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Articles

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"Perhaps the largest driving force for increasing the inventory of settled policies is the investment community that believes this is another safe way of earning more than prevailing Treasury bond yields."

A Life Settlement Mosaic

by Peter Katt, CFP, LIC

My life settlement views are formed from my experiences with clients. Since I am solicited by clients and not the other way around, I take on what is brought to me. I think this produces a rather accurate mosaic of happenings in the life settlement universe. From these experiences I have done some research into certain issues, but mostly I extrapolate from these client experiences to what I believe are larger lessons. This column updates life settlement issues from this perspective.

The market for the buying and selling of life insurance policies for investment purposes had a rational basis in the beginning. The original life settlement business plan was to buy unwanted or unneeded policies from insureds over age 65 whose health had deteriorated more than from just the passage of time. This provided mortality arbitrage needed to make the purchase price higher than most policies' surrender value.

The major player has been Coventry First that has a strong financial relationship with AIG. It is my understanding that Coventry buys policies for institutional investors and that there is no chance an individual investor can learn who the insureds are. Coventry has stated that it has a traveling covenant that protects insureds from becoming known to individual investors. If this is true, it protects insureds of policies that have been bought by Coventry.

It has been my experience that Coventry's purchase offers are often lower than those of many settlement bidders. Clients need to decide whether they want to maximize their take or be more prudent by going with a sale to Coventry that claims to have this privacy covenant.

Although life settlement companies deny that they give investors information about who the insured is, I have had three experiences to the contrary. This is what Coventry's alleged covenant is supposed to avoid.

It is likely that some 95 percent of potential policy sellers should retain them. That there are many policy sales is a tribute to the tenacity and selling skills of those soliciting the purchases. There are only two situations where selling a policy is the best choice. One is when cash is desired. The other situation is a policy with heavy

surrender charges, poor pricing, and the insured is still in good enough health to replace the offending policy. The settlement value will be substantially higher than the surrender value even if there hasn't been a deterioration in health. Prior to the sale, another policy with better pricing would be acquired to replace this coverage as long as the client's net worth would justify both policies.

Most Insureds Should Retain Policies

Almost all other possible life settlement situations should result in the policyowner retaining the policy—at least until the policy is near termination. Let's say a policy owner named Don wanted to stop paying premiums on his \$1 million universal life policy with \$100,000 cash values. Now 72 years old, with health problems he didn't have when the policy was bought at age 60, Don can sell the policy for around \$275,000. But he doesn't need the cash—he just wants to stop paying premiums—so the best move is to keep the policy for another five years using the \$100,000 cash values to pay the cost of insurance. After five years, the policy will probably be worth around \$475,000 in the life settlement market because Don's life expectancy is getting shorter, and there is about a 35 percent probability Don will die in the next five years. Keeping the policy for five years allows his beneficiaries to receive \$1 million tax-free if he dies. Don will very likely improve his situation if he waits and sells in five years.

The life settlement industry and their solicitors have created the image that many policy owners often come to the rational conclusion they want to sell their life insurance policies and then contact an agent. This image was picked up in a Business Week July 30, 2007, cover story when author Matthew Goldstein stated, "Some 90 million Americans own life insurance, but many of them find the premiums too expensive; others would simply prefer to cash in early." This is a false picture. Almost always it is the agent soliciting policyowners to sell their policies because of the very high commissions they are paid. In the situation described above, the agent recommending the sale for \$275,000 would be paid around \$55,000, meaning the life settlement firm would have paid out \$330,000 for the policy, but Don would not have known about the \$55,000 going to the agent. My firm handles life settlement negotiations for our normal hourly fees. A case like Don's would usually incur fees of around \$5,000, saving him \$50,000.

Big Appetite

The appetite for doing life settlement transactions has become so great that the industry has convinced itself that life insurance is so mispriced that the policies of insureds in the same health are attractive targets as well. "Life settlements are one of several life insurance innovations through which companies that develop innovative actuarial analyses have been able to glean profits through their superior ability to assess mortality and other risks" (Neil A. Doherty and Hal J. Singer, Wharton Institutions Center, "The Benefits of a Secondary Market For Life Insurance Policies"). This is complete nonsense because these investments haven't matured and profits are almost certainly an illusion. But many buyers are only acting as middlemen who sell them to institutional and individual investors who will bear the brunt of exaggerated investment yield claims.

Not content to only buy policies already available, some operators solicit wealthy seniors to rent their high net worths and lives to become insured for the sole purpose of then selling the life insurance policies in two years. (Jokingly, a client told me that in Scottsdale, Arizona, a senior can have free four-star dinners nearly every evening by attending such solicitations.) These transactions often involve a third party paying the premiums and providing the wealthy senior a bonus for renting his life (see my May 2006 Journal column). The problem is that insureds don't really know who will end up owning these policies or how desperate this investor might get to see their investment mature.

The most egregious situation I have seen is an agent who caused \$30 million of life

insurance to be placed without the client/insured's knowledge by paying the premiums himself and owning the policies (see my November 2005 newsletter http://www.peterkatt.com/newsletters/ATI_v7n6.html). This came to light when the agent tried to get the insured to agree to turn over medical records so he could begin selling the policies. Litigation resulting from policy-initiated life settlement business is fast becoming a cottage industry.

Investment Blow-Up

Perhaps the largest driving force for increasing the inventory of settled policies is the investment community that believes this is another safe way of earning more than prevailing Treasury bond yields. Because they don't really know the most critical piece of the expected yield equation—the actual life expectancy of insureds—they are very likely to have another new new investment vehicle blow-up, and their investors harmed.

I believe direct seller-to-buyer sales of life settlement policies similar to viatical sales is underway in a major way. As proof of this, it has come to my attention that independent financial salespersons are touting on a radio program they host the investment benefits from buying interests in life insurance policies. Claims that settled policies have historically returned 16 percent have been heard. This, of course, is an impossible assertion since life settlements haven't been around nearly long enough. My advice is to pass on such investments.

Ethical life insurance companies are doing battle with this expanding life settlement market, especially the horrid practice of investor-initiated life insurance. Regulators are actively pursuing model legislation, but I believe the penalties will be too weak for the insurance companies to prevail in this battle, and lobbying on behalf of life settlement interests will neuter any useful legislation.

What started as a worthwhile secondary market for the very few situations where it makes sense to sell a life insurance policy has gotten completely out of control because of huge hidden fees and commissions, and the misplaced belief that policies are a great investment.

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Peter Katt, CFP, LIC, sole proprietor of Katt & Co., is a fee-only life insurance adviser located in Kalamazoo, Michigan (269.372.3497).
