The Secondary Market: The Next Generation – Why the Market's Future is Bigger than You Thought

by Michael L. Coben

It seems that only a few years ago the secondary market for life insurance exploded onto the financial planning scene providing a revolutionary alternative to surrendering or lapsing unneeded policies. During that time, the market has gained widespread acceptance while rocketing to an estimated $6 billion annually. But, amid all the excitement, three new trends are quietly signaling that the market is having a far greater impact and is opening even more opportunities than first anticipated.

Longer Life Expectancies

Initially, secondary market transactions were limited to policyowners with life expectancies of 10 years or fewer. To people who met such criteria, the market provided a tremendous opportunity to realize far more than cash surrender value for their unneeded or underperforming policies. But, the benefits or the market seemed out of reach for "healthier" policyowners with longer life expectancies. No more.

In recent years, competition within the secondary market has provided a powerful incentive for companies to find value in cases with much longer life expectancies. The effect has been a kind of "life expectancy race" that has opened the door to policyowners with life expectancies in excess of 20 years. As a result, secondary market cases regularly include people in their 60s who are in relatively good health.

Indeed, one of the classic trigger events for a secondary market valuation is no longer a prerequisite at all – a recent change in health. So who is now a candidate for a secondary market transaction? The short answer is any client aged 60 and over with life insurance assets that no longer meet current needs.

The majority of secondary market transactions result in additional life insurance being sold. In other words, secondary market transactions are not being used to exit unwanted policies, but to replace underperforming ones. This is a profound shift in the insurance marketplace since policyowners now have the tools to manage and modify their insurance assets as their needs change over time, which leads us to the next big change in the market.

The Secondary Market as a Financial Planning Tool

In recent years, forward-thinking advisors have started looking to the secondary market for new strategies to achieve complex financial planning goals for their clients. The market has responded with an ever-increasing range of flexible solutions including life settlements, partial settlements, and guaranteed death benefits. As a result, advisors are now creating customized transactions that address the client's individual needs. Increasingly, the ability to offer individualized solutions, as opposed to the best offer price, is driving transactions.

Here is a recent real-life scenario: After her husband's death, a client was holding a $15 million survivorship universal life policy purchased through a split dollar plan with the family business. Because her future insurance need was only $8 million, the policy was a poor fit for her new financial situation. This case is a perfect example of how good financial planning can sometimes go bad. The policy, which made sense several years ago, became a liability.

Fortunately, she had a skilled advisor who suggested splitting the policy in two and selling the $7 million policy on the secondary market. The policy yielded a $1.85 million life settlement, which was used to repay the $1.25 million needed to roll out the policy with the family business. The client placed the remaining $600,000 into an annuity to supplement the premiums on the remaining $8 million policy. The insured's children, who owned the company, then used the $1.25 million as investment capital to expand the business. The secondary market offered the client a rescue opportunity. She was able to reduce the total face amount to keep coverage that is more appropriate, reduce her future premium outlay, and generate a significant amount of investment capital for her children's business.

Not surprisingly, the market is fast becoming relevant to a far greater range of clients, not just to clients who want to sell their assets on the open market. As any financial advisor will tell you, there are other ways to leverage an asset's value than through an outright sale. Enter the third, and perhaps biggest, change of all.

Premium Financing On the Secondary Market

If you can sell an asset, you should also be able to borrow against it. The latest innovation from the secondary market enables policyowners to do exactly that. Unlike traditional programs, premium financing through the secondary market takes into account the market value of the underlying insurance policy in the terms of the loan. As a result, the need for additional collateral is reduced or eliminated altogether.

This kind of financing program is proving especially useful to clients who need significant coverage, but do not want to liquidate assets. For example, given the uncertain future of estate taxes, clients can use premium financing through the secondary market to meet their insurance needs while leaving existing assets largely untouched. It is also an effective strategy for reducing premium outlays on new or existing coverage.

As the most recent secondary market innovation, it should be noted that premium finance programs require careful due diligence to protect the client's interests. In general, you should be sure that there is no buy-back provision and that 100% of the death benefit in excess of the loan balance goes to the beneficiary while the loan is outstanding. Prudent advisors will also make sure that the lender backing the loan is a major national bank, which is federally licensed to issue loans nationwide.

Clearly, secondary market transactions have expanded well beyond their initial role as exit vehicles for unneeded policies. It's no wonder that current estimates of the market's potential now exceed $180 billion, nearly double earlier estimates. The market is more open than ever and it shows no signs of slowing down. ❑

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