

A Reality Check on the Industry and Its Maturing Product Life Cycle

by Sean McNealy and Marlene Frith

As the secondary market for life insurance surpasses a decade of steady expansion, the number of insurance and professional advisors engaging in life settlement transactions continues to multiply. In addition, we are seeing more wealth management firms, CPAs, and attorneys embracing the product due to its utility in the estate-planning process for high net-worth clients. On the consumer side, satisfied seniors who have sold policies are spreading the word. Senior consumers who are hearing about life settlements are beginning to drive the industry by asking their financial advisors about it.

Industry researchers cite several factors that are spurring the industry's rapid growth, including the following:

- Longer life expectancies, which may cause seniors to outlive the usefulness of their life insurance policies.
- The decline in interest rates over the past few years, which could result in lower cash values within existing policies.
- The reduction in estate tax burden and the proposed elimination of the estate tax altogether.

However, most industry experts agree that the life settlement industry is growing

so rapidly simply because it provides a valuable service to high net worth seniors. According to statistics released by the Life

have handled life settlement transactions that resulted in \$78 million beyond the cash-surrender value. This is a significant amount of money going into our economy in the form of new insurance and financial products, among other uses. Thirty-five percent to 45% of the life settlement cases we transact involve some form of replacement coverage. Other seniors are using the proceeds for a host of reasons, including real estate investments, charitable giving, and family lifestyle needs.

Higher Offers: A Rising Tide Raises All Ships

On the funding side, we have seen offers increase substantially over the past year. The offers are higher because more institutional investor capital is available than policies are available for purchase.

Experienced life settlement brokers who wield bargaining power with funders are also contributing to the increase in offers. A life settlement broker's primary objective is his or her obligation to the policyholder, which involves creating an auction-like environment in which multiple providers or funders present competitive offers for the same policy. Unlike brokers, providers

(funders) have one main objective – to pay as little as possible for a policy since their primary interests lie with their shareholders and investors and not the seller.



Settlement Institute in April 2005, life settlements have paid policy owners more than \$1 billion over the cash-surrender value for their policies. In the past nine months, we

Variance in Pricing Models: Comparative Shopping a Must

It is important for agents and advisors to understand how pricing models affect offers. Advisors should not accept one offer from just one funder and assume it represents the policy's highest market value. It is important for agents to work with an experienced life settlement broker who will shop the secondary market for the highest possible offer for the client.

Providers operating on the secondary life insurance market are not unlike other types of businesses when it comes to managing factors such as, their reputation, overhead expenses, product flow, revenue, profit margins, return-on-investment for investors; finding affordable sources of capital; positioning themselves in the marketplace, and developing business.

Insurance and financial advisors must be aware that providers vary in their pricing models for life settlements, in large part, due to their business models and operational infrastructures.

The following business factors affect the life settlement offer:

- Recurring revenue stream (For example, continuous product flow from large brokers who serve as feeders for policies).
- Cost of capital (debt and equity).
- Amount of premium reserves.
- Regulatory issues, such as minimum capital investment requirements for institutional investors in accordance with SEC Rule 144a, 17 CFR 230.144A(a).
- Tax consequences and tax treaties between the U.S. and foreign countries that are sources for institutional capital/investment.
- The value of the U.S. dollar in countries where foreign investment originates.
- The pledging of securities or other assets as collateral for a loan in relation to life settlement portfolios.
- Policy analysis factors that affect the life settlement offer include the following:
 - 1 The type of policy and the amount of the death benefit.
 - 2 Rating of insurance carrier when the policy was issued (Most prefer A rated carriers or higher).
 - 3 Premiums paid on the policy thus far and remaining premiums to maturity.
 - 4 Loans on the policy.
 - 5 Cash value in the policy.
 - 6 Health impairment of insured (life

expectancy).

7 Accuracy of actuarial data used to calculate life expectancy.

Because so many variables affect each provider's pricing model, offers given on policies often reflect the provider's purchasing capacity and revenue objectives.

Running on Four Cylinders: There is Room for Acceleration

Even though more professional advisors are recommending life settlements, the product is often under-used. We often hear from registered reps of broker-dealers that have wealthy senior clients who are pressuring them to assist with a life settlement transaction. Since some broker-dealers do not permit their registered reps to engage in life settlement transactions, reps often refer the client to the financial planner or insurance agent down the street. In some instances, the lost opportunity for the registered rep turns into lost revenue for the broker-dealer firm and perhaps even the loss of a client to a new financial advisor.

Also, some insurance agents and financial planners are not proficient enough with the product to recognize readily when a life settlement may be the best option. Louis Pasteur, who has been called "the founder of modern medicine," once said, "Chance favors the prepared mind." Professional advisors should take the time to read case summaries and industry articles that may trigger ideas for problem solving using a life settlement.

We recently encountered a case in which an 82-year-old woman was working with her advisor to free up some cash for real estate investments. Her advisor noted that she owned several large life insurance policies totaling \$4.8 million for which she was growing weary of making the premium payments. Rather than accept a low cash surrender value of \$242,983 to be used for her real estate investments, the agent recommended a life settlement for each policy, which would net her four times the cash-surrender value. She had much more capital available for real estate investments because her advisor had done his homework.

It is important for insurance professionals to be mindful that a life settlement is not just a transaction involving an insured senior with an unwanted life insurance

policy. A variety of family dynamics should be considered during a problem-solving discussion that includes using the proceeds from a life settlement. Therefore, it is important to think outside the box when identifying opportunities for life settlement solutions that may require new insurance products or cash to achieve other family objectives.

One agent with whom we worked was clearly thinking outside the box when his client, a wealthy widow, no longer wanted to pay the annual premiums for a \$4 million second-to-die survivorship policy, which her husband had donated to a large community foundation six years earlier. Since the foundation was not in a position to maintain the policy, it was considering letting the policy lapse or accepting a cash-surrender payment of \$474,000. The agent explained to the foundation and his client how a life settlement could address both of their concerns. They agreed to the life settlement and we presented them with a payment of \$1.395 million – nearly three times the cash-surrender value.

However positive things may seem with the expansion of life settlements and a maturing product life cycle, it does not mean that the life settlement industry is running on eight cylinders. Although we have seen movement in the needle on many fronts, there is much work to be done. As problem solvers, financial planners and insurance professionals should take the time to explore creative ways in which a life settlement can be used to achieve other financial objectives. Once the client decides to pursue a life settlement, it is important to remember not to accept just one life settlement offer assuming it represents the policy's value on the secondary market. The chance to help your clients begins with doing your research and, in the words of Louis Pasteur, "having a prepared mind." □

Sean McNealy is co-president of Advanced Settlements Inc. and may be reached at sean@advancedsettlements.com. Advanced Settlements is one of the largest and oldest life settlement brokers in the country and provides representation on the Viatical and Life Settlement Association of America. Marlene Frith is Marketing Director for Advanced Settlements, and may be reached at marlene@advancedsettlements.com.