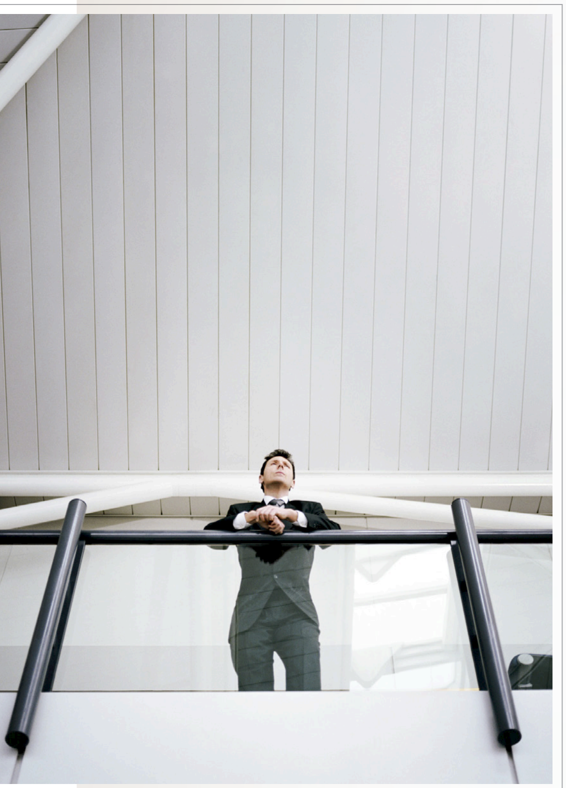
WHITE PAPER

The Real Story About Life Settlements



Inform yourself about an often-misunderstood—and potentially powerful—tool in your advisor's toolbox

If you're like most advisors, the following words may pop into your head when you think about life settlements: Confusing. Privacy concerns. Questionably legal. Unregulated. Or just plain creepy. Some of these ideas about life settlements stem from real concerns, while others are based on misconceptions or outdated information.

The truth is that life settlements are simply another powerful tool in an advisor's toolbox. They can be used skillfully to put a client's money in motion, helping create important liquidity events for them. Research from the London Business School indicates that life settlements provide an average of four times as much money as the cash surrender value offered by insurers.[1] In cases where a client risks defaulting on his or her life insurance premiums, life settlements can be a way to find benefit in a policy that has become burdensome.

However, when it comes to life settlements, the biggest stumbling block that advisors face is simply a lack of understanding. Indeed, according to a recent survey by WealthManagement.com and the Lifeline Program[2], among the most common reasons advisors don't recommend life settlements to their clients is their own lack of knowledge about these options.[3] "People have very outdated ideas about life settlements," says Snow Inocencio, Senior Business Development Manager at the Lifeline Program. "The landscape has changed so much over the past 10 years, and many advisors aren't aware of that."

What Advisors Said

Real responses from advisors about how their clients feel about life settlements

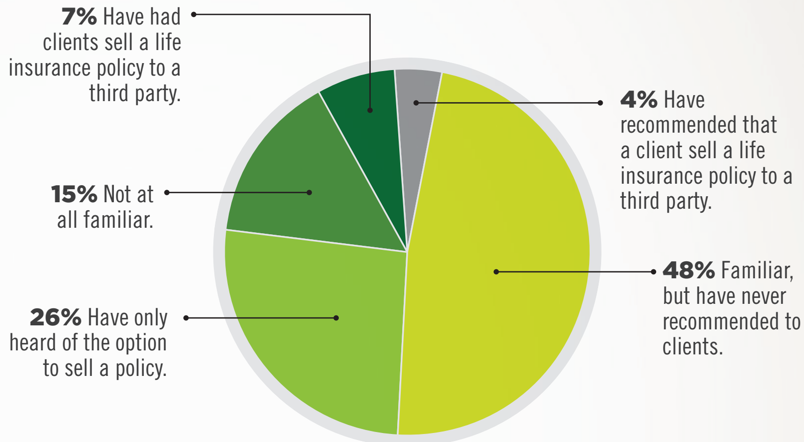
"It's a practice that requires expertise."

