

The Benefits of a Secondary Market
for Life Insurance Policies

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THE BENEFITS OF A SECONDARY MARKET FOR
LIFE INSURANCE POLICIES

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Editors' Synopsis: This Article analyzes the benefits that accrue to policyholders and incumbent insurers from an active secondary market for life insurance policies. It begins 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, it outlines 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 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 no external market for reselling policies exists, 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. Entry by firms in the secondary market erodes monopsony power. Finally, the Article examines the benefits of an active secondary market for life insurance policies to policyholders and incumbent insurers in the primary market and discusses the fixture of life settlements. The magnitude of the benefits is correlated positively 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

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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 began to take form in the late 1980s in response to the Acquired Immunodeficiency Syndrome ("AIDS") epidemic, as many young people began to have the sudden need for money to pay for medical treatment and to maintain their standard of living. These individuals sought liquidity from any long-term assets they owned, including life insurance policies. The shortened life horizons of those living with AIDS meant the actuarial values of their policies—the risk-adjusted value of the death benefit taking into account future costs—significantly exceeded the surrender values of their policies.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

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 (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, and thus it is an asset of the policyholder. The extinguishment of this obligation by the insurance carrier results from its acquisition of the policyholder's asset, and therefore, it is a purchase. For this reason, even a lapse represents a purchase (for zero price).

companies have historically earned economic rents on the repurchase of impaired policies. 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 predetermined 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-arranged termination terms offered by the insurance companies. Viatical firms emerged to facilitate these sales, and the secondary market for life insurance was born.⁴

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 having the opportunity to invest in a previously inaccessible asset class. The viatical industry has grown rapidly since the early 1990s. Between \$1.8 billion and \$4.0 billion worth of policies were viaticated in 2001,⁵ up from \$50 million in 1990 and \$1.0 billion as recently as 1999.⁶ 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.⁷

¹ The terms "normal" and "impaired" are used throughout this Article 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.

² 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. Accordingly, these elements of the early market may 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 identities of the individuals whose policies they now hold. See Stephen Rae, *AIDS. Still Waite* *ig*, N.Y. TIMES MAG., July 19, 1998, at 11.

³ See Erich W. Sippel & Alan H. Buerger, *A Free Market for Life Insurance. CONTINGENCIES*, Mar.-Apr. 2002, at 17 (citing studies by Erich Sippel & Company and the Viatical Association of America).

⁴ See Carrie Coolidge, *Death Wish Investors in Insurance Policies for the Terminally Ill ark' Watching Their Capital Get Annihilated*, FORBES, Mar. 19, 2001, at 206.

⁵ The annual rate of return on a life insurance policy purchased in the secondary market is the excess of the policy's face value over the price offered to the policyholder divided by the future lifespan of the individual insured by the policy. The risk associated

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 availability of AIDS drugs in the mid-1990s, which 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 sixty-five, have experienced a decline in health, and have 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 twenty percent of policyholders over the age of sixty-five are estimated to hold policies the economic values of which exceed their cash surrender values.¹² Conning Corporation, 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

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-1990s significantly increased the life expectancies of individuals living with AIDS, and created a greater variance in the risk associated with what previously had been a fairly predictable disease.

David W. Dunlap, *AIDS Drugs Alter an Industry's Math*, N.Y. TIMES, July 30, 1996, at D1.

⁹ See *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) [hereinafter *Wriap Statement of David M. Lewis*].

¹⁰ See *id.* See also Lynn Asinof, *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., May 15, 2002, at D2; *Seniors Should Exercise Caution When Considering Life Settlements*, ASSOC. PRESS, Feb. 8, 2001, WL Westnews (News and Business Database), Associated Press (AP) Newswires-Plus File (citing Michael Snowdon, academic associate at the College of Financial Planning); see also Juan Hovey, *Selling Your Life Insurance Policy Can Help Ensure Business Liquidity*, L.A. TIMES, Apr. 30, 2001, at C3 (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% of the death benefit).

¹¹ See Press Release, Coventry First, L.L.C., Coventry First Applauds New Pennsylvania Viatical Settlements Law: Pennsylvania Senior to Benefit (July 10, 2002), available at <http://www.coventryfirst.com/resource/files/pr71002.pdf>.

life settlements is close to \$100 billion.¹³

The secondary market for life insurance policies allows 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 secondary market sale of a policy by an eligible individual 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.
- A reduction in the value of the policyholder's estate reduces the tax liability for which the life insurance policy was designed to provide.
- 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 resulting from such a donation.¹⁵

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

Alan Buerger, co-founder and CEO of Coventry First, L.L.C. ("Coventry First"), a leading life settlement firm, cautions that most people "shouldn't be selling their policy if they have the means to keep it." Asinof, *supra* note 11, at D2. However, as Mr. Buerger explains, "the reality is that people drop insurance every day."

¹⁴ See Jack V. Sinclair, *PLANNER*, Sept. 1, 2001, at 2-3; Kaja Whitehouse, *Viaticals*

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 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 the 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 essentially are similar to innovations introduced in prior generations, such as the differentiation between smokers and nonsmokers that began in the 1980s. However, unlike most prior innovations in the insurance industry, which sought to "skim" the healthiest — the least risky-patients from the pool, life settlements actually benefit those who have become greater-than-average risks." Moreover, because the existence of a secondary market for life insurance has improved the liquidity of all life insurance policies that 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 the secondary market for life insurance policies, 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

Mature. But Risks Remain, Dow JONES NEWS SERVICE, Jan. 14, 2002, WL, Westnews (News and Business Databases), Dow Jones News Service Plus File (citing Martin Issenbaum, national director of retirement planning at Ernst & Young, L.L.P.).

