Introducing Life Settlements - An Alternative Non-Correlated Asset Class

Brad Thompson, President of Fidelity Settlements, gave a fascinating presentation to delegates at the Hubbis Independent Wealth Management Forum to highlight the value of US life settlements, an asset class that he explained is non-correlated to the equity or bond markets. The purchase of life settlements, he reported, can be viewed as a zero-coupon bond with a projected maturity and that typically offers annual returns between 5% and 10%. The underlying asset is well-regulated in the US. A tertiary, or "re-sale" market also offering liquidity has also developed, should the investors want to cash out before maturity.

THOMPSON BEGAN BY INTRODUCING HIMSELF AS AN AMERICAN IN ASIA and offering some background on US life insurance policies. US Life insurance policies are not endowment policies and therefore differ somewhat from most policies issued in other countries. "They pay death benefit upon the demise of the insured," he explained. "In 1911, the US Supreme Court deemed that the ownership in a life insurance policy by a US citizen was personal property, so that US citizens can sell their ownership interest in a life insurance policy, just like you can sell a car or a plane. In 2015, the United Nations endorsed life settlements in their Principles for Responsible Investment document."

He then explained that a life settlement offers the potential to transfer ownership and the beneficiary rights of a life insurance policy to a third-party investor for value. "The settlement," he said, "is generally made in lump sum payments, not via instalments. The purchase price is a discount of the policy's face value,

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but significantly more than the cash surrender value of the policy. When the insured passes away, the investor receives the whole face value of the policy."

The calculation for a policy's value is relatively simple – it is a net present value discount calculation, based on the death benefit, the projected life expectancy of the insured, the premiums required to keep in the policy in force for at least the projected life expectancy of the insured, and the rate of return expected by the investor.

The policyholder sells life insurance policies in the life settlement market to monetise an otherwise unwanted or no longer needed illiquid asset. An example of a no longer needed policy would be a key man life insurance policy owned by a company on a retired executive. In the past a company would give the policy to the retired executive who, in turn, would either lapse the policy for no value or surrender the policy to the Insurance Company for the cash surrender value. The life settlement option allows the retired executive to receive payment for his policy much greater than the cash surrender value.

Another example Thompson cited related to inheritance tax. In the US, he explained, the threshold for inheritance tax has changed dramatically. It used to be that people with a net worth greater than USD600,000 were subject to inheritance tax. That threshold has now been increased to USD12 million. "In the past, inheritance tax was funded through an insurance policy. Now, with the higher threshold, there is generally no need to keep that insurance policy. Instead of lapsing the policy for no value or collecting the cash surrender value, the life settlement option offers the policyholder an enhanced value."

Thompson explained that investor benefits are rather straightforward; the asset is not correlated to any market; it has minimal volatility and great predictability. "It is basically a zero-coupon bond with a projected maturity," he explained. "Life settlements are advantageous to the investor and the policy owner. It is an overall win-win situation."

He also highlighted how this particular asset class is performing at a rate higher than other fixed-income products. "We target a return of 8% per annum," he reported. "Most life settlements are returning 5% to 8%, with some even returning up to 12% reportedly, although that seems rather too high, honestly. I think a range of 5% to 10% is very realistic and quite achievable. There is low credit risk on the underlying assets, as life insurance policies purchased by life settlement funds are generally issued by life insurance companies rated investment-grade, those being B plus or higher. Since 1860, US life insurance companies have always paid death benefits. Yes, people have lost on some annuities issued by US life insurance carriers, but death benefits have always been paid."

Thompson added that the reason death benefits have always been paid is due to the very proactive regulatory and reserve requirements to which US life insurance companies are subject. Regulators can force the sale of a troubled insurance carrier to a healthier carrier. Moreover, the reserve requirements in the US for life insurance carriers are rather high, he explained. Thompson stated he believed that there is virtually no credit risk on the

underlying asset, which is subject to very tight regulation in the US."

He then noted that there are two types of markets for life settlements in the US. The secondary market is the sale of the life insurance policy from the original policyholder to the investor. The potential gross market for policies which may be candidates for life settlements is reported to be around USD2.5 trillion, according to data from Conning. Annual trading in the secondary market is somewhere between USD1.8 billion to USD2 billion in face value. "This means that this is very much a niche market," he concluded. "The second type of market are trades between investors, or what is known as the tertiary market. We estimate there is today between USD30 and USD35 billion in face value of policies owned by investors. Trading in that market is fairly active allowing investors the ability to liquidate policies within about 90 days should they desire to get out of their positions."

And with that, Thompson closed his talk by encouraging delegates to consider this asset as an alternative instrument for their HNW clients. ■

Brad Thompson and Life Settlements

Brad Thompson is the co-founder of Fidelity Settlements, a life settlement company established in 2001. Brad was formerly very active with the life settlement industry's US trade association (Life Insurance Settlement Association - LISA), including serving on the Executive Committee of the Board of Directors as Vice President and Treasurer for over six years.

During that time Brad was also the Chairman of the Accounting Issues Committee where he was instrumental in assisting the Financial Accounting Standards Board (FASB) draft FSP 85-4-1 "Accounting for Life Settlement Contracts by Third Party Investors" in 2006. Staff at FASB also requested Thompson, on behalf of LISA, to define methodologies to determine fair value for life settlements. Brad chaired that project and released a White Paper, published in 2007.

Thompson also co-authored the life settlement industry's Code of Ethics in 2004 and the first version of the industry's "Best Practices" in 2008. Before founding Fidelity Settlements, he had held several senior executive positions (CFO, COO and CEO) with a public reporting entity that he co-founded, Imtech Office Solutions, and before that was in Public Accounting for 16 years, primarily with Grant Thornton. ■