"I would have to be much more informed..."

"I'm just not familiar with the rules."

"It feels like I am opening myself up to big liability if things don't go as planned."

To what extent are you familiar with the ability of the owner of a life insurance policy to sell it to a third party for more than the cash value or surrender value?



As a fiduciary, you owe it to your clients to offer a full range of options. This means clearing up some of your own misconceptions so that you can have an informed, frank discussion with your clients about when life settlements work and when they don't.

These kinds of conversations are becoming increasingly common as life settlements continue to grow in popularity. The market for life settlements grew by 20% in 2013[4] and it is expected to continue to grow in 2014 as investors seek additional yield.[5] "It's a tool; the more you have awareness of it, the more you'll know how and when to utilize it," notes insurance expert Jordan Smith, Vice President of Advanced Design at Schechter Wealth, a wealth management firm with locations in Michigan and New York.

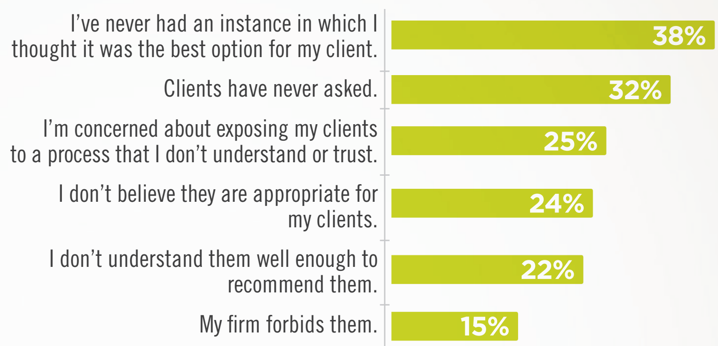
Addressing Common Misconceptions

Life settlements allow people to sell their existing life insurance policies to a third-party life settlement provider, often for much more than the policies' cash values. Despite the potential benefit of such a technique, advisors still have many questions and concerns about when—if ever—life settlements may be appropriate.

WHITE PAPER

WealthManagement.com

Why haven't you ever recommended that a client sell a life insurance policy to a third party?

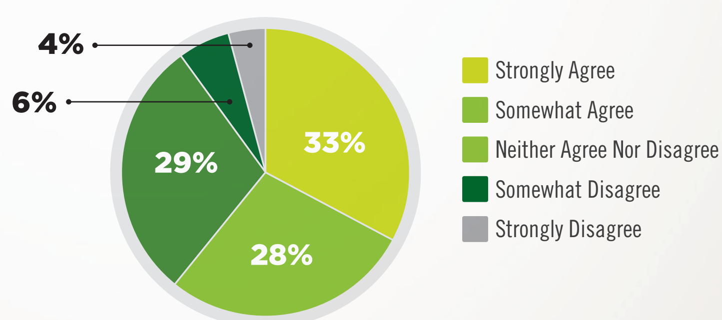


The recent WealthManagement.com/Lifeline survey identified advisors' top concerns with regard to recommending life settlements:

"Life settlements are for experts only."

Some 61% of advisors believe that helping clients obtain a life settlement requires a specialized knowledge set.

Such a transaction requires a very specialized knowledge set to recommend or enter into.



The Lifeline Program®

What Advisors Said

Real responses from advisors about how their clients feel about life settlements

"I strongly do not agree with 'Stranger Owned LI' in any manner."

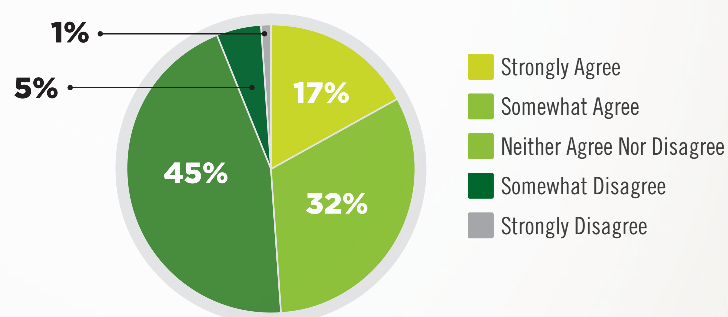
"No idea who to trust with this type of scenario."