^N As Erich W. Sippel of Erich Sippel & Co. & Alan H. Buerger of Coventry First point out,

At bottom, the case for the secondary market in life insurance policies is pro-freedom and pro-consumer. The existence of the secondary market eliminates the disadvantageous 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 & Alan H. Buerger, *Viatical Response*, CONTINGENCIES, July-Aug. 2002, at 6-8,

¹ 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 almost always must be impaired for him to sell a policy for more than its cash surrender value. As Doug Head of the Viatical and Life Settlement Association of America explains. "[B]y 'healthy,' the industry actually means 'a little sick,' or 'won't live to full life expectancy.'" Jane Bryant Quinn, *'Life Settlements,' Not East Money for Seller or Buyer*, S. FLA. SUN-SENTINEL, Mar. 19, 2001, at D3. 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.

will have a positive effect on the demand for life insurance.' This observation is fairly intuitive. For example, 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 to consumers in the secondary market extend to consumers, insurance agents, and life insurance companies in the primary market for life insurance.

Part II of this Article provides an analysis of the effect 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. Parallels are drawn between these markets and the secondary market for life insurance, and reasons for allowing consumers in the primary market for life insurance to benefit are detailed.

Part III of this Article provides an overview of the secondary market for life insurance. The overview includes a discussion of how incumbent carriers exercised monopsony power in the secondary market for life insurance policies, and also examines the effect of entry by life settlement and viatical firms. The overview also details the competitive response of incumbent carriers to that entry.

Part IV examines 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's"),¹⁹ but also does not include the benefits the secondary market for life insurance policies generates for customers in the primary market.

The future of the secondary market for life insurance is examined in Part V. It includes a review of the efforts of incumbent life insurance companies to stymie entry into the secondary market. The conclusion is that the actions of incumbent life insurance companies represent an effort to maintain monopsony power over their customers in the purchase of impaired policies.

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

Incumbent carriers have reacted to secondary market entry with ADB 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 properly should be considered in an evaluation of the positive economic effect of secondary market entry.

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 W. Carlton of the University of Chicago and 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 the 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.

This Section examines 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 insurance, and life insurance. For each industry, the table identifies the consumers and suppliers in the primary and secondary markets and describes the benefit owing to the enhancements in the secondary market.

Table 1. The Effects of Enhancements in the Secondary Markets

	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 ²¹	Policyholders ²²	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

As Table 1 shows, life settlement and viatical firms in the life insurance industry play a role similar to entrants in other financial services industries. 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

²⁰ Although homebuyers purchase mortgages, they also supply associated streams of payments that represent the assets for sale in the secondary market. Because these assets are the focus of our analysis, the homebuyers are the suppliers in the primary market.

²¹ The policyholders are the suppliers in the primary market for catastrophe risk insurance, in a way similar to homebuyers' roles in the primary market for home mortgage payments.

suppliers 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 is 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.³ This reduced the credit risk associated with mortgages because 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.⁴

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 risk insurance is 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

³ See James W. Kolari et al., *The Effects of Securitization on Mortgage Market Yields: A Co-Otegration Analysis*, 26 REAL EST. ECON. 677, 677 (1998).

⁴ Mortgage rates were lower in markets served by Freddie Mac and Fannie Mae. See Dennis W. Carlton et al., *The Competitive Effects of Fannie Mae*, FANNIE MAE PAPERS (Fannie Mae, Washington, D.C.), Jan. 2002, at 3; see also Kolari, *supra* note 23, at 677.

risk is a useful tool for asset diversification because catastrophe losses are not correlated with either the stock or bond market.²⁵ 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, it has prompted an increase in secondary demand.

This demand, in turn, significantly has improved the liquidity of an insurance company's position in catastrophic risk policies and reduced credit risk by providing a superior financial vehicle to insurance firms to hedge against downside risk.⁶ 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 correspondingly have increased their demand for catastrophe risk and extended greater quantities of risk insurance." 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 illustrations 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. Consumers now know that if they experience a decline in life expectancy and no longer need (or can no longer afford) their life insurance policies, they will be able to sell the policies for their market value instead of having to surrender them for the low price offered by the insurance carrier. The secondary market for home mortgages caused mortgage lenders to place a higher value on mortgage payments and to demand a higher quantity of these payments. By the same process, the modern secondary market for life insurance has caused consumers to place a higher value on life insurance policies, a positive result that has 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

²⁵ See Gurdip Bakshi & Dilip Madan, *Average Rate Claims With Emphasis on Catastrophe Loss Options*, 37 J. FIN. & QUANTITATIVE ANALYSIS 93, 94 (2002).

See Sara Borden & Asani Sarkar, *Securitizing Property Catastrophe Risk*, CURRENT ISSUES IN ECON. & FIN., Aug. 1996, at 1-3.

See generally KNUT K. AASE & BERNT ARNE ODEGAARD, EMPIRICAL TESTS OF MODELS OF CATASTROPHE INSURANCE FUTURES 2-3 (Wharton