to come back with other proposals for the healthy.

And speaking of being diddled, I spent considerable time trying to find a life settlement firm that would provide me with actual purchase information so I could evaluate the reality of these transactions. Half a dozen promised to provide such information but then went into their shells. Finally, I found a firm that has completely cooperated.

### It Depends on the Definition of *Needed*

Life settlement firms and proponents always refer to the sale of life insurance policies that are no longer *needed*. However, *needed* is not a particularly useful definition because many of my clients have life insurance they don't need but that they want. I think of *needed* life insurance as fulfilling a risk management function such as having others financially dependent on an insured, such as the primary family-income-earner raising children. I think of *wanted* life insurance as an asset that can perform its objective more effectively than alternatives, but doesn't have a risk management element. Often, life insurance policies move from the *needed* to the *wanted* category as children have become independent or a family business is sold.

But a discussion of the difference between needed and wanted life insurance seems to miss the point in the context of life settlements that, by definition, only involve insureds who are in much worse health than when they bought their life insurance policies. The only reason this so-called life insurance secondary market can exist is because the subject policy has become much more valuable due to the insured's poor health. This makes such a policy anything but unneeded.

Life settlement firms readily point out that life settlements almost always involve the affluent who can continue paying life insurance premiums. And it is to this group that my valuation comments apply. For those few who sell their policies because of their inability to continue paying premiums, selling their policy may be a rational choice.

## Life Settlement Transaction

To follow are the steps and factors involved in the purchase of a life insurance policy with an insured over age 65, having 2 to 13 years life expectancy and whose policy underwriting category is much better than current health would warrant.

- Detailed health history is obtained from the insured's doctors by the life settlement firm and sent to reviewers to assign a life expectancy.
- Detailed information about the policy structure and pricing is obtained and analyzed by the life settlement firm.
- The insurance company must have certain minimum financial strength ratings.
- Based on the life expectancy, policy pricing and structure, a purchase price is calculated so that the life settlement firm can earn a return of 12 percent to 15 percent.
- Commissions of 10 to 15 percent of the purchase price are paid to the insurance salesperson or other soliciting agent.
- Because of the life settlement firm's life insurance pricing expertise, it establishes the most cost-efficient premium structure based on the insured's life expectancy. This is an advantage that civilians and their non-insurance pricing expert advisors can't match.
- The policy seller must include the gain in the income and pay taxes on this amount. If a policy's cost basis is \$650,000, the cash value is \$750,000 and the life settlement purchase price is \$1 million, one possible tax result is the recognition of \$350,000 as ordinary income (difference between the sales proceeds and cost basis). However, some tax experts claim that only the difference between the cost basis and cash value, or \$100,000 in this example, is ordinary income and the balance of \$250,000 is capital gain. I don't believe the Internal Revenue Service has ruled on this yet, so the capital gain treatment is not certain.
- When the insured dies, the life settlement firm must recognize insurance proceeds less cost basis as ordinary income.
- The insured appoints several agents to keep the life settlement informed on a regular schedule of the insured's life and death status.
- Life settlement firms do not independently evaluate possible purchases to determine which ones will and will not benefit policy owners. Life-settlement firms are pursuing their own financial interests. Policy-sellers beware.

## Financial Analysis and Case Study

Based on the foregoing steps and factors, the following financial analysis can be used to determine the value of the life settlement offer based on our case study.

Case study facts:

- \$5 million level death benefit universal life policy with a required premium of \$175,000 through the tenth policy year, then premiums are flexible.
- Policy was issued Standard Nonsmoker in October 1998 to a 72-year-old male insured.
- The insured was determined to have a remaining life expectancy of five years as of October 2001.
- The policy's cost basis was \$525,000 with no surrender value due to surrender charges.
- The life settlement firm paid \$1,448,500 for this policy in October 2001. The seller netted either \$1,079,100 or \$1,263,900, depending on whether ordinary income or capital gains apply. For the purposes of this column, let's assume that capital gains is the correct way to pay taxes and the net proceeds are \$1,263,900 to the policy seller, though a conservative interpretation would be about \$200,000 less.

Analysis methodology:

- Calculate the after-tax value of the sales proceeds using both the ordinary income (\$1,079,100) and the ordinary/ capital gain (\$1,263,900) alternatives.

