

THE BENEFITS OF A SECONDARY MARKET FOR LIFE INSURANCE POLICIES

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In this article, we examine the benefits that accrue to policyholders and incumbent insurers from an active secondary market for life insurance policies. We begin by examining the benefits of secondary markets in the home mortgage and catastrophic risk insurance industries as points of comparison for the benefits of the secondary market for life insurance policies. Next, we outline the economic theory of a life insurance market both before and after the introduction of a secondary market. Without an active secondary market, the equilibrium quantity of impaired policies that is surrendered is inefficiently low. Although competition among insurance companies in the primary market leads to reasonably competitive surrender values given normal health, surrender values based on normal health do not appropriately compensate individuals with impaired life expectancies for the resulting appreciation of their policies. If there is no external market for reselling policies, insurers have no incentive to adjust their surrender values for impaired policies to competitive levels because they wield monopsony power over the repurchase of “impaired” policies. Viatical and life settlement firms erode this monopsony power. Finally, we examine the benefits of an active secondary market for life insurance policies to policyholders and incumbent insurers in the primary market. The magnitude of the benefits is positively correlated to the quantity of coverage sold to life settlement firms and to the improvement in the terms of accelerated death benefits offered by incumbent carriers. The emergence of the secondary market for life insurance policies has been pro-competitive and pro-consumer. Lawmakers should therefore design regulations that encourage, rather than dissuade, participation and investment in this secondary market.

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I. INTRODUCTION

The emergence of a robust secondary market for life insurance is a relatively recent phenomenon. The modern market arose in the late 1980s in response to the AIDS epidemic, as many young people were faced with the sudden need for money to pay for medical treatment and maintain their standard of living. These individuals sought liquidity from any long-term assets that they owned, including life insurance policies. The shortened life horizons of those living with AIDS meant that the actuarial values of their policies—that is the risk-adjusted value of the death benefit, taking into account future costs—had come to significantly exceed the policies’ surrender values.¹

Unfortunately for these individuals, incumbent life insurance companies wielded monopsony power² over the repurchase of their own policies. As a result of this imbalance of bargaining power,³ the insurance companies have historically earned economic rents on the repurchase of impaired policies.⁴ In the case of the lapse of a term-life policy, a policyholder who could no longer afford premium payments simply lost his insurance coverage and received nothing. In the case of the surrender of a universal- or whole-life policy, the pre-determined schedule of surrender values offered by the insurance company (representing at most the reserve set aside to fund future insurance costs at standard rates) did not compensate a policyholder for the full actuarial value of the impaired policy. Investors who did not share the same liquidity constraints as the policyholders were willing to purchase those policies for substantially more than the pre-

1. When a policy becomes impaired, the present value of the death benefit increases because the payment of benefits will occur sooner than originally projected. At the same time, the present value of premium payments decreases, because those payments will not continue for as long as originally projected. Both effects cause an increase in the actuarial value of a policy for an individual with a shortened lifespan.

2. The term ‘monopsony’ refers to a firm that is the only purchaser of goods or services in a given market. *See* DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 105-07 (Addison-Wesley, 3d ed. 2000).

3. The surrender of a policy is a purchase because the obligation of the life insurance carrier to pay the policyholder a certain face value at the maturity of the contract constitutes a property right of the policyholder, and thus, an asset. The extinguishment of this obligation by the insurance carrier results from its acquisition of the policyholder’s asset, and is thus a purchase. For this reason, even a lapse represents a purchase (for zero price).

4. The terms “normal” and “impaired” are used throughout this paper to refer to an individual’s state of health (and the corresponding state of that individual’s life insurance policy). An individual’s health is “normal” if that individual’s life expectancy has followed the expected path of decline since the issuance of the policy. An individual’s health is “impaired” if that individual’s life expectancy has decreased to a greater degree than expected at the issuance of the policy.

arranged termination terms offered by the insurance companies. Viatical firms emerged to facilitate these sales, and the secondary market for life insurance was born.⁵

Viatical firms facilitate the liquidity goals of individuals living with terminal illnesses by making lump-sum payments to them and matching their life insurance policies with investors. Policyholders benefit from improvements in the quality of their final days, and investors benefit by acquiring investment to a previously inaccessible asset class. The viatical industry has grown rapidly since the early 1990s. According to the Viatical Association of America, between \$1.8 billion and \$4.0 billion of policies were viaticated in 2001,⁶ up from \$50 million in 1990 and \$1.0 billion as recently as 1999.⁷ The main shortcoming of this secondary market for insurance policies was that the investment criteria of viatical firms typically limited market access to policyholders with life expectancies of less than two years.⁸

The market responded to this shortcoming when, around the millennium, “life settlement” firms emerged to create access to the market for substantially more policyholders. The rise of life settlements in an industry that had previously focused primarily on the policies of AIDS patients can be traced to the fact that better AIDS drugs in the mid 1990s increased the lives of afflicted individuals and made the purchase of these policies less profitable. This change in the financial calculus of viatical settlements led to a search for new areas of growth.⁹ Life settlement firms have developed more sophisticated underwriting models that allow them to purchase policies from individuals who are not terminally ill. In fact, life settlement firms do not purchase policies from individuals who are terminally ill.¹⁰ Rather, life settlement firms purchase policies from individuals who are over the age of 65, have experienced a decline in health, and have

5. A few policyholders did sell their policies to individual speculators prior to the advent of viatical and life settlement firms. This early market, however, was largely underground, and was not a viable option for most policyholders because such a sale of a policy gave no safeguards against the financial interest in the policyholder's early death that the transaction provided the individual purchasing the policy. These elements of the early market may, in fact, have contributed to the negative regulatory aura that still lingers to some extent around the modern market. Although some viatical firms continue to match individual investors with individual policies, many of the top firms in the market now aggregate policies into diversified pools, which prevents investors from knowing the individual identities of the individuals whose policies they now hold. See Stephen Rae, *AIDS: Still Waiting*, N.Y. TIMES at 6 (July 19, 1998).

6. Erich W. Sippel and Alan H. Buerger, *A Free Market for Life Insurance*, CONTINGENCIES at 18 (Mar. 2002) (citing studies by Erich Sippel & Company and the Viatical Association of America).

7. Carrie Coolidge, *Death Wish Investors in Insurance Policies for the Terminally Ill are Watching Their Capital Get Annihilated*, FORBES at 206 (Mar 19, 2001).

8. The annual rate of return on a life insurance policy purchased by a viatical firm is the excess of the policy's face value over the price offered to the policyholder, divided by future lifespan of the individual insured by the policy. The risk associated with the purchase of policies is the probability of unexpected longevity on the part of the insured, which spreads the “gain” from the policy's purchase over a larger number of years, thus reducing the rate of return. Breakthroughs in AIDS treatments in the mid nineties significantly increased the life expectancies of individuals living with AIDS, and created a greater variance in the risk associated with what had previously been a fairly predictable disease.

9. David W Dunlap, *AIDS Drugs Alter an Industry's Math*, N.Y. TIMES at D-1 (July 30, 1996).

10. *Retirement Protection: Fighting Fraud in the Sale of Death: Hearing Before the House Subcomm. on Oversight and Investigations*, 107th Cong. 66 (2002) (written statement of David M. Lewis, representing the Life Settlement Institute).

remaining life expectancies of between six and twelve years (although in some cases life expectancies outside this range are considered).¹¹ Given the relative infancy of the life settlement industry, it is plausible that as the industry matures life settlements will become available to even more policyholders.

More than 20 percent of policyholders over the age of 65 are estimated to hold policies whose economic values exceed their cash surrender values.¹² Conning and Co., an insurance industry researcher, concluded that the total value of life insurance policies held by senior citizens is \$492 billion, which means that the potential market for life settlements is close to \$100 billion.¹³

Viatical and life settlement firms allow policyholders who have experienced a negative shift in life expectancy to obtain the fair market value for their life insurance assets. Although it does not make sense for most policyholders to surrender their policies at the market value,¹⁴ the flexibility offered by the secondary market for life insurance policies gives a policyholder the ability to respond to changes in his life situation.

There are a variety of situations in which the sale of a policy by an eligible individual to a viatical or life settlement firm is welfare improving:

- The premiums on the policy are no longer affordable.
- The beneficiary for whom the policy was originally purchased is now deceased or no longer has a need for the policy.
- A key-man policy, designed to protect a company from the financial loss of a key executive, is no longer necessary, either because the business has folded or the individual is no longer integral to the business's success.
- The policyholder owns multiple life insurance policies and wishes to eliminate one.
- The policyholder wishes to replace an individual policy with a survivorship policy, a long-term care insurance policy, or funds for long term care.
- The policyholder requires funds to pay for medical expenses or for new and experimental treatments for himself or someone close to him.
- The sale of the policy would allow the policyholder to maintain a desired standard of living and live out his final years with dignity.
- The policyholder wishes to remove the policy from a trust or estate.

