A Question of Life Settlements

ARE LIFE SETTLEMENTS AN INNOVATIVE FINANCIAL PLANNING TOOL or dangerous instruments that cause more problems than they solve? John Skar, senior vice president and chief actuary at Massachusetts Mutual Life Insurance Co., raises a few questions about life settlements ... and provides his own answers.

Q: *What is a life settlement? How is it different from a viatical settlement?*

Skar: Structurally, they're identical. Both involve selling a life policy to an unrelated investor for more than the cash value. The investor picks up the premium payments and expects to make a good return on investment when the insured dies. Viaticals involve terminally ill individuals with life expectancies of two years or fewer, while life settlements are for people over 65 with life expectancies ranging from two to 12 years.

Q: *What is the target market for a life settlement?*

Skar: Most life settlement companies summarize the target market as follows:

- Policy is performing poorly, no longer wanted, or no longer affordable beyond contestable period;
- Net death benefit is at least $250,000;
- Insured is at least 65 and has experienced a negative change in health resulting in a life expectancy of 12 years or fewer.

Q: *Why did you get involved in this subject?*

Skar: Our agents and policyholders are flooded every day with what I will call potentially misleading articles and ads playing up the value of life settlements as an "innovative financial planning tool." In reviewing this material and talking to agents, I became concerned that the life settlement companies' sales pitch could lead to inappropriate financial recommendations. In the great majority of situations, these policies should be retained, not sold. In response, we developed a great deal of educational material for our agents so that our policyholders receive balanced, appropriate advice.

Q: *Isn't a life settlement better than a lapse or surrender?*

Skar: Of course it is. The real issue is whether it's better than keeping the policy in force. Since there's always a decline in health involved, these policies have a high expected return—that's why a sophisticated investor wants to buy them. Why would you sell your highest yielding asset at a discount? The financial adviser should not recommend a lapse or a sale as long as leaving an estate is important to the client.

Q: *But why is it better to keep the policy? What about situations in which the original reason for the insurance is no longer valid, or the policyholder's needs have changed in some other way?*

Skar: It's irrelevant whether the original purpose of the policy has changed or whether the policy has "performed" according to original expectations. The relevant point is that the policyholder has sustained a serious decline in health, and this policy is now a great estate asset. Sophisticated investors want to buy these policies and expect to make a high return, even after incurring substantial acquisition expenses and paying tax on the death benefit. The policy represents a very high-return estate asset. If there's still an estate plan, this particular life policy should be part of it.

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Appropriate questions for the financial adviser to ask are: "Have you given up any plans for passing an estate at your death?" or "If you need cash right now, what other assets are available besides this life insurance policy?"

Q: *What about using the life settlement proceeds for other purposes, such as gifts, or perhaps to buy other insurance products, such as long-term care?*

Skar: Unless the policy owner has no interest in leaving an estate to children, other family members, or a favorite charity, that policy should not be sold or surrendered. It's financially superior to raise cash from other sources that have lower expected returns.

It's particularly inappropriate to recommend selling one life policy and using the proceeds to buy a replacement policy. The insured is now in poor health and can expect to pay a higher cost for life insurance with the replacement coverage. Quite often, the suggested replacement is a survivorship policy, where the uninsurable individual uses a healthy spouse to replace the policy being sold. But this is replacing a high-return asset (the current policy) with a relatively low return asset (the new survivorship policy).

Of course, if the life settlement company and the life insurance company are using inconsistent underwriting criteria or are provided with conflicting medical information about the applicant, it's possible for the insured to "sell high" and "buy low." In most cases, however, the insured isn't receiving equivalent or greater value in the new policy.

If the insured wants to use the life settlement proceeds as a gift to children, grandchildren, or a charity, the financial adviser should make it clear that the gift would generally be worth much more if it were simply allowed to pass at death rather than before. It's unlikely that someone can invest the proceeds of a life settlement and end up with more money in the estate.

