RE swaps: Using life settlement policies as currency

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In the prior article dealing with asset swaps, I touched on the idea of utilizing alternative assets as currency to exit out of impaired real estate equity/debt positions.

Such a "Barter" transaction would in effect provide several potential benefits to the owner of the impaired asset.

First, the owner receives a basket of Life Settlement Policies (LSFs) with a face value equal to a multiple of the equity value of their asset.

Secondly, the owner may potentially not have to take an actual write down of their position based on their interpretation of LSFs and Barter accounting rules.

Additionally, the owner may replace a management / capital intensive investment with one that is passive and has credit like qualities (there has never been a death benefit not paid due to a life insurer default).

What is a Life Settlement?

The 1911 U.S. Supreme Court case of *Gribsby v. Russell* established that policy owners have the right to transfer an insurance policy in a manner similar to any other asset.

A Life Settlement is the sale of an existing life insurance policy to a third party who will receive the future death benefits afforded under the policy.

The third party buyer will pay more then the cash surrender value but less than the expected net death benefits for the policy.

There are a number of reasons why a policy holder may wish to sell his policy rather then continuing to hold and pay premiums; the policy is no longer needed or wanted due to divorce or death, the premium payments have become unaffordable, changes in estate planning needs, rising healthcare costs or other financial concerns.

History of the Market.

Although the secondary market for life insurance was officially launched with the judicial ruling in 1911 the first of such transactions occurred amidst the AIDS epidemic in the mid-to-late 1980s.

These transactions involved the purchase of policies from terminally ill individuals for a percentage of the policy face value with the proceeds from the sale used to finance expensive health care fees (viatical settlements).

The current shape of the life settlement market took form after the passage of the Health Insurance Portability and Accountability Act in 1996.

The law established a framework for the administration and safeguarding of data, confirmed the right of the policy owner to transfer their beneficial ownership to a third party having no insurable interest to the original insured party and determined the tax treatment of the corresponding gain.

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Market Size and Institutional Involvement

The life settlement market has experienced tremendous growth. The estimated face amount cleared grew from $3B in 2003 to more than $12B in 2008. A recent study by Conning & Co. has estimated that the market has the potential to reach $160B in the coming decade.

In March 2007, the Institutional Life Market Association was formed by six leading investment banks (Bear Sterns, Credit Suisse, Goldman Sachs, Mizuho Int., UBS and West LB) to spearhead a number of initiatives focused on legislative and best practices in the life settlement industry. Additionally, as other industries have done, life settlements can point to Warren Buffet's Berkshire Hathaway investment into the asset class as a stamp of legitimacy.

Parties to a Life Settlement

A life settlement provider acts as the lynchpin between capital flowing into the industry and individuals seeking to sell their policies. Providers usually aggregate individual policies and sell them to third party investors. Provider firms are responsible for valuing individual life policies and executing the necessary paperwork to transfer beneficial ownership.

A Provider can also provide asset management services such as managing premium payments, tracking the insured and processing death benefits. Other participants can include financial advisors, brokers, underwriters and third party asset servicers.

Cash Flow – (really, really simplified)

Life Settlement investors are primarily concerned with the timing rather then the probability of the payout. The median life expectancy of a portfolio is typically 8-12 years but can vary greatly based on an investors goals. The owner of the policy must continue to make associated annual premium payments (typically 2%-4% of the outstanding policy) in order to keep the policy in force and collect the death benefits.

Therefore the equity multiple and IRR return is driven solely by the length of time it takes to realize the death benefits.

It should also be noted that even though the portfolio starts out with a negative carry (premium payments are greater then total current death benefits) a properly structured portfolio can become cash flow positive by the 5-7th year (estimate based on typical distribution i.e. bell curve).

What's next?

This will involve working with a third party willing to take the balance sheet risk of acquiring the real estate asset as well as having the expertise and capital to provide a portfolio of (or a combination of cash and) LSFs.

Subsequent articles will explore in further details how to utilize Life Settlement Policies as currency for an asset "swap" and/or as a principal "wrap" for at risk capital investments into real estate..