11. See *id.*; Lynn Asinof, *Your Pocketbook: Selling Off Life Insurance: Good Policy? – It Can Be for Seniors Who No Longer Need It, But Some Financial Advisors Are Skeptical*, WALL ST. J. at D2 (May 15, 2002); *Seniors Should Exercise Caution When Considering Life Settlements*, ASSOC. PRESS (Feb. 8, 2001) (citing Michael Snowdon, academic associate at the College of Financial Planning); see also Juan Hovey, *Special to the Times*, L. A. TIMES at C3 (Apr. 30, 2001) (citing Michael Cavalier Sr., president and CEO of Cavalier Associates Insurance Services) (explaining that life settlement firms prefer policies with face values of \$500,000 or greater, and policies for which the cash value is no more than 40 percent of the death benefit).

12. Press Release, Coventry First, Coventry First Applauds New Pennsylvania Viatical Settlements Law: Pennsylvania Senior to Benefit (Sept. 10, 2002).

13. Teresa Dixon Murray, *Viaticals Carry Risk of Fraud, State Warns Betting On Death Unwise, Experts Say*, PLAIN DEAL REPORTER, at G1 (Mar. 31, 2002).

14. Alan Buerger, co-founder and CEO of Coventry First LLC, a leading life settlement firm cautions that most people “shouldn’t be selling their policy if they have the means to keep it.” However, as Mr. Buerger explains, “the reality is that people drop insurance every day.” Asinof, *supra* note 11.

- A reduction in the value of the policyholder's estate reduces the tax liability which the life insurance policy was designed to provide for
- An increase in the liquidity of the policyholder's estate eliminates the need for the policy.
- The policyholder wishes to donate highly appreciated assets to charity, but would be faced with liquidity constraints as the result of such a donation.¹⁵

The many examples listed above detail situations in which a policyholder might wish to sell his life insurance policy. Although it has always been possible for a policyholder to sell his policy to the incumbent life insurance company, in cases where the policyholder had experienced a decline in health, the underpayment by the insurance company restricted the policyholder's ability to meet the above goals. The secondary market for life insurance policies gives the policyholder the economic freedom to choose between a number of buyers and, in so doing, to receive the fair market price of his policy.¹⁶

Life settlements are one of several life insurance innovations through which companies that develop innovative actuarial analyses have been able to glean profits through their superior ability to assess mortality and other risks. In this sense, life settlements are essentially similar to innovations introduced in prior generations, such as the differentiation between smokers and non-smokers that began in the 1980s. However, unlike most prior innovations in the insurance industry, which sought to "skim" the healthiest (that is, the least risky) patients from the pool, life settlements actually benefit those who have become greater-than-average risks.¹⁷ Moreover, because the existence of a secondary market for life insurance has improved the liquidity of all life insurance policies that might potentially qualify for settlement, the secondary market makes policies in the primary market more valuable for all consumers, regardless of their current state of health.

As more policyholders become aware of the opportunities presented by viatical and life settlements, and as it becomes possible for more policyholders to obtain the fair market value of their policies, consumers will perceive an increase in the *quality* of life insurance, which will have a positive effect on the demand

15. Jack V. Sinclair, AICPA Planner, 2-3; Kaja Whitehouse, *Getting Personal: Viaticals Mature, But Risks Remain*, DOW JONES NEWS SERVICE (Jan. 14, 2002) (citing Martin Nissenbaum, national director of retirement planning at Ernst & Young, LLP).

16. As Erich W. Sippel of Erich Sippel & Co. and Alan H. Buerger of Coventry First LLC point out, "[a]t bottom, the case for the secondary market in life insurance policies is pro-freedom and pro-consumer. The existence of a secondary market eliminates the situation in which policyholders have traditionally found themselves in disposing of an unneeded life policy: being able to sell to only one buyer (the company that issued the policy) at a price set by the buyer. That restriction on freedom doesn't apply to the sale of any other asset." Erich W. Sippel and Alan H. Buerger, *Viatical Response*, CONTINGENCIES at 6-8 (Aug. 2002).

17. Some accounts of the viatical and life settlement industry claim that it is possible for healthy people to viaticate their policies. However, an individual's health must almost always be impaired in order to sell a policy for more than its cash surrender value. As Doug Head of the Viatical and Life Settlement Association of America explains, by "healthy," the industry actually means "a little sick," or "won't live to full life expectancy." Jane Bryant Quinn, *Staying Ahead: "Life Settlements" Not Easy Money for Seller or Buyer*, S. FLA. SUN-SENTINEL at D3 (May 15, 2001). Substandard life annuities, which have enjoyed significant growth since their inception, are another innovation in the insurance industry aimed at serving the needs of individuals with impaired health.

for life insurance.¹⁸ This observation is fairly intuitive—consider how the demand for housing would decrease if purchasers could sell their house back to only the original seller. The secondary market for life insurance effectively removes such a restriction on resale. Thus, the benefits of the secondary market are not limited to consumers in the secondary market, but also include consumers, insurance agents, and life insurance companies in the primary market for life insurance.

In Part II, we analyze the impact of the emergence of a secondary market on consumers and producers in the primary market in the related industries of home mortgages and catastrophic risk insurance. We draw parallels between these markets and the secondary market for life insurance, and explain why consumers in the primary market for life insurance should benefit accordingly.

In Part III, we provide an overview of the secondary market for life insurance. We begin by discussing how incumbent carriers exercised monopsony power in the secondary market for life insurance policies. Next, we examine the effect of entry by life settlement and viatical firms. We also examine the competitive response of incumbent carriers to that entry.

In Part IV, we examine the effects of entry by viatical and life settlement firms on consumers. We estimate that life settlements, alone, generate surplus benefits in excess of \$240 million annually for life insurance policyholders who have exercised their option to sell their policies at a competitive rate. This estimate is little more than the proverbial tip of the iceberg, for it not only fails to account for the corresponding benefits from viatical sales and accelerated death benefits (ADB),¹⁹ but also does not include the benefits the secondary market for life insurance policies generates for customers in the primary market.

In Part V, we examine the future of the secondary market for life insurance. We review the efforts of incumbent life insurance companies to stymie entry into the secondary market. We conclude that the actions of incumbent life insurance companies represent an effort to maintain monopsony power over their customers in the purchase of impaired policies.

II. THE BENEFITS OF SECONDARY MARKETS IN FINANCIAL SERVICE INDUSTRIES

Microeconomic theory reveals that an efficient secondary market for a particular good or asset will improve the value of that good or asset in the primary market. Professors Dennis N. Carlton of the University of Chicago and

18. Indeed, much of the potential secondary market for life insurance policies, which JE McGowan Consulting estimates at greater than \$18 billion annually, remains untapped. Neil Alexander, *New Value in Old Policies*, J. ACCOUNTANCY ONLINE (Oct. 2001), downloaded on Sept. 19, 2002 at <<http://www.cpa2biz.com/ResourceCenters/Personal+Financial+Planning/Insurance+Planning/New+Value+in+Old+Policies.htm>>.

19. Incumbent carriers have reacted to secondary market entry with accelerated death benefit contracts, which give policyholders the option to receive a portion of their death benefits when their life expectancies fall below a threshold level. Because these benefits would not have been available to policyholders in the absence of a secondary market for life insurance policies, they should properly be considered in an evaluation of the positive economic effect of secondary market entry.

Jeffrey M. Perloff of the University of California at Berkeley explain the economic rationale as follows:

When resales are possible, the price that consumers are willing to pay for a durable good depends on both the value of the services of the durable good during the period that consumer owns it and the resale value at the end of that period. That is, consumers' expectations about the future resale price affect the initial price.²⁰

The creation of a secondary market or the enhancement of an existing secondary market improves the value of the underlying good to consumers by making it a more liquid asset.

In this section, we examine the effects of the emergence of a robust secondary market in the home mortgage and catastrophic risk insurance industries. These industries share similar features with the life insurance industry, and thus provide useful insights into the benefits of the creation of a secondary market for life insurance.

Table 1 outlines the effects of enhancements in the secondary market for home mortgage payments, catastrophic risk, and life insurance. For each industry, the table identifies the consumers and producers in the primary and secondary market, and describes the benefit owing to the enhancements in the secondary market.

