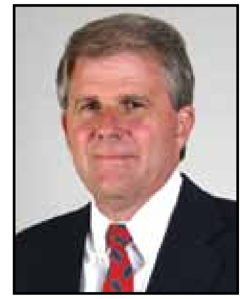
Placing a Value on Your Life Insurance Policy



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Although a life insurance policy is a very complex financial product, the underlying principal is quite simple: the present value (PV) of the stream of premiums must equal the present value of future benefits, plus expenses and profits. Obviously there are a great many assumptions and sophisticated mathematics involved in balancing that simple equation, but the principal is straightforward.

The same principle applies in valuing an in-force life insurance policy as a potential life settlement. To the extent that the present value of future benefits (pvfb) is greater than the present value of future premiums (pvfp), the policy has the potential to provide a payment in excess of the policy's cash surrender value as a life settlement.

Since the required premiums and the face amount of a particular policy are readily determined via an in-force illustration, two key assumptions must be made for pricing purposes: the appropriate interest rate for determining the present value of the required premium stream and discounting the future value of the death benefit, and the amount of time before the death benefit is likely to be received.

The appropriate discount (interest) rate is largely a function of market forces and a particular investor's expectations. Historically, investors in life settlements expected returns in the 10-12% range, but in the wake of the financial crisis and the accompanying exodus of capital from the space, expected returns shot up into the mid 20's. Although assumed IRRs have gradually declined, they are still relatively high given the characteristics of the asset class.

Since the real risk an investor is assuming is longevity, the key to appropriate assumptions as to duration (how long must premiums be paid before the death benefit is received) is forming a view as to the life expectancy of the insured. Typically, third party life expectancy studies (LEs) are used for this purpose. It is important to understand, however, that an LE is not a forecast that a particular individual will die at a specific time in the future. LE Providers use underwriting techniques to assign a particular insured to a risk class, then apply that risk rating (sometimes referred to as a "mortality multiplier") to a mortality table to determine the probability of survival at various durations.

Once the assumptions are in place, actuarial pricing models are used to perform a valuation, which in turn provides a range of potential pricing. Some of these models are quite simplistic, while others use sophisticated techniques including stochastic modeling.

Why Some Products Work While Others Don't

In all cases, however, part of the value process is to "optimize" future premium payments by determining the minimum premium stream necessary to keep the policy in-force. The carrying cost of the policy is a key component of the life insurance. Companies with products with lower COIs (cost of insurance) are more attractive in the secondary market than companies with products having higher COIs. Because of the required premiums in guaranteed products, there's no flexibility whatsoever in those policies. This is the principal reason why current assumption UL polices typically produce better results for a life settlement than guaranteed or "no-lapse" UL polices where a specific fixed premium must be paid.

At the end of the day, the value of a particular policy is determined by the marketplace - a policy is ultimately worth what someone is willing to pay for it. Despite that fact, getting to the best answer for a potential settlement begins with a thorough evaluation of the insured and the policy along with the ability to perform a valuation which indicates a range of the policies' potential in the marketplace. FA

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