

The Impact of Interest Rates and Inflation on Life Settlement Returns

- **Abstract**

Life Settlements, which is the buying and selling of existing life insurance policies in a secondary market, can provide a unique and profitable investment opportunity. However, many investors wonder how changes in interest rates, inflation and the current economic environment may impact the returns of these investments. This white paper aims to address these questions by providing an analysis of how interest rates and inflation affect Life Settlement returns. The paper will discuss how these economic factors impact the cash flows, valuations, and supply and demand of Life Settlement policies. Finally, the paper will compare the returns of Life Settlements to other fixed income products, such as treasuries and private debt.

- **Introduction**

Life Settlements have become an increasingly popular investment opportunity, as they offer robust returns, strong credit quality and low correlation to other asset classes. However, and in light of the current economic climate, it is important for investors to understand the potential impact of interest rate hikes and inflation on their Life Settlement investments. The Federal Reserve and the European Central Bank have both raised interest rates to historically high levels in 2022, which has led to a decline in financial conditions and increased risks to financial stability. This has resulted in a decrease in financial asset prices, increased market volatility, and at times, difficulty for market participants to meet margin calls. Furthermore, inflation has risen significantly due to supply chain disruptions and rising energy costs, following Russia's invasion of Ukraine. For that reason and today more than ever, Life Settlement investments continue to offer a valuable and reliable way to diversify investment portfolios, with the potential to provide consistent returns over time.

- **The Impact of Interest Rates on Life Settlement Returns**

Life settlement policies offer a unique investment opportunity for investors and funds looking for diversification in their portfolio. Unlike traditional investments that are directly impacted by interest rate fluctuations, life settlement policies are not dependent on interest rates and provide a stable cash flow. The investment performance of these policies is based on a mortality event which is not correlated with interest rates.

One of the key benefits of life settlement policies is the fixed face value of the policy. This means that the value of the policy does not change in response to economic events, providing a predictable and stable investment return for the investor. If an investor or a fund owns a life settlement policy and the strategy is to hold the policy until maturity, interest rates will not affect the investment return of said policy. The Face Value is fixed, it does not change according to economic events and the liquidity event is the death of the insured which is not correlated to traditional macroeconomic variables. Hence if an investor owns a life settlement policy and holds it to maturity, the investment return is not affected by any economic event such as high interest rates and/or inflation.

On the other hand, changes in interest rates and or inflation, may have an indirect impact on the market value of Life Settlements by affecting the market's supply and demand forces. Rising interest rates and inflation may encourage policy owners, who may be affected by rising costs of consumer goods, to sell their life insurance policies to supplement their expenses thereby increasing supply. At the same economic recession may affect the demand, with investors choosing to invest in defensive strategies. While a period of increased supply and decreased demand would affect negatively the market value of life settlements, it is important to keep in mind that the maturity value is still fixed and would not change. Similarly, periods of decreased supply and increased capital would affect the value of a life settlement contract positively and potentially increase their returns.

- **The Impact of Inflation on Life Settlement Returns**

Life Settlements offer returns that are not closely correlated to the broader economic conditions and are immune to inflationary pressures. These factors make them an ideal addition to a diversified investment portfolio.

Unlike traditional assets like bonds and equities, the returns from Life Settlements are fixed and are solely determined by the underlying maturity/mortality event. This feature of Life Settlements makes them a stable and consistent source of returns within a portfolio. Furthermore, the lack of correlation with other asset classes can help to mitigate overall portfolio risk. In summary, the distinct features of Life Settlements make them an

attractive investment opportunity for those seeking to diversify and stabilize their portfolios and perform completely independent of inflationary trends.

- **Impact of Rising Interest Rates on Life Insurers**

The carrying charge for a life insurance policy is its premium, which is paid to keep the policy in good standing. Included within the premium is the cost of insurance (COI). While the COI component may increase with age, this is not a direct result of inflation, but rather due to the increased likelihood of mortality as the insured individual ages.

During periods of low interest rates, some life insurance companies may have increased their premium levels to maintain a positive profit margin. In the environment of increasing interest rates, most of the insurance carriers have seen limited exposure to losses from fixed income assets, however they shall be poised to profit from re-investment into higher yielding bonds in the long-run. This means that life insurance companies may be able to achieve better returns on their assets while allowing for the better premium optimization strategies used by life settlement investors to improve their returns.

Better returns on assets improves their financial health and fortifies their credit ratings making the guarantor of the face value for life settlements stronger.

- **Comparison of Life Settlements Returns to Other Fixed Income or Private Debt Products**

When it comes to fixed income products, Life Settlements offer significantly higher returns compared to traditional options such as treasuries. While 10-year treasury yields currently over around 4%, Life Settlements have the potential to provide double-digit returns. While treasuries are highly liquid, this liquidity comes at the cost of potential reprising in the event of an increase in interest rates or inflation. Further their market value is also a lot more sensitive and correlated to economic circumstances than Life Settlements.

In contrast to private debt products, Life Settlements can offer more favourable returns. The collateral for private debt is often of non-standard credit quality, which can be highly vulnerable to changes in interest rates and inflation. Shall aggressive tightening continue some predict that default rates for US leveraged loans could next year rise beyond 10%. An impact for emerging markets may be much more pronounced. On the other hand, the collateral for Life Settlements is backed by some of the world's largest and most reputable Life Insurance Companies, which have a proven track record of stability and resilience even during economic downturns.

USD default rates up against HY spread developments with implied default rates



Source: ING, ICE, Moody's

- **Conclusion**

In summary, investing in life settlements can be a valuable opportunity for those looking to diversify their portfolio and earn consistent returns over time. Unlike traditional investments that are impacted by changes in interest rates and inflation, life settlement policies are not dependent on these macroeconomic factors and offer a stable cash flow when held to maturity. The value of these policies is based on market supply and demand, rather than interest

rates, making them a reliable investment option. Additionally, changes in interest rates and inflation can even benefit life settlement investors by increasing the supply of policies on the market and increasing opportunities.

Furthermore, comparing to other fixed income products, life settlements offer significantly higher returns, and are also backed by some of the world's largest and most reputable life insurance companies, which have a proven track record of stability and resilience even during economic downturns. Life Settlements offer a unique investment opportunity with limited correlation to economic circumstances and are not impacted by inflation or interest rates. They provide an attractive alternative to traditional fixed income products such as treasuries and private debt products, with higher potential returns and a robust credit quality.