20. CARLTON & PERLOFF, *supra* note 2, at 485.

TABLE 1: THE EFFECTS OF A ROBUST SECONDARY MARKET IN FINANCIAL SERVICES INDUSTRIES AND IN THE LIFE INSURANCE INDUSTRY

	Home Mortgages	Catastrophe Risk Insurance	Life Insurance
Primary Market	Home Mortgages	Catastrophe Insurance Policies	Life Insurance Policies
<i>Consumers</i>	Mortgage Lenders	Insurance Companies	Policyholders
<i>Suppliers</i>	Homebuyers*	Policyholders*	Life Insurance Companies
Secondary Market	Resale of Home Mortgages	Resale of Catastrophe Insurance Risk	Resale of Life Insurance Policies
<i>Consumers</i>	Investors	Insurance Companies, Investors	Life Insurance Companies, Investors
<i>Suppliers</i>	Mortgage Lenders	Insurance Companies	Policyholders
<i>Entrants in Secondary Market</i>	Fannie Mae, Freddie Mac, Ginnie Mae	Chicago Board of Trade, Other Financial Institutions	Viatical and Life Settlement Firms
Role in the Secondary Market	Created the Secondary Market	Enhanced the Secondary Market by Providing Securitization	Enhanced the Secondary Market by Increasing Options
<i>Demand Effect</i>	Demand for Mortgages Has Increased	Demand for Catastrophe Risk Has Increased	Demand for Life Insurance Has Been Positively Affected, and May Ultimately Increase.
<i>Price Effect</i>	Value of Home Mortgage Has Increased	Value of Catastrophe Policy Has Increased	Value of Life Insurance Policy Has Increased

Note: * Although a homebuyer purchases a mortgage, he also supplies an associated stream of payments, which represent the asset for sale in the secondary market. Because this asset is the focus of our analysis, the homebuyer is the supplier in the primary market. For similar reasons, the policyholder is the supplier in the primary market for catastrophe risk.

As Table 1 shows, life settlement and viatical firms in the life insurance industry play a similar role to entrants in other financial services industries. Note that, for each industry, the consumer in the primary market becomes the supplier of the asset in the secondary market. For example, in the case of home mortgages, lending institutions are the consumers of the streams of payments associated with mortgages in the primary market and the supplier of these same streams of payments in the secondary market. In all three cases, entry in the secondary market increases the value that the consumer in the primary market attaches to the underlying good.

A. *Home Mortgages*

The underlying asset with which the secondary market for home loans is concerned is not the loan itself, but rather the associated stream of payments made by the homeowner over the life of the mortgage. Thus, for our purposes, the consumers in this market are the mortgage lenders and the suppliers are the homebuyers. The asset in this market is risky because if the homeowner defaults on the mortgage (or prepays the outstanding amount), the lending institution stands to lose a considerable amount on the transaction.

Most home loans involve a substantial amount of money and have a long duration. Home loans thus typically involve significant credit risk. A lending institution that faces significant credit risk is not willing to extend the amount of credit of which it was capable because if its lending capacity should decline in the future, it would not be able to withdraw from its current loans.

The government's creation of a secondary market for home mortgages, and the subsequent securitization of mortgages increased the liquidity of the underlying asset to mortgage lenders because mortgage lenders gained access to other financial institutions who also demanded home mortgage contracts from homeowners. This reduced the credit risk associated with mortgages, as mortgage lenders could escape from loans by reselling them for their market value on the secondary market.

The improvements to the secondary market for home mortgages made the issuance of home mortgages more attractive to financial institutions. As a result, the demand of financial institutions for home mortgage contracts increased. Those institutions were willing to pay a higher price for a mortgage's associated stream of payments, which they demonstrated by offering lower mortgage rates to homebuyers.²¹

B. *Catastrophic Risk Insurance*

The asset sold on the secondary market for catastrophic risk insurance is the insurance company's position in a policy—in essence, the excess of the present discounted value of payments by a policyholder over the present discounted value of the potential liability. Catastrophe risk insurance first became securitized in 1992, and in 1993 the Chicago Board of Trade began trading a contract for this risk. Catastrophe risk is a useful tool for asset diversification because catastrophe losses are not correlated with either the stock or bond market.²² Prior to securitization, however, catastrophic risk was too risky for most investors. The securitization of catastrophic risk insurance has mitigated much of this secondary market risk and thus prompted an increase in secondary demand.

This demand, in turn, has improved significantly the liquidity of an insurance company's positions in catastrophic risk policies and reduced credit risk by providing a superior financial vehicle to insurance firms to hedge against

21. Mortgage Rates were lower in markets served by Freddie Mae and Fannie Mac. See Dennis W. Carlton, David B. Gross, and Robert S. Stillman, *The Competitive Effects of Fannie Mae*, 1 FANNIE MAE PAPERS 1 (Jan. 2002); James W. Kolari, Donald R. Fraser and Ali Anari, *The Effects of Securitization on Mortgage Market Yields: A Cointegration Analysis*, 26 REAL ESTATE ECON. 677 (Winter 1998).

22. Gurdip Bakshi and Dilip Madan, *Average-Rate Claims With Emphasis On Catastrophe Loss Options*, 37 J. FIN. & QUANTITATIVE ANALYSIS (2002).

downside risk.²³ These improvements in the secondary market have increased the valuation that issuing insurance companies place on their positions in these policies. As a result, issuing insurance companies have correspondingly increased their demand for catastrophe risk and extended greater quantities of risk insurance than they did previously.²⁴ The increased demand of insurers has translated into both a greater availability of policies, and lower rates for those policies.

C. Analogues to the Life Insurance Industry

The examples examined above provide useful examples of the benefits of a robust secondary market in the life insurance industry. The emergence of a secondary market for home mortgages, and their subsequent securitization, has increased the liquidity of the underlying asset to mortgage lenders and reduced the credit risk associated with the purchase of the asset in the primary market. The emergence of viatical and life settlement firms, by the same process, has led to an increase in the liquidity of life insurance policies. Furthermore, this liquidity has fostered a decline in a credit risk, of sorts, for consumers in the primary market. A consumer now knows that if he should experience a decline in life expectancy and no longer need (or no longer be able to afford) his life insurance policy, he will be able to sell it for its market value instead of having to surrender it for the low price offered by the insurance carrier. The secondary market for home mortgages caused mortgage lenders to value mortgage payments more highly, and to demand a higher quantity of these payments. By the same process, the modern secondary market for life insurance has caused consumers to value life insurance policies more highly, which has positively affected the demand for life insurance in the primary market.

In the case of catastrophe risk, the enhancement to the secondary market brought about by securitization allowed insurance companies—the purchasers of catastrophe risk liability in the primary market—to more easily retreat from (or hedge) risk liability. Just as the secondary market for catastrophic risk insurance mitigates much of the downside risk from the original acquisition of a risk liability, the secondary market for life insurance mitigates the downside risk from the purchase of a life insurance policy on the primary market. A consumer knows that should he need or desire to sell his policy in the future, he will not have to accept an amount less than the market price. This mitigation of downside risk led insurance companies to purchase more catastrophic risk liability in the primary market, and it should likewise be expected to cause consumers in the primary market for life insurance to demand a greater quantity of coverage.

III. ANALYSIS OF THE SECONDARY MARKET FOR LIFE INSURANCE

With a whole-life policy, earlier premiums are greater than necessary to compensate for the low death risk in the early years. As a result, the policy builds

23. Sara Borden and Asani Sarkar, *Securitizing Property Catastrophe Risk*, CURRENT ISSUES IN ECON. & FIN. at 2-3 (Aug. 1996).

24. Knut K. Aase and Bert Arne Odegaard, *Empirical Tests of Models of Catastrophe Insurance Futures*, Wharton Financial Institutions Working Paper Series No. 96-18, 2-3 (1996).

up a surplus from which future premiums can be subsidized.²⁵ If we assume that policies are priced in an actuarially fair manner, then—for any given policyholder—the expected value of the payment by the insurance company to the policyholder’s beneficiaries equals the total expected value of the premium payments over the life of the policy.²⁶

But what if a policyholder’s preferences change and he no longer needs the policy he has purchased? The policyholder would naturally wish to receive payment for the value that has built up in the policy by virtue of his surplus payments. Indeed, if it was not possible to cash out of a policy that was no longer needed, uncertainty about future insurance preferences would decrease the value of whole-life insurance to consumers. Life insurance carriers recognize this, so whole-life policies include an option for the policyholder to resell, or “surrender,” a policy to the issuing insurer in return for a cash sum.

Surrender values can be thought of as secondary market prices for policies. Before the entry of viatical and life settlement firms, the life insurance carrier could exercise monopsony power in the secondary market for its own policies. As we will now argue, however, competition in the primary market prevented the incumbent from exercising this power in the repurchase of *normal* policies—that is, policies for which the insured is of normal health. Primary market competition did not eliminate this monopsony power for *impaired* policies, and life insurance carriers have historically earned economic rents on the surrender of those policies.

A. *The Purchase of Impaired Policies by Incumbent Carriers*

Surrender values and conditions under which policies can be surrendered are usually specified in the insurance contract, and thus determined in the primary market for life insurance. The primary market is typically characterized as having a relatively high degree of competition, which means that the premiums and terms of life insurance policies are set at roughly competitive levels. Furthermore, surrender values are set to roughly correspond to the surplus value that builds up in policies over time, based on the assumption that the health of the policyholder unfolds on a normal path.²⁷

The existence of a surrender value for a policy does not obligate an individual who wishes to resell his policy to resell to the issuing insurance carrier. Indeed, life insurance policies are typically assignable, which means that a policyholder is free to transfer his ownership of the policy to another person. A policyholder’s right to assign his policy to someone other than the insurance carrier has existed for some time, which means that there potentially has been a secondary market for life insurance policies for as long as policies have been assignable. In its early stages, this market consisted of only the issuing life insurance carrier and a handful of individual speculators.

