LIFE SETTLEMENTS: THE NEXT WAVE?

Just when you think you know all of the investment vehicles, companies invent new ways to part investors with their money. Earlier this year, the National Association of Securities Dealers issued an Investor Alert, warning investors about the practices of life settlement companies. Several national business publications published articles on this booming business.

In fact, South Florida is the epicenter for life settlements. This should come as no surprise, given the concentration of well-to-do, highly educated residents older than 65. Most "Baby Boomers," whether from the sale of a business or as part of their estate planning, have large insurance policies. A substantial business has blossomed aimed at these policyholders.

Life settlement companies purchase life insurance policies from senior citizens. The life settlement company pays the policyholder a sum greater than the policy's cash surrender value — the amount that the insurance company would pay if the policyholder wanted to cash in the policy, but usually far less than the death benefit. For example, a policy with a face value of $5 million and a cash surrender value of $1.2 million might be solicited for purchase for $1.4 million. Upon purchase, the life settlement company assumes payments of premiums and, at the policyholder's death, the company receives payment of the death benefit.

Life settlement companies are similar to viatical companies, which purchase life insurance policies from policyholders who have been diagnosed with terminal illnesses. These companies are rooting for an early death because they earn their profit only when the death benefit is paid. The NASD estimated that the burgeoning life settlement industry could mushroom into a $100 billion business, and according to one organization, life settlement amounted to a $12 billion industry last year.

Still, the possibilities for abuse are rife. First, what is not often disclosed is that there is a substantial secondary market, where the price offered often varies by several hundred thousand dollars, and many agents have flipped these contracts and pocketed this difference. These monies should have gone to the policyholder. Second, there are alternatives to selling the policy outright that may make more financial sense to the policyholder, and this, too, is often undisclosed. Third, life settlement companies target senior citizens without regard for their capacity or their needs. Many experts conclude that life settlement transactions are suitable for only a small fraction of senior citizen policyholders. Fourth, life insurance policies are difficult to value despite the recent increase in competition, because the market is not regulated. Five, life settlement companies pay sizeable commissions to agents, and in many instances these enormous commissions are not disclosed to the policyholders.

Policyholders can protect themselves by shopping around and investigating cheaper alternatives to achieving the type of income they hope to gain by selling their policies. Tax consequences of a sale versus borrowing against the policy should be fully explored. Policyholders also should thoroughly check out the bona fides of the life settlement companies. While there are policyholders who might benefit from a life settlement transaction, offers to purchase life insurance policies should be carefully considered.


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