Sell your insurance policy?
A look at life settlements

Life insurance provides protection when children are young and major expenses lie ahead. In one's later years, however, the need for life insurance may diminish.

For some, continuing to pay regular premiums may seem an unnecessary expense. But one's choices are limited. One can, of course, let the policy lapse or turn it in for a low surrender value.

But in recent years a new option has appeared: An insured can sell his or her policy to a financial institution, avoiding any additional premium payments and receiving a cash payout (a "life settlement"), increasing his or her capital base for retirement or to pass on to future generations. And life settlements are growing in popularity: A $10 billion marketplace in life settlements has emerged over the past few years.

The basics of life settlements

Selling a life insurance policy isn't difficult. There's no cost to apply and no medical exam requirement. (However, the insured is likely to be asked to supply two or three years of medical records.)

The financial institution buys the policy for a discounted percentage of the policy's net death benefit, based upon its present-day value. The size of the discount is determined by a number of factors, including: age and medical condition of the insured; type of policy (e.g., universal life, whole life, term); rating of the issuing insurance company; amount of premiums necessary to keep the policy in force; and amount of any compensation that the life settlement broker receives.

The rights and obligations under the policy are transferred to the new owner, and a new beneficiary is named to receive the proceeds upon the death of the insured. Some financial institutions name themselves as beneficiaries; some bundle the policies and auction them as a package.

Be cautious with IILIs and STOLIs

A variation on life settlements is investor-initiated life insurance (IILI) and stranger-owned life insurance (STOLI). These are policies that are purchased specifically by individuals for sale on the secondary market at a later date, typically after two years. Such policies may have large premiums during the time of ownership.

Some states are concerned about the potential for abuse with these policies. In April North Dakota became the first state to adopt stringent rules regarding IILIs and STOLIs. At this writing, at least nine other states are considering similar statutes.

What to do before you act

There are legitimate and, often, compelling reasons to consider selling a life insurance policy. But also there are good reasons to consult your legal and financial advisors before entering into a life settlement contract. Although some states are beginning to regulate life settlements, it is still relatively new territory.

Some points to consider:

• Don't believe everything that you read about life settlements: Currently, there are little or no advertising guidelines for them.

• Life settlement proceeds may be taxable. Consult with your tax advisors about the tax impact of receiving a lump sum payment.

• Check to see if there is any affiliation between the life settlement broker and the life settlement company to which the broker may sell the policy.

• Finally, be sure to confirm that those with whom you deal—brokers, provider representatives and providers (the institutions that may buy your policy)—are registered in your state.

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