

# Life Settlements as a Viable Option

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**Abstract:** *The rapid development of the life settlement market since its inception in the mid-1990s has resulted in a vibrant secondary market for life settlement policies. This article describes the purchase process for life settlements and identifies target markets. Situations where life settlements are inappropriate are also identified. The article sets forth the key due diligence issues involving financial advisers regarding life settlements, and it calls attention to the significant expansion of the funding sources emerging in this market.*

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Until recent years, the disposition of life insurance policies was restricted by a monopsony<sup>1</sup> situation in which there was only one buyer for any policy—the insurance company that originally sold it. That situation changed radically with the emergence of viatical settlements in the late 1980s as a way to advance funds to terminally ill individuals with life insurance policies. Life settlements evolved from this nascent area. In the early to mid 1990s the life settlement market began to emerge in earnest and is now a multibillion dollar market.

Viatical settlements and life settlements are structurally identical. Both involve selling a life insurance policy to an unrelated investor for more than the policy's cash surrender value. The investor assumes the obligation of making further premium payments and expects to realize an attractive rate of return on the investment when the insured finally passes. However, whereas viatical settlements involve terminally ill individuals with life expectancies of two years or less, life settlements typically cater to people over age 65 with considerably larger life insurance policies and with life expectancies of 3 to 12 years.

The purpose of this article is to set forth the issues that should be addressed by seniors in considering pursuing a life settlement.

## How Does a Life Settlement Work? What Is the Purchase Process?

The process typically works in the following way.<sup>2</sup> Initially, a senior policy owner learns how a life settle-

ment might be an appropriate financial option through an insurance agent or financial planner. An application is submitted through that person to a life settlement company. Once the application is received, the case is reviewed by an underwriting team. If the policy meets certain criteria, it will be approved for purchase.

The life settlement company next submits an offer to the policy owner. If accepted, closing documents are sent. Once such documents are received by the life settlement company, the funds are placed in escrow at a financial institution as required by applicable laws. After the appropriate change of ownership/beneficiary forms are received by the financial institution, the funds are released to the policy owner. The entire transaction takes about six to eight weeks. Finally, once the transaction is consummated, the purchaser (i.e., the life settlement provider or an affiliated entity) becomes the new policy owner, premium payer, and beneficiary of the death benefit.

### **Target Market— Who Should Consider a Life Settlement?**

A typical prospect for life settlement consideration would be an insured who is over age 65 and who has experienced a decline in health since the policy was first issued.<sup>3</sup> The insured's policy would be for at least \$100,000 coverage and the policy would be beyond its contestable period. The policy would typically be a universal life or "second-to-die" version (some term policies are good candidates also) with relatively low cash surrender values. Also, the original purpose for the insurance may no longer exist and the current policy owner may no longer have a need for the policy death benefit.

### **Current Examples of When a Life Insurance Policy Has Exceeded Its Usefulness**

A situation frequently encountered is that a policy is performing poorly and premiums are becoming cost prohibitive to keep the policy in force and from lapsing without value. Another example involves term insurance policies where the level term period is about to expire and renewal premiums will be significantly higher. There also may have been changes in the insured's estate, now requiring less insurance. Addi-

tionally, the insured may have outlived the intended beneficiaries or the needs of the beneficiaries may have changed.

Further examples may involve business insurance.<sup>4</sup> These include buy-and-sell agreements funded with life insurance where the owner has retired or the business has been sold. A further situation involves deferred compensation plans or key person plans where the executive has left the company that purchased the insurance.

Life settlements are an option that seniors need to know about as they age and their needs change. For seniors with children in their 30s, continuing to maintain a poorly performing life insurance policy might make less sense than using its liquidity to help fund a long-term care policy. In this way, the current life insurance policy can become a real current asset. Life settlements permit policy owners to buy more appropriate coverages such as long-term care policies, income annuities, or second-to-die policies.

### **When Should Life Insurance Policies Be Kept in Force and Not Used for Life Settlements?**

The vast majority of seniors still need their life insurance for its original or new financial purpose and these policies may still be cost effective and quite affordable. There are also some policy owners who simply do not want a third-party investor holding a life insurance policy on their life. It can also be argued that, assuming a deterioration in the insured's health, the policy becomes an increasingly valuable estate asset<sup>5</sup> which might be better retained, as long as premiums remain affordable and other better options do not exist.

For very healthy seniors with poorly performing policies or those with policies involving increasingly unaffordable premiums, a life settlement may not be available. In such situations, an IRC Sec. 1035 policy exchange to a more suitable life insurance policy may be the better answer if the current policy is no longer appropriate.

### **Impact of Life Settlements on Life Insurance Company Profitability**

Clearly, when an insured's health has declined, in an ideal world, a policy should be maintained in force by the

policy owner. However, the reality is that most such policies are not kept in force. Indeed, actuarial consulting firm Milliman U.S.A.<sup>6</sup> has estimated that almost 90% of all universal life policies do not mature into a death claim. Given this fact, a life settlement is a valid option if the policy owner might otherwise lapse or surrender the policy. Some reports indicate that the average purchase price received by the policy owner in a life settlement has been about 4.5 times the corresponding average cash surrender value!

Life settlements may actually serve to enhance insurer profitability since the settled policies will be kept in force until the insured dies and are not otherwise lapsed or surrendered. Moreover, as more policy owners become aware of the opportunities presented by the secondary market for life insurance policies, and as it becomes possible for more policy owners to obtain the fair market value of their policies, consumers will perceive an increase in the quality of life insurance which will have a positive effect on the demand for life insurance. The secondary market effectively removes monopolistic restriction on policy resale. Thus, the benefits to consumers in the secondary market extend also to insurance agents and life insurance companies in the primary market for life insurance as new sales may take place.

