Robin & Peter on LIFE SETTLEMENTS

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Life Settlement Appraisals: How Valuable Are They?

"Complimentary appraisal," "*free valuation*," and "*no-cost estimate"* are offers used in advertisements and websites by many life settlement providers and brokers to encourage life settlement inquiries. A life settlement appraisal of a life insurance policy can provide valuable information for financial planning purposes and, also, for tax reasons. However, complete reliance on these estimates for either of these functions can be misguided.

In most instances, for tax purposes, these informal estimates provided by brokers and providers will not satisfy the IRS standards of what qualifies as a valid appraisal.

For financial planning purposes, a life settlement appraisal can be equally insufficient as it only provides a guide as to what a policy might be worth on the life settlement market. And in the case of a provider's valuation, it may well be just an estimate of what the individual provider is willing to offer rather than a look at the market as a whole.

The appraisals only estimate what a policy's life settlement value might be, but life settlement value and cash surrender value are not the only way to measure a policy's worth. These estimates completely disregard the potential value of the life insurance policy death proceeds to the beneficiaries, which can be much greater. A complete appraisal of a policy's value should not be limited to only what a policy might sell for on the life settlement market.

These appraisals are being used by life settlement providers and brokers as a marketing tool to create interest in doing a life settlement. But as financial advisors, we need to do what's best for the client and that means doing an analysis that is more comprehensive than just a life settlement appraisal. While "a bird in the hand is worth two in the bush" might be enticing to a client, it can be a short-sighted mistake.

There are many valid reasons for doing a life settlement: 1) when a policy is no longer needed, 2) when a policy is no longer affordable or 3) when an immediate financial need must be dealt with like medical related expenses. However, making a quick buck should not be one of them! With that said, when a policy is likely going to be terminated, a life settlement appraisal can provide meaningful insight about an alternative to surrendering a policy.

The life settlement value of a policy is primarily based on three factors: the insured's life expectancy, the cost to carry the policy and the rate of return (discount rate) that the purchaser desires. In today's market, the compounded rate of return that buyers seek, at least for pricing purposes, generally exceeds 15%. The sales proceeds are also reduced by transaction costs and, quite possibly, income taxes. This means that if the policy is not sold, but maintained by the policy owner, the return on investment to the policy-owner/beneficiaries would also likely exceed 15%, and, in most cases, would be free of taxes and transaction costs. This does not make a life settlement a bad deal when compared to surrendering a policy, but it is likely not a good deal when compared to keeping a policy.

Even disregarding the investment value to the policy-owner/beneficiary for maintaining the policy, a life settlement appraisal does not take into account or evaluate the potential human benefits of the death proceeds for the beneficiaries like income for a surviving spouse, a fund for a grandchild's education, paying off a mortgage or other debt, paying estate or inheritance taxes, funding orderly business succession, etc.

Life settlement appraisals can be perfectly valid for what they do: estimate the value of a policy on the life settlement market, but they don't tell the whole story. They don't reflect the overall value of a policy because they don't take into account the value of the potential death benefit to the heirs. To help your clients make good decisions, it is important to point out the limitations of these appraisals so as to not underestimate the true value of a life insurance policy. Inevitably, such analysis leads to the conclusion that a life settlement is an alternative to surrendering a policy, not an alternative to keeping it.

Needs, wants and obligations change over time. As your senior clients determine that a lapse or surrender of their life insurance is appropriate, before they do, it's incumbent upon you to evaluate the potential of a life settlement as one more opportunity to do something good for them. When that happens, be sure to give us a call so that we can help you through the process.

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