Q: ***Why is that?***

Skar: The investor expects to make a high rate of return on the policy, even after paying substantial commissions, reinsurance fees, taxes, and other transaction costs.

The insured's estate, on the other hand, incurs none of these additional expenses, so it will necessarily have a higher rate of return than the investor's return. Most of these policies have a double-digit expected return on future premiums.

Q: ***What if the insured lives much longer than expected? Isn't there a chance of doing better by taking the settlement offer?***

Skar: Yes, but it's usually not a good chance. Peter Katt, a well-known insurance adviser in Michigan, addressed this question in the July 2002 issue of the *Journal of Financial Planning*. Using a discounted cash flow analysis, Katt estimated that the insured must survive to about twice life expectancy to make the life settlement financially superior to retaining the policy. Roughly 90 percent of the time, taking the life settlement results in a lower discounted cash flow than just keeping the policy.

Q: ***But what if the policy owner simply can't afford to make the premium payments?***

Skar: In that case, I would explore the possibility of a financial arrangement with the beneficiary. For example, the beneficiary could pay the premiums. The beneficiary's expected return is probably higher than any other alternative investment. The beneficiary might even want to borrow money to keep that contract in force.

Another option is to restructure the policy to minimize premium payments, using policy loans or other contractual options that may be available in the life insurance contract.

Q: ***What if the original beneficiary pre-deceased the insured?***

Skar: We come back to the basic question: Does the insured have any interest in an estate? Is there any estate plan? If the answer is yes, then there must be a new beneficiary. Change the beneficiary designation, and keep the life insurance in force

Q: ***What about corporate-owned or key person policies where the insured executive has left the company?***

Skar: The answer is the same: keep the contract. It's highly unlikely that the corporation has any other asset with a higher expected rate of return.

Q: ***Are life settlements a threat to the life insurance industry?***

Skar: There's a popular myth that life companies are opposed to life settlements because they would rather see the policies lapse. Nothing could be further from the truth. Any pricing actuary knows that lapses are anti-selective, so we already build in appropriate extra mortality assumptions for unhealthy lives retaining their policies. As a senior executive of a large life insurance company, my concern with life settlements has to do with making sure that our agents and customers aren't being misled with a one-sided sales pitch. What I'm saying is, don't sell the policy; keep it in force.

Q: ***Is there any situation where a life settlement may be an appropriate financial recommendation?***

Skar: Yes. If the owner is totally focused on current needs and has no interest in building an estate, a case can be made for considering a life settlement. I just don't believe that a large percentage of seniors with large policies are in that situation. It certainly doesn't justify the settlement companies calling their product an "estate planning tool." If you're building an estate, keep the policy.

Q: ***But you agreed that a life settlement is better than a lapse or surrender. Since there are thousands of lapses and surrenders every year, doesn't that mean that there's a sizable market for life settlements?***

Skar: No. The question is, what portion of lapses are from people over age 65, with large policies, who have experienced a serious decline in health? Now, within that much smaller group, it's only those with no interest in leaving an estate for whom a life settlement makes good financial sense.

Q: ***Some suggest that agents have a fiduciary responsibility to make their clients aware of the opportunity to sell their policies. Isn't there a risk for agents who fail to inform?***

Skar: I think financial advisers have an obligation to provide the best financial advice, not just "better than" advice. As we've discussed, in most of the situations that means recommending retention, not sale of the policy. The fact pattern is worse where the agent gets a commission or fee for facilitating the sale, especially if the proceeds are then used to purchase another insurance product with a lower expected rate of return and another commission to the agent.

Q: ***Do you think life settlements should be banned?***

Skar: No. Owners shouldn't be restricted from transferring their property for value, if that's what they want to do. My concern is making sure that consumers get good, unbiased financial advice.

Q: ***Any final thoughts?***

Skar: If consumers receive appropriate financial advice, fully consider all their options, and act rationally, the number of life settlement transactions will be small. As agent and consumer education on this subject improves, I expect the number of companies in the life settlement industry will decline dramatically. ●