Factsheet

What is a Life Settlement?

Life settlement: an asset class and a transaction

The term ‘life settlement’ has two meanings: one related to an asset class, and one related to a transaction.

The life settlement market involves a longevity-linked alternative asset class with both equity and fixed income like characteristics. Institutional investors accumulate a portfolio of life insurance policies that they trade or hold until maturity. These policies are originally sourced from policyowners who have conducted a life settlement transaction.

The market is specific to the USA due to the country’s legal and regulatory framework, under which life insurance policies are considered property, the legal ownership of which can be transferred by sale.

A life settlement transaction is the sale of the ownership of an in-force life insurance policy issued by an American insurance company (i.e., a carrier) to a third-party investor. The sale is typically for cash consideration that is less than the face value of the policy, but more than the surrender value offered by the company carrier that issued the policy.

The new owner assumes the ongoing responsibility to make premium payments to the carrier until the insured’s passing, at which point the investor files a claim for the associated policy’s death benefit.

What are the origins of the life settlement market?

The life settlement industry technically began in 1911 with Grigsby v Russell, a court case in the United States. The case went through the country’s lower courts system all the way to the Supreme Court, which ruled that life insurance is private property and can be legally assigned by its owner.

After the Grigsby case, there was very little activity in the ‘life settlement’ market, until the mid-1980s, where, at the height of the AIDS epidemic in the US, those who were HIV+ sold their life insurance policy to cover living expenses and medical bills associated with their condition. The market at this point was called the ‘viatical settlement’ market – a specific term used to define policies that cover insureds who have life expectancies of less than 24 months. That continued for approximately ten years or so until the late 1990s, when the bulk of the market activity was replaced by seniors selling their unwanted life insurance policies. The term ‘life settlement’ began to be used more commonly as the life expectancies of the insureds were generally longer and the market became dominated by policies owned by the senior cohort.

Around that time, US states began to create a regulatory environment for the buying and selling of life insurance policies as deal flow began to increase. Now, 45 states and Washington, DC, regulate what is called the life insurance industry’s secondary market (i.e., the sale of a policy by the original policyowner to an investor) in the life settlement marketplace, and even though five states - Alabama, Missouri, South Carolina, South Dakota, and Wyoming - don’t have a defined regulatory environment for the secondary market, life settlement transactions do occur in those states.

What is the life settlement market and who is involved?

The life settlement market can be viewed as having two parts: a consumer facing, secondary market, and an 'investor to investor' aftermarket, or tertiary market (the primary market in the life insurance industry involves the original purchase of a life insurance policy by an individual from a life insurance company).

SECONDARY MARKET

In the secondary market, a policyowner sells their policy to an investor through a licensed entity known as a life settlement provider. The seller is often represented by a life settlement broker – a licensed life settlement specific intermediary - or via an advisor, like a life insurance agent, an attorney, an accountant, etc. These intermediaries will often solicit bids from multiple life settlement providers and an auction will be conducted with interest from multiple investors.

The broker has a fiduciary duty to secure the best available price and execution for their client, the policyowner. The provider purchases the policy, either for their own account, or as is more common, on behalf of an investor, such as specialty life settlement asset managers, ILS funds, private equity investors and funds with even broader mandates, as well as direct investors like insurers, reinsurers, and other corporates.

