By **Jason T. Mendelsohn**

"Willing Buyers" Change the Face of Life Insurance Valuations

Seniors will benefit the most

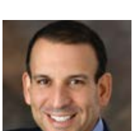
The new tax law increasing estate tax exemptions is one in a series of recent changes that are impacting seniors who've previously deployed life insurance strategies for estate and tax planning. Other factors, which were unforeseen for life insurance policies issued several years ago, are also creating unanticipated consequences for seniors. For example, most wealthy seniors are living longer than they expected and may no longer need their life insurance or are in danger of outliving their coverage. Also, the sustained low interest rate environment we're experiencing has had a devastating effect on the inside cash buildup of many policies. As a result, many insurance carriers are increasing the cost of insurance as much as 200 percent. Outdated tax rules are also hurting senior clients who own universal life (UL) insurance and modern-day term insurance and need an alternative valuation for tax planning. If there's a ray of sunshine in all of this, it's the coming of age of the secondary market for life insurance, the life settlement market. The abundance of qualified institutional life settlement "willing buyers" and client-centric life settlement regulation now opens the door to estate and tax planning solutions that were previously unavailable.

Let's review why life insurance should no longer be considered a hard-to-value asset. I'll also explore the life settlement market as it is today, what the market went through to get to this point and potential solutions offered by a market-based secondary market valuation (SMV) of life insurance. The SMV combines willing buyer/willing seller data with longevity-based medical underwriting that includes a customized life expectancy analysis and real-time market feedback to produce a reliable valuation for tax practitioners, estate planners, irrevocable life insurance trust (ILIT) trustees and other planners and fiduciaries in need of a more precise valuation of fair market value (FMV) for planning purposes.

"Willing Buyers" and FMV

What's FMV? In layman's terms, it's defined as how much someone will pay for property such as a home, car, jewelry, collectibles and other items to become the owner of that property. Sellers can get an idea of the present value of their car from *Kelly Blue Book* and a number of other sources. The present value for houses can be determined by getting a property appraisal from a realtor who uses data from recent sales of comparable houses in the seller's area. The common element in these present value estimates is the use of real-time comparison data from the current markets that reflect what willing buyers are currently paying for said property.

In recent years, the growth of the life settlement industry has helped establish life insurance as an asset class. Determination of FMV for life insurance has always been confusing, especially for UL and term insurance policies that have been the cornerstone of estate and tax planning since their inception in 1979. Planners are becoming more accustomed to viewing life insurance as property and are taking cues from Internal Revenue Service regulations to determine property value. For tax purposes, the value of property is generally



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considered its FMV. Treasury Regulations Section 25.2512-1 provides that the value of the transferred property is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts."[1] Revenue Ruling 59-60 gives a substantially similar definition of FMV for hard-to-value assets. The term "fair market value" appears in approximately 200 sections of the Internal Revenue Code and 900 sections of the Treasury regulations.[2] In both layman's terms and IRS definitions, the "current appetite of willing buyers" determines what the end result will be. This is also true about determining the FMV of life insurance property. Seniors and fiduciaries struggling with outdated tax regulations stand to benefit the most in situations allowing an alternative appraisal of FMV. Wealthy seniors live longer and tend to place life insurance in an ILIT. Our experience has shown us that the majority of policies held in an ILIT that are in need of a valuation are UL policies. The Form 712 interpolated terminal reserve values issued by insurance carriers on UL policies are health agnostic and are rarely a true reflection of FMV. If your senior client transferring a policy is in good health, the SMV value will almost always be equal to the cash surrender value (CSV). When we're engaged to complete an SMV on a large UL policy held in an ILIT, it's not uncommon to see a Form 712 value that's several multiples of the SMV value on a healthy senior. Is this a situation in which tax practitioners would be well served to use the SMV as an alternative appraisal? Are there other applications of a willing buyer/willing seller alternative appraisal in which IRS rulings aren't clearly defined for UL and sophisticated term products?

History

The life settlement industry has been much maligned over the past 25 years because of the actions of a few bad actors. A quick historical review regarding life settlements will help you understand what's changed, how the market has matured and why the market can now be relied on for accurate data. Let's start with the definition of a "life settlement" as the sale of a life insurance policy to a third party for a value in excess of the policy's CSV, but less than its face value, or death benefit. Prior to the existence of the life settlement industry, there was only one buyer for unwanted policies: the insurance carrier that issued the policy. Insurance carriers have a contract with the policy owner that will never pay more than the CSV. For term insurance, there's no CSV. However a senior client who was in preferred health several years ago when the policy was issued and now has significant health problems may have significant FMV in the life settlement marketplace. Now that life insurance is viewed as an asset, with competition among multiple institutional buyers driven by a knowledgeable broker, "seniors selling their policies in a life settlement transaction received almost 8 times as much money as they would have had they surrendered the policy to the insurance company."[3]

Planners and fiduciaries need to be prepared to protect client best interests by having reliable valuation data for their clients.