25. This surplus is also calculated to create an endowment equal to the face value of the policy at a maturity age (typically 100).

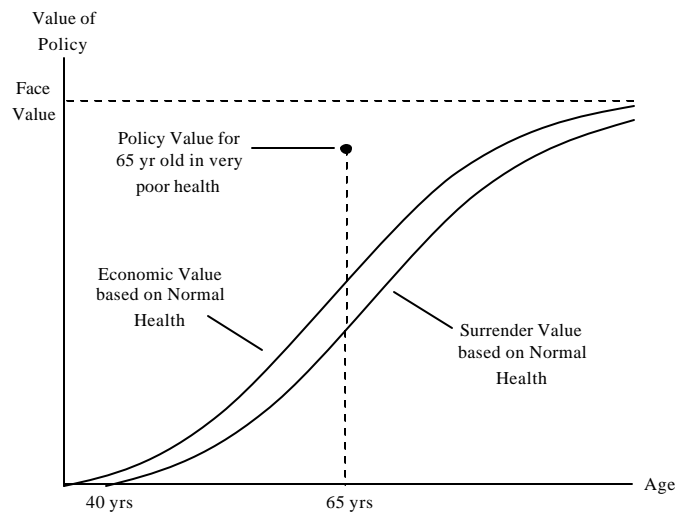
26. In reality the insurance carrier would earn a margin on the policy according to the competitiveness of the market, and the final payment would include investment returns on the policyholder’s premium payments.

27. In the case of a term-life policy, a schedule of premiums is set to cover the projected mortality risk associated with a policyholder over the life of the policy. Because there is no buildup of value in a term policy, the surrender value is zero.

Although a few policyholders did sell their policies to individual speculators, most were unwilling to make such sales because there were no safeguards against the financial interest of the speculator in the early death of the insured. Thus, for the majority of policyholders, the issuing life insurance company was the only viable buyer of its policies in the secondary market.²⁸ Because surrender values are set *ex ante* in the primary market, rather than *ex post* in the secondary market, however, competition in the primary market prevented the exercise of monopsony power over policyholders with normal health.

Figure 1 shows how the surplus payments of a whole-life policyholder create economic value in the policy over time, and how the surrender value tracks this increased value.²⁹ In this case, the policyholder buys the policy at age 40. The buildup of policy value assumes that the policyholder's health follows a normal pattern as he ages. The vertical distance between the two curves is the economic margin earned by the life insurance carrier on the surrender of a healthy policy, together with an allowance for transaction costs.

FIGURE 1: ECONOMIC VALUES AND SURRENDER VALUE



Now consider a policyholder whose health suddenly deteriorates significantly at age 65. Because the policyholder's life expectancy is curtailed, the present actuarial value of the policy will be much higher than for a 65-year-old in normal health. Figure 1 demonstrates that if the issuing insurance company creates a single schedule of surrender values based on a uniform assumption of

28. See, e.g., Asinof, *supra* note 11; Sinclair, *supra* note 15, at 1. Individual speculators in life insurance policies are ignored because most policyholders were not willing to sell to such speculators and because the effect of these speculators was insufficient to affect the market power of incumbent life insurers.

29. We have in mind a whole-life policy but the same mechanism can be applied to term life with flat premiums. Also, note that the curve of surrender values lies below the curve of the economic value of a healthy policy because of the limited nature of competition in the primary market.

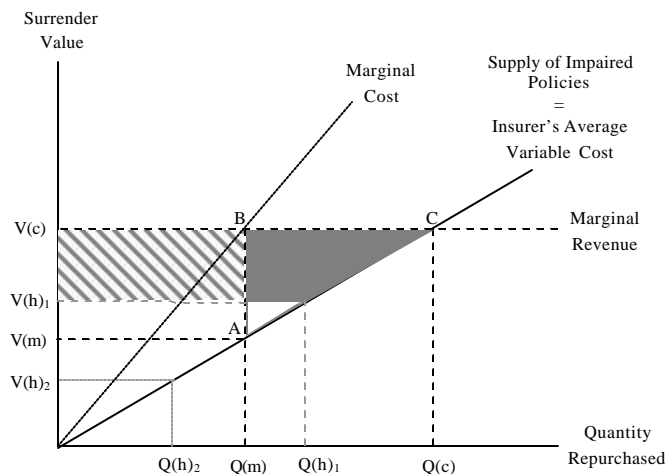
normal health, the company's surrender terms will be low relative to the actual policy value for an individual with impaired health.

A policyholder with impaired health cannot bargain effectively for a more generous surrender offer *ex post* because the issuing carrier is the monopsony repurchaser of the policy. The policyholder would be forced to either accept an amount that is substantially less than the true economic value or elect not to surrender the policy.

If competition in the primary market constrains an insurance carrier's monopsony power over the surrender of a normal policy, then why does competition not have the same effect on the surrender of an impaired policy? In principle, a life insurer could increase its market share in the primary market by committing, in the primary market, to a set of health-dependent surrender values. Such an offering of explicit health-dependent surrender values by a life insurance carrier, however, would be fraught with regulatory, actuarial, and administrative difficulties. The costs enforcing such *ex ante* conditions are likely to be high and laden with moral hazard. This is a good illustration of what economists call "unenforceable" contracts and such pre commitment has not been forthcoming. While it is true, as we examine later, that insurers have made concessions for the surrender of impaired policies (accelerated death benefits), the timing of this development suggests that it has resulted from competition in the secondary, and not the primary, market.

Let us consider the price that an incumbent monopsonist life insurance carrier would pay for the surrender of an impaired policy. Imagine a block of identical policies with the same face value, covering individuals with the same age and the same level of health impairment. Figure 2 shows the price level that the incumbent monopsonist life insurer will select, subject to the constraint that it offers the same surrender value to all similar policies.

FIGURE 2: SUPPLY CURVE OF THE SURRENDER OF IMPAIRED POLICIES



The supply curve in Figure 2 shows how many policies will be surrendered to the insurer at any given surrender value; the higher the surrender value, the more offered by policyholders.³⁰ This supply curve is also the average variable

30. CARLTON & PERLOFF, *supra* note 2.

cost to the insurer of re-purchasing the impaired policies because, for any given quantity of policies repurchased, it represents the price that the insurance carrier must pay for each policy. The marginal cost to the insurer—that is, the change in total repurchase costs as a result of repurchasing one more policy—will be higher than the average cost as shown by the marginal cost curve.³¹ The marginal benefit to the insurer from repurchase is the actuarial value of the policy (the expected present value of the future claims payment, adjusted for future mortality risk) because the insurer benefits by buying out this liability. With our assumptions, the actuarial values of policies in the block are constant and thus the marginal benefit is simply this actuarial value, as depicted by the flat marginal revenue curve.

Assuming it can offer a surrender price *ex post*, the incumbent insurer will maximize its profits by choosing the quantity, $Q(m)$, at which marginal cost equals marginal revenue for the impaired policy. For this quantity $Q(m)$, the supply curve determines the monopsony surrender value to be $V(m)$, as depicted by A. The monopsonist's rent is the rectangle bounded by $V(m)$, A, B, and $V(c)$. The deadweight loss, or efficiency loss, from this choice of surrender values is equal to the area of triangle ABC.³²

Now suppose that the insurer has already committed to a competitive surrender value based on *normal* health, $V(h)_2$. If the established surrender value for a normal policy is higher than $V(m)$, as depicted by $V(h)_1$, the incumbent carrier will be unable to achieve the monopsony price for the surrender of the impaired policy because it is contractually obligated to offer the competitive healthy rate.³³ Nevertheless, the incumbent will still earn supracompetitive rents on the surrender of impaired policies. The sum of those rents is equal to the diagonally-shaded rectangle, and they produce a deadweight loss equal to the solidly-shaded area.

If there were a competitive secondary market on which these policies could be re-sold, however, the incumbent insurer would lose its ability to set the price in the secondary market.³⁴ The surrender value would rise to its competitive level, $V(c)$, with a higher number of policies, $Q(c)$, being resold. The entry of competition into the secondary market would therefore eliminate both the monopsonist's rent and the efficiency loss identified above.

31. The marginal cost is higher than the average variable cost because, in order to obtain a marginally higher quantity of impaired life insurance, the carrier must offer a higher price to not only the marginal seller, but to *all* sellers.

32. For a discussion of deadweight loss, see PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* (Irwin McGraw, 16th ed. 1998).

33. By virtue of its impairment, $V(h)_1$ must be less than $V(c)$ —the competitive price for the surrender of impaired policies. However, it is possible for the competitive surrender value for a normal policy to be lower than $V(m)$, as depicted by $V(h)_2$. If such is the case, the incumbent insurer has an incentive to raise the surrender value to the monopsony rate *ex post*. There are certain financial mechanisms that the incumbent insurance carrier can use to effectively raise its surrender value for the impaired policy to the monopsony rate.

34. This follows from the economic principle that a monopolist loses its price-setting ability with the entry of competition. See, e.g., WILLIAM J. BAUMOL & ALAN S. BLINDER, *ECONOMICS: PRINCIPLES AND POLICY* 272 (Dryden Press, 6th ed. 1994).

