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ARTICLES

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# Life Settlements Gain Greater Attention from Private Funds

**MARKET VOLATILITY STEERS CAPITAL TOWARD ALTERNATIVE INVESTMENTS, BUT RISKS LOOM FOR THE UNINITIATED.**

Given the threat of a significant repricing across multiple asset classes, investors are looking for fresh ideas. The current bout of market volatility has not spared many categories of investment, as equities and fixed income have moved downward in sympathy, and the outlook for other major classes of investment, like real estate, is clouded by rising interest rates. What investors long for during periods like this are assets that are uncorrelated with financial markets. Many so-called alternative investments are designed to fill that niche; however, these investments don't always escape the gravity of falling financial markets and are more correlated than they might otherwise appear to be, particularly when crisis dynamics take hold.

This predicament partly explains the increasing interest in life settlements from the private fund industry. Life settlement is a means of selling a life insurance policy when the insured no longer needs, wants, or can afford the policy. This class of assets was essentially created by a 1911 U.S. Supreme Court case, *Grigsby v. Russell*, establishing that life settlements are to be treated in much the same way as fundamental property, with the policyowner retaining the right to sell his or her policy. When a policy is taken out, an insurable interest must be present; however, once a policy is issued, the policyowner is granted the same privileges as any other owner of property. As such, the policy can be transferred or sold without restriction, as long as the policy is outside of its two-year contestability period.

Life settlements as an asset class can provide investors with equity-like yields and a superior risk profile, and importantly, they are not correlated with

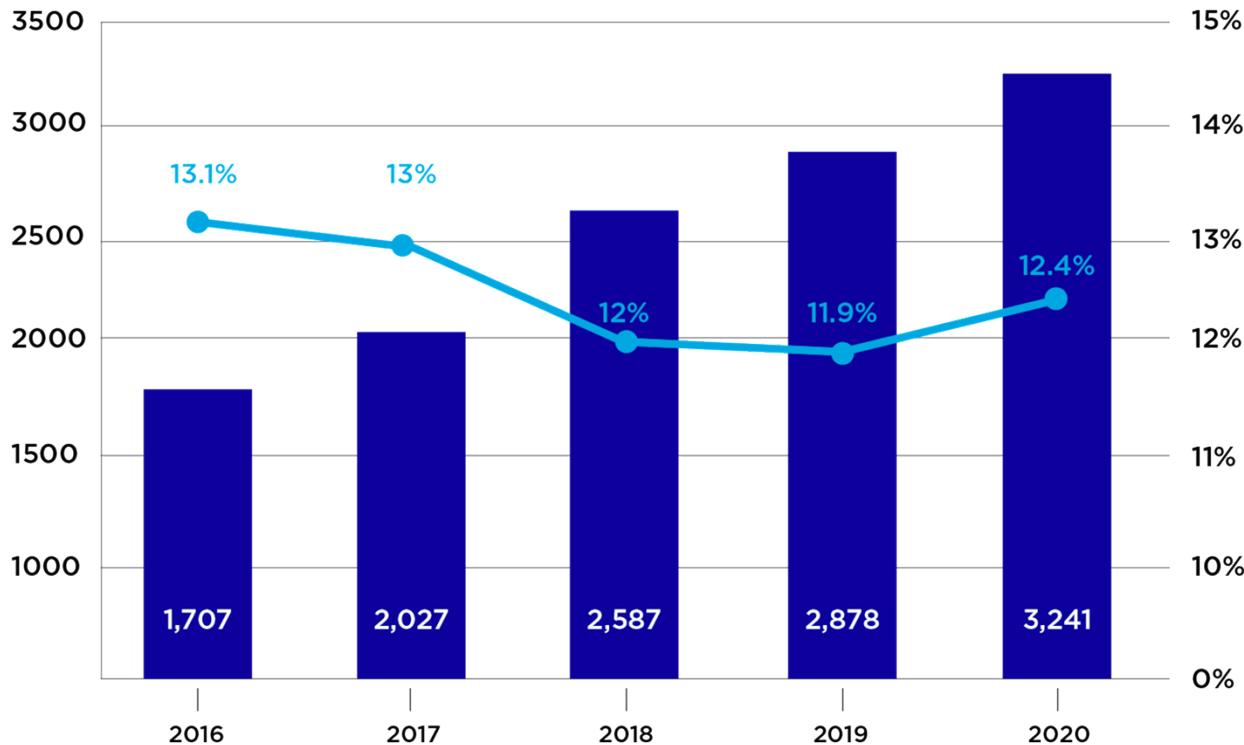
financial markets; however, they are not risk-free. There are important legal and tax implications for life settlement transactions that buyers need to weigh and consider.

