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Capturing Insurance Capacity

The Value of Owning All the Life Insurance You Can Get

By Kenneth R. Samuelson and Brandon W. Davis

The Background

Fundamentally, the purchaser of life insurance uses currently available, hard earned money to provide an insurance benefit for, well, somebody other than himself. On top of that, purchasing life insurance can be a mysterious process fraught with negative emotions.

The fact is most people want to buy as little life insurance as possible.

But times are changing. About five years ago, hedge funds and institutional investors showed up. They began investing heavily in mortality-based products by way of the premium financing and life settlement businesses. These professional buyers started acquiring life insurance benefits by the billions and based their decisions only on the statistics, primarily life expectancy and rates of return.

These institutional buyers make the life insurance companies nervous, because the professional money figured out that life insurance can be a valuable risk-adjusted asset to hold in a portfolio. A difference of opinion exists in the marketplace, an inefficiency if you will, between the insurance companies and institutional investors. Hedge funds are betting that life insurance is underpriced, and insurance companies are concerned that they may be right.

The Lesson

If life insurance is good enough to command Wall Street's attention and money, it may be good enough for Main Street's attention and money too. Clients may need to reassess the traditional "buy as little as possible" attitude toward life insurance.

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The Question

How much life insurance can a client qualify for? Said more artfully, "What is my client's insurance capacity?" In true consultant fashion we would, of course, answer with "it depends." Assuming a client over age 70 in good health, the approximate amount would be: one times net worth up to a maximum of about $125 million.

The Method for Systematic Evaluation of Insurance Capacity: ICE

The discussion about insurance capacity can be broken down into three components (complete with its own convenient, easy-to-remember acronym).

I: In-force coverage. This represents the insurance that is already in place. If the policy is more than five years old, it is very likely that it can be made more efficient through re-evaluation of the client's medical circumstances and comparison to new policies available in the market. A lot has changed, and many clients have reaped the benefit of this re-evaluation process. The reality is that old policies are built on old assumptions and are likely out of step with today's insurance pricing models. This is an area of large potential financial gain for clients. For additional commentary on this aspect, we refer you to our article on the importance of policy evaluation in the March 2007 issue of *The Will & The Way*.

C: Calculated need. This represents any additional insurance the client needs to complete or complement the current estate plan. Generally the client is willing to devote personal capital to accomplish such goals. Life insurance can address a specific need or create a desired financial result at death. For example, it can fund an estate tax liability, fund a buy-sell agreement or deliver a specific benefit to charity. It is important to evaluate these needs and place this

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Life Insurance *from page 1*

coverage before tackling the third component, excess capacity.

E: Excess capacity. This represents any untapped insurance capacity that the client does not currently want for estate planning or business purposes. Because life insurance has inherent value as a non-correlated asset class, the client may wish to put a policy in "inventory" for later use.

The big question looming in the client's mind: "Even if I see the benefit of owning my excess capacity, where is the money going to come from to buy it? I don't want to spend all of my liquid assets buying life insurance, no matter how good it is."

Capturing Excess Capacity

Currently, clients have two primary alternatives for harvesting the value of excess insurability: (1) own it themselves or (2) capitalize it by utilizing someone else's money to finance the acquisition of it. Because this asset has inherent value, we are proponents of having the family fund and control the asset. We will also address alternatives for capitalizing excess capacity with outside, third-party money. Chances are good that someone has approached or will approach your clients about this very topic.

Owning Excess Insurance Capacity

If Wall Street and foreign banks find this asset class valuable, perhaps clients should find value in it too and own it themselves. Why let others reap the benefit when the client's family could do the same? Just like a company keeps a supply of products in a warehouse, we often call this strategy "warehousing" insurance capacity. A couple of rational alternatives exist for clients wishing to warehouse insurance capacity for later use.

Good old-fashioned Term Insurance.

We are always looking for a reason to buy the cheap stuff. Well, here it is. Buy a term policy. The key: buy a policy from a high-quality provider that is "convertible" into a wide selection of permanent policies. At older ages, health can change in an instant; and once that happens, a term policy can have substantial value to the family.

It can also have substantial value in the life settlement market, an emerging and rapidly growing secondary market for unwanted life insurance policies. Under appropriate circumstances, selling a policy in the life settlement market can extract significant value from an existing life insurance policy–especially a term policy.

Please note that we do not advise clients to purchase life insurance with the *intention* of selling it. Frankly, it is bad for the industry and contrary to the underlying principles of insurance. Increasingly, regulators are establishing rules to prevent this from happening. But we view it as our duty (and perhaps your duty) to advise clients that the settlement market exists. It may be a viable alternative for maximizing the value of an unwanted policy when appropriate.

So, in short, why buy a term policy? It is an inexpensive way to warehouse insurance and guarantee future insurability. In a worst-case scenario, the client cancels the policy and receives no return of premium. The client has paid a fair market value for the cost of life insurance in the meantime.

Permanent life insurance. There is no shortage of varieties of permanent policies. A few unique design considerations bear mentioning. First, a number of high quality insurance carriers offer "high early cash value" policies. If structured properly, a client pays premium and the policy is projected to retain cash value near, equal to or greater than the amount of premium paid. It is a simple and cost-effective way to maintain significant insurance flexibility.

Secondly, select carriers offer unique product features designed to maximize long-term returns within the policy. A thoughtful and creative policy structure can dramatically improve the overall estate plan.

Lastly, remember the life settlement market. Under the right circumstances, premiums may be recovered by selling the policy in the secondary market. We have seen examples of clients purchasing life insurance, using it for a particular need over a specified time frame, and selling it in the secondary market for value in excess of premiums paid - sometimes significantly in

excess of premiums paid.

Capitalize Excess Insurance Capacity

Types of programs. Programs using third-party money fall into two categories: (1) fully disclosed and (2) non-fully disclosed, aka "stealth" transactions. Regarding the latter transactions, perhaps you have heard about the New York State Department of Insurance's recent outrage over Investor Owned Life Insurance ("IOLI") or Stranger Owned Life Insurance ("STOLI"). Insurance commissioners and life insurance providers alike are cracking down on inappropriate use of life insurance as an investment tool for institutions and investors.

Transactions being completed without full disclosure are considered "stealth" transactions. That is, they are completed such that the insurance company does not know that an investor initiated the transaction with the possible intention of selling it in the secondary market for a substantial profit. The immediate concern in such transactions is "does the investor have an insurable interest in the party being insured?" Insurable interest is a cornerstone of the life insurance industry. Would the initiator of the policy suffer a financial loss at the death of the insured such that insurance on the life of the person would be necessary? In stealth transactions, typically the answer is "no."

On the other hand, there remain a number of legal, valuable and viable alternatives for converting the ability to buy life insurance into a valuable asset. Most involve a conservative, well thought-out plan to finance the life insurance with a third party. They also involve participation by the insured in the form of cash paid out-of-pocket and/or the posting of collateral. No more free lunches.

Short-Term programs. "Short-term" programs typically involve a relatively small amount of cash or collateral on the client's part. In return, the client receives life insurance coverage for two to five years with the bulk of premiums paid by a lender. At the end of the program's term, the client typically has the ability to either retain the policy by repaying a loan that has accrued or walk away from the transaction by paying off a pre-determined portion of the loan. Note: even if the client walks away, the lender reserves the right to keep the policy in-force or sell it in the secondary market, which permanently ties-up a portion of the client's overall insurance capacity.

Long-Term programs. "Long term" programs typically involve an agreement to finance the life insurance policy for the entire life of the insured. Again, the insured is required to contribute some cash out-of-pocket and/or post collateral for the loan that will be accrued.

In exchange for financing excess insurance capacity, the insured's beneficiaries, e.g. heirs or charity, receive a portion of the policy's death benefit. The share of the new policy allocated to the insured's beneficiaries is typically 5% to 15%. For example, if a client uses $10,000,000 of excess insurance capacity, the projected benefit to the insured's designated beneficiary typically would be between $500,000 and $1,500,000.

No free lunch. A significant "cost" of capitalizing insurability is the permanent use of the insured's overall insurance capacity. Traditionally, most people have not assigned value to their insurability. However, the loss of a person's ability to buy additional insurance can be a significant loss. Capitalizing insurability is not a "something for nothing" arrangement. If the person anticipates ever purchasing additional life insurance, he or she should not commit all of the excess insurability to such a program.

The Bottom Line

Wealthy clients are constantly being approached about purchasing financed life insurance and they will come to you for advice. The ICE model articulated above will help guide decisions about life insurance capacity in a systematic and productive way. The model takes into account three important components of insurance capacity: In-force coverage, the Calculated need and Excess capacity. ■

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