Investment in Life Settlements: Certainty in Uncertain Times

By J. Mark Goode
November 30, 2010

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Life settlements are not directly correlated with traditional bond and equity markets and have the potential to yield above-market returns in the intermediate and long terms. Unlike the equity and bond markets, the returns on life settlements are uniquely tied to mortality.

A life settlement is the sale of an in-force life insurance policy (typically for a high net worth individual aged 70 or older) to a third party for an amount less than its death benefit but greater than the policy's cash surrender value. The selling policy owner is not restricted in the use of the cash proceeds received from the sale. In return for the cash payment, the purchaser owns the life policy, names the beneficiary, pays all premia and eventually receives the entire benefit at the time of the insured's death.

Limited partnership interests and "Regulation D" private placements are available to accredited investors. These products are backed by a diversified pool of life settlements, which manages mortality risk and reduces volatility.

The credit quality of life settlement investments is very high. The timely payment of policy benefits are guaranteed by rated and regulated life insurance carriers, which hold reserves against future benefit claims imposed by state law. Never in the history of the highly regulated US life insurance industry have life carriers failed to pay a death claim on a valid insurance contract. The certainty that a carrier will pay a fixed benefit upon the death of the insured provides outstanding investment security.

As the marketplace for life settlements has increasingly tilted toward institutional investors, opportunities for private investors to get in the act have been limited, and the products that are out there have not met the standards of professionalism, experience and transparency that sophisticated private investors demand. Now, however, investment advisors can access the life settlements market through well-structured and transparent life settlement products.

Life settlement fundamentals

The legal structure of life insurance companies is one reason life settlements are such a safe investment. Life insurance policies are issued by rated life carriers, all carefully regulated by insurance commissioners. Future carrier obligations related to death benefits and cash surrender values are backed by segregated, statutorily mandated reserves, under the strict supervision of regulators. And life insurance policies sit at the top of the insurer's capital structure. Even in the event of insolvency, policy holders are paid first from the statutory reserves, above all creditors, bond holders and equity investors.

Investment in a life settlement is characterized by a known purchase price, a relatively predictable cost of insurance, and a fixed death benefit. Successful investment in life settlements relies upon four basic fundamentals: (1) independent medical underwriting of life expectancy estimates; (2) accurate probabilistic actuarial valuations; (3) clean, compliant life settlement origination, including a thorough anti-fraud review; and (4) reduction of cash flow volatility and statistical fluctuation achieved by aggregating a diversified portfolio of insured senior life insurance policies issued by a variety of A-rated life carriers.

The development of the life settlement market

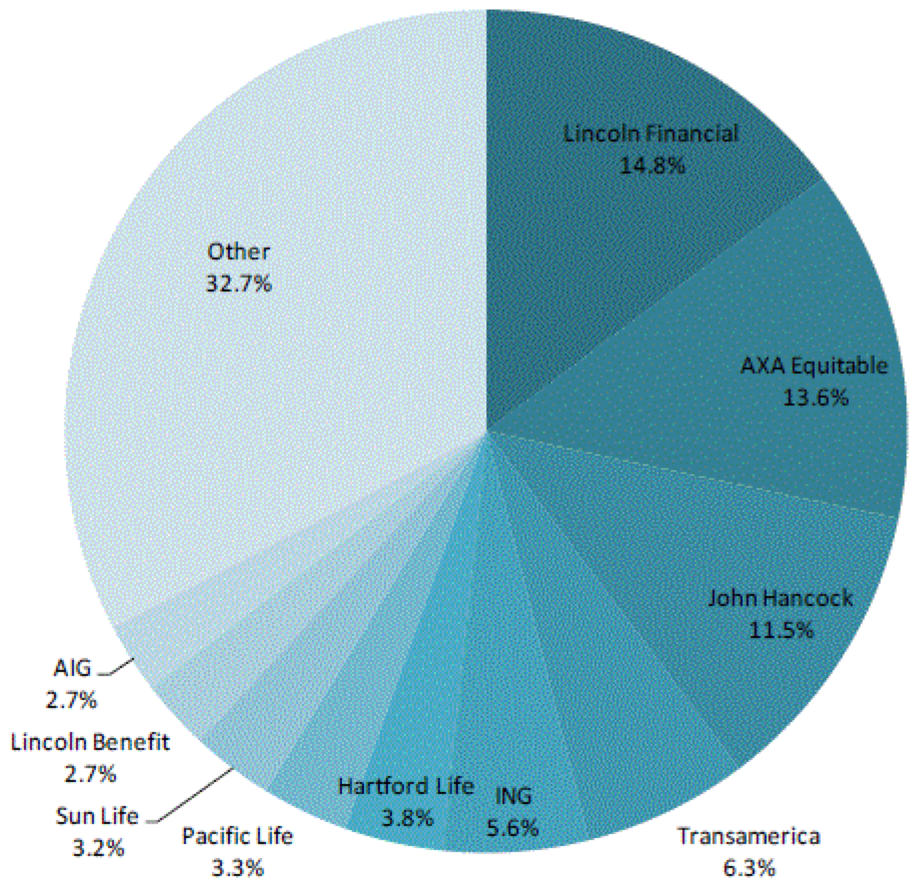
While a policy owner has always enjoyed the legal right to sell a life contract, before the establishment of a liquid secondary market there were never opportunities for them to do so. The United States Supreme Court ruled in 1911 (*Grigsby v. Russell*, 222 US 149) that a life policy is personal property and can therefore be sold by its owner. In the late 1990's, almost a century after the Grigsby ruling, the capital and technologies finally came together to allow the sale and transfer of life policies by the original policy owner and the creation of a secondary market.

