

# Your Hidden Asset

The amount of insurance individuals can buy usually exceeds the amount they need.  
New financial technology allows them to profit from the surplus.

By Nemo Perera

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**S**MART INVESTORS UNDERSTAND that a crucial part of maximizing their wealth involves leveraging and administering their assets efficiently. However, many individuals overlook an important asset, which, if managed effectively, could significantly boost their net worth: their insurability.

A person's insurability is simply the total amount of life insurance that he or she can purchase. It is a valuable asset, provided freely by the life insurance industry. In most cases, it is approximately equal to your net worth. In the past, individuals have only considered their insurability when purchasing life insurance policies intended to provide security for their beneficiaries. However, new financial and insurance technologies now enable wealthy individuals to access and monetize this asset while they are alive.

The amount of life insurance that many affluent individuals can purchase often far exceeds the financial needs of their beneficiaries. Unless you stay up at night worrying about the financial security of your wife's next boyfriend, you can monetize your excess insurability and increase your net worth, while you are still alive to enjoy it. The market for these types of transactions currently totals about \$10 billion; we expect it

to expand to \$100 billion or more in the next several years as individuals learn how to exploit this underutilized asset.

## A BIRD IN THE HAND

The emergence of a secondary market for life insurance policies is the driving force behind the ability to monetize your insurability. Until the late 1980s, life insurance companies were the only entities that repurchased their own policies. However, the emergence of the AIDS epidemic spurred the capital markets to develop ways for patients to obtain cash from their life policies while still alive, in order to pay their medical bills and other expenses. Because life insurance policies are typically assignable, policyholders are free to transfer ownership of their policies to third parties. The policyholders therefore sold their policies to brokers called viatical companies, which bundled them together and sold them to investors.

These viatical transactions became popular. Policyholders were able to use the extra money to improve their quality of life in their final days; meanwhile investors benefited by acquiring a new, zero-beta asset class, one that has no correlation to the bond or equity markets. This heralded the birth of the secondary

market for life insurance policies.

Life settlement companies determined the fair market value of the policies based upon the insured's life expectancy and other factors, including the solvency of the underlying life insurance carrier and the rates of return required by investors. The life settlement companies pay the insured individual in these transactions a percentage of the face value of the policy. Today, most transactions offer 2 to 3 percent of the face value, depending upon when the payment is made. Upfront payments are typically smaller, while those made later on tend to be higher.

Some people find it unsettling to know that another party will benefit from their death. However, their concerns are unfounded. Life settlement companies do not know the names or identities of the insureds, and the life settlement market is not concerned about the lifespan of any single individual; investors base their decisions on the overall expected mortality of the general public. Policyholders can also take comfort from the fact that life insurance companies will not pay a claim if there is any foul play, or even suspected foul play, by the beneficiary. Also, life settlement companies are large, established institutions that would not risk losing their entire investment by participating in any illegal activities.

## BROADER APPEAL

In the past, only those who met strict criteria could take advantage of insurability monetizations. They were required to be wealthy, 75 years of age



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to provide death benefits for their families, and by then monetizing the balance, cannot increase the amount of insurance they carry, unless their insurability value (that is, their projected net worth or income) increases.

Financial advisors who understand this product can help clients find and vet transactions that are most appropriate for their

or older, with some health impairment and a life expectancy of fewer than 10 years. Such requirements allowed investors to estimate the size and timetable of their returns. As a result, only a small group of qualified candidates were able to convert their insurability into cash. This caused many financial planners to dismiss life settlements as only a niche product, not applicable to large numbers of clients.

However, using new, cutting-edge risk transfer technologies, life settlement companies can now cater to a much larger field of clients. These financial innovations allow them to disperse some of the risks involved in these deals into the capital markets and the property-casualty insurance market. Because of this, they can offer healthier candidates as young as 55 the ability to monetize their insurability.

Ideal candidates for this new generation of life settlement transactions must still meet the life insurance industry's net worth and/or income requirements. The minimum financial

qualifications are a net worth of \$5 million or an annual income in excess of \$1 million. Also, life insurance companies usually require a medical examination, as with any life insurance policy.

These new transactions aimed at younger clients generate financial rewards over a fixed period, generally varying from two to 10 years, and payouts can be tailored to the needs of individual clients and their unique situations. Also, they need not always be designed from scratch. Individuals who already have life insurance policies in force, but who no longer need them, should not allow them to lapse. A specialist in this field can analyze any form of life insurance, whether universal, variable, term or whole life, to determine its realizable value.

Life settlement transactions have varying degrees of rigidity—some cannot be changed, while others may be modified—so clients must consider the consequences of entering into these deals carefully. In most cases, people who exploit all their insurance capacity by obtaining a policy

age, net worth and goals. They must consider a range of factors, including the terms of the life insurance policies or programs, the face values, the policy crediting rates and the carriers' attitude toward the settlement industry. Advisors must scrutinize these proposals for both their long- and short-term considerations—the commission a life agent stands to earn should not be the only issue given serious analysis. The tax consequences of these transactions also vary. Individuals considering them should determine whether a particular deal's payout will be treated as capital gains or ordinary income tax; in some cases it is not taxed at all.

Few of us like to consider the financial benefits of our own death; we prefer to dwell on the financial benefits of life. As a result, many individuals have a poor understanding of how to leverage and maximize this sizeable and free asset on our personal balance sheets. Those who take the time to understand it may find it has the potential to add millions of dollars to their net worth. **W**