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Weighing the Merits of a Life Settlement

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By Jeanne Lee

Once the kids have flown the nest, or a family business has matured and changed hands, you might decide that a life insurance policy purchased years ago is no longer needed. As life circumstances change, the coverage may not seem worth the premiums.

Your first thought might be to surrender the policy back to the insurance company in exchange for whatever cash value it has. But if you do, you could be unwittingly leaving money on the table. A less well-known option—*life settlement*—could yield you a better price or a better financial outcome for your family.

With a life settlement, a company purchases your policy as an investment, taking over the premium payments and receiving the rights to the death benefit. "Say you had a $1 million policy that was meant to protect the children. You've reached retirement age and no longer need it, but are still paying premiums," says Mike Molewski, a principal and financial advisor at CAPTRUST Financial Advisors in Allentown, Pennsylvania. A policy with a cash surrender value of, say, $100,000, could potentially be sold to a life settlement company for several times that amount.

But you have to know what to ask. Normally, "insurance companies will send you the surrender form and cash the policy in. They do not advise you that you can sell the policy," says Molewski, who provides life insurance strategies and wealth planning services to high-net-worth individuals and families.

That means it's up to policyholders or the financial advisors acting on their behalf to do the legwork in order to unlock any hidden value. A life settlement could yield a lump sum to defray the cost of long-term care, pay for a couple's travel plans, help with a grandchild's tuition—or any purpose at all.

Who Should Consider a Life Settlement?

Life settlements are suitable for people age 65 or older who have a permanent, cash-value life insurance policy and a life expectancy longer than two years. Term life policies are, in some cases, eligible for life settlements if they are convertible to a permanent policy.

If you're 65 or older and considering dropping or reducing life insurance coverage, investigate the benefits of a life settlement before surrendering a policy, says Molewski, especially if there have been any changes to your health status since you purchased the policy.

From a financial standpoint, it's not always obvious what's best. It's only by methodically working through the math, often with the guidance of a financial advisor, that the policyholder can navigate to the best decision, he says.

A life settlement differs from a *viatical settlement*, which is the sale of a life insurance policy by a person with a critical illness, typically with a life expectancy of two years or less.

Case Study: Large Policies, Unaffordable Premiums

Molewski helped an 82-year-old client navigate a life settlement for the $10 million universal life no-lapse guarantee policies she purchased 17 years earlier. Her husband had passed away, and the premiums—about $450,000 a year—had become a burden. Although she had paid several million dollars in premiums over the years, the surrender value of the policies was just $225,000. Molewski helped her shop the policies to licensed life settlement companies and received multiple offers. "If there are a number of policies, we try to sell the weaker policies and keep the stronger ones," he says.

He advised her to sell a portion of the policies to raise enough money to pay off the premiums on the rest of the coverage. She didn't receive cash in the sale. Instead, the proceeds were applied toward future premiums payments, so she was able to keep $3.6 million of coverage in place without having to pay any more premiums. This type of life settlement is called a *retained death benefit supplement.* Her family had no additional cash outlay and will eventually receive a tax-free life insurance payout 16 times greater than the present-day cash surrender value.

Side Benefit: Assess Your Unneeded Policy as an Investment

People who buy life insurance as protection for their families sometimes have trouble assessing their policies as investments—the same way they would a stock or bond. That's why it's useful to have your unneeded policy evaluated for a life settlement, even if you ultimately choose not to do one, says Brodie Barnes, a principal and financial advisor at CAPTRUST in Salt Lake City. Barnes is known as one of Utah's top life insurance specialists and works primarily with ultra-high-net-worth clients and businesses.

The life settlement shopping process provides insight into how professional investors see your policy. "What I love about the life settlement marketplace is that it often helps my clients or their families decide to keep their life insurance policies and understand them for the great investments they are," says Barnes. He says, when people receive high life settlement offers on their unneeded policies, they often start to feel it's more worthwhile to keep paying those premiums.

Case Study: Attractive Offer, But No Thanks

One of Barnes's clients is an 85-year-old woman with a $1.5 million policy that she purchased years earlier to provide funds for estate tax payment. When the federal estate tax exemption increased, she no longer needed the coverage. She and her family considered surrendering the policy for the cash value of approximately $45,000. But Barnes said, “Let’s look at this. There is potentially more value in a life settlement than in the surrender value.”

Based on health records, it was determined that the policyholder had a statistical life expectancy of four years. (Note: For planning purposes, it’s important to recognize that, by definition, a person could live for a shorter or longer period than the mathematical average life expectancy.) A life settlement company made an attractive life settlement offer of $700,000. After tax, the family would have had a net gain of $640,000, about 14 times the surrender value.

Even so, Barnes encouraged them to hold on to the policy. He calculated that even if they continued premium payments for six more years (two years past life expectancy), they could expect a return on investment of a bit over 10 percent a year once they ultimately received the tax-free death benefit. That high rate of return would be hard to beat with any other investment. Since the family could comfortably afford the annual premiums of $44,000 a year and had no urgent need for money, they decided to keep the policy.

In today’s market, Barnes says life settlement companies aim for a 12 to 14 percent return on capital—meaning their outlay for the life settlement and the premiums they expect to pay.

“What family doesn’t want that same kind of return?” says Barnes. He says it’s often more advantageous to hold on to your life insurance policy than sell it, unless the premiums become unaffordable. The family may decide it’s smarter to keep a policy as an investment once they hear how much an investor is willing to pay for it.

Have questions? Need help? Call the CAPTRUST Advice Desk at 800.967.9948 or schedule an appointment with a retirement counselor today.