At the same time, a growing, older segment of Americans found themselves holding life insurance policies they no longer needed or could no longer afford. The life settlement market developed with liquidity provided by institutional investors to serve this senior insured population. The very first institutional funding for life settlements came from insurance and financial service giants, Zurich, AIG and GenRe. These insurance-focused investors were well prepared to underwrite and manage mortality risk in life settlements just as they had in the primary market for life insurance.

The fundamental reason for the life settlement market grew rapidly was that it created value for consumers. According to the Market Analysis for 2009 prepared by Life Policy Dynamics, an affiliate of my firm, Peninsula Life Management, the average life settlement traded at 17.5% of the death benefit value. Contrast that with the modest cash surrender values, averaging 4% of death benefit, that life carriers pay the same population of policyholders when they surrender the policies back to the insurers.

The same 2009 study estimated that investors paid approximately $1.6 billion for nearly $9 billion in life settlement benefit value, more than four times the $360 million that insurance carriers would have paid for the same policies. The average life settlement in 2009 involved a life insurance policy with an average benefit value of $2,800,000. It is estimated that the secondary life market served nearly 3,200 individual senior insurance consumers in 2009, unlocking an average $387,500 of additional value per policy for each policy owner.

Diversification of carriers within a life settlement portfolio makes the underlying cash flows more certain than traditional asset classes historically have been. Based on a sample of 861 Policies in our 2009 Life Policy Dynamics Market Analysis report, the graph below depicts a breakdown of the carriers whose policies have been sold in the life settlement market. Overall, 56 carriers were represented in the research, with the largest 10 illustrated below.



As evidenced by this statistical sampling, the life settlement market involves a diverse group of highly rated life insurance carriers.

During the past decade, major financial institutions have acquired substantial life settlement portfolios representing billions of dollars in life insurance benefit value. With demand fueled by institutional investors, nearly $60 billion in life settlement benefit value has changed hands in the last decade.

Why life settlements now: An opportunistic buyers market

Currently, thanks to an abundance of policies offered for settlement that is not matched by the limited capital available for purchase, an imbalance exists in the life settlement market that will create exceptional returns for buyers and investors.

The abundance of life settlement options is driven by the demographic shift in the US, which now has a rapidly growing population of affluent seniors. Growing awareness on the part of consumers, their life agents, and their financial advisors about the benefits of life settlements has also played a role in the expanding supply of life settlement opportunities. These combined and complimentary forces have yielded an increased supply of policies available for settlement in the marketplace.

The timing is also right to enter the life settlement market because it recently completed its first decade of existence in the US. Any early market stage risk and the inefficiencies of a new market have dwindled as the market matured. The young market has evolved over a decade into a more regulated and transparent marketplace with greater standardization.