How did life settlements come to be? It all started in 1911 with the U.S. Supreme Court case of *Grigsby v. Russell*,[4] when Justice Oliver Wendell Holmes rendered an opinion that a life insurance policy is private property, which may be assigned at the will of the owner. He went on to say that life insurance possessed all the ordinary characteristics of property, and therefore, represented an asset that a policy owner may transfer without limitation.[5] This ruling has allowed estate planners over the past century to use these transfer rights for charitable giving, placement of life insurance in irrevocable trusts and trust-to-trust transfers, to name a few. These same transfer of ownership rights were applied to the concept of viatical settlements in the 1980s. Some individual investors saw it as an opportunity to capitalize by purchasing life insurance policies from terminally ill patients for less than its mature value. This way, the patient could benefit from the proceeds while living. Almost 100 years have passed since *Grigsby*, but it's widely viewed as the birth of what would later be known as the life settlement industry. Unfortunately, because of actions of a few, it put a stain on the industry, as some promoters of these viatical settlements were sued because of a process that was tainted by fraud and misrepresentation.

An individualized longevity analysis is the key to unlocking a policy's true FMV.

However, this early form of a life settlement did expose the benefit of health arbitrage in life insurance policies by insureds who were healthy at policy issue but later were impacted by health issues. The early 2000s ushered in the opportunistic era of stranger-originated life insurance (STOLI), which threatened the very future of the life insurance industry by circumventing insurable interest laws. Some advisors seized on the concept of non-recourse premium financing to help seniors "purchase" the policies. Having not learned the lessons of viatical settlements in the 1980s, many unscrupulous advisors falsified medical records and fabricated financial statements to drag unsuspecting clients into an illegal insurance scam. There was a proliferation of lawsuits for almost a decade, and many of the bad actors were prosecuted. Today, STOLI is completely dead, and you'll not find a single institutional investor that will purchase an inforce policy with even a hint of STOLI. Even so, it was the second strike against the life settlement industry, which had

SPOT LIGHT

Puzzling
Abstract by Willem de Kooning sold for $855,000 at Sotheby's Contemporary Art Day Auction in New York City on Nov. 17, 2017. The extraordinarily successful De Kooning had a very humble beginning. He migrated to the United States as a stowaway on a British freight ship in 1926, after which he found work as a house painter in Hoboken, N.J. His abstract expressionist paintings have sold at auction for record-breaking prices.

gained the reputation of the "wild, wild west of life settlements" by those who knew of the industry only through the lens of viaticals in the 1980s and STOLI in the early 2000s. It would be several more years before public opinion would start to shift to see the benefit of legitimate life settlements.

Impact of Great Recession

The Great Recession of 2008-2009 cut off most of the capital and credit supply chain available for life settlements and rooted out most of the "cowboys" who didn't have the fortitude or foresight to develop a viable and sustainable business plan moving forward. There was also the significant adjustment during the fourth quarter of 2008 Valuation Basic Tables (VBT) life expectancy provided by third-party regulated companies, which considerably constricted the buy-box, further crippling the market. After adjustments were made, market leaders surfaced to strengthen the market moving forward.

The tide has now turned, and we're witnessing the strongest secondary market in over a decade with well-known sophisticated institutional buyers. Pricing and underwriting methods have become much more sophisticated, thereby eliminating the performance volatility from the emerging life settlement market prior to 2010. As the smoke settled, a new breed of institutional investors, such as pension funds, municipalities, universities, endowments, family offices and reinsurers, have all joined private equity firms, hedge funds, global banks and others seeking a non-correlated asset with reliable double-digit rates of return. The market has been further bolstered by life settlement regulation that's been enacted in 44 states covering 90 percent of the U.S. population. One notable inclusion in much of this legislation is protecting the rights of policy owners to sell their policy on the life settlement market if they should choose to do so. Protection of consumer rights, coupled with a stable market competing for policy flow, computes to a win-win for senior policy owners who no longer want or need their life insurance due to a change in circumstances.