### **A Case Study**

As part of a benefits package, a corporation insured its chief executive officer with a \$4.5 million universal life policy, paying \$98,000 per year into the policy. After seven years, the need for coverage had dissipated and the company decided to assess its options. The company was sporadic with the timing and regularity of its payments, but the policy was in good standing despite having zero surrender value. Working with an experienced life insurance representative, who is also licensed for life settlement transactions, legal counsel proceeded to assess the fair-market value of the policy.

The application process is straightforward. Interestingly, an exam or physical is not required. Keep in mind that this is an inverse process from when the policy was issued. The insured filled out an application, signed a HIPAA authorization, and medical records were requested from his physicians. Upon receipt of a complete set of medical records, such records are sent to a life expectancy provider (depending on the dynamics of a case, anywhere from two to five life expectancy analyses are solicited for any given case). The assessments can range from \$350 to \$500, a cost typically covered by the settlement company.

## Life Settlements: Total Policies Sold vs. Median Investor Return



Source: *Harbor Life Settlements*, “American Seniors Are Losing Billions Every Year, Here’s How the Financial Industry Can Help.”

Once the required number of life expectancy analyses have been secured, the medical records and life expectancy certificates are sent to 20-30 life settlement purchasers. Typically, each potential purchaser knows what it’s looking for in a policy based on its preferred investment approach, but valuation is a key part of the life settlement process. For example, in our case study above, the initial offer and the final offer varied by over \$400,000. Such gaps in valuation, when extrapolated on a portfolio-wide basis, clearly can be material to a fund’s performance. Upon offer acceptance, the investor will provide the policyowner and insured with a purchase agreement.

### The Role of State Law

The entire life settlement process is governed by state insurance departments, specifically the state where the policyowner resides. The purchase documents must be reviewed and approved by the state governing the specific transaction. While at first glance the documents appear cumbersome—similar to that of a mortgage—it is important to know that state insurance departments have gone to great lengths to protect the policyholder in these transactions. Note that in most states there is a recission

period that begins when the money is wired from the settlement provider to the policyowner. In the event someone has a change of heart or the insured passes away during the recission period, the original rights of the policy will go to the owner.

## **Policy Characteristics and Types**

Understanding the terms and conditions that attach to the underlying insurance policies is a key to success when pursuing a life settlement investment strategy. Ideal sellers have a life expectancy of less than 18 years but over two years with 10 years serving as the median (a viatical settlement is the sale of a policy on a person whose life expectancy is less than two years). Insureds are typically over 65 years old, with 77 serving as the average. If an insured incurs a change in health from the date of policy issuance to present day, this is favorable for the establishment of fair-market value of the policy. As previously mentioned, this is an inverse process from when the policy was first established.

Universal life, whole life, variable universal life, guaranteed universal life, indexed universal life, and term insurance are all candidates to be purchased in the life settlement market. In most cases, term insurance will still need to have conversion options available. Overall, in this market, underfunded or underperforming universal life policies seem to be most appealing to potential purchasers. Term insurance is also attractive because generally the purchaser can convert the term insurance to the product of the buyer's choosing. All other types of policies can be sold, but the cost of insurance can be higher than those previously mentioned.

## **Taxation of Policy Proceeds**

As with any investment or transaction, the way proceeds are taxed can have a huge impact on the underlying economics of the deal. As set forth under the 2017 Tax Cuts and Jobs Act, the tax treatment for a life settlement is as follows:

Up to Basis (premiums paid into the policy)—No Tax Consequence

Basis to the Surrender Value—Ordinary Income

Sale Proceeds exceeding Surrender Value—Capital Gain

Most settlement transactions typically only involve capital gains because it is uncommon to see a universal life policy with a surrender value in excess of basis. When the total premiums paid into a policy exceeds the settlement value, there is no tax consequence to the seller.

## **Conclusion**

The life settlement process is a very valuable mechanism for certain insured and potential buyers to mutually benefit from the transaction; however, it may be underutilized due to a lack of awareness or

full legal understanding of the related implications. Involving experienced advisors from a legal and life insurance standpoint can significantly reduce the amount of risk compared to potential reward in these situations. In addition, the industry's regulatory standards add an extra level of transaction risk that investors will need to navigate.