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Your Money or Your Life Insurance?
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You're short on money. You have a life insurance policy you may no longer need. One option is to sell it to a third party for cash. Should you do it?

Such transactions, called life settlements, are a decent-sized business these days: Policies with a face value of more than $10 billion were sold last year, according to Life Partners Holdings, Inc. (LPHI), a leading firm in the industry.

There's nothing wrong with life settlements, in theory: You're selling a future payout for a one-time, immediate cash payment. When you die, the person or company who purchased your policy gets the insurance payout.

In practice, selling a policy isn't quite so simple. Anyone considering the move needs to do a lot of homework first.

"There are a couple of situations where it may make sense," in particular, when you no longer need your policy (for instance, once your children are grown and financially independent) says Scott Witt, an actuary and fee-only insurance advisor in New Berlin, Wisc. "Almost always, the policy being sold is far more valuable in the hands of the owner than it is in the hands of the person buying it."

Financial advisor Tom Orecchio, a principal at Modera Wealth Management in Old Tappan, N.J., takes only a slightly more benign view. He says he has run through the calculations for clients and in some cases it made financial sense to sell the policy. But he also remains highly cautious. The market for life settlements is not very efficient, he warns, and it's difficult to determine what a policy should really be worth.

The life settlement business has lately been a buyer's market. Just ask Scott Peden. He's the president of Life Partners, Inc., a boutique investment firm specializing in life settlements. People and institutions usually buy policies in bundles, though they can sometimes buy individual policies. Mr. Peden says average returns on investment have been about 10 to 12% a year.

That's a remarkable return, if you can get it. Life settlements typically involve people with a life expectancy of seven to 10 years. If you were to buy enough policies, and if the actuarial projections were accurate—meaning that the former policy holders did not live beyond their expected date—then the risks are moderate. By comparison, Treasury bonds lasting that long will pay you just 3% or so.

But things don't always turn out the way actuaries project they will. Some investors in the industry have found returns were lower than expected because the insured lived much longer than forecast, so payouts took longer to realize.

In investing there are no free lunches, and if the buyers are getting are getting very high returns then sellers are getting less. But the buyers' returns aren't the only cost.

You also have to factor in hefty fees and other expenses. That can include fees for your broker, the buyer's broker, plenty of paperwork, and costs involved in estimating the life expectancy of the policy holder. The buyers will also take on the costs of paying future premiums. Plenty of people drop out of the sales process along the way, too, and those industry costs get passed along to customers as well.)

Taxes present another issue, and vary widely. All things being equal, the policy is worth more to your heirs than it is to an investment fund in Delaware. Ultimately, Mr. Peden says sellers may only expect about 20 cents for each dollar of a policy's face value.

So who, if anyone, should sell?

Mr. Orecchio argues that selling a policy makes sense mainly for people who truly need money and who have exhausted all other resources, or when the policy has outlived its use, or if other members of your family are unwilling to keep up the premiums. (A case in point might be where you bought life insurance while your children were in school or college, but they are now independent.) Mr. Witt says it might also make sense to sell a policy if you are dumping a mediocre policy for a better one.

Although $10 billion to $12 billion of policies were sold in life settlements last year, over the same period policies worth about $500 billion were left to lapse, according to Mr. Peden. It's probably fair to say that selling a policy, even for twenty cents on the dollar, makes more sense than throwing it away. (Rogue thought: If you are cursed with materialistic heirs, threatening to sell your life insurance policy might also keep them more attentive during your final years.)

If you are considering selling your policy in a life settlement, here are the smart steps to take.

1. Seek independent advice from someone who does not have a vested interest in the sale. You may have plenty of other, better alternatives, such as surrendering the policy to your insurer for cash. The National Association of Personal Financial Advisors (NAPFA) can help you find a fee-only advisor, but many will not be experts in life settlements. There are a few fee-only insurance advisors around, but they are rare.

2. Get expert help in selling. People buying policies are advised by experts, and you should be, too. There are specialist life settlement brokers. You may be able to find some through the Life Insurance Settlement Association, or your state's insurance commission. Many states license brokers, and give them a fiduciary responsibility to put your interests first: But that really only protects you from the most egregious abuses. Interview several brokers if possible to find one you trust.

3. Negotiate commissions. Glenn Daily, a fee-only insurance advisor in New York and creator of the whatsmypolicyworth.com, warns that the industry has been plagued for years by outrageous commissions, though they are coming down. "[Sellers] should not have to pay more than 10% of the gross purchase price, and you can sometimes pay much less," he says. Negotiate hard, and demand full transparency. Your broker works for you, and you should know exactly how much he or she is getting paid for the transaction.

4. Make sure your broker gets multiple quotes. Remember that potential investors are aggressive on price because they have to be. This is not Apple stock. No one's buying a life insurance policy because it's going to grow. The profit,for buyers says Mr. Peden, lies in the discount. A policy "has a future, face value…the key is not paying too much for it."

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