

Trusts & Estates®

The Journal Of Wealth Management For Estate Planning Professionals

NOVEMBER 2002



FEATURES

- 8** THE HERSHEY POWER PLAY
Christopher H. Gadsden
- 17** WHEN AN ESTATE IS THE IRA BENEFICIARY
Christopher R. Hoyt
- 23** COMMUNICATE WITH CLIENTS—OR BE LIABLE
Owen G. Fiore
- 33** LIFE SETTLEMENTS COME OF AGE
Alan H. Buerger
- COMMITTEE REPORT**
High-Net-Worth Families & Family Offices
- 39** MULTI-FAMILY OFFICE MANIA
Sara Hamilton
- 44** KIDS AND MONEY
Doris Meister
- 50** HOW TO SELL A FAMILY BUSINESS
Jonny Frank, Ronald Chopoorian and Jamal Ahmad

Life Settlements Come of Age

This rapidly growing market imposes new duties on financial advisors. Life insurance policies now have a fair market value. A look at the implications.

By **Alan H. Buerger**, chief executive officer and co-founder, Coventry First, Fort Washington, Pa.

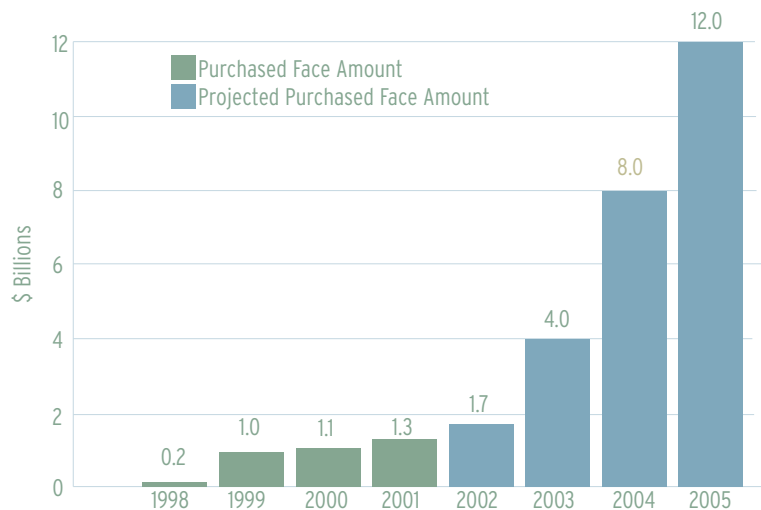
Do your clients know the fair market value of their life insurance policies?

In a recent case handled by our firm, a 77 year-old man, insured for \$3.9 million was unsure that his family could maintain the premiums on his policy. His advisor recommended that the policy be appraised. Coventry First determined that the market value of his policy was \$740,000—four times its cash surrender value. The client decided to sell the policy and use the proceeds to fund a new, more cost-efficient policy on the life of his spouse. The new policy had a face value of \$4.4 million and significantly lower ongoing premiums.

Such cases are an everyday occurrence now that the secondary market for life insurance policies has transformed the financial planning landscape for high net worth individuals. At Coventry First alone, during the last nine months, policy submissions have increased three-fold to an average of \$500 million a month. We expect this number to triple again in the next 12 months. Of that number, about 40 percent have more value than what is reflected in the cash value of the policy. Half of the policies that qualify are subsequently purchased by a life settlement company.

GREAT EXPECTATIONS

Since 1998 when the life settlement option was born in the U.S., its use has grown rapidly, but industry experts are predicting a veritable explosion.



Source: Erich Sippel and Co.

New World

Before the advent of the life settlement market in 1998, it would have made little sense to speak of a policy's fair market value. But, according to Erich Sippel and Co., a life insurance consulting firm, the life settlement market has grown from \$200 million purchased face amount in 1998 to an estimated \$1.7 billion this year. Sippel and Co. also estimates that the market will grow to \$10 to \$15 billion during the next

three to five years. (See "Great Expectations," above.) The Viatical and Life Settlement Association of America has similar estimates.

