# Life Settlements

## What Financial Advisors and Fiduciaries Need to Know

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# Disclaimer

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# Financial Advisor’s issue:

When is the sale
of a life insurance policy
the most appropriate
recommendation?

# What do we know?

- Investor is generally sophisticated and expects high rate of return
- Investor incurs high transaction costs: commissions, underwriting, tax on death benefit, marketing, reinsurance & profit
- None of these costs apply if policy is retained

# What does this imply?

- Expected return on policy is much higher than investor’s return
- This particular life policy is one of highest return assets in the estate
- Owner should not sell this asset, as long as any estate needs exist

# Simplified Example:

- $1.5 million UL policy
- Issue age 55; life expectancy: 80
- Now 65, life expectancy:  72
- Annual premium = $30,000
- Cash value = 0
- Life settlement offer:  $280,000

# Cash Flow to Investor

| | | |
|---|---|---|
| Time 0 | -$490,000 * | |
| 1 | -$30,000 | |
| 2 | -$30,000 | |
| 3 | -$30,000 | IRR: 10% |
| 4 | -$30,000 | |
| 5 | -$30,000 | |
| 6 | -$30,000 | |
| 7 | 1,209,500 ** | |

* $180,000 expense +$280,000 settlement + $30,000 premium

** $1.5 million death benefit less $290,500 in tax (35% rate)

# Cash Flow to Estate/Beneficiary

| | |
|---|---|
| Time 0 | -$310,000 |
| 1 | -$30,000 |
| 2 | -$30,000 |
| 3 | -$30,000 |
| 4 | -$30,000 |
| 5 | -$30,000 |
| 6 | -$30,000 |
| 7 | $1,500,000 |

IRR: 20%

# What happens if the insured lives longer than expected?

- All rates of return will be lower
- Estate's return is still much higher than Investor's return
- There is a crossover duration where it would have been better to sell

# How long must insured live until life settlement is a better deal?

- Compare settlement offer to discounted cash flow of premiums and death benefit
  * Peter C. Katt article in Journal of Financial Planning, July, 2002.
- At 7% discount, insured would have to live twice life expectancy
- Less than 10% chance of this happening

# Present Value Comparison

## 7% discount rate (000)

| End of Year | PV DB | PV Prem | Net | vs.$280 | IRR |
|---|---|---|---|---|---|
| 3 | 1,224 | 109 | 1,116 | 836 | 64% |
| 5 | 1,069 | 153 | 916 | 636 | 32% |
| 7 | 934 | 192 | 742 | 462 | 20% |
| 12 | 666 | 268 | 398 | 118 | 9% |
| 14 | 582 | 292 | 289 | 9 | 7% |
| 17 | 475 | 323 | 152 | -128 | 5% |
| 18 | 444 | 332 | 112 | -168 | 5% |
| 20 | 388 | 348 | 40 | -240 | 4% |

# Accumulate proceeds plus foregone premiums to equal Death Benefit

| End of year | 4.70% | 7.35% | 12.36% |
|---|---|---|---|
| 2 | 371,235 | 389,450 | 425,076 |
| 4 | 471,247 | 515,580 | 608,231 |
| 7 | 639,593 | 741,716 | 976,925 |
| 10 | 832,809 | 1,021,470 | 1,500,000 |
| 14 | 1,135,543 | 1,500,000 | ------------ |
| 18 | 1,500,000 | ------------ | ------------ |

