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Robb Report Worth

Industry View

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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SMART 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