B. Entry into the Secondary Market for Life Insurance

Health status plays a large part in a consumer's decision to surrender a policy. If an individual's health is above-average, then that individual's life insurance is no longer a good value because he is paying premiums based on the average level of mortality risk—a figure which is higher than his actual mortality risk. Because such an individual's positive shift in life expectancy decreases the value he attaches to his policy, he will thus be more likely to surrender his policy than an individual with normal health. This propensity of policyholders to surrender their policies when their life expectancy exceeds the average is known as adverse selection, and is costly to incumbent insurers because it means that the average life expectancy for the remaining pool of policyholders is lower than projected at the time the policies were issued.³⁵

If an individual's health is below average, then he is less likely to surrender his policy because an impaired policy is worth more than a normal policy. On the other hand, a negative shift in life expectancy changes the consumption preferences of many individuals (in favor of current consumption), particularly if the motivating factors for the life insurance policy are no longer relevant.³⁶ For example, many AIDS victims found it difficult to pay premiums and needed immediate money to pay medical bills to maintain their quality of life in their few remaining years.³⁷ An individual whose consumption preferences have changed in favor of current consumption values cash more highly at the current time, and thus is willing to accept a lower price for his policy's surrender than he would have when his health was normal. Thus, absent entry by third parties into the secondary market, insurance carriers are able to reap significant gains by underpaying for the surrender of these impaired policies.

Because entrants into the secondary market—both viatical and life settlement firms—are only interested in acquiring policies of individuals with impaired health, entry into the secondary market will systematically reduce the number and value of impaired policies that are surrendered to the incumbent carrier for less than the competitive rate. At the same time, viatical and life settlement firms do not affect the number of individuals with average or above-average health who surrender their policies to the incumbent carrier. It is obvious that, by lowering the number of cost-reducing surrenders to the incumbent without causing any corresponding reduction in the number of cost-increasing surrenders, entrants into the secondary market for life insurance policies cause net increases in incumbents' costs. The increase in costs may not come solely from the loss of rents from surrenders, but may also result from higher surrender values offered for impaired policies by incumbents themselves through the use of provisions such as accelerated death benefits. If the incumbent carriers are pressured by viatical and life settlement firms to make competitive offers for impaired

35. For a more thorough examination of the adverse selection phenomenon, see G. Akerlof, *The Market for Lemons*, 84 *QUARTERLY J. ECON.* 488 (1970).

36. The concept of health-state dependent preferences has been explored in numerous economic articles, including one written by one of this paper's authors. See Neil Doherty and Harris Schlesinger, *Viaticals: A Matter of Life and Death*, Working Paper for Presentation to the European Group of Risk and Insurance Economists 10 (Sept. 2000).

37. As noted earlier in this paper, the need of these policyholders was instrumental in the development of the viatical market. More recently, this market for settlement has grown to include other health- and age-related lapses and surrenders. Although not as dramatic as the AIDS case, these other health impairments also create shifts in the consumption preferences of policyholders.

policies, those carriers would still lose that portion of the return that was supracompetitive.

Entry by viatical and life settlement firms will eliminate the economic rent that incumbent carriers have previously earned on the repurchase of impaired policies firms, and will place upward pressure on insurance premiums. Those increased premiums, however, will simply match a quality enhancement in policies themselves due to their increased liquidity, as we will examine further in the following section.

Furthermore, only a portion of the incumbent carriers' cost increases will be passed on to consumers. The degree to which any cost increase is passed on to consumers is dependent on the elasticity of demand for life insurance in the primary market—the more elastic the demand, the less of the cost increase the incumbent insurers will be able to impose on consumers.³⁸ Finally, any quality improvements due to increased liquidity will likely increase the demand for life insurance in the primary market, just as such quality improvements increased the demand of financial institutions for home mortgage payments.

C. The Competitive Response of Incumbent Carriers: Accelerated Death Benefits

Before the entry by viatical and life settlement firms, the only buyer in the secondary market for a given life insurance policy was the insurance company that had issued the policy. In the early 1990s, after entry by competitors, life insurance companies developed accelerated death benefits (ADB), which give policyholders the option of receiving between 25 percent to nearly 100 percent of their death benefit while they are still living.³⁹ To qualify for an ADB, a policyholder must have a death benefit rider on his policy (although in many cases it is not difficult to add such a rider once it is needed) and, depending on the policy, must either have a dramatically reduced life expectancy, suffer from one of a number of specified medical conditions—often called “dread diseases”—or require long-term care.⁴⁰ Early on, a large percentage of ADBs were triggered by either dread diseases or long-term care, but by 1994 terminal

38. This is the same principle that applies to tax burden analysis. *See, e.g.,* BAUMOL & BLINDER, *supra* note 34, at 241-42, *see generally*, EDGAR K. BROWNING & WILLIAM R. JOHNSON, *THE DISTRIBUTION OF THE TAX BURDEN* (American Enterprise Institute, 1979).

39. FTC Facts for Consumers, *Viatical Settlements: A Guide for People with Terminal Illnesses*, at 2 (May 1998) (visited on Aug. 12, 2002) <www.ftc.gov>. ADBs can even be offered in the secondary market because it is possible for a whole life policy to be converted to add such features. Thus, ADBs represent one of the mechanisms that an incumbent insurance carrier could have used to raise the surrender values of impaired policies if this value was lower than the monopsony rate. *See also* Whitehouse, *supra* 15, citing American Express certified financial planner, Thomas A. Endersbe. For example, on its website, New York Life states: “[i]f your policy does not contain the LBR (living benefits rider) option, you can add it to your policy now or when you may need it.” New York Life, Viatical Marketing, downloaded on Sept. 23, 2002 at <<http://www.newyorklife.com/NYL2/DisplayOne/0,1237,9247-22-76,00.html>>.

40. LIMRA INTERNATIONAL & AMERICAN COUNCIL OF LIFE INSURANCE, *ACCELERATED DEATH BENEFITS: 1998, 4 (1999)* [hereinafter LIMRA INTERNATIONAL STUDY]. *See also Accelerated Death Benefit Provisos on the Rise*, INS. ACC'T. (Apr. 19, 1999) [hereinafter *ADB Provisos*].

illness was the overwhelming condition necessary for the exercise of an ADB.⁴¹ Although the life expectancy required for the exercise of an ADB varies by company, product, and state, twelve months is the most common maximum allowed life expectancy: only between two and five percent of the ADBs on the market triggered by terminal illness allow a policyholder with a life expectancy of greater than one year to accelerate his death benefit.⁴²

ADB were developed as a competitive reaction to the emergence of viatical firms.⁴³ The number of policies with ADB riders has grown in line with the growth of the viatical and life settlement industry, as life insurance carriers added them to policies with increasing regularity during the mid and late 1990s. According to LIMRA International, approximately 39.9 million life insurance policies contained ADB provisions in 1998, which was more than double the number of ADB policies in 1994, and more than 35 times the number of ADB policies in 1991.⁴⁴

ADB have also become cheaper and more easily available over the last decade. In 1990, nearly 90 percent of ADBs required additional premium payments or cost of insurance.⁴⁵ By 1998, however, only thirteen percent of policies with a death benefit rider involved a higher premium or an otherwise increased cost of insurance,⁴⁶ and over half of ADB features available on individual policies were automatically offered to eligible policyholders by insurance companies.⁴⁷

Analyses of the life insurance industry indicate that viatical settlements and ADBs are close substitutes. The Federal Trade Commission (FTC) characterized ADBs as a substitute for viatical settlements in its 1998 release on the viatical industry:

Many options exist for people with terminal illnesses when financial needs are critical. For example, you may consider a loan from someone such as the original beneficiary of your life insurance policy. Or, if you've already ruled out less expensive alternatives to raise cash, you might sell your life insurance

41. *Id.*, at 3.

42. *Id.*, at 7. A full 73 percent of the ADBs examined in the LIMRA study required a life expectancy of one year or less, and another 21 percent required a life expectancy of 6 months or less. *Id.* See also, AFLAC.com: "How to Read Your Policy," downloaded on Sept. 16, 2002 at <http://www.aflac.com/policy_services/understand_policy_read.asp>.

43. *Living Benefits More Popular Add-On*, ADVISOR TODAY 36 (Aug. 1, 2000). As this article states, the accelerated death benefit "was conceived more than a decade ago largely in response to the creation of viatical settlements." *Id.* See also, *ADB Provisos*, *supra* note 40, at (stating that "[t]he increased trend toward more ADB policies follows the growing popularity of the viaticals option for terminally ill policyholders seeking funds before death.")

44. LIMRA INTERNATIONAL, *supra* note 40, at 19. At least 245 life companies, which held 78 percent of the life insurance in force in the United States, offered policies with some form of ADBs in 1998. *ADB Provisos*, *supra* note 40, at 1 (Apr. 19, 1999).

