

Private Placement Life Insurance

The New Alternative in Insurance

By Brad Cole (brad@colepartners.com) and Christine Kailus (christine@colepartners.com), Cole Partners

As equity market profits have eroded over the last couple years, interest in hedge funds and other liquid alternative investment strategies has increased dramatically. Once considered investment toys of the wealthy, hedge funds are quickly becoming part of mainstream portfolios as a diversifier to traditional holdings. These funds satisfy investor demand for market diversification, often through the use of hedging, leveraging, or various trading strategies. As the demand for hedge fund products increases, financial services firms and members of the brokerage community are looking for means to facilitate related products.

Insurance companies are one example of traditional financial services firms integrating hedge funds into their offerings. While many insurance companies have embraced the hedge fund concept, finding efficient ways to feed hedge fund products to their policyholders is still a work in progress. Within this report, we attempt to illustrate a simple bridge between hedge fund and insurance language and products, attempting to uncover the edge that exists in combining these fundamental vehicles of traditional and alternative investment worlds.

Insurance Overview

First, we will consider some insurance basics. A key feature to distinguish among various insurance products is flexibility. The simplest insurance products do not offer policyholders their choice of underlying investment vehicles or payment structure, while more sophisticated products offer customization in almost every area. Figure A outlines some of the rudimentary elements of common insurance products; below, we summarize some important points.

Figure A

Life Insurance Products

Term Life Insurance: This is the simplest form of life insurance. Policies cover a certain amount time period, i.e. 20 years. The death benefit doesn't usually come into play, as the insured usually does not die during the term of the policy. **These policies generally do not build cash value, so they cannot invest in hedge funds**

Cash Value Insurance: Generally refers to any policy with higher premiums because assets will build up cash value and be invested. Different types of cash value insurance products include:

Whole Life Insurance

- Covers for life
- Fixed premiums. Loans available
- Cash value typically invested in a account within the insurance company's general account, which is managed internally
- **Underlying investment is not chosen by policyholder, so cannot invest in hedge funds**

Universal Life Insurance

- Flexible premiums
- Cash value is invested by the insurance company, generally in a new money rate portfolio
- **Underlying investment is not chosen by policyholder, so cannot invest in hedge funds**

Variable Life Insurance

- Policyholder may choose the investment vehicle for cash value investment (stock, bonds, mutual funds) These funds may be managed by the insurance company or by outside advisors appointed by the insurance company.
- **Because not limited to accredited investors, cannot invest in hedge funds**

Variable Universal Life Insurance

- Variable and Universal policies are often sold as a combined product
- Flexible premiums and death benefit
- Policyholder may choose cash value investments
- Death benefit increases/decreases with performance of investments
- Tax-free growth on investment
- **Because not limited to accredited investors, cannot invest in hedge funds**

Private Placement Life Insurance

- Investor may chose underlying investments
- Tax-free growth on investment
- Income tax-free death benefit
- Product is generally customized to meet individual needs concerning premiums and death benefit
- Only open to a limited number of accredited investors
- **May incorporate alternative investments such as hedge funds**

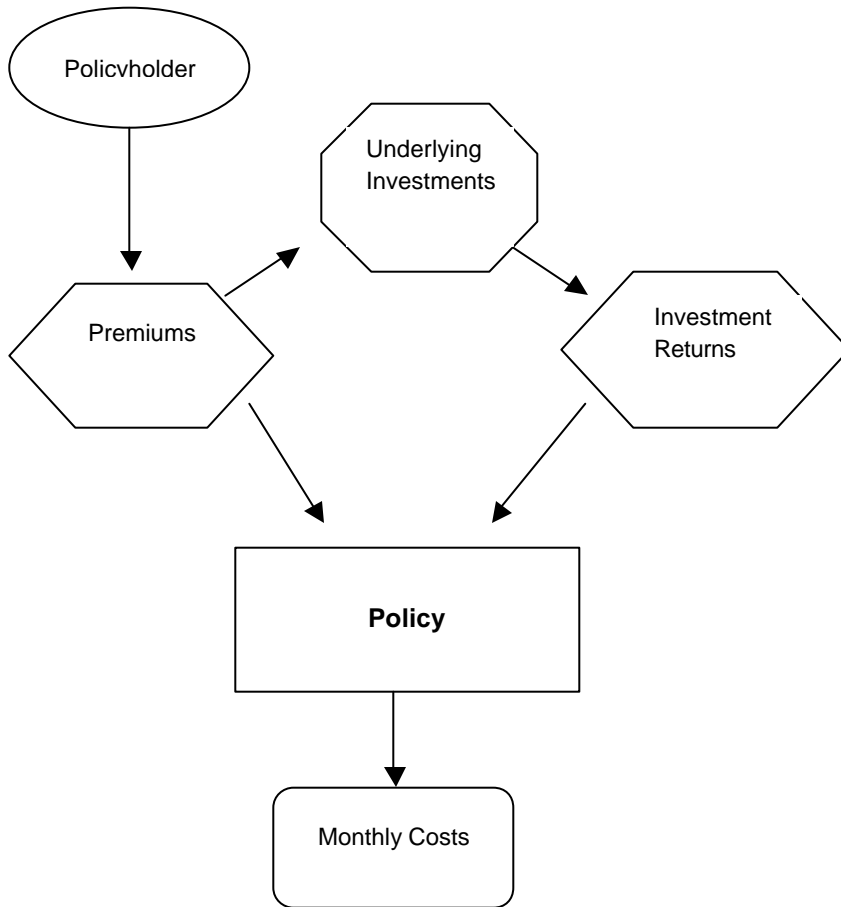
One broad distinction to make among insurance products is whether or not they build cash value. Cash value products introduce an investment component and thus will be the focus of our discussion.