By its very existence, this new and growing secondary market for policies bestows on every policy a fair market value like the client's other financial assets.

This year, an estimated \$1 billion has been committed to the secondary market by General Re Corporation (a subsidiary of

Berkshire Hathaway Inc.), Zurich Financial Services Group, Dresdner Bank, Merrill Lynch & Co., Inc. and other sophisticated sources of capital. This capital is expected to fuel the growth of the market at an accelerated pace.

A robust life settlement market changes what financial advisors must know and do to help their clients make the most of their policies. The possibility that a client's insurance policy will have a market value well above its surrender value has at least three major consequences:

- When estate planners inventory the market value of a client's assets, they'll need to know the fair market value not only of stocks, bonds, and real estate, but of life insurance policies as well.

- In estimating death taxes, advisors need to consider whether the Internal Revenue Service will value any life insurance policies on others' lives at their fair market value.

- In advising clients how to exit from an unwanted insurance policy, planners need to consider whether a life settlement at fair market value is the most suitable choice.

In short, the professional or fiduciary obligations of financial advisors now include the need to treat life insurance policies as a fully evolved property on a par with the client's other financial assets. In many cases that means a bank or trust company serving as a trustee must consider a life settlement.¹

Candidates

In the typical life settlement, the policyholder:

- is over 65 years of age;
- has experienced an adverse change in health, but is not terminally ill;
- owns a policy with a face amount of \$250,000 or more;
- no longer wants—or can afford—the insurance policy.

That's a pretty broad net. Indeed, a study this year by Milliman USA, Inc., a leading actuarial consulting firm, found over 89 percent of universal life policies issued ultimately do not pay a death claim. Those poli-

cies are surrendered or permitted to lapse. Another study published in Dec. 1999 by Conning & Company, an insurance investment and research firm, found that more than 20 percent of the policies owned by seniors have life settlement values in excess of their cash surrender values.

A life settlement can be a good option for a variety of reasons. The

There is a new reality—and all clients 65 or older should have their life insurance policies appraised.

insured may have outlived the risk insured against; the spouse has passed away; the children have completed their educations; the business partnership has dissolved; or an insured, key employee has retired after a long career.

In other cases, investment projections may have proven unduly optimistic in the current low-interest, bear-market environment. So-called "vanishing" premiums have not vanished, and the financial plan built around the policy is not being met. In any such case, the owner may want out of his policy, either to move the value into another asset or to buy a more efficient insurance policy.

Appraisal

There is a new reality to life insurance policy ownership, and all clients age 65 or older should have their policies appraised. Obtaining a policy valuation is a straightforward process. Some basic information about the policy, a policy illustration run to maturity, along with health details similar to what would be used to place a substandard insurance case (without a medical exam), are submitted to a life settlement provider or providers for a valuation. The resulting valuation is the amount that the provider would likely pay to acquire the policy. Armed with this information, the policyholder can decide how best to use the newly discovered value.

The market value of a life insurance policy is the difference between the present value of the death benefit and the present value of the anticipated premiums. (This simplification ignores the existing cash value, and the real cost of carrying a policy is not the premiums paid but the charges assessed for insurance protection.) The amount

is very sensitive to the insured's life expectancy. A shorter life expectancy means that a smaller discount will apply to the death benefit and fewer premiums will probably need to be paid. The insured's life expectancy depends on his age, sex, smoking status, and health history. The anticipated premiums depend on the specific provisions and cost structure of the subject policy.

Providers

Because the seller of a life insurance policy receives cash and has no ongoing financial commitment to pay premiums, it might seem that the only relevant feature of a life settlement offer is the amount. But there are other aspects that the fiduciary will want to consider in the sale of a policy.

There is, for one thing, the question of privacy. Sellers should make sure that only institutional funding is used and that the life settlement provider will guarantee in writing that no ownership or identifying information about the insured will be provided to individual investors.

