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Secondary Market For Life Insurance Heats Up

An active secondary market for life insurance policies is quietly blossoming for individuals in their sixties and seventies who have outdated or unwanted coverage and burdensome premiums. The ability to sell such a policy in the secondary market, through a transaction known as a life settlement, could provide financial advisors with an alternative to letting client policies lapse or accepting a low cash surrender value. In some cases, a life settlement can also mean a sizable commission.

But consumer advocates and advisors warn that instances of fraud and spotty regulation in this nascent industry make due diligence a must. “In certain cases, life settlements can be a useful financial planning tool,” says Brian Brooks, an attorney with O’Melveny & Myers LLP, Washington, D.C. “But this is a brand new industry that is not consistently regulated from state to state. I think it will take a number of years before people feel comfortable with them.”

The pitch for life settlements is relatively simple: For a variety of reasons, life insurance coverage that was once desirable becomes unnecessary. Seniors who do not wish to continue paying premiums can sell the policy to an investment company, either directly or through a broker. The company continues premium payments and, when the seller eventually dies, collects the death benefit. The amount the seller gets depends on life expectancy, the type of policy and other factors.

Life settlements follow the same basic principal as viatical settlements, which take place when the policy owner has a terminal illness and is expected to live two years or less. While some use the terms life settlements and viatical settlements interchangeably, the latter have acquired a somewhat notorious reputation.

Several viatical investment companies that bought life insurance policies from the terminally ill became the subject of scrutiny in the 1990s when state and federal authorities investigated them for fraudulent practices. In some instances, unlicensed brokers sold investments in policies that did not exist. The industry also suffered a decline in profitability when new drugs dramatically extended life expectancies for AIDs patients.

But proponents say life settlements are a more refined, less ghoulish beast. The transactions are marketed to individuals over age 65 who are expected to live between six and twelve years, and who have policies with face amounts of $250,000 or more. Although they may have experienced a decline in health from conditions such as a heart ailment or hypertension, most do not face the same desperate need for money that the terminally ill do. The sale of the policy may simply be motivated by a desire to use premium payments on coverage they no longer need for other purposes.

“Viatical transactions are generally viewed as lower-end or seedy, whereas life settlements are more of a financial planning transaction,” says Brooks. “States believe there is more potential for fraud with terminally ill individuals who have a desperate need for money, so companies involved in viaticals face greater litigation risk.”

The increasing participation by institutional investors, particularly over the last three years, adds both capacity and legitimacy to the life settlement industry. Two years ago, a subsidiary of Berkshire Hathaway provided a $400 million cash infusion to Living Benefits Financial Services, a Minnesota-based life settlements buyer. Industry sources say insurance giant American International Group is a major financial backer of Coventry First, the country's largest life settlements buyer.

Coventry First CEO Alan Buerger acknowledges institutional backing, but declines to name specific companies. He says his company is on track to acquire policies with a face value of around $2 billion this year. Other names reportedly linked to the life settlement investment business include Merrill Lynch and HBK Investments, a Dallas hedge fund.

Transactions are gradually expanding from insurance-based professionals to the broader financial planning community, with some broker-dealers quietly adding life settlements to their menus. Buerger says Coventry First "works with quite a few broker-dealers." Other broker-dealers do not have a formal relationship with his firm but sanction life settlement transactions, while a sizable number prohibit life settlements altogether. "I think there is a lack of understanding about these transactions that relates to the old viatical days," says Buerger. There is a lot of misinformation out there.

Others say concerns about relationships with insurance companies that benefit financially from policy lapses have kept some broker-dealers gun-shy about the transactions, and that insurance companies often prohibit their captive agents from engaging in life settlements as well.

Despite the cold shoulder from some corners, evidence suggests that life settlements are changing the secondary market for life insurance. Gloria Wolk, a consumer advocate and viatical expert in Laguna Hills, Calif., says the industry is moving away from viatical settlements to more lucrative life settlements, which typically pay a much lower percentage of face values because of longer life expectancies. "I used to see viatical settlements of 60% or 80% of the policy's face value," says Wolk. "Now, I haven't seen an offer of more than 30% made to someone who is terminally ill. The market is abandoning those with serious illnesses and focusing on the wealthy who don't need their policies anymore."

For financial advisors, that focus could translate into a source of business. Jason Hyatt, a vice president with life settlement broker 1st Life Financial in Orlando, says that 6% of the policy's death benefit is a standard commission. If a financial advisor refers someone to him, Hyatt splits the commission with the advisor.

"In a typical scenario, a financial advisor will contact my firm to discuss a client who is interested in a market appraisal of a policy," says Hyatt. "He'll tell me what the insurance company is offering for the policy, and will ask if I can do better. Many times, I can. "

Beyond financial motivation, say industry advocates, is a fiduciary duty to explore every possible alternative before letting a policy lapse or accepting a low surrender value. "Any financial advisor who does not fully analyze a life insurance policy as a transferable asset is not doing his job," says Doug Head, executive director of the Viatical & Life Settlement Association of America.

Coventry First's Buerger sees "potential liability by not providing a life settlement option to a client where it may be appropriate."

The question, of course, is which situations warrant a life settlement, and when other options may be more advisable. Brooks says an appropriate candidate might be someone in his sixties or seventies who has paid off a mortgage and college expenses, and is outside the window where a death benefit is necessary. "That person might be faced with coughing up $30,000 a year in premiums, or letting the policy lapse, " he says. "In some cases, a large life insurance policy can have substantial value." A policy might also be sold in cases where it was originally purchased to pay estate taxes, but is no longer necessary because of new estate tax laws. Key person insurance that a policyholder no longer needs due to the sale of the business may also have value on the secondary market.

Jonathan Proby, national sales director for the Life Settlement Alliance, a life settlement brokerage firm in Fort Lauderdale, Fla., says much of his firm's business comes from the sale of underperforming universal life insurance policies. During the 1980s and 1990s, many of these were sold as "vanishing premium" policies. "But when interest rates dropped, so did the crediting rate," he explains. "So people are paying premiums for a lot longer than they expected to. "The poor performance of variable rate universal life subaccounts, he adds, can also lead to unexpected premiums that prompt policy sales.

Wolk says financial advisors should explore other alternatives before considering a policy sale. These include donating a policy to charity, or keeping some of the insurance and selling only the coverage they no longer need. Those who are terminally ill should find out whether their policy offers an accelerated death benefit, which allows policyholders to collect a percentage of the death benefit before they die.

Bernard Krooks, a New York City attorney specializing in elder law, says that in some cases policyholders may no longer need to continue making premium payments if the policy has sufficient cash value. "The insured will keep getting bills for premiums, and seniors are usually pretty meticulous about paying their bills," he says. "The insurance agent may not tell them that they can stop paying, and their insurance will not be cancelled."

Wolk warns financial advisors to be on the lookout for aggressive sales tactics. "A lot of salespeople won't talk about other options, or will lie about the possible tax consequences of selling a policy," she says. "You need to get all the facts. "Krooks concurs. "This is not a bad industry," he says, "but it has its share of bad apples."