Cash value insurance products generally have higher premiums than term insurance products. Essentially, the policyholder overpays the premiums and assets are considered the cash value of the policy. The cash value is invested to build up overall policy assets, and monthly withdrawals are made to cover the cost of insurance and related charges (please see Figure B). Because returns on investments made under the life insurance wrapper compound tax-deferred, insurance emerges as a tax-advantaged investment vehicle.

A simple cash value product is *whole life insurance*. Generally, a whole life policy consists of fixed premium payments where the policy's cash value is invested in the insurance company's general account. The insurance company often manages this account internally, investing in conservative equity and fixed-income funds. *Universal life insurance* is similar, but the policyholder may adjust the premium payments and face value of the policy. The cash value, however, is invested in a new money rate portfolio.

Variable products introduce flexibility to the underlying investment vehicle and are often combined with universal policies to create a similar product known as *variable universal life insurance*. In variable universal products, the policyholder decides how the cash value will be invested. The issuing company typically offers a directory of traditional stock, bond, and money market mutual funds to choose from (At this point, it's still too soon for hedge funds to be an option). Returns on these investments compound tax-free. The risk in this type of policy is that the cash value of a policy can decrease with ill-performing investments. As financial markets have struggled in recent years, this possibility has become a legitimate concern.

Figure B
Structure of a general cash value product



Monthly costs include: a) cost of insurance b) administration charges c) mortality and expense charges

Products for the Sophisticated Investor

In response to the need for higher returns and more diversification in underlying investments, insurance companies have introduced a new wave of insurance products. This is where the diversification benefits of hedge funds emerge.

Investors seeking uncorrelated returns now have the option of purchasing *private placement life insurance (PPLI)*, which is essentially an unregistered variable universal policy. Because these policies are considered private placements, PPLI is only available to accredited investors¹. As such, these investors may choose to invest their policy assets in hedge funds.

There are two ways to invest in private placement products: offshore and domestic onshore. Many states were slow to lift restrictions on insurance companies investing in hedge funds, which initially prompted some hedge fund investors to create this type of arrangement offshore. Schmidt Financial Group is a Chicago-based financial consulting firm that specializes in implementing offshore private placement life insurance products. Their clients are usually investors that would like to invest their existing hedge funds with the insurance tax wrapper.

“The overall motive here is not for insurance, but for tax deferral,” Sandy Schmidt, President of Schmidt Financial Group, says.

This idea seems to have caught on; many states have relaxed their restrictions on insurance investments and many of the large domestic carriers are becoming involved as well.

¹ An accredited investor, as defined by Regulation D of the Securities act of 1933, is any person “whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1 million; who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.”

Bob Hebron, Senior Vice President of New York Life Insurance Company explains why PPLI can be so attractive to policyholders: “The build-up on these investments, as long as the product stays within the realm of life insurance, is tax deferred.”

Hebron notes several qualifications that a PPLI must meet in order to maintain its tax-deferred “life insurance” status under the Internal Revenue Code. One requirement concerns investor control. If the policyholder has too much control over the underlying investments, the policy will not qualify as life insurance. Policyholders may talk to the manager if they have questions about the fund or performance, but should not have the ability to influence the investment decisions of the manager. Essentially, the insurance company becomes the client of the hedge fund and the policyholder owns an insurance contract; they do not own the underlying investments. Another requirement pertaining to underlying investments relates to diversification. According to section 817 (h) of the Internal Revenue Code, no more than 55 percent of the value of the total assets of the account can be placed with any one investment. No more than 70 percent may be placed with any two investments; no more than 80 percent with any three investments; no more than 90 percent with any four investments².