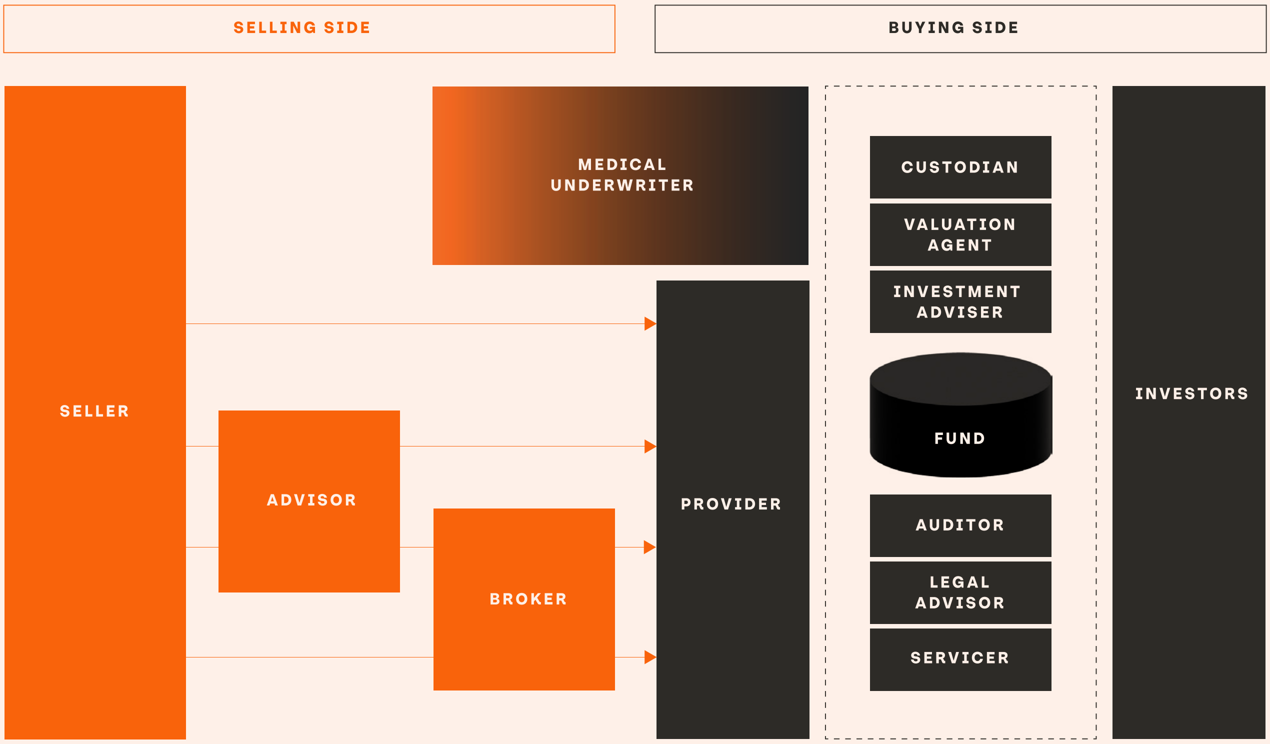
TERTIARY MARKET

In the tertiary market, individual policies or portfolios are traded between investors. Life settlements are traditionally a buy-and-hold investment, but investors may sell policies because a fund is at its end-of-life stage and is therefore liquidating its remaining holdings, and/or the fund has a need for cash to meet premium payments or redemptions, for example.

Some funds also engage in a trading strategy where they accumulate individual policies before selling them on to other investors in blocks. These trades can be intermediated, but they are not regulated under the same model as in the secondary market.

In addition, several service providers are involved in life settlement transactions in the secondary market, for example, lawyers, medical underwriters, custodians, administrators, and auditors, as can be seen in Figure 1 below.

Figure 1: the life settlement transaction process in the secondary market



Where do life settlements fit into an institutional investor's portfolio?

Institutional investors tend to allocate to life settlements because they are looking for an asset class that diversifies their core portfolio exposure(s). The underlying exposure in life settlement investing, which is longevity risk, exhibits a very low correlation to traditional financial markets and consequently provides investors with an asset class that does not move in lockstep with equities and fixed income. Some investors will have a specific allocation to diversifying strategies, so life settlements would fit well here.

For investors that take a more granular approach, life settlements can fit into either a private equity or alternative credit allocation. Life settlements are one of those rare asset classes that have characteristics of both; equity-like features because the investment fund manager owns the policies and credit-like features because of the fixed negative coupon, the fixed final value, and the obligation on the part of the insurance company to pay the policy benefit.

What type of end investors allocate to life settlements investment funds?

Life settlements are long term investments, in which returns are realised over a period of many years. Consequently, end investors tend to include those that have long-term investment horizons; these include pension funds, endowments, foundations, insurance companies, and sovereign wealth funds.

Family offices also allocate capital to third party investment managers, and some participate in the life settlement market directly. Most end investors that invest in life settlements do so by allocating capital to a third-party investment manager which specializes in transacting in the life settlement market.

What are the main risks in life settlement investing?

As with any asset class, there are risks involved in life settlement investing. Some of the main risks include, but are not limited to:

1. Longevity risk: the risk that the individual insured person lives longer than anticipated, leading to lower financial returns for the investor due to payment of more premiums to sustain the policy.
2. Liquidity risk: life settlements are long term investments which may not be easily liquidated.
3. Cost of Insurance (CoI) risk: the originating carrier can, subject to certain rules, increase the cost of insurance component of a life insurance policy it has issued, which in turn results in an increase in premiums charged to maintain that policy. This results in decreased returns for the investor due to higher-than-expected premium payments.
4. Operational risk: the risk of loss resulting from inadequate or failed internal processes, such as missing a premium payment, which may cause the policy to lapse and render it null and void.
5. Legal risk: the risk that the death benefit due to the life settlement investor is subject to a claim by others which may result in the investor losing the death benefit.
6. Credit risk: the risk that the insurance company that wrote the insurance policy can't pay the claim for the policy's death benefit when it matures.