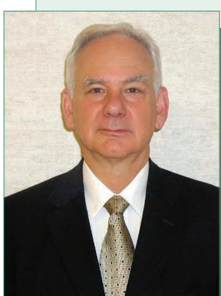
PHILIP LIAN

is managing director of marketing for New York-based Newgate Services Inc., a wholly owned subsidiary of Hagedorn & Company. He has over 25 years experience in the insurance industry. Prior to joining Hagedorn & Company in 2000, Lian served as vice president at Marsh Inc., the insurance brokerage arm of Marsh & McLennan, Inc., in their financial and professional services group.

Lian holds a BA degree from Fordham University with majors in finance and economics.



EVAN SOLDINGER

is managing director of operations for Newgate Services Inc. He joined Hagedorn & Company in 2000 as director of life insurance planning services. Previously, he was a marketing manager in Prudential's corporate office, a brokerage manager for New England Life, and a vice president with Alexander & Alexander

Soldinger earned his BA degree in history from the University of Toledo and his MBA degree from Fairleigh Dickinson University with majors in finance and economics.

Lian and Soldinger can be reached at Newgate Services, 20 Exchange Park, New York, NY 10005. Telephone: Lian—212-763-3424 and Soldinger—212-763-3413. Email: ***philip.lian@newgateservices.com*** *and* ***evan.soldinger@newgateservices.com****.*

Converting A Term Policy For A Life Settlement

Ever since Jane Bryant Quinn suggested in one of her *Newsweek* columns some years back that consumers should "buy term and invest the difference," it seems many people have heeded her advice. The sales of term life insurance relative to permanent forms have been skyrocketing past other types of insurance for years.

Yet, even before Quinn suggested term (as far back as 15 years ago), the vast majority of life insurance policies sold were term life contracts. In the past, the only option available to an owner who wanted to eliminate the policy was to let it lapse because there was no cash surrender value (CSV).

However, today, through a life settlement transaction, an owner—age 65 and older—can turn an unwanted or unneeded life insurance policy into a source of cash. Best of all, they always receive more than the CSV of the policy.

This is an appealing option for those individuals who have outlived the original purpose of the life insurance policy they had purchased years earlier for personal or business reasons.

This article will discuss how a term policy can be converted for a life settlement transaction with an institutionally funded, fully compliance approved life settlement provider such as Stone Street Financial. We strongly caution against doing business with any life settlement providers who do not meet these criteria. First, let's review the evolution of term policies over the past two decades.

Early annual term life policy premiums were directly reflective of an insured's increasing mortality. The costs per benefit were higher at issue ages than they are now, and they increased each year the policy was kept in force. About 20 years ago, aggressive and less traditional insurers began offering term contracts with premium schedules that remained level for a period of years and then offered aggressively priced renewal rates available to anyone who could state that his health had not declined since the original policy issue date. If health became an issue in the years after the original policy issue date, the insured would either be offered a higher-priced level premium option or the carrier would place the insured in an unfavorable cost schedule that increased annually.

In situations where deteriorating health occurred before the insurance premium schedule reached its renewal date, a shrewd insurance consultant might counsel his client to convert the term policy (if permitted) to a form of

Real Life Example: Using Term In A Life Settlement Situation

Mike Easter, now age 68 and retiring, has been CEO of Jagawag Corporation for 18 years. When he became CEO the firm provided him with $5 million of term insurance as a management perk. The policy was issued as a preferred risk when he was 50 and is a 20-year level premium term plan, convertible through age 70.

Mr. Easter made use of the company's financial planning benefit available to senior officers and arranged his affairs to effectively provide for his family and limit his estate settlement liability. All of his life insurance needs are provided through existing survivorship policies; he has no need for the $5 million term policy.

In a recent routine medical exam, Mr. Easter's doctor discovered a spot on one of his lungs, which turned out to be cancerous. He has undergone operations, chemotherapy and radiation since then, but the malignancy persists—and has spread. His doctors project a long, slow battle for him and forecast his life expectancy to be about five years, based on current science.

A pragmatist, Mr. Easter began new discussions with his financial planner about his changed life circumstances. Everything was put on the table, including the $5 million term policy, which was now his personal contract. All expenses his family might face are provided for by other means.

Mr. Easter didn't need the coverage and didn't want the expense of paying for the converted policy, so he asked his financial planner to explore other ways to dispose of it. The answer was a life settlement transaction.