"Seems like an area ripe for abuse, misinformation and sales by unlicensed individuals."

This belief may stem from the fact that advisors don't feel confident that they understand life settlements. While it's true that advisors should ensure that they have a firm grasp on the process before making any recommendations to their clients, there are plenty of resources to help advisors better understand how life settlements work. "We recommend that people get out there and do the research or talk to someone knowledgeable," says Inocencio. "Don't be satisfied with preconceived notions or outdated information."

In many cases, choosing a life settlement is easy. Take, for example, a client who is about to let an expensive policy lapse rather than continuing to pay the premiums. In this case, a life settlement offers the client the chance to actually receive compensation for the policy instead of allowing it to lapse and become worthless. In fact, nearly 50% of the advisors who were surveyed agreed that clients who plan to let their coverage lapse should consider selling that policy.

Clients who plan to let coverage lapse should consider selling their life insurance policy



"The life settlement market is too unregulated."

Many advisors operate under the misconception that the world of life settlements is still uncharted territory. "Some advisors still think the life settlement market is like the Wild West when, in fact, it's regulated in the majority of states," says Inocencio. The

life settlement industry is becoming increasingly regulated, and these regulations that help protect sellers' privacy (among other things) are currently in place in 42 states. (The Lifeline Program follows guidelines even in unregulated states.)

"Aren't life settlements the same thing as STOLIs?"

Nearly 3 in 10 advisors said that life settlements' association with stranger-originated life insurance (STOLI) policies gave them pause. This makes sense: STOLIs have been linked to a number of scams, many of them targeting the elderly. "People were providing STOLIs under false pretenses," explains Blair Jacobson, President of Jacobson Associates, a Pittsburgh, PA-based financial services company.

However, it's important to note that STOLIs and life settlements are not the same thing. For starters, STOLIs have been illegal in the United States since 2010; life settlements are indeed legal.

In fact, the recent crackdown on STOLIs means that the life settlement industry faces more scrutiny than ever, leading to an industry that's even healthier and more solid in its fundamentals than it has been in the past. That's why Jacobson, who warned his clients against STOLIs, has embraced life settlements in situations where they have provided a benefit to his clients.

"There are no trustworthy buyers."

Advisors cited concerns about a lack of trustworthy buyers as one major reason they've avoided life settlements. In fact, 13% of the survey respondents said they were unaware of any trustworthy life settlement buyers.

Fortunately, there are easy ways to identify a dependable partner. You can find lists of reputable, licensed life settlement providers by going through your state's Department of Insurance. The Life Insurance Settlement Association, the trade association for the life settlement industry, also lists reputable providers on its website, lisa.org.

What Advisors Said

Real responses from advisors about how their clients feel about life settlements

"Had a client mention he...found it disgusting."

"Creepy."

"Morbid."

"It seems unethical."

"I am not sure it is allowed at my firm or in New York State."

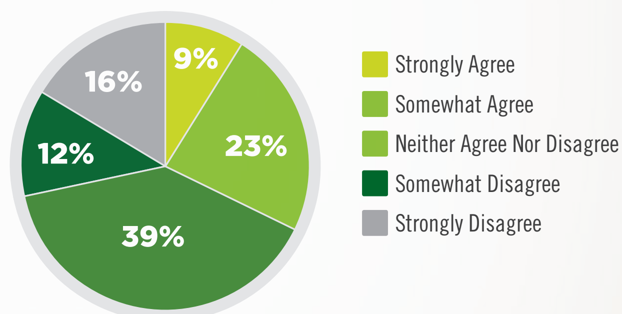
"Not sure if it is legal."

