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## **Trading life insurance policies**

The validity of trading insurance policies is founded on the legal ground that insurance contracts can be absolutely assigned to any third party. One common assignation scenario in the market is a mortgagor pledging his "mortgage reducing term insurance" to the bank. In other words, in the event of the death of the mortgagor, the payout from the mortgage insurance would be used to repay the outstanding loan and the property under mortgage could be released to the estate of the mortgagor. A similar arrangement is done in the case of a HDB loan. In this case, the third party is HDB instead of the bank.

Trading of insurance policies is common in the US and has been taking place for more than 10 years. It is commonly known as Vatical Settlements. Simply put, Vatical Settlements are transactions whereby the beneficial interest of a life insurance policy is transferred to a third-party investor. In exchange, the seller of the policy will receive a discounted cash settlement. Not only are Life Settlements an excellent opportunity for financial gain for the purchaser, they can provide the sellers with the freedom to live the remainder of their lives with more dignity and fewer monetary concerns. Say for example a policyholder certified to have no more than three years lifespan due to a terminal illness sells his policy of sum assured \$100,000 to someone at \$60,000. If the policyholder passes away in two years, the buyer would receive \$100,000, which is \$40,000 more than his original investment. This works out to be more than 30% return a year. If however, due to a miracle or medical breakthrough, the policyholder survives for another 15 years, the buyer's effective yield from his investment would drop to less than 3% a year.

There are also many ethical issues surrounding Vatical settlements. So I caution all who want to invest to make sure they understand the ethical implications fully, whether it is from the religious or moral standpoint. However, from a purely financial standpoint, the return sounds reasonable for the risk we need to take.

Another common transaction is the trading of endowment policies. Unlike life policies, the death benefit of an endowment plan is usually quite low. Hence the purchaser of a second hand endowment plan is more concern about the maturity payout of the endowment. Most endowment plans are structured in such a way that a big chunk of the return can only be realised if the policyholder keeps his plan until maturity when he is entitled to a maturity or terminal bonus. Even a few years from the actual maturity, the surrender value of the endowment can be pretty low. As such, if the policyholder needs more money than the surrender value of his endowment at that point, he can sell his endowment policy to a third party for possibly a higher value than surrendering it directly to the insurance company. The buyer of the endowment would then continue the premium payment and received the full maturity proceed when it is due. The internal rate of return for the buyer can be up to 10% p.a. This is compare to the typical interest of endowment plan which is only 4% p.a.

## **What is the risk?**

For the insurance policy trading to work, the finance company would need a big pool of informants to highlight to them potential sellers, as not many people would be thinking about selling their policies. Existing financial advisors who have direct contact with big pool of clients may be recruited on a referral basis by the finance company. The risk is that less-informed policyholders may be asked to sell their policies against their interest as there is a financial bias on the part of the financial advisors, bearing in mind that if the policy is surrendered to the insurance companies, they do not receive any financial gains versus the potential quite lucrative referral fee that they may otherwise received. As this is an area which is not directly regulated by the insurance company, the policyholders would have minimum recourse in the case of wrongful advice.

By and large, there is no incentive for the insurance companies to support such initiatives officially. First, this would take away one of the most lucrative investment from the insurance companies, which is Policy loan. Policyholders who need cash but find that the surrender value of their policy is too low to justify an out-right surrender may opt to take a loan from the insurance companies. As the loan is backed by the policy value, this line of business is risk free for the insurance companies and returns up to 6 to 6.5% p.a., which stands pretty well against other fixed income instruments that the insurance companies are holding. No doubt equity investment may yield returns above that, but the excess returns come with significantly higher risk. In the fixed income asset segment, policy loan and auto premium loan (i.e. the loan granted to you automatically to pay your insurance premium if you stop paying your premium for any reason) remains the preferred choice. The proliferation of insurance policy trading may no doubt reduce the quantum of this lucrative business segment. This is why the official position of the insurance companies is to caution the policyholders about the risk of such practices. They cannot prohibit it as the assignment is legally supported and remains the legal rights of the policyholders.

From the claims perspective, proliferation of life insurance policy trade would no doubt increase the eventual premiums that policyholders need to pay over the longer term. Many policies which would have lapsed or surrendered would be kept in force, would become payable in the event of a claim, which would inflate the total claim figures. As insurance premiums are ultimately determined by the insurance claims, the higher claim record would eventually lead to insurance companies raising premium to offset the higher claims.

Moral risk may also become more prevalent. For example, a person who is in need of cash and suspect that he may be suffering from some serious illnesses may try to buy a term life policy and upon the confirmation or diagnosis of a terminal illness, sell the policy to the insurance policy trader at hundred of times the premium he paid for.