### An Analysis of Life Settlement Policies

In separate studies<sup>7</sup> we have developed the profile and analyzed the expected experience with respect to a large number of policies approved for life settlements. Of these policies, 48% were on male insureds, 22% on female insureds, and 30% involved second-to-die policies on the lives of male/female insured combinations. The average size policy studied was \$1.75 million.

For the single life policies, the average age of the male insureds was 78.3 years and of the female insureds it was 80.6 years. For the second-to-die policies, the average ages of the male/female combinations were 80.4/79.9 years respectively.

The average life expectancy for the male insureds, as determined by the life settlement company underwriters, was 6.15 years. The corresponding life expectancy for the

female insureds was 5.79 years. For the second-to-die policies, the average life expectancy of the male/female combinations was determined to be 7.32 years.

### Regulation of Life Settlements

In 1992, the National Association of Insurance Commissioners (NAIC) began developing a Model Act for the regulation of viatical settlements. This effort resulted in the current Viatical Settlement Acts that now apply to life settlements. More than 50% of the states have enacted statutes based on this or a prior version of the Model Act. As noted earlier in this article, although there are significant differences between viatical settlements and life settlements, state and federal regulatory bodies usually lump them together.

At the NAIC's 2004 Spring Meeting, regulators voted not to require separate viatical broker's licenses for certain licensed insurance producers in a draft of the Viatical Settlement Model Regulation currently being worked on.

### Financial Advisers and Due Diligence Regarding Life Settlements

Life insurance agents and financial planners have a fiduciary duty to represent the policy owner's interest in a life settlement transaction. These advisers should approach this responsibility using the following process:<sup>8</sup>

1. They should assess the client's financial situation to determine whether a life settlement is a viable option.
2. They should perform an analysis on the policy in question to determine its current and likely future performance.
3. They should perform due diligence by examining the marketplace to find reputable life settlement providers/brokers backed by solid institutional funding.
4. They should obtain the highest market value for the policy owner by insisting on multiple offers from the life settlement providers.

### Funding Sources for Life Settlements

Life settlements are and have been funded primarily by institutions including insurers, banks, hedge funds and mutual funds.

Institutional investors often prefer life settlement

companies with diversified revenues and a customer base, good reputation and experience—or more simply put, a solid infrastructure. They will require audited financial statements that show stable earnings, and they will want to monitor progress. Originators will need to have information management systems that can generate timely, accurate financial statements and all relevant operational data. Finally, institutional investors look for evidence of managerial depth, including a succession plan that ensures smooth operational continuity and adequate safekeeping of their collateral (i.e. the life insurance policies).

Because they are allocating large amounts of investment money to this asset class (\$50 million to \$1 billion), institutions carefully pick life settlement providers to originate policies for them. Having to contend on a daily basis with issues ranging from reputation to achieving yield goals and performance, institutions place a high level of scrutiny and due diligence on providers. First of all, they will look at the management team and through a series of meetings will determine management's capacity to perform their function. Second, management's caliber will be compared to the provider's audited financials. Third, they will look at a provider's reputation both within the field of life settlements and outside, if any. Fourth, investors will look at the ability of a provider to originate policies in line with the institution's capital deployment goals.

Although billions of dollars have been poured into life settlements by institutions, the market is in its infancy. Several institutions have been watching their peers enter the market and they are in the process of evaluating the "right" time for their entry. This will, inevitably, create greater efficiency and competition. Consequently, the life settlement industry will be able to more efficiently provide service to eligible policyholders.

Institutions from around the globe have already participated in the life settlement industry in one way or another. Some of them include: 1) HVB FondsFinance (a unit of HypoVereinsbank), 2) Gen Re (a former unit of Berkshire Hathaway), 3) Merrill Lynch, 4) Lloyds of London, 5) C.N.A., 6) Zurich, 7) Abbey National, 8)

DG Bank, 9) BVT, 10) Maple Financial, 11) AIG, 12) UBS, 13) Deutsche Bank, 14) Citibank, 15) GE Capital, 16) The Bank of New York, 17) Dresdner Bank and 18) U.S. Bank & Trust.

## Concluding Comments

It is estimated that there are about \$500 billion of life insurance in force today held by people over age 65. Even if one assumes that only 5% of this coverage involves insureds who might qualify for a life settlement in any given year, the market is still quite significant and it will grow fast. Starting in the next decade, the first significant wave of baby boomers will be over age 65. This coupled with lower estate tax rates should converge to greatly expand the universe of potential policy sellers. Furthermore, as the capital markets become educated about life settlements and the market's enormous growth, the life settlement industry will attract more capital and thereby be able to provide expanded opportunities for policy owners. The life settlement industry is building credibility with investors, regulators and the general public every day as life settlements become a mainstream financial/estate planning technique.

The arrival of transparent institutional funding from banks and investment companies has strengthened quality standards, customer protection, and transactional discipline. A life settlement is merely one of many options available to insureds who find themselves in situations where the financial burden of maintaining premium payments has become onerous. But, when used properly, life settlements offer a valuable alternative to lapsing or surrendering a policy and help open the doors to more beneficial investment opportunities. However, life settlements are not appropriate for many seniors and, therefore, determining the proper life settlement candidates is crucial. In any event, with life settlements there is now a full range of options available for seniors over age 65 holding large life insurance policies that may have outlived their usefulness.

Secondary markets for financial products provide liquidity and thereby enhance the value of these products. This value enhancement usually feeds back in the

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primary market to an expansion of demand. The emergence of the secondary market for life insurance policies has been pro-competition and pro-consumer. ■

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