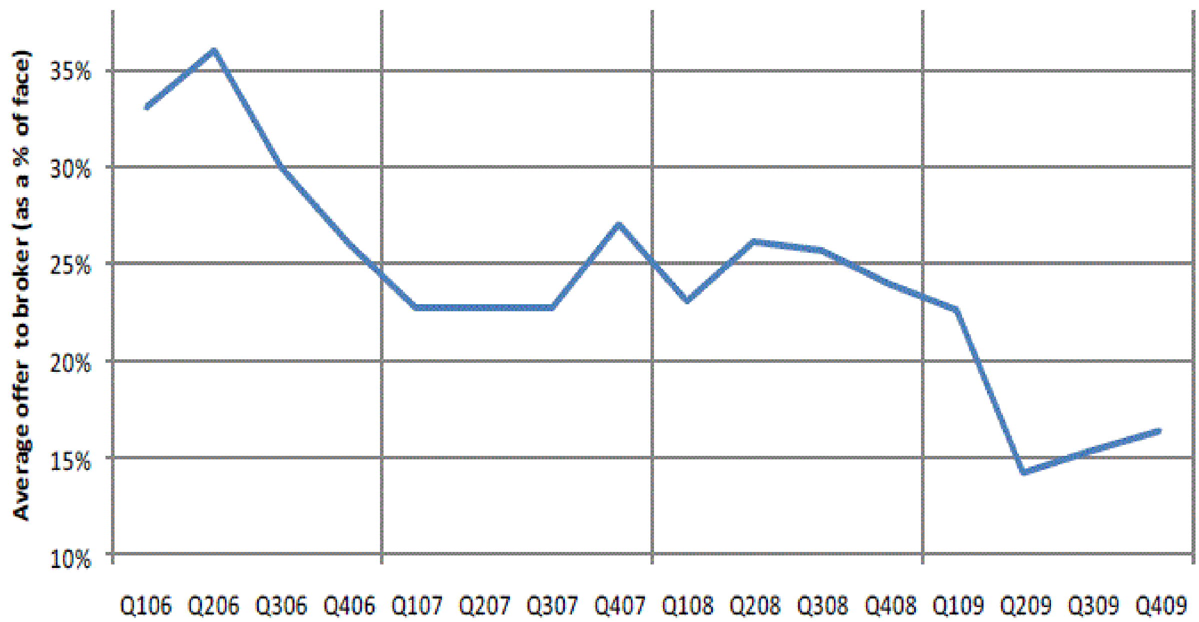
Trends in life expectancy and its analysis are also making the life settlement market increasingly attractive. Mortality risk, which affects the timing of returns on investment, is well understood. On a combined basis, the largest and most respected life expectancy analysts have completed nearly a million individual life expectancy projections during the last decade. Today’s longer life expectancies benefit investors with more reliable mortality predictions and lower ultimate purchase prices for life insurance policies.

Leading trade associations, such as the Life Insurance Settlement Association, the Institutional Life Markets Association, and the European Life Settlement Association have worked toward greater market transparency, standardization and “best practices.” The most important example is the mandatory disclosure of agent and broker commissions to an insured person selling an insurance policy. Commission disclosure is now a statutory requirement in both New York and California. These states are home to the two largest life settlement markets, accounting for nearly 40% of all transactions in 2009.

Today’s investors also benefit from an increased level of industry professionalism and more effective use of experts such as actuaries, medical underwriters and service providers.

Market-wide data bear out the idea that now is a historically good time to get into the life settlements market. Arguably the most important metric from an investment standpoint is the rate-of-return offered by a life settlement purchase. The 2009 Life Policy Dynamics Market Analysis report collected data on the offer amounts to the broker as a percentage of the life insurance policy face value as a proxy for analyzing the prevailing market rates.

Although this metric does not directly take into account the cost of insurance projections or the expected mortality experience, it does give some indication of market trends from an investment perspective. The diagram below illustrates the development of the life settlement market over the past four years.



As indicated in this chart, based on a random statistical sample of 2,220 actual Life Settlements traded over four years, the value proposition for investors has increased over time, since an investor can successfully offer a purchase price at a lower percentage of the face value of the insurance policy. It is unclear how long the current percentage of purchase price to face value will remain at historically low levels.

Market growth factors

The life settlement market has grown from a *de minimis* amount in 1999 to a forecasted annual market of $9 billion in 2010. As I mentioned earlier, recent figures from both Conning and Cantor Fitzgerald suggest that $60 billion of Life Settlements have been transacted in the past decade. Based upon assumptions from the Life Policy Dynamics Life Settlement Market Report, nearly 24,000 individual senior insurance consumers were served by the life settlement market in the past 10 years.

Because of a lack of liquidity and the limited availability of credit, market volumes are reported to be down in 2010. The $9 billion projection for the market in 2010 is down from $10 billion in 2009 and a market high of $12 billion in 2008. While capital was difficult to source during the recent credit crisis, the Conning Report contains a prediction that capital will return to the life settlement market "because of the inherent appeal of the product to some investors" because of its "low correlation to equity market returns and because of its yields relative to other fixed income, or other investment options at this time." The size of the potential life settlement market has been estimated by Conning in the range of $500 billion.

In addition to the creation of insurance consumer value, changing demographics will help drive the growth of the life settlement market in the next decade. The population of the United States is rapidly becoming proportionally older and, in addition, Americans are living longer. The Census Bureau projects the number of individuals in the United States over age 65 will grow from 34 million today to 69 million by 2030, at which point seniors will represent more than a quarter of the US population. At this expected rate of growth, the population above age 65 will grow by 51.6 million people by 2050, with a percentage increase of 113.8% in the 65-84 age group and 388.9% in the over-85 age group. These seniors represent the single largest growth group in the nation.

As world financial markets continue to fluctuate and traditional investment products experience volatile and diminishing performance, many investors today are looking for non-correlated investments that provide greater certainty and less sensitivity to market turmoil while still offering potential for growth. Life settlements are an alternative asset class that offers investors portfolio diversification and attractive, statistically predictable returns.

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