Robin & Peter on LIFE SETTLEMENTS

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5 Dangerous Misconceptions about Life Settlements

It has been years since the wild, wild, west days of life settlements in the mid-2000s. Life settlements are now regulated by 42 of the 50 states covering over 90% of the USA's population. The erroneously short life expectancy reports that were used in the pricing of life settlement offers have been corrected. Nonetheless, certain misconceptions linger from those bygone days.

Surveys have indicated that many producers do not discuss life settlements with their clients because they lack knowledge about them. This, sadly, deprives some consumers of the possibility of a life settlement for a policy that they are about to lapse or surrender. Even more problematic than uninformed producers, however, are misinformed producers and critics who likely have never participated in a life settlement transaction, yet, disseminate negative misinformation anyway. Of the various mistaken beliefs about life settlements, these five are particularly unfortunate and widespread:

(1) A life settlement is an alternative to keeping a policy.

A life settlement is an alternative to lapse or surrender - not to keeping a policy. Having been bitten once by erroneous life expectancies, life settlement investors are now twice shy, requiring more rigorous underwriting and higher returns to compensate them for what they perceive is an unproven asset class. With target internal rates of return in the range of 15% per annum, one thing is clear: if investors can make those kinds of returns on a life insurance policy, just think how much the insured's beneficiaries stand to gain if policy is kept and not sold. As a result every effort should be made to find a place close to home for a life insurance policy rather than selling it on the life settlement market. There are a wide range of alternatives to a life settlement including gifting it to a loved one or borrowing to pay premiums. Only once it is determined that continuing the policy in force is not feasible, and the policy is about to be lapsed or surrendered, should a life settlement be considered.

Why is this misconception dangerous? Policy owners could be parting with property that could have tremendous value to their beneficiaries. The glitter of a quick buck in a life settlement needs to be weighed against the long term value of the policy. A life settlement should only be considered as a last resort to lapse or surrender in order to maximize the policy's salvage value.

(2) On average a policy is worth 20% of face amount on the life settlement market.

This is a misreading of the old statement: "the average value of a policy ***that is sold*** on the life settlement market is 20%." For every policy that receives an offer on the life settlement market, however, 10 or more have no value whatsoever as a life settlement. This makes the average value of a policy on the life settlement market a lot closer to zero than it is to 20%. Additionally, even the actual, correct statement about policies that are sold is probably no longer valid now due to the lengthening of life expectancies and rates of return demanded by life settlement investors today. Finally, averages mean little because policies are individually underwritten by the life settlement market based on the insured's unique health condition and the pricing of the particular policy.

Why is this misconception dangerous? It creates unrealistic expectations by would-be sellers. Thinking that 20% is a number they should be getting, policy owners could reject a fair offer and hold on to the policy thinking a better offer is out there somewhere. As a result, people who might benefit from a life settlement could mistakenly continue to hold onto policies and pay additional premiums only to discover no better offer is available in the future and, by then, they will have paid even more into the policy. Perhaps even more dangerous is the misguided speculation this misconception can cause. People have been and can be misled into buying a policy solely based on the idea that they can make a quick buck by selling it for 20% down the road. That's a dangerous and costly illusion.

(3) Use a life settlement to get your investment in the policy back.

Life settlement pricing is based almost entirely on the age, health and life expectancy of the insured and the cost to carry the policy going forward. The policy owner's investment in the policy is completely irrelevant to the prospective purchaser other than to ensure that the policy has not lapsed and the minimum premium requirements have been satisfied. The amount that has been paid into the life policy is a sunk cost. It's gone and has no direct bearing on the life settlement value of a policy.

Why is this misconception dangerous? Like #2, it puts a false number out there as an expected value for a life settlement. As a result, a seller may turn down a fair offer that doesn't recoup the investment or, perhaps, accept an offer that is too low because recouping premiums was the only goal although the policy's actual value may be much more. While it is attractive to talk in terms of getting some or all of the premiums back, it has no validity for determining the life settlement value of a policy. When doing a life settlement, the goal should be to get the highest possible value for the seller, irrespective of their cumulative cost. Additionally, this misconception focuses the life settlement decision on the wrong thing. The heart of the matter should be whether there is a continuing need and an ability to pay for the policy, not on the possibility of getting one's money back.

(4) Life settlement commissions are excessive.

In the vast majority of the 42 states that regulate life settlements, commissions must be fully disclosed and are negotiable. This is in contrast to life insurance commissions which are, generally, neither disclosed nor negotiable. But more to the point, life settlement commissions can, no doubt, be substantial, however, it is an expensive business and it is done on a contingency basis. Each case requires a significant cash outlay for life expectancy appraisals and medical records of elderly insureds that frequently have voluminous medical histories. Yet, only about 1 in 10 or more policies get an offer. You do the math - commissions may be significant but hardly unfair, which is what the word 'excessive' implies.

Why is this misconception dangerous? The specter of excessive commissions can easily persuade someone who could benefit from a life settlement to ignore that possibility and simply accept whatever surrender value the insurance company provides. A policy owner is under no obligation to accept any bid for their contract. If the offer, net of commissions, is inadequate, they can simply walk away.

(5) You can sell a policy and then replace it.

This kind of thing actually could have happened years ago through a rare combination of an overly short life expectancy analysis and overaggressive insurance company underwriting and pricing. But the fact is, today, it is pretty much impossible. Life expectancy underwriting has gotten much longer and is now more in line with insurance company mortality. Insurance companies do much more careful underwriting and pricing of policies on older age insureds. This, combined with the rates of return investors are now seeking, means life settlement prospects generally start with someone who is uninsurable or so highly rated that a new policy could not possibly benefit the policy owner. It might be possible to replace a single life policy with a survivorship policy where the other insured is healthy. This approach, however, requires careful analysis. Not only does the new policy offer significantly different death benefits than the original one (second death, not first), the pricing would need to be quite favorable to make it work.

Why is this misconception dangerous? An existing life insurance policy is uniquely valuable property. Unsuspecting policy owners could be convinced to sell their existing coverage only to discover, too late, that no new coverage is available. This delusion can also produce more misguided speculation and possible misstatements of health to make the deal work.

A life settlement can be an important financial tool and a valuable alternative for someone who no longer wants, needs, or can afford their policy. However, mistaken beliefs can cause costly errors in evaluating the life settlement transaction, missed opportunities and, as a consequence, harm to the consumer. It's time that these past misconceptions are put to rest. Producers with actual knowledge of life settlements can do their clients a great service, whether it is counseling them to keep a policy or sell it on the life settlement market. The ability to offer knowledgeable advice could be worth its weight in gold to both the client and the producer.

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