The policy and premium projections for both term and converted values were forwarded to a life settlement team to analyze. The current term premium of $15,000 per year has one more year to run, after which the policy will lapse unless it is converted to permanent coverage. Converting the policy to $5 million of universal life at Mr. Easter's attained age 68 has a minimum 10-year guaranteed annual cost of $73,900, based on the policy's issue class of preferred, non-smoker—even though he is now uninsurable.

If Mr. Easter were to live the five years his doctors expect, the policy would cost $369,500. If he survived for 10 years, the cost would be $739,000 for the $5 million death benefit. If his life expectancy was in the middle, the cost would be $517,300.

The life settlement was negotiated as follows: Mr. Easter was paid $1.5 million for the life insurance policy—a significant return on his previously attributable income expense for the cost of insurance paid by the corporation. The settlement company, in addition to the payment to Mr. Easter, incurred the annual premium expense, upon which they placed a present value at $412,538 for seven years.

For a total cost of $1,912,539, the settlement company owns an asset worth $5 million. They projected receiving the proceeds in five years, for an annual return on their investment of 21.19 percent. If they were off by two years and collected in seven years, their return was still substantial—14.72 percent.

In the end, all parties did extremely well: The firm provided a $5 million benefit to its most important employee for only $15,000 per year for 18 years. Mr. Easter paid tax on only the premium paid for the policy, then converted an unneeded contract into $1.5 million cash. The life settlement company acquired an asset for which they could reasonably project an annual return of between 15 and 20 percent, depending on maturity. ❑

permanent coverage. Doing so allowed taking advantage of the more favorable underwriting classification under which the policy was issued, which would no longer be available to him otherwise. The result would be that the insured, in declining health, could purchase permanent life insurance at lower rates and with higher values.

Within the past decade, the guaranteed level premium periods offered by term policies have expanded to as much as 30 years, and the maximum age for the guarantee to hold can exceed age 80. However, the privilege to convert many of these term policies has been eliminated. In its place, policies that survive to the end of the initial premium guarantee period before age 80 are slotted into an annually increasing term premium until they reach age 80. Beyond that, they are slotted into a level premium to age 100—often at excessively high rates.

When it comes to life settlement transactions, the process most often used to determine pricing for a policy purchase is to weigh the policy's annual premium, projected mortality of the insured(s), policy net cash value, growth rate for the cash value, insurance face amount, and financial strength of the issuing company. These are all put into a formula to develop a price agreeable to both seller and buyer.

With term insurance and life settlements, at least two of these keys are removed and potentially, a third. Cash values and their rates of return become nonfactors, and premium projections are likely to show significant jumps once guaranteed premium schedules reach their end. The result of these factors when applied to life settle-ment pricing is unpredictability—and nothing makes this nascent market more uncomfortable than the uncertainty of what lies ahead.

There are two ways to mollify this concern about uncertainty when considering a life settlement transaction: (1) Convert term policies to permanent plans and make buy/sell decisions based on the new, universal life or whole life contracts. (2) Buy term policies that will remain at the same term premium well beyond an insured person's projected mortality.

One important note is that not all term policies are convertible at all ages. Some don't permit conversion and clearly state so within the contract. If this is the case, the only reasonable way to approach a life settlement transaction is with the term premiums guaranteed well beyond life expectancy. For example, a 65-year-old, initially insured at 59 with a 20-year level premium contract issued at favorable underwriting rates but who now has a four year life expectancy, would be a viable candidate for a life settlement. Even though the policy could remain term through age 78 only, the life expectancy projections would be short of the premium guarantee period by 10 years. If the mortality projection and the premium guarantee period were significantly closer—two or three years, for example—a buyer would be leery of the premium risk should the policy remain in force beyond the premium guarantees.

If a term policy allows conversion and it is still available at the insured's attained age, the life settlement transaction should be based on the converted policy's costs and values. A converted policy allows the owner to manage premiums and cash values into the future by adjusting annual outlays based on reasonable projections by the insurer. These newly permanent contracts can retain their market viability even if the mortality projections prove much too aggressive. Since the conversion is done at the same underwriting classification as when the term plan was issued, the rates will be lower and the cash values higher than any contract available to the significantly impaired risk and perhaps uninsurable policyholder.

A final word of caution about selecting a life settlement provider: We recommend using only those providers with a strong track record of compliance approval and solid institutional funding. Anything less puts you—and your clients—at risk, which is something no one wants. ❑

Subscriptions $6/yr. 1-800-762-3387
Used with permission from Insurance Publications