"Life settlements are only for people with terminal illnesses."

The life settlement industry traces its origins back to the viatical settlements that were popular among AIDS patients in the 1980s. However, much has changed since then. These days, life settlements are generally considered appropriate for people with at least 24 months of life expectancy.

Unfortunately, many advisors are still operating under an outdated understanding of who can benefit from life settlements. One-third of the advisors surveyed believed that life settlements were only appropriate for people with terminal illnesses or other special circumstances.

It is only for people with terminal illness and other special cases



In fact, quite the opposite is true. Life insurance policies often include an associated death benefit rider for people with terminal illnesses. These provisions often mean that a life settlement is not the optimal choice in such situations. (See "When Life Settlements Work" below for more examples of when life settlements are likely to work in a client's favor.)

"Life settlements are too creepy."

It's not only advisors who have misconceptions about life settlements; clients can misunderstand them, too. For example, clients may bristle at the idea of a stranger owning a life insurance policy in their name.

"I let my clients know that we have a rule in place that means we won't sell their policy to any one individual, The buyer doesn't know who they are or where they live."

— Pamela Bancsi, Director of Insurance Services with ValMark Securities,

However, in most cases, life settlement providers sell policies to institutional investors or to funds that include a blind pool of hundreds or thousands of policies. "I let my clients know that we have a rule in place that means we won't sell their policy to any one individual," says Pamela Bancsi, Director of Insurance Services with ValMark Securities, a licensed broker/dealer that frequently works with life settlements. "The buyer doesn't know who they are or where they live." Some brokers go even further: ValMark treats life settlements as securities, which means they're also subject to FINRA regulations that provide an extra layer of documentation and protection.

"My firm doesn't allow life settlements."

Some 32% of the advisors surveyed believe that most advisory firms have policies that forbid the use of life settlements. In reality, many firms do allow the use of life settlements. Advisors may want to investigate where their firms stand on the issue. A recent lawsuit in California targeted advisors at an insurance company who failed to educate their clients about life settlements.[6]

When Life Settlements Work

Every client situation is unique. That said, there are some common situations in which advisors have tended to find life settlements to be useful:

• **When the client can no longer afford the policy.** In situations where the client's life situation has changed to the extent that life insurance policy premiums are putting a strain on his or her finances, the client may be considering letting the policy lapse.

For example, Bancsi recalls working with a client who had a $500,000 life insurance policy and was close to bankruptcy. The client was on the verge of not paying the policy's premiums, which would mean that the policy would lapse and essentially be worth nothing. In cases such as these, life settlements enable the policyholder to receive compensation instead of being forced to let the policy lapse and become worthless.

• When the client outgrows his or her policy. Consider a client who may have taken out a life insurance policy decades ago when he or she had young children. Now those children have grown up and have life insurance policies of their own; their parent's insurance is no longer a necessity.

"Maybe you've got a plan you put in place 15 or 20 years ago when your family was growing, and now the coverage is too expensive," says Inocencio. "In that case, you may want to have that policy evaluated because it could be worth money."

In other words, a life settlement may allow such a client to stop paying premiums on a policy that's no longer needed—and instead invest the money in a manner that is more in keeping with his or her current needs.

• When long-term care needs arise. As clients age they may find themselves saddled with high premiums while facing long-term care expenses. Selling an unwanted life insurance policy may help people in such situations fund their ongoing health-care expenses.

• When the client is looking to free up funds for a more appropriate investment. Over the years, clients may discover that the policies they bought decades ago are a mismatch for their current financial realities.

This was the case for one of Jordan Smith's clients. The 75-year-old owner of a Detroit auto parts supply manufacturer owned a life insurance policy worth some $23 million. In the event of the owner's death, his successor would use the life insurance proceeds to purchase the company from the owner's estate. It was a hefty policy, and the premiums cost the company $1 million a year.