- For a period extending twice the insured's life expectancy, calculate the death benefit's present value using a reasonable discount factor. (Because the measuring point is the October 2001 life settlement purchase offer, future death benefits need to be discounted back to that date). For example, a \$5 million death benefit that is paid out in five years, discounted at five percent, has a present value (October 2001) of \$3,917,631.
- For a period extending twice the insured's life expectancy, calculate the expected premium payments' present value. The expected premium for the first five years after the sale of the policy is \$175,000 and the present value, discounted at 5 percent, is \$795,541. This represents what it costs the policy owner if the policy is retained.
- Make special adjustments that are relevant to a particular case. For example, if the life settlement firm has taken a large policy loan as part of the purchase proceeds with the attendant loan interest costs; if the policy were retained by the policy owner, the firm wouldn't take the loan. This needs to be accounted for in the analysis.
- Compare the net sale proceeds with a figure arrived at by subtracting from the death benefits' present value the expected premiums' present value. Using our prior examples for the fifth year, this figure would be the death benefits' present value of \$3,917,631, minus expected premiums' present value of \$795,541, equals \$3,122,090. This figure is then compared with the net sales proceeds. Again referring to the above example, the proceeds are either \$1,079,100 or \$1,263,900. The net present value if the policy had been retained and the insured dies in five years is \$3,122,090 compared with net proceeds of either \$1,079,100 or \$1,263,900. A clear advantage for retaining a policy.

Using this financial analysis, the valuation comparison between selling or retaining the policy can be made, shown in Table 1.

Insured Dies <sup>1</sup>	Present Value of Death Benefits	Present Value Premiums	Value if Retained Death Benefits Minus Premiums	Net Sale Proceeds	Advantage if Retained
2002	\$4,761,905	\$166,667	\$4,595,238	\$1,263,900	\$3,331,338
2003	4,535,147	341,667	4,193,480	1,263,900	2,929,580
2004	4,319,188	500,397	3,818,791	1,263,900	2,554,891
2005	4,113,512	651,568	3,461,944	1,263,900	2,198,044
2006 <sup>2</sup>	3,917,631	795,541	3,122,090	1,263,900	1,858,190
2007	3,731,077	932,658	2,798,419	1,263,900	1,543,519
2008	3,553,407	1,107,486 <sup>3</sup>	2,445,921	1,263,900	1,182,021
2009	3,384,197	1,312,568	2,071,629	1,263,900	807,729
2010	3,223,045	1,554,296	1,668,749	1,263,900	404,849
2011	3,069,566	1,815,209	1,254,357	1,263,900	-9,543

1. Assumes insured dies in October.  
2. Life expectancy.  
3. Expected premium through 2007 is \$175,000 then increasing in each subsequent year to \$240,000 \$303,000 \$375,000 and \$415,000 respectively.

I reviewed two other life settlement policy purchases and the financial analysis came out very close to this one. Based on this case study, the before-tax return should be around 18 percent and the after-tax return around 12 percent. This is measured at life expectancy in five years. Because life expectancy refers to approximately half dying before and half after the specified time, in the aggregate, life settlement firms should achieve the investment return they plan for. But each individual insured will have different financial results depending on which side of the average they fall, which is why it is important to evaluate the financial prospects so each potential policy seller can assess the potential advantages and disadvantages according to their own view. In the case study presented, and I suggest generally true, the crossover point is twice life expectancy. Based on this case study (and probably generally true), there is about a ten percent probability that the insured will be alive when retention of their policy becomes less valuable than having sold it. Put another way, there is a 90 percent probability that having retained the policy is more beneficial.

## Conclusions

1. Have an independent financial analysis done before a policy is sold. The life settlement firm isn't in the business to determine what is in the best interests of prospective sellers. It is naturally pursuing its own financial interests.
2. If you don't have an independent financial analysis done, the benefits of retaining the policy recede because of the likely failure to pay premiums most effectively. I estimate that the crossover point, instead of being twice life expectancy is a couple of years less because ignorance will often cause more premiums than are necessary to be paid. This could change the advantage of keeping the policy from a 90 percent probability to about a 70 percent to 80 percent probability.
3. If selling appears to be in your client's best interests, obtain several purchase offers. Don't rely on only one life settlement firm's offer.
4. If you are recommending that your clients sell their unneeded policies, increase your malpractice insurance. Recommending that clients be their own beneficiary may end up causing the former beneficiaries to put the offending advisors in the dock when ol' Dad dies in several years and they go looking for all that insurance money.
5. If you believe that life settlement offers represent the true value of a life insurance policy for tax purposes, increase your malpractice insurance. Measuring a life insurance policy's value after an insured's health has gone bad will produce a completely erroneous value that benefits the IRS at the expense of the policy owner.

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