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Understanding Life Insurance as an Asset Class: Investor Insights and Regulatory Measures

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Investing in a portfolio of life insurance policies can provide attractive returns while potentially avoiding the ebb and flow of a volatile market. Institutional investors and family offices continue to invest at an increasing rate, with average growth surpassing 10% over the last 2 years. The keys to successfully deploying capital into the asset class and positioning a fund for favorable financial returns is understanding policy position within an insurance company's capital stack and accurately assessing the carrier's financial stability.

This article explores the intricacies of life insurance as an asset, its obligations within an insurance company's capital structure, and the regulatory requirements that ensure investors, who ultimately benefit as policy beneficiaries, receive the death benefits.

Life Insurance as a Liability

Life insurance policies represent a significant liability within an insurance company's capital stack. The capital stack is composed of several layers, including prescribed reserves, surplus, and capital. These layers ensure the company can meet its financial obligations to policyholders and other stakeholders.

Policyholder reserves are the most substantial liability and include the total expected claims from life insurance policies. These reserves are set aside to pay future claims and are calculated based on actuarial assumptions about mortality rates, policy lapse rates, and interest rates.

In addition to policyholder reserves, surplus and capital provide an additional cushion. This includes retained earnings and additional paid-in capital, which act as a financial buffer to absorb unexpected losses.

Life insurance policies are senior to most claims, positioned only below senior debt and subordinated debt within the insurance company's capital structure. The position of life insurance in the capital stack is crucial

for investors as it affects the risk and return profile of the investment, meaning they have priority over other claims in the event of a payout. This seniority provides greater security for investors, as they are more likely to receive payments before other creditors or equity holders.

Likelihood of Non-Payment Due to Insolvency

The likelihood of a life insurance policy not paying out due to the insolvency of the issuer is relatively low, thanks to stringent regulatory oversight and the safety nets provided by state guarantee associations.

A strong regulatory framework means that insurance companies must adhere to strict solvency standards, thereby reducing the risk of insolvency.

State Guaranty Associations are organizations that protect policyholders in the event of an insurance company's insolvency. SGAs are required by law in all states and are funded by assessments charged to insurers. SGAs provide a partial backstop, ensuring that even if an insurer fails, policyholders can receive their benefits up to the SGA's coverage limits.

The life insurance industry is generally stable, with a low incidence of failures compared to other financial sectors.

Let's take a closer look at each requirement.

Insurance Company Cash Requirements

Insurance companies must maintain adequate cash reserves to meet the total face amount of active life insurance policies. Regulatory frameworks require insurers to hold a certain percentage of their liabilities in liquid or near-liquid assets. These requirements aim to ensure that companies can meet policyholder claims promptly.

Liquidity Requirements: Insurers must maintain a portion of their investments in highly liquid assets to meet immediate claims. These typically include government securities, high-quality corporate bonds, and cash equivalents.

State Guaranty Associations

Each state in the U.S. has a State Guaranty Association that protects policyholders if an insurance company becomes insolvent. These associations are part of a safety net designed to provide limited coverage and ensure policyholders receive at least part of their benefits.

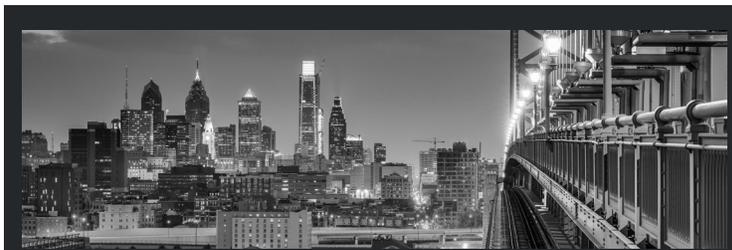
- **Coverage Limits:** State Guarantee Associations typically cover up to \$300,000 in life insurance death benefits and \$100,000 in cash surrender or withdrawal values per policyholder.
- **Funding:** These associations are funded by assessments on solvent insurance companies operating within the state. When an insurer fails, the guarantee association steps in to cover claims up to the specified limits.

Acquiring the Assets of a Failing Insurance Company

Although unlikely and rare, if an insurance company fails, most often, other insurers step in to acquire its assets and liabilities. This process is typically overseen by state regulators and involves the following steps:

1. **Transfer of Policies:** The policies of the failing insurer are often transferred to a solvent insurer. This can involve selling the company's assets to raise the necessary funds or directly transferring the policies to another insurer willing to assume the liabilities.
2. **Maintaining Policyholder Protection:** The acquiring insurer ensures that policyholders continue to receive their benefits without interruption, adhering to the terms of the original policies.

In conclusion, life insurance policies hold a significant position in the capital stack of insurance companies, backed by robust reserves and regulatory safeguards. The combined efforts of state guaranty associations and potential acquisitions by other insurers further mitigate the risk of non-payment due to issuer insolvency, providing policyholders and investors of these assets with a high level of security and peace of mind.



The LifeCap Advantage

LifeCap specializes in providing institutional investors and family offices unparalleled access to longevity-oriented investments through our strategic relationships with leading companies in the secondary market for life insurance.

The LifeCap team has spent more than 20 years working alongside institutions, advisors, and individual investors alike to educate investors about alternative assets, with a focus on longevity-oriented investments.

To learn more about life settlements and how LifeCap can enable you to leverage the potential of the longevity-oriented asset class, schedule a call with us at lifecap.com.