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Liquidity Improving For Life Settlements

Double-digit returns, lack of correlation with financial markets lures hedge, pension funds

Life settlements, or insurance policies sold to third parties by high-net-worth individuals ahead of their deaths, are quickly developing into a liquid asset class as large institutional investors, particularly hedge and pension funds, continue to wade into the nascent market. Some banks have also joined the fray—DZ Bank, Deutsche Bank, Abbey National and Citigroup—but most remain on the sidelines at this point.

Although returns are compressing as more investors enter the market, life settlements typically offer double-digit yields, much better than junk bonds. That is not bad considering they are largely obligations of highly rated insurance companies. Aside from the robust returns, some investors also like them because they are not correlated with the bond or stock markets.

"Pension funds are in dire need of



Life Settlement Solutions' Simon: 'As soon as you see a true securitization done, you will see a flood of investment bankers going to the marketplace.'

higher returns. Hedge funds are looking for noncorrelated assets," said Larry Simon, president and founder of Life Settlement Solutions, a servicer that opened its doors in 1999. "Banks are also interested in

returns and have a low cost of capital, so if you can get decent returns on this versus a low cost of capital, it's pocket change."

Life settlement servicers typically pay policyholders 20-30% of the death benefits they stand to receive but more than the cash surrender value of the policies. Simon estimates there will be \$12 billion worth of life settlement transactions done this year, up from \$8 billion a year ago. In 2006, he expects the market will grow to \$15-16 billion. Analysts at Sanford C. Bernstein see the entire secondary market for these products growing more than tenfold to \$160 billion over the course of the next several years.

More investors continue to come into the market, including government pension funds that need to close their funding gaps. For example, legislators in St. Thomas earlier this month passed a law allowing a

government pension plan to buy life settlements. "You are going to see more of that," Simon said. "[St. Thomas] is underfunded by about \$800 million, and this is a way for them to get back to where they need to be."

One catch, however, is that there is not much trading in these policies, and they generate no current returns for anywhere from two to 12 years. Therefore many hedge funds stick these investments in side pockets, a separate class of shares created to hold illiquid investments that may be difficult to value. Shares in side pockets can't be redeemed until the investment is liquidated or matures (see *IDD*, "More Hedge Funds Aim for Side Pockets," 10/17/2005). "I've seen one hedge fund that actually has 25-year lockups on one of their funds. That's a perfect vehicle for this," said Simon.

Still, investors must be selective as there have been many incidents of fraud in the sector. These tend to be in the form of so-called wet-paper deals, which refer to insurance policies that come to the settlement market before the ink has dried, some

as quickly as two months. There have been instances where investors in life settlements have not been paid because the insurer discovered fraud in the underwriting of the policy, and wet-paper deals are a potential warning sign that something could be amiss. "If they're not careful in the paper they buy, hedge funds can get burned and wind up with policies that insurance companies may void," said Thomas Weinberger, special counsel with New York-based law firm Mound Cotton Wollan & Greengrass.

Another potential source of liquidity, an obvious one to some, is insurance companies, most of which have been conspicuously absent from the life settlement market. Some suspect that this is partly because they do not want to encourage its development. Insurers build into pricing the assumption that a number of policyholders will let their policies lapse, according to Weinberger. As life settlement transactions increasingly provide policyholders with an alternative to allowing lapses, life insurers could find their assumptions being thrown off.

Yet another problem for insurers is that part of the charm of a life insurance policy is its tax-deferred nature. If life settlements start to be viewed as investment vehicles, there is concern that the cash value of these policies could become taxable, according to Weinberger, and that could deter underwriting business.

Another massive pool of capital that could be tapped more aggressively is the securitization market. There has been a trickle of small bond deals backed by pools of life insurance settlements done almost exclusively in the private-placement market, and a larger, public transaction with ratings is still likely years away. This is partly because of a lack of historical data for the rating agencies. "As soon as you see a true securitization done, you will see a flood of investment bankers going to the marketplace," said Simon. "There will be more money in the market than we know what to do with."

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Larry Simon is director, chief executive officer and president of Life Settlement Solutions Inc. based in San Diego, Calif. Life Settlement Solutions and its management have an established, proven industry record, having purchased life insurance policies in excess of \$1 billion aggregate face value to date.

For more information regarding Life Settlement Solutions, visit www.lss-corp.com.