A third requirement considers the amount that is invested versus the amount that is available for insurance. If the ratio of premium payments to death benefit is too great, the policy may be classified as a modified endowment contract and lose the benefit of tax-free policy loans.

Products that meet these requirements will be considered life insurance and growth on underlying investments will accumulate tax-deferred. The death benefit will also be tax-deferred. These tax benefits are applicable to any life insurance product, but in the case of PPLI the advantages may be more significant for two reasons: First, because PPLI is only available to accredited

² As described in section 817 (h) of the Internal Revenue Code, “A variable contract, which is otherwise described in this section and which is based on a segregated asset account shall not be treated as a life insurance contract for any period (and any subsequent period) for which the investments made by such account are not, in accordance with regulations prescribed by the Secretary, adequately diversified.

investors, the larger amount of assets involved can create higher tax consequences for a non-deferred strategy. Second, hedge funds are typically short-term trading vehicles, which can subject their returns to significant taxes when considered without the insurance wrapper.

“When it comes to hedge funds, people see the possibilities for higher returns but also see the tax consequences,” Judy Rudnick, Industry Knowledge Manager for the Family Office Exchange says. “The advantage here is that you can invest in a taxable investment that has a high rate of return, but *without* certain tax consequences.”

The Family Office Exchange (FOX) is an organization that acts as an independent resource for wealthy families who operate single or multi-family offices. Rudnick is involved with a FOX program that provides a PPLI solution to wealthy families. Underlying investments may grow tax-deferred until death, but they will eventually still become an estate planning issue. Therefore, Rudnick suggests that PPLI investors work with an estate planner to configure the most inclusive tax-advantaged scenario.

Another consideration policyholders face is that in order for a hedge fund to be involved in a life insurance product, large domestic insurance carriers often require that the fund only accept insurance money. To meet this requirement, Hebron notes, hedge funds generally create a “clone” of their original fund that only accepts life insurance assets. This generally does not happen in the case of offshore products because investment managers are often negotiating with a smaller, less well-known insurance carrier that does not require an insurance-only fund.

The process of structuring a customized private placement contract can take as long as six to nine months.

In an attempt to make the process more efficient, New York Life and other large insurance carriers are starting to create private placement products that will bring hedge funds to the table rather than have the investor choose the funds. These

new products will give policyholders the option of investing in hedge funds that a) the insurance company has already negotiated with and b) already have insurance funds established. The advantage of a product like this is that the investor does not have to seek out a hedge fund and start the clone fund alone.

“Previously, only a certain number of accredited investors had the resources to initiate a PPLI product,” Hebron says. “To start the insurance fund, they would need at least \$10- 20 million and insurance underwriting. Hedge fund investors are used to a \$1 million minimum investment. Because PPLI has more substantial minimum, it has been very hard – up until now – for such investors to go into private placement life insurance.”

PPLI products offer a minimum investment that can be as low as \$1 million, but is commonly closer to \$5 million (Minimum investments are determined jointly by the insurance company and investment manager). The minimum investment often has premiums paid in over a few years, thus reducing the initial investment.

“Someone could potentially invest in a private placement product for \$250,000 a year,” Schmidt says.

PPLI Risks and Regulators

Investors must consider, however, that investments made with the cash value of one’s policy may not necessarily generate a profit. If the investor’s chosen fund proves to be ill-performing, the investor may have to sell shares, realize a loss, and invest in something else. The realized loss cannot be used to offset personal realized gains for income tax purposes.

The law firm of KMZ Rosenman has facilitated the production of hedge fund insurance products, represented insurance companies negotiating PPLI products, and represented individuals investing in PPLI. Wesley Nissen, a partner in the Chicago office of the firm, notes another important consideration for PPLI investors: credit exposure. When an investor buys into a fund directly, the investor is generally subject only to the credit risks of the fund itself. However,

when investing through PPLI products, the investor also is subject to the credit risks of, and possible defaults by, the insurance carrier.

“Investors should look to the strength of the institution they are buying from,” Nissen says. “It may be important.”

For example, in the occurrence of carrier insolvency, the assets in a segregated private placement account are safe from creditors, but the death benefit (the net amount at risk – the difference between the cash value and the death benefit) may be subject to claims of other creditors.

The Securities and Exchange Commission (SEC) does not regulate private placement products because they are unregistered, but two new regulatory figures emerge in its absence.

The Internal Revenue Service (IRS) regulates the tax treatment of different life insurance policies and monitors investor control. Most insurance companies, when creating PPLI products, use Section 817 (h) of the Internal Revenue Code as their guide and may interpret it as conservatively or aggressively as they feel comfortable doing, which explains the variance among policy norms. Well-known large domestic carriers tend to have a more conservative interpretation, while less well-known offshore carriers may take a more aggressive stance. There is no need for official regulatory approval because the product is a private placement, but the product must lie within the boundaries of 817 (h) to have tax-deferred status.