Increased Accuracy

Planners and fiduciaries need to be prepared to protect client best interests by having reliable valuation data for their clients. Without it, fiduciaries will have no way to evaluate offers from providers and institutional buyers and may fall victim to tactics used to diminish offers to their clients. Providers/buyers have a fiduciary duty to get the best rate of return for the funds they represent, not for your client. Methodologies differ from one valuator to another based on access to data. The methodology a valuator will use to determine the FMV of a life insurance policy will use some form of discounted cash flow analysis in its calculations. Prior to the emergence of a strong secondary market for life insurance, valuators used methodologies that collected historical data and data from markets of similar assets for their calculations. Furthermore, only generalized health conditions were considered in these valuations.

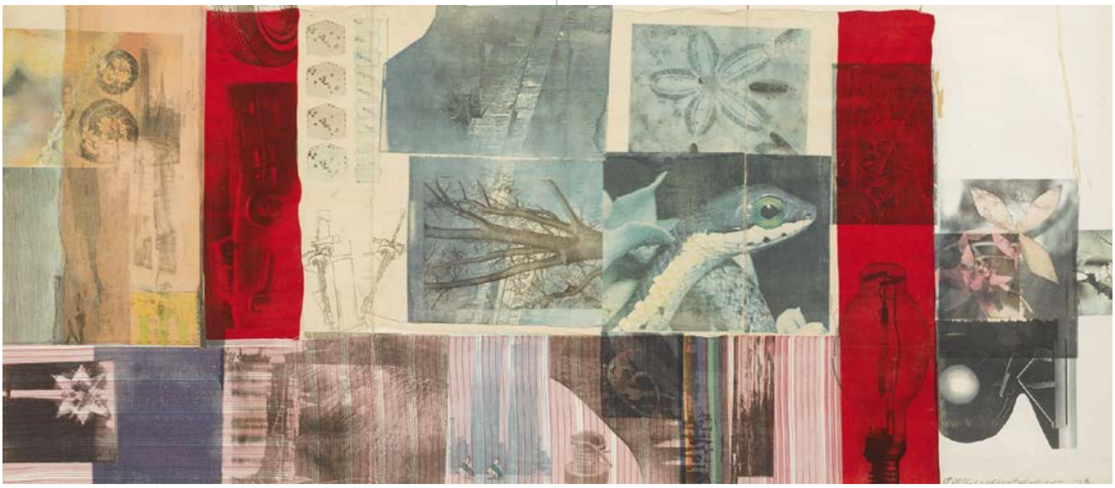
> Competition is an essential component for a policy owner to get FMV for the sale of a policy on the secondary market.

In 2010, Ashar Group developed the SMV that uses a more granular approach that reflects the buying characteristics of the life settlement market at any given point in time. This market-based methodology is enabled by having access to real-time market analytics and understanding the day-to-day nuances that determine FMV. The SMV financial and medical underwriting methods determine a discount factor based on multiple factors pinpointing the FMV using real-time data. An individualized longevity analysis is the key to unlocking a policy's true FMV. It's easy to estimate the present value of cash payments or to forecast future premiums for a policy, but without knowing the length of the payments or the timeframe until the death benefit is expected to be received, this knowledge does little to help in financial planning. An insured expecting to live five years will plan much differently from an insured expecting to live 20 years. When most valuators discuss life expectancy, they're referring to standardized tables, such as the 2014 Society of Actuaries VBT and tables provided by various global and regional studies on life expectancy. In both cases, the tables are derived from the averaging of statistics based on a large sample group of same age individuals and give no consideration to health and lifestyle credits. This type of life expectancy analysis was the only type available prior to the life settlement market. The buyers in the life settlement market use a different approach and determine life expectancy from the perspective of longevity risk—the risk of the insured living longer than the norm. Institutional funds compete to arrive at FMV, and it only makes sense for valuators to use the same methods for determining FMV.

Individualized Analysis

The SMV uses the same methodology used by institutional buyers to determine FMV. The market-based SMV determines life expectancy from a perspective of longevity risk. To account for this risk, the SMV life expectancy is based on health and lifestyle credits, not just debits. This is the only methodology that mimics underwriting completed by institutional buyers that purchase policies on the secondary market to pinpoint life expectancy, thereby allowing the SMV to provide a more accurate reflection of FMV.