However, with the decline in Detroit's auto industry, plus the economic downturn, the value of the company declined and the company's executives decided to explore alternatives to paying the $1 million in premiums for the policy. At that point, the policy's cash account value was $2.2 million and the cash surrender value was $1.7 million (due to around $500,000 in surrender costs). The client opted to sell the policy on the life settlement market for $4.4 million, which he was then able to use to buy a new policy with a death benefit of $13 million (a more appropriate figure considering the company's current valuation). The annual premiums were considerably lower at about $250,000. Ultimately, the life settlement allowed the company to purchase a plan that was a better fit for its current circumstances.

“I’ve had clients who’ve been interested in life settlements but couldn’t get an offer above the cash surrender price for their policy, In that case, it obviously doesn’t make financial sense.”

— Jordan Smith, Vice President of Advanced Design at Schechter Wealth

• **When changes in estate tax exemptions influence planning.** In recent decades, the purchase of life insurance policies was a popular way for individuals to reduce their taxable estates. However, estate tax exemptions have risen significantly in recent years. This means that many of these people are now saddled with relatively large life insurance policies that are no longer serving their previous role of mitigating taxes. Selling the policies can mean that these clients no longer have to pay premiums for policies that no longer fit into their larger financial plans.

A Careful Evaluation

While the above situations illustrate cases in which life settlements can benefit clients, it’s also important to remember that not everyone who wants a life settlement will qualify for one or receive an appropriate offer. In addition, while life settlements work well for some clients, they may not be an appropriate option for others.

For instance, life settlements may not be useful for someone who’s 65 years old and healthy. Many life settlement providers are primarily interested in the policies of people with life expectancies of 10 years or less. (The Lifeline Program expands that range to 15-year life expectancies.) Sometimes, too, the particularities of the policy profile and the life expectancy projections mean that a settlement is simply not financially feasible for a client. “I’ve had clients who’ve been interested in life settlements but couldn’t get an offer above the cash surrender price for their policy,” says Smith. “In that case, it obviously doesn’t make financial sense.” Life settlements may also not be the best choice for someone who is on his or her deathbed, as more and more insurance products now offer an accelerated death benefit option.

Blair Jacobson notes that people who sell high-value policies may run into difficulties if they intend to buy more insurance down the road. “The life insurance industry will only issue policies up

to a certain amount. Even if a policy is sold to a third party, it still counts toward that total," he points out.

Finally, clients who are interested in exploring life settlements should be fully aware of the tax planning implications. Lump-sum life insurance payouts are generally tax-free for the beneficiaries; life settlement benefits typically are not. (In recent years, the IRS has adjusted tax rules on certain types of life insurance such as life settlements. As a result, it is important that individuals considering a life settlement check with a tax professional to understand any potential tax liabilities.) Depending on estate planning considerations, this could make life settlements a less appealing option.

Ultimately, the more you know about life settlements, the better you'll know when they might benefit your clients. If a client is pleased with his or her policy, there may be no need to look into a third-party sale. But if a policy is underperforming, too expensive, or otherwise misaligned with the client's overall financial plan, a life settlement can be a valuable tool—and one that many people may not be aware of.

"Many clients simply don't understand that their policies may have a significant asset value beyond what's in the contract," Jacobson notes. "Showing your client how a life settlement could be beneficial can really enhance your value as an advisor." ■

[1] Januário, Afonso V. and Naik, Narayan Y. "Empirical Investigation of Life Settlements: The Secondary Market for Life Insurance Policies," London Business School, 2013.

[2] "Life Settlement Research," WealthManagement.com/The Lifeline Program, December 2014.

[3] "Life Settlement Research," WealthManagement.com/The Lifeline Program, December 2014.

[4] "2014 Market Outlook for Life Settlements," The Deal, August 14, 2014.

[5] Bloomberg Businessweek, "Investing In Other People's Life Insurance Makes a Comeback," July 30, 2014.

[6] WealthManagement.com, "Three New Reasons for Life Settlements," June 6, 2014.

For more information, contact life settlement professionals by calling **1-800-282-2388** at The Lifeline Program. Or visit **www.thelifeline.com**.