45. LIMRA INTERNATIONAL, *supra* note 40, at 11.

46. *Id.* at 10-11. Of policies with a death benefit rider, 36 percent charge nothing—except, in some cases, an administrative fee—and 46 percent charge policyholders only if the rider is exercised. *Id.* For example, New York Life offers a "Living Benefits Rider" at no additional cost. The rider can be exercised if the insured is terminally ill and has a life expectancy of one year or less, and provides roughly 85 percent of the face value of the policy. New York Life, "Viatical Marketing," downloaded from company website (Sept. 23, 2002) at <<http://www.newyorklife.com/NYL2/DisplayOne/0,1237,9247-22-76,00.html>>.

47. LIMRA INTERNATIONAL, *supra* note 40, at 8.

policy through a viatical settlement. Many life insurance policies in force nationwide now include an accelerated benefits provision.⁴⁸

Viatical settlements and ADBs also have been considered substitutes by financial analysts and industry experts.⁴⁹

ADBAs are not close substitutes for life settlements, however, because the eligible life expectancies for the two products do not overlap. Yet incumbent life insurance carriers do compete with life settlement firms by offering surrender values based on normal health. Although such offers are not particularly attractive, the fact that one product competes poorly with another does not mean that the two products are not substitutes. Surrender values are substitutes for life settlements to a health-impaired individual seeking to sell his policy—they are just inferior substitutes.

By 2001, incumbent carriers began to compete more effectively with life settlement firms by lobbying for expanded definitions of “qualifying events” that trigger ADBs. If an incumbent carrier is permitted to offer an ADB for chronic illness, in addition to terminal illness, that carrier can provide a closer substitute to life settlement firms. In September 2002, the New Jersey Department of Banking and Insurance proposed an amendment to expand the circumstances under which an ADB could be exercised to include chronic illness. The Department determined that such an expansion should “positively affect consumers,” and further predicted that “[i]nsurers should benefit since policyholders now have more flexibility in accelerating a portion of their life insurance rather than exercising other life settlement options.”⁵⁰ This explicit reference to life settlement firms by the New Jersey Department of Banking and Insurance demonstrates that the Department views insurance carriers and life settlement firms as competitors in the secondary market for life insurance.

IV. THE BENEFITS OF A SECONDARY MARKET FOR LIFE INSURANCE POLICIES

The emergence of viatical and life settlement firms has generated an increase in the liquidity of life insurance policies in much the same way that improvements in the secondary markets for home mortgages and catastrophic risk insurance improved the liquidity of the underlying assets in those markets. The secondary markets for home mortgages and catastrophic risk policies mitigate the downside risk of purchases in the primary market for those assets. In the same manner, the secondary market for life insurance mitigates the downside risk from the original purchase of a policy in the primary market. A consumer now knows that if he should experience a decline in life expectancy and no

48. FTC Facts for Consumers, *Viatical Settlements: A Guide for People with Terminal Illnesses* at 2 (May 1998) (visited on Aug. 12, 2002) <www.ftc.gov>. The FTC’s release also mentions that Congress amended the tax code in 1997 to carve out exemptions for the receipt of both accelerated death benefits and viatical settlements, provided the individual insured by the original policy has a life expectancy of less than two years. *Id.* at 3. This tax action suggests that the United States Congress also views accelerated death benefits and viatical settlements as existing in the same product market.

49. See, e.g. Carolyn T. Geer, *1996 Money Guide: Cashing in Your Chips*, FORBES at 208 (June 17, 1996).

50. Proposed Amendment: N.J.A.C. 11:4-30.3 (Sept. 16, 2002).

longer need (or no longer be able to afford) his life insurance policy, he will be able to sell it for its market value instead of having to surrender it for the low price offered by the insurance carrier. This mitigation of downside risk led insurance companies to purchase more catastrophic risk liability in the primary market, and it should likewise be expected to cause consumers in the primary market for life insurance to demand a greater quantity of coverage.

In this section, we perform a theoretical analysis of the welfare gains that are obtained by the emergence of competitive firms in the secondary market for life insurance, and examine statistical evidence to develop a conservative estimate of the consumer welfare gains from life settlements. Finally, we describe the response of the incumbent life insurance carriers to the emergence of viatical and life settlement firms and detail those ways in which a robust secondary market benefits those incumbents.

A. *Welfare Analysis*

As in any market, the quantity of insurance sold in the primary market is determined by the price. Higher prices induce more supply and less demand and lower prices enhance demand but depress supply. The market reaches equilibrium at the price that equates supply with demand. For insurance, the “price” is a little subtle and needs some explanation.

The premiums paid by a policyholder for a life insurance policy with a particular face value might intuitively appear to be the appropriate measure of price. However, most of the premiums are returned to the policyholders as claims payments or surrenders. Economists and industry analysts thus uniformly view the price of insurance as the spread between the premium paid and the amount that insured expects to have returned on average in claims and surrenders.⁵¹ Almost all empirical studies of insurance markets use the spread as the appropriate price that equates supply and demand.⁵²

The spread is the amount paid to the insurer for the service of transferring risk and can be measured as:

$$\text{Spread} = (P - C - S) / (C + S)$$

where P represents the total expected premium payments made for the product, C is the expected claims payouts, and S is the expected payments made for surrenders (net of surrender charges).⁵³

An insurer will increase its supply of insurance in the primary market if by doing so it can generate risk-adjusted returns that exceed its cost of capital. These returns do not depend on the dollar value of the premiums but on the markup over costs accruing to the insurer when selling its policies; the higher this markup

51. See, e.g., Erich W. Sippel, *The Heart at War With the Pocketbook: Life Insurance Distribution and Financial Intermediation*, 10-12 TOWERS PERRIN.

52. See, e.g., David F. Babbel, *The Price Elasticity of Demand for Whole Life Insurance*, 40 J. FINANCE 225 (1985).

53. All variables in the above formula represent net present values. The formula represents a simplification to focus on the issues at hand. A few of the subtleties affecting life insurance pricing, such as investment income earned by the insurer, are ignored. These omissions do not materially affect the analysis of life insurance spread undertaken in this paper.

or spread, the higher the return on capital. Thus, other things being equal, the supply of insurance will increase as the spread increases.

Similarly, the dollar value of premiums is not the main determinant of insurance demand; it is the markup or loading to the insurer that determines whether consumers will transfer their risk to the insurer. But this does not mean that the price spread is the only factor to affect the demand for insurance. The quality of the product is also an important determinant of demand. Following the arguments made earlier in this paper, the enhanced liquidity of insurance provided by viatical and life settlement firms gives rise to a more flexible policy. This flexibility permits the policyholders to manage not only the risk of death, but also the financial consequences of impaired health.

With these concepts of supply, demand, and economic price in mind, we can now compare the incumbent insurer's anti-competitive hypothesis concerning the entry of viaticals and life settlement firms with the pro-competitive model. If we assume that the creation of the secondary market has reduced monopsony rent, and if insurers engaged in "lapse supported pricing," then the dollar premium for primary insurance would increase as the insurers contend. However, secondary-market entry would not decrease competition in the primary market—that is, entry would not increase the spread between the premiums and the insurers' payouts from claims and surrenders. If the premiums, claims, and surrenders before entry were P_1 , C_1 and S_1 , and the comparable values after entry were P_2 , C_2 and S_2 , then the spreads before and after would be:

$$(P_1 - C_1 - S_1) / (C_1 + S_1) = (P_2 - C_2 - S_2) / (C_2 + S_2).$$

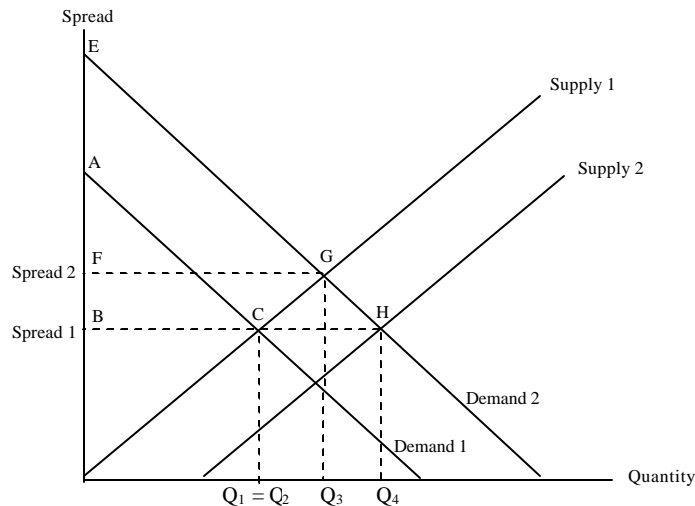
Thus, we should not expect entry to have a material effect on either supply or demand in the primary market. The volume of primary insurance would change little and any increase in dollar premiums would be matched by an increase in surrender or settlements to policyholders. If we consider only the spread, the overall effect on consumers is neutral. The economic spread is unchanged because consumers were buying an inferior product at a lower premium, and are now buying a more liquid—and hence, superior—product at a corresponding higher premium.