# The Life Settlements Market – *An Actuarial Perspective on Consumer Economic Value*

Deloitte Consulting LLP
Deloitte-UConn Actuarial Center -- 2004

# Methodology

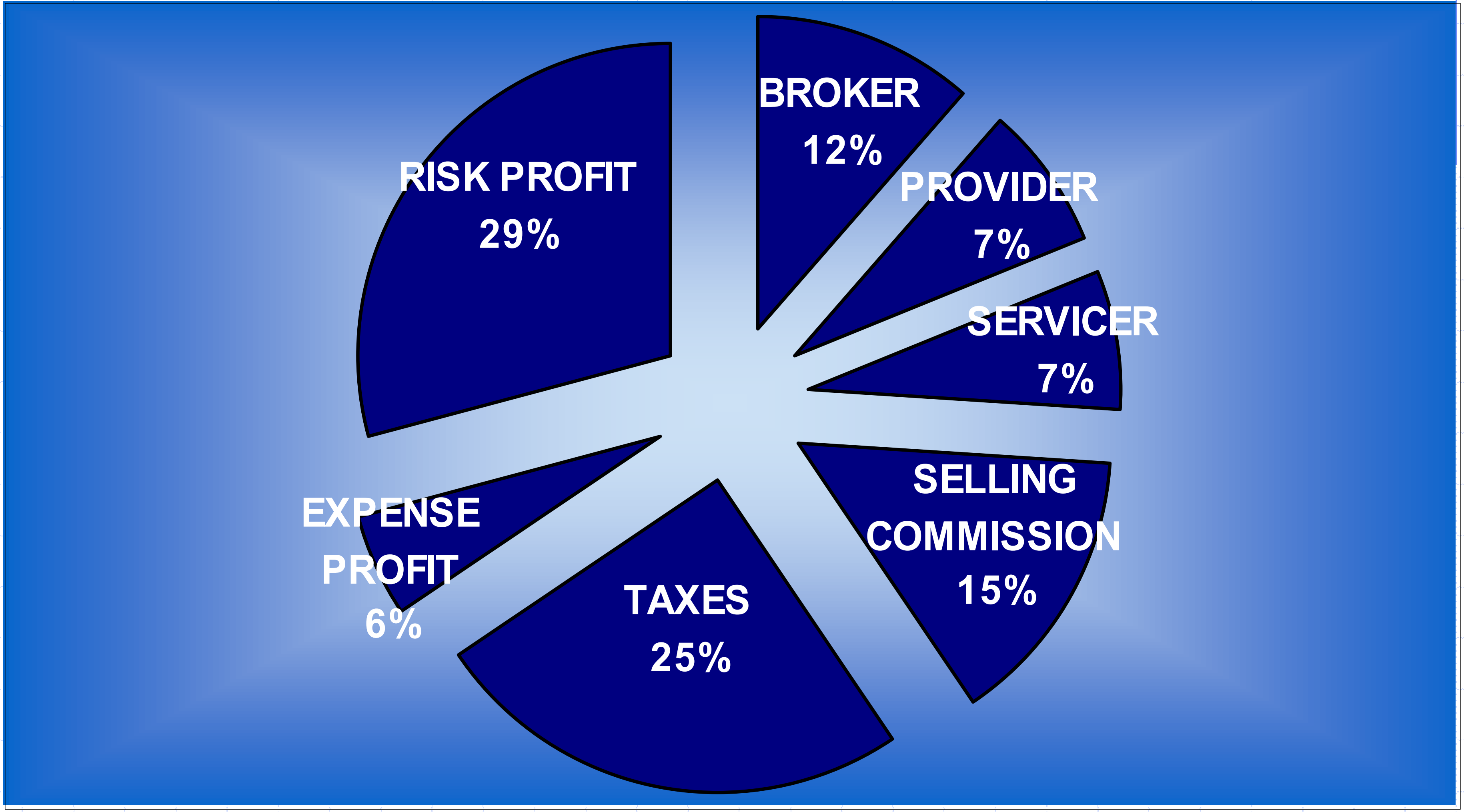
- Assumptions applied to Schedules 7 & 8 of New York filings of Life Settlement companies
- Lost economic value =
  - Loss in expected value from selling versus retaining
  - Difference between the Intrinsic Economic Value and the Life Settlement Value

# Results of Empirical Analysis – Schedule 8

| Intrinsic vs Life Settlement Values<br>(New Sales - $ Millions)* | | | | | | |
|---|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2003 | Total | % of Face |
| Face Amount | $22 | $41 | $46 | $117 | $226 | |
| Life Settlement Value | $7 | $9 | $8 | $20 | $45 | 20% |
| Intrinsic Economic Value | $15 | $29 | $26 | $71 | $141 | 62% |
| Lost Economic Value | $8 | $20 | $18 | $51 | $96 | 42% |

*** Source : New York filings, Schedule 8 – New Life Settlement Sales**

# Breakdown of Lost Economic Value – Schedule 8



# Comparison of Asset Transaction Costs

| Asset Type | Transaction Costs* |
|---|---|
| Stocks | 0% - 1% |
| Bonds | 1% - 2% |
| Mutual Funds | 0% - 5% |
| Gold | 3% - 5% |
| Residential Real Estate | 4% - 6% |
| Factoring Receivables | 4% - 10% |
| Reverse Mortgages | 10% - 14% |
| Fine Art | 10% - 15% |
| "Payday" Loans | 18% - 34% |
| *Life Settlements* | *50% - 75%* |

* as a percentage of intrinsic asset value

# Conclusions:

- Highest yielding asset in the estate
- Very high “surrender charges”
- Don’t sell the policy

- <u>Exception:</u>  no estate plan

# Exception:

What if settlement offer is mispriced?

- How does agent / seller make that assessment?
- More likely with individual investors, but this is a bad group to deal with

# Financial Advisors should help Client

- understand the high rate of return on future premiums when health has declined
- find an alternative to either sale or lapse of the policy
- act on sound principles, not emotion

# Non-financial concerns

- Ownership may change many times
- Ongoing “tracking” of insured’s health
- Original beneficiary’s disappointment

# Life Company's concerns

- No impact on expected results
- Appropriate training for agents
- Sound advice to customers

# Life Settlement Marketing

- Review typical “sales pitch”
- What is potential for misleading agents, planners and consumers?

# Typical questions:

- Business owned policy outdated?
- Is policy “underperforming”?
- Is original beneficiary deceased?
- Are premiums affordable?
- Does Client need extra income?

# The Most Important Question:

Is the client interested in leaving an estate, whether to family members, religious or charitable institutions?

# Use of Settlement Proceeds

- Gifts to family members
- Buy a new life policy
- Make an investment for heirs
- Charitable donation, or CRT
- Buy another insurance product (where estate need still exists)

# Life Settlement Companies

- Providing a better alternative for a policy which is about to lapse ?

  OR

- Proactively searching for seniors in poor health who can be persuaded to sell their policies, then use the proceeds for another product sale?

# Advisor’s Potential Liability:

- Fails to tell client about life settlement
- Recommends sale of the policy rather than keeping it
- Recommends selling existing policy in order to buy a new one

# Conclusions

- Life Settlement rarely the best financial recommendation  (no estate need)
- Agents, advisors and consumers are getting bad advice from marketers
- Better alternatives will evolve, e.g., “line of credit” or “policy equity” loans