The other regulatory body is the insurance industry. Hedge fund managers have a certain amount of freedom not available to managers of SEC-regulated products, but must accommodate the regulatory requests of an insurance company to get involved in PPLI. When negotiating with hedge fund managers, insurance companies often employ a thorough due diligence process and demand a high level of transparency. Again, the company’s interpretation of 817(h) determines how rigorous this process is.

These products may present hedge fund managers with an opportunity for new assets and an additional marketing channel, but they also introduce some new considerations.

One very important issue is the new “clone” fund a manager may have to create for onshore carriers. The new fund can be created through a partnership arrangement whereby the hedge fund manager sets up a partnership with the insurance carrier and the carrier has partner ownership of the fund.

After the fund is established with insurance assets, the manager may co-mingle assets from other insurance carriers. It is important to note that each policy counts as one investor under the regulations regarding 3C1 or 3C7 funds, thus capacity may become a concern for the hedge fund manager³. Being aware of exactly how many policyholders are invested under the insurance company’s holdings is the responsibility of the manager.

Another issue to consider is the liquidity requirements set forth by the insurance carrier. Lock up periods for hedge funds may range from one month to over a year, but because the insurance contract requires certain payouts to be made from a policy, the hedge fund manager may have to make some adjustments. There are two issues to confront when discussing liquidity: 1) coverage for monthly policy withdrawals and 2) coverage for death benefit payouts. Depending on the policy and the agreement between the manager and insurance carrier, the manager may be required to surrender some of his lock-up provisions. In the case of the death benefit payout, the manager may be asked to provide emergency liquidity, whereby lock-up provisions are waived at a policyholder’s death and assets may be redeemed.

Once these matters are dealt with though, the manager can essentially go about business as usual.

³ According to Sections 3 (c) (1) and 3 (c) (7) of the Investment Company Act of 1940: 3c-1 funds may not have more than 99 limited partners. Each limited partner must be an accredited investor. 3c-7 funds can have up to 500 limited partners; however, each limited partner must be a qualified purchaser. (Qualified fund purchasers are individuals or families of companies with \$5 million in investments or an entity that holds and controls \$25 million in investments)

Beyond the PPLI Marketplace

With all the recognizable advantages of these products, insurance companies and managers alike are now focusing on bringing related products to a wider audience. For example, institutional investors who find PPLI with embedded hedge fund components attractive can find similar investment opportunities in the form of structured products. Insurance companies have been engineering these products in the form of guaranteed notes.

Products aimed at institutional clients are becoming available with the tax-advantaged insurance wrapper. At AEGON, one of the world's largest insurance groups, they are developing a product geared toward the institutional investor.

According to Mike Herp, Director of Business Development for AEGON's Structured Products division, the product will be a medium-term, principal guaranteed note. Assets within this product will initially be fully invested in hedge funds or fund of funds. If performance deteriorates, some assets will be moved to an "immunization cell" of fixed income investments. The investor fully participates in the returns (net of fees) of the fund and fixed income investments. The returns on these investments will accrue and be paid out as a lump sum at maturity. The accrual of returns is assumed to be tax-deferred, but as the product is aimed at offshore institutional investors, the payout at maturity will be subject to tax regulations of the investor's home country.

The principal is guaranteed, so the investor gets at least the principal amount when the note matures. The aim of a product like this is to allow institutional investors access to alternative investments while mitigating some of the risk associated with such investments. In order to protect the investor's assets, there is a stop-out point at which all hedge fund assets will be transferred to fixed income investments.

"We have derived a formula," Herp says. "If the cushion begins to erode, cash in hedge funds or fund of funds will be transferred to fixed-income instruments."

This product demonstrates a new approach to these insurance offerings, and we are bound to see more in the future.

Private placement life insurance is a hot topic in the insurance world; it's a hot topic in the hedge fund world. The bottom line here is that there is an exceptional opportunity for tax deferral for hedge fund investors. The benefits of investment diversification are secondary, and the need for actual life insurance is tertiary at best. When you couple this with an attractive fee stream to the brokers, we will most likely witness an aggressive shift in product marketing to help exploit this opportunity.

Between the structured notes for institutions, the domestic pre-packaged offerings of the bigger insurers, and the customized offshore partnerships, hedge funds are moving closer to mainstream America. Does this signal the broad based inclusion into whole life products for non-accredited investors? It is too soon to tell.

Right now, the most important thing is to gain understanding of the language and risks involved with matching hedge funds to insurance related private placements.

Cole Partners was established in 1998 as a marketing and sales consultant specializing in alternative investments. The firm offers a variety of strategic marketing, product development, and educational capabilities. Please visit www.colepartners.com for further information.