Considering only the spread, however, ignores the effect of the reduced riskiness of the product on insurance demand. Enhanced liquidity brought about by the secondary market makes life insurance a superior risk management product that enables the policyholder to more effectively protect himself from the financial effects of death or health impairment. Stated differently, entry into the secondary market eliminates the downside risk of receiving less than the market value for the policy if the policyholder experiences a decline in health.

At any price spread, risk aversion will cause consumers to demand more of a product whose payouts are less risky. Thus the demand curve will shift outward, as shown in Figure 3. The demand before entry is represented by the curve "Demand 1" and the supply is denoted by the curve "Supply 1." The market price or spread is therefore "Spread 1" and the quantity is Q_1 , as shown by point C. The entry of viaticals and life settlement firms will improve product quality, and will increase demand to "Demand 2". In the short run, entry will cause excess demand and increase the price to "Spread 2" with a higher quantity, Q_3 , as shown

by point *G*. In the long run, the higher margin will attract new capital into the primary insurance industry and thereby increase supply to “Supply 2”. This higher margin will restore the spread to its previous level “Spread 1” and the volume of insurance will increase further to Q_4 , as shown by point *H*. Thus, the cumulative effect of entry into the secondary market for life insurance is a larger but equally competitive primary industry.

FIGURE 3: CONSUMER WELFARE ANALYSIS



The consumer benefit from entry into the secondary market can be measured by comparing the “consumer surplus” before and after entry occurs—that is, the area under the demand curve bounded at the bottom by the spread. Before entry, the consumer surplus is the triangle *ABC*. In the short run, entry increases demand, thereby increasing consumer surplus to *EFG*. Even at the temporary higher spreads, consumers are better off with entry in the secondary market because the product is much improved. In the long run, as the higher spreads induce additional insurance capacity, the spread decreases and consumer surplus rises even more to the triangle *EBH*. The improvement in product quality, together with competitive pricing, provides a clear benefit to consumers.

B. Benefits to Consumers

As explained above, entry by viatical and life settlement firms should improve the welfare of policyholders. One measure of this improvement in welfare is the difference between a policy’s surrender value and the amount by which the policyholder was compensated by a life settlement firm, summed across all policyholders who exercised their option to sell their policies in the secondary market. Table 2 estimates the welfare gains earned by policyholders in 2002 from the exercise of life settlement options.

TABLE 2: ANNUAL CONSUMER WELFARE GAINS
FROM THE USE OF LIFE SETTLEMENTS (IN MILLIONS OF DOLLARS)

	Coventry First		All Life Settlement Firms
	Jan. – Aug. 2002	2002 Projected Total	2002 Projected Total
Policies	352	528	1,584*
Total Surrender Value	\$20.8	\$31.1	\$93.4
Total Offer to Policyholders	\$79.1	\$118.6	\$336.3**
Total Policyholder Surplus	\$58.3	\$87.4	\$242.9

Note: This table is estimated by extrapolation from data provided by the market leader in life settlements, Coventry First, to market estimates. * Coventry First estimates that its transactions represent roughly one-third of total life settlements. ** This number represents a lower average offer for the industry relative to Coventry First (3.6 times the surrender value as opposed to 3.8 times the surrender value). This adjustment was made for purposes of conservatism because the offers made by Coventry First tend to be a few percentage points higher than those of its competitors.

Source: Coventry First internal customer data (on file with authors).

As Table 2 demonstrates, life settlement firms improved policyholder welfare by over \$240 million in 2002. This number vastly understates the true positive effect of the secondary market on policyholders, however, because it does not account for the welfare gains generated by viatical firms. Second, our estimate does not incorporate the welfare gains of policyholders from the unexercised option to sell their policies in the future. Unfortunately, this valuable option is difficult to measure. Finally, and perhaps most importantly, this figure does not capture the response of the incumbent insurers to the entry of secondary market players. Following the entry of these players, incumbents have introduced accelerated death benefits (enhanced surrender values) for those demonstrating reduced life expectancy. The magnitude of this response is such that the numbers shown in Table 2 vastly underestimate the benefits to consumers from the new secondary market.

C. Benefits to Incumbent Carriers

Although life insurers will lose monopsony power and therefore lose economic rent from the termination of policies, the life insurance industry would benefit in the long term from the stronger demand created by the secondary market. Furthermore, by standing as ready purchasers of policies, firms in the secondary market could discourage the repeal of nonforfeiture laws and keep incumbent insurers from the unfair, and ultimately unworkable, practice of using high lapse expectations to under-price certain policies.⁵⁴

By analogy, it is useful to consider the case of the motion picture industry. Movie producers vehemently opposed the advent of VCRs because they felt that the devices created a cheaper secondary market for their films and would hurt their theater receipts. Ultimately, however, theater receipts did not decline, and the motion picture industry profited handsomely from the new source of demand created by the secondary market.

54. William C. Koenig and Stephen H. Frankel, *Don't Forfeit Nonforfeiture*, BEST'S REVIEW (June 2002).

A final benefit to insurers lies in their ability to manage risk. Securitization of life settlement portfolios would create financial instruments whose payoffs are correlated to mortality risk. By taking positions in such instruments, an incumbent insurer could hedge its pre-existing mortality risk. Whereas some reinsurers resisted the introduction of these instruments in the catastrophe insurance market, others have initiated securitizations as a way of hedging their risk and thereby expanding their capacity to offer more reinsurance.⁵⁵

V. THE FUTURE OF LIFE SETTLEMENTS

Despite some advantages that accrue to insurers from the new secondary market, those carriers have resisted the entry of viatical and life settlement firms by a variety of tactics. Establishing entry barriers is not surprising. Incumbent life insurance carriers have earned a substantial portion of their margins from surrenders by policyholders with diminished life expectancies, and seek to protect those margins. The incumbent carriers' actions are more likely motivated by what economists describe as rent-seeking behavior.⁵⁶ They are attempting to protect the profits derived from their monopsony position in the secondary market.

A. *Incumbent Carriers' Attempts to Maintain Market Power*

Incumbent insurance carriers have a clear economic motive to eliminate viatical and life settlement firms from the secondary market for life insurance policies.⁵⁷ This motivation explains why life insurance carriers have lobbied for regulations on viatical and life settlements that are unfavorable to *any* secondary market transactions. The incumbents' strategies can be best understood in light of their economic interest in re-establishing monopsony positions in the secondary market.

Incumbent carriers have pressured their agents to shun the viatical industry. For example, in a November 2000 letter to its financial advisors, AXA explained that its financial professionals were "expressly prohibited from participating in any viatical settlement or life settlement activity."⁵⁸ Other large insurers have also prohibited their career agents from dealing with viatical or life settlement companies or providing such services to policyholders.⁵⁹ In particular, agents of these companies were prohibited from providing viatical or life settlement firms with information about any of the carriers' clients for the purpose of having a

55. We do of course recognize that the degree of risk imposed on property liability insurers by catastrophes might differ from the degree to which mortality risk affects the solvency of life insurers.

56. See generally TOWARD A THEORY OF THE RENT-SEEKING SOCIETY (J. Buchanan, R. Tollison, and G. Tullock eds., Texas A & M University Press 1980).

57. See, e.g., Holman W. Jenkins Jr., *Business World: Back to the Future When Life Insurance Was Fun*, WALL. ST. J. at A23 (Mar. 14, 2001) (explaining that "by selectively keeping in force only the industry's losing policies, investors can't help but screw up the industry's returns.").

58. Letter from John Lefferts, President of Retail Distribution, AXA Advisors, to all Regional Presidents, Regional Executive Vice Presidents, Regional Vice Presidents, and Financial Professionals, AXA Advisors 1 (Nov. 14, 2001) (on file with authors).

59. Career agents are the most common distribution system of insurance companies. See, e.g., Robert Chamerda, *Conserving Annuity Assets*, I/R Code 19.00, at 3 (LIMRA 2000).

client enter into an arrangement with the viatical or life settlement firm. In a compliance alert letter sent in February 2002, GenAmerica directed its agents to encourage policyholders interested in viatical or life settlements to use “product alternatives” such as ADBs.⁶⁰ Agents were further instructed to refer a policyholder to the state insurance department if he insists on talking with a viatical or life settlement firm.⁶¹ Finally, agents of GenAmerica Financial (GAF), NEF, and MetLife have been expressly prohibited from providing any assistance (beyond that which is legally required) to a client who wishes to assign his company contractual death benefits to a life or viatical company.⁶²

Principal Life prohibits all career agents (as well as their employees, field management, and administrative staff) from participating in *any* viatical or life settlements transaction—even if the policy being transacted is not a Principal Life policy.⁶³ Principal Life prohibits any broker from participating in a viatical or life settlement transaction involving a Principal Life policy if either a) the policyholder intends to transfer only a portion of the policy to the purchaser, b) the purchaser sells interests in policies to investors, or c) if the insured is eligible for accelerated death benefits from Principal Life.⁶⁴

B. The Regulatory Environment Confronting Viatical and Life Settlements

Certain states have increased the regulation of viatical and life settlement firms. For example, in Kentucky, new regulations, which were introduced by incumbent insurance carriers, mandate that a life insurance agent must complete an approved 40 hour viatical “prelicensing classroom course of study,” apply for and obtain a separate license from the state, and pay a fee of \$250 before he is allowed to broker a life settlement with a client for whom such a settlement might be the best option.⁶⁵ Although sensible licensing requirements help to eliminate fraudulent viatical and life settlement transactions, licensing requirements such as those passed in Kentucky eliminate nearly all viatical and life settlement transactions, and their associated benefits.