Security is important. The seller should make sure that the life settlement provider places the settlement funds in an escrow account to assure they are available before the seller permits transfer of the policy. (In ascertaining that institutional funds are being used, the seller should not mistake an institutional escrow agent

for an institutional source of funds.)

Then there is the matter of professional liability insurance. Sellers should make sure that both the provider and broker have adequate Errors and Omissions coverage.

Taxes

The sale of a life insurance policy may be a taxable event. Tax experts disagree on the details of taxation, but there is a general consensus that if the cash surrender value of the policy exceeds the premiums paid on it, the life settlement proceeds will be taxed as follows:

- The portion exceeding the investment in the contract but not exceeding the cash surrender value, will be taxed as ordinary income.

- The portion exceeding the cash surrender value will be a capital gain.

Where the cash surrender value of the policy is less than the investment in the contract, the I.R.S. may take the position that only the cash surrender value represents a tax-free return of basis—and everything else is gain on the sale of the asset. This stance is not universally accepted, so professional advice on any particular situation is in order.

Regulation

As might be imagined with an emerging product, the regulatory environment for life settlements is a patchwork quilt of state laws of varying vintage and detail. The National Association of Insurance Commissioners has created a model act that has been adopted by 14 states, with the customary local variation.

The Gramm-Leach-Bliley Act contains important provisions regarding the uniformity and reciprocity of

licensing of insurance professionals. It is unclear how those rules will affect the life settlement business as states disagree on the basic question of whether the life settlement business is part of the business of life insurance.

One thing that does seem clear is that the purchase of a life insurance policy by a life settlement

The individual investor in life settlements has largely been replaced by institutional funders.

provider is not a securities transaction for federal or state purposes. The North American Securities Administrators Association recently and unanimously passed the Model Settlement Guidelines for the states. It clearly states that the sale of a policy to a provider by the policy owner is not a security.

Types of Settlements

The life settlement market grew out of the viatical settlement market that developed in the early 1990's to provide cash to needy AIDS patients. The viatical business received some well-earned bad press, so it is important to distinguish the modern life settlement business from its viatical ancestors.

The early viatical businesses too often matched desperate AIDS patients with unsophisticated individual investors. Much has changed, most importantly, the parties' sophistication and bargaining positions.

Life settlement sellers are usually accredited investors in their own right, substantial individuals under

no particular financial pressure, advised by professionals with expertise in financial matters. And the individual investor has been largely replaced by institutional funders—insurance companies or banks with insurance companies providing risk management services—all performing extensive due diligence.

The result is that today's life settlements are essentially anonymous. Providers pool policies with the goal to create and sell bonds backed by the pool of policies. The buyers look at the investment much as an insurance company regards its book of annuity business, that is to say as just another actuarial job. The policies are typically held in trust, and the anonymity of the insureds is protected. If interests in policy pools are securitized, the security holders never need to see individual policy details.

The maturing secondary market for life insurance policies is changing how clients look at their insurance assets. Financial professionals need to understand this market and the opportunities and obligations it brings to them. ♦

Endnote:

1. Miller, Dean Edward, "Life Settlements, and Trust Accounts: A Possible Modification of Trustee's Responsibility?" *The Banking Law Journal*, May, 2002.

Reprinted with permission from the November 2002 issue of *Trusts & Estates*.[®]
Copyright 2002, PRIMEDIA Business Magazines & Media Inc. All rights reserved. TE-19-DH



COVENTRY FIRST

Adding greater value to life insurance.™

For more information contact us at 877.836.8300 or www.coventryfirst.com

Coventry First LLC, Coventry Corporate Center, Fort Washington, PA 19034 / TEL 877.836.8300 / www.coventryfirst.com

© 2002 Coventry First LLC. All rights reserved. Coventry First™ and Adding Greater Value to Life Insurance™ are service marks of Coventry First, LLC.

This material is intended for financial professional use only. It is not for use with the general public.