Another important aspect of the market-based SMV is financial underwriting of the policy features, benefits, carrier rating and a multitude of other value indicators. Using reliable software to determine a policy's FMV is critical. Like the medical underwriting, the underwriting of the specific policy in question is an important piece of the valuation puzzle. The SMV analyzes specifics such as cost of insurance both now and moving forward, tail risk, risk of outliving coverage, policy type and characteristics, carrier rating and cash hurdle. To reliably perform the financial underwriting for an SMV, the



SPOT LIGHT

Snake in the Grass

Enticer by Robert Rauschenberg sold for $187,500 at Sotheby's Contemporary Art Day Auction in New York City on Nov. 17, 2017. An American painter and sculptor, Rauschenberg is known for his "combines," a form of artwork that incorporates various objects into a painted canvas surface. Additionally, Rauschenberg was involved in designing sets and costumes for various dance productions—some of which he even choreographed himself.

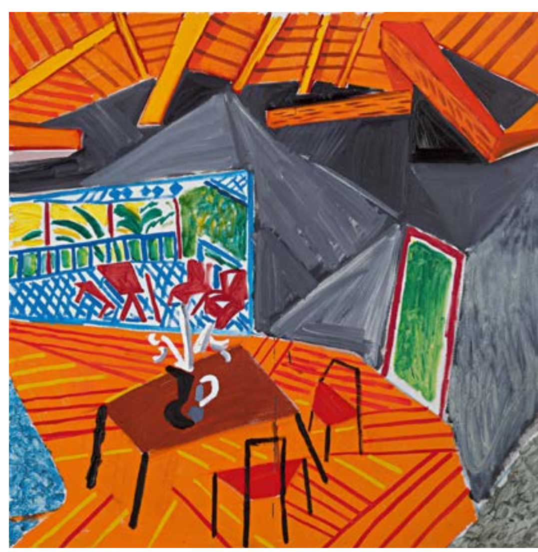
valuator and potential buyers must consider all of these factors and then will determine a discount rate. Also, past policies with similar qualities that have been transacted in a reasonable timeframe through this process are strong reference points to determine a policy's FMV. Potential buyers will make an offer, often being forced by a life settlement broker to reduce their discount rate by making better offers than their competitors. The market essentially lines up the crosshairs of medical and policy analytics and makes an offer. As this process comes to conclusion, the final offer is derived from a competitive bidding process that represents FMV for that particular policy and insured at that point in time.

Competition

Willing buyers will only compete if they're forced into it. Competition is an essential component for a policy owner to get FMV for the sale of a policy on the secondary market. Similar to the sale of any other asset, it's critical to have an experienced advocate representing one's best interests. Independent representation by a life settlement broker that has a fiduciary duty to the policy owner is necessary to create the competitive bidding that leads to FMV. Brokers sit on the same side of the table with the policy owner and the advisory team. Providers sit on the other side of the table with a fiduciary duty to the institutional buyers. Licensing is required to transact a life settlement contract in all but a few of states. Brokers and providers are the licensed entities in the transaction process. Licensing is a costly and cumbersome process to initiate and maintain, therefore, most of the institutional buyers go through a provider that maintains licensing. However, some institutional buyers have also gone through the process to get licensing and mimic the role of providers. It can be a confusing proposition for a policy owner and his advisory team to be sure they're dealing with a third party that protects the best interest of the policy owner. The "willing buyers" in the institutional market are very savvy and prefer to have a transaction that's devoid of competition. Some providers are even trying to disintermediate the life settlement broker and the advisory team by advertising for client direct business. When this happens, the unsuspecting client is acting without representation and is subject to the opportunistic purchasing methods that honor the provider's fiduciary responsibility to the buyer to get the highest yield possible for the institutional buyer purchasing the policy. Make sure your client gets independent representation by asking if your resource is a fiduciary to your client or to the purchaser.

Endnotes

1. Internal Revenue Bulletin 2008-29.
2. John Bogdanski, *Federal Tax Valuation* (Thompson Reuters/WG&L (2012)).
3. "Government Accounting Office Study on Life Settlements," *www.businesswire.com/news/home/20100728006282/en/GAO-Study-Finds-Life-Settlements-Deliver-8.*
4. *Grigsby v. Russell*, 222 U.S. 149 (1911).
5. *Ibid.*



SPOT LIGHT

Tropic Views

California Interior by David Hockney sold for $1.8 million at Sotheby's Contemporary Art Day Auction in New York City on Nov. 17, 2017. Hockney is currently the subject of a major retrospective at the Metropolitan Museum of Art in New York City in honor of his 80th birthday. The exhibition looks back at some of his most iconic works and includes his most recent jewel-toned landscapes.