As of September 2002, viatical and life settlements were governed by a patchwork of state and federal regulations. In 1996, the SEC’s bid to regulate

60. *Compliance and Marketing Practice: Alert!!*, e-mail from GenAmerica Financial Ethics and Compliance Officer to All GenAmerica Financial Agents (Feb. 2002) (on file with authors).

61. *Id.*

62. *Id.*

63. Principal Financial Group, “Your Business Practices.” (on file with authors). Furthermore, if the broker is a registered representative of Princor, in addition to the above restrictions, the broker must obtain prior written approval to participate in any viatical or life settlement transaction—even if the policy being transacted is not a Principal Life policy and the broker is not being compensated for the transaction. *Id.*

64. *Id.* Furthermore, if the broker is a registered representative of Princor, in addition to the above restrictions, the broker must obtain prior written approval to participate in any viatical or life settlement transaction—even if the policy being transacted is not a Principal Life policy and the broker is not being compensated for the transaction. *Id.*

65. Viatical Settlement Broker License Code, 806 KAR 9:310 (Ky. 2001), available at <<http://www.lrc.state.ky.us/kar/806/009/310.htm>>.

viaticals under federal securities law was rejected by the D.C. Court of Appeals.⁶⁶ But even though they were not considered to be securities under federal law, many states classified viatical settlements as securities and regulated their sale to investors as such.⁶⁷ In February 2002, 35 states regulated viatical transactions through their insurance regulatory departments, but only 13 of these regulated life settlements.⁶⁸ Roughly half the states did not have licensing requirements for viatical selling.⁶⁹

The regulatory environment has allowed certain abuses by unscrupulous companies. These abuses, however, have tended overwhelmingly to involve the fraudulent sale of interests in viaticated policies to *individual investors*, or the fraudulent acquisition of new policies for resale to unscrupulous or unsophisticated firms in the secondary market.⁷⁰ In contrast, there have been relatively few instances in which *policyholders* have been the target of fraudulent practices. Indeed, in a March 2002 letter to the House Subcommittee on Oversight and Investigations, NAIC president Terri Vaughan explained that “[i]n reality, most settlement frauds now involve the investor side of the transaction, not the insurance policyholder side.”⁷¹

Previous articles have attested to the need for sensible regulation of the secondary market,⁷² and the top firms in the life settlement and viatical industries have been supportive of antifraud laws on the grounds that such laws would help to curtail abuses by disreputable firms and inspire public confidence in (and demand for) the services of the industry as a whole.

One example of self-regulation is the Life Settlement Institute, which is a non-profit trade group consisting of six of the major institutionally funded life settlement providers and financiers.⁷³ In 2002, the Life Settlement Institute began

66. Securities and Exchange Commission v. Life Partners Inc., 87 F.3d 536 (D.C. Cir 1996). In February 2002, however, the SEC won a preliminary injunction against a brokerage firm for fraudulently selling fractional interests in life insurance policies. The SEC was able to win this injunction, its first court victory since the Life Partners case, because the firm had offered guaranteed repurchase terms, which classified the investment as a security. Todd Mason, *SEC Bars Fort Worth, Texas, Brokerage Firm's Sale of Policy Shares*, FORT WORTH STAR-TELEGRAM (Feb. 27, 2002).

67. Carol M. Ostrom, *A Warning About Fraud in Death-Benefit Sales ; \$1.8 Million Lost in State, Securities Chief Testifies*, SEATTLE TIMES at B1 (Feb. 27, 2002).

68. Written Statement of David M. Lewis, *supra* note 10, at 66.

69. Coolidge, *supra* note 7.

70. The extent of the first—and most common—type of fraud, can be perceived from the following excerpt from the *Washington Post*: “Securities regulators from 21 states have reported that thousands of investors, many of them elderly, have been defrauded of more than \$400 million over the past three years, according to the North American Securities Administrators Association (NASAA). In one case in Texas, a viatical settlement company sold investors shares in nonexistent insurance policies.” Michelle Singletary, *The Color of Money: A Foolish (And Ghoulish) Investment*, WASH. POST at H1 (Mar. 10, 2002). Although there are not reliable estimates of the extent of the second type of fraud, allegations that some viatical brokers were encouraging individuals with terminal illnesses to fraudulently obtain insurance policies led to a federal investigation in 2000. Joseph Gerth, *Kentucky Pulls Viatical Company's License*, THE COURIER JOURNAL at 6C (Sept. 25, 2002).

71. Letter from Terri Vaughan, president, NAIC, to Sue Kelly and Luis V. Gutierrez, chair and ranking member (respectively), House Subcommittee on Oversight and Investigations 2 (Mar. 27, 2002). In the letter, Vaughan criticized the Committee’s staff report for its misuse of NAIC data to wrongfully imply that policyholders are the chief target of fraud in the secondary market for life insurance policies. *Id.*

72. See, e.g., Sippel and Buerger, *A Free Market for Life Insurance*, *supra* note 6, at 20

73. Written statement of David M. Lewis, *supra* note 10, at 65.

building an anti-fraud database for companies to share information of suspicious or fraudulent activity by policy sellers, brokers, doctors, financial advisors, or the insured, themselves.⁷⁴ In addition to such self-regulation, the Life Settlement Institute has publicly advocated a stricter and improved regulatory environment. David M. Lewis, president of the Life Settlement Institute, stated in written testimony to the U.S. House Committee on Financial Services, that the Life Settlement Institute strongly supported strict regulation by state insurance and securities regulators of the viatical and life settlement marketplace,⁷⁵ and supported amending the Federal Securities Act of 1933 so that interests in pooled life insurance policies sold to individual investors would constitute “securities” under the Act.⁷⁶

Several states have moved to regulate the secondary market for life insurance. In January 2001, Ohio enacted a law for the regulation of viatical firms modeled after the National Association of Insurance Commissioner’s (NAIC’s) Model Viatical Settlement Act. The *Journal of Insurance Accounting* explains the benefits of the law:

The new law expands the definition of viator to include life or senior settlements, and requires disclosures at a time no later than the time of the application by the provider or broker. In addition, the law provides a 15-day window for the viator to rescind the contract and protects their identity. To combat fraud, the law provides a clear definition of what constitutes viatical fraud and requires licensed brokers and providers to show a plan to identify and combat fraud.⁷⁷

As of February 2002, only 20 states regulated the sale of interests in viatical or life settlements to individual investors.⁷⁸

There is a strong trend in the industry towards more sophisticated (and larger) investors, which should diminish the opportunities for investor fraud. As Terri Vaughan explains, “[v]iatical settlements today are typically pooled together for sale in larger amounts to more sophisticated investors.”⁷⁹ As just one such example, in October 2001 Warren Buffet’s Berkshire Hathaway arranged to invest up to \$400 million in Living Benefits Financial Services LLC.⁸⁰ The due-diligence performed by such investors will have a policing effect on the industry, as firms must either meet the necessary investment criteria of institutional investors, or fail to acquire such capital.

74. *Institute to Track Viatical, Life Settlement Fraud*, BEST’S INSURANCE NEWS at 1 (Sept. 12, 2002).

75. Written statement of David M. Lewis, *supra* note 10, at 68.

76. *Id.* at 66. Mr. Lewis further stated that “on the state level, [the Life Settlement Institute and its members] urge the passage in every state of legislation patterned after the NAIC Model Act.” *Id.*

77. *Ohio Governor Signs Viaticals Law*, INSURANCE ACCOUNTING (Jan. 22, 2001).

78. Written statement of David M. Lewis, *supra* note 10, at 67.

79. Letter from Terri Vaughan, *supra* note 71.

80. John Hoogesteger, *Berkshire Unit Lends \$400M to Startup; Firm Buys Out Life Policies*, MINNEAPOLIS, ST. PAUL BUS. J. ONLINE (Feb. 1, 2002), downloaded on Sept. 26, 2002 at <<http://twincities.bizjournals.com/twincities/stories/2002/02/04/story1.html>>.

VI. CONCLUSION

Secondary markets for financial products provide liquidity and thereby enhance the value of those products. The value enhancement usually feeds back to the primary market in an expansion of demand. We have seen this in the markets for home mortgages. The market for catastrophe risk also appears to be going through such a transition. The primary market for life insurance also has been supplemented by a secondary market. A rudimentary secondary market for life insurance has always existed; policyholders could surrender their policies to the incumbent carrier. However, the incumbent was a monopsonistic buyer and extracted rents on these transactions. The arrival of viatical and life settlement firms now provides competition on secondary transactions and this liquidity provides welfare benefits and efficiency gains.