Whole Life and Life Annuities Enter the Secondary Market

by Michael L. Coben

Since it's possible to acquire policies for insureds with life expectancies of 21 years or more, life insurance has truly become more powerful, more flexible, and more valuable than ever before. The secondary market allows consumers to access increased value from their life annuities, term insurance, and whole life policies.

For years, predictability has been the appeal of whole life. Policyowners always knew where they stood because premiums were locked in and cash values and death benefits were scheduled. The promise was in steady, modest performance with no surprises. Unfortunately, many whole life policies haven't performed as expected. This is due primarily to unrealistic and unfulfilled expectations of the policy's dividend performance. Many policyowners relied on dividend performance to offset the ongoing premium cost. In some cases, inflated investment projections created heightened expectations. In other cases, a combination of external factors has undermined expected performance. In the end, policyowners who thought they were purchasing a guaranteed return received an unwelcome surprise – continual ongoing premium payments resulting from poor dividend performance.

These disillusioned clients are searching for a way out. The latest innovation from the secondary market may provide just the incentive they have been seeking. Rather than surrendering their underperforming policies, many whole life policyowners are turning to the secondary market. With more sophisticated pricing tools, they are finding increased valuations, which go a long way toward easing the sting of unmet expectations. As a result, the whole life settlement is one of the fastest growing segments of the secondary market.

New Value for Whole Life

Consider the case of a 73-year old man with a $1 million whole life policy. His need for insurance had changed and he no longer has an appetite for the high premiums he has been paying. In addition, a $98,000 loan against the policy has further exacerbated his premium burden. In the past, a surrender or reduced paid up policy would have been the only options. But, instead of taking the $28,000 cash value in the policy, his advisor suggested to have it valued in the secondary market. The result was a life settlement offer of $50,000, which allowed the client to unload a burdensome asset while almost doubling his cash-surrender value.

This case illustrates how the increasingly sophisticated secondary market is creating opportunities where none existed. For years, life settlements have been limited to owners of universal life policies. Until recently, the complex dividend structure of whole life policies has placed them off limits for settlements. But, now highly experienced life settlement firms, particularly those with a strong background in life insurance, can assess the underlying structure of whole life policies and bring new value to consumers.

Whole life settlements can offer a very welcome exit strategy for policyowners. Given today's relatively low interest rates and flat investment markets, a significant percentage of in-force whole life coverage is falling short of expectations. By creating unexpected value, a life settlement gives advisors an important opportunity to regain the trust of clients who may be disappointed by underperforming assets. As a result, whole life settlements are projected to comprise more than 15% of total secondary market volume by 2008.

What are the characteristics of a candidate for whole life settlements? Look for an insured aged 60 or older who has a whole-life policy that is no longer needed or not performing up to expectations. A common scenario involves whole life policies that have been compromised with various strategies to help lower up-front costs. For example, a term rider may have depleted policy values even more. For these clients, a life settlement can be a very attractive alternative to the accelerated or extended payments required to make up the shortfall in policy performance.

Exiting Life Annuities

Another promising innovation involves another asset that may not be performing as expected – life annuities. Over the past 20 years, people seeking competitive and predictable interest rates and favorable tax treatment have moved billions of dollars into these contracts. But, for many annuity purchasers, the tax advantages are limited to a specific time frame, which creates a major tax liability once the exemption is gone. In other cases, the annuity's income is no longer needed.

Now, these people have a new option – a secondary market for life annuities. Like many life insurance policies, annuity contracts can contain significant value that is not available from the issuing carrier – value that has been created by changes in interest rates or other factors. This value is fully recognized on the secondary market. A settlement is highly attractive to people for whom a life annuity no longer makes sense. It enables them to capture significantly more value than previously possible.

Advantages for Advisors

These innovations underscore the market's evolution to a full-fledged financial planning tool. Having a free marketplace for underperforming assets allows advisors to create customized solutions for their clients. When an inefficient life insurance policy is hurting a client's cash flow, advisors can use the secondary market to get better performing coverage. When an annuity that was purchased for all the right reasons becomes a tax time bomb, the savvy advisor can create a solution tailored to the client's needs. As a result, forward thinking advisors are no longer thinking in terms of specific transactions like life settlements. They are focusing on their clients' planning objectives.

These are good times for advisors. The rise of the secondary market gives them new power and greater control over their clients' assets. What began as an exit strategy for unwanted universal life products has expanded into a fully developed marketplace where policies of all shapes and sizes are traded. In this market, every client presents a unique opportunity. As life circumstances change and economic conditions shift, clients need a continuous flow of new tools to increase the efficiency and performance of their life insurance holdings. With its ever-increasing array of options, the secondary market lets advisors do what they do best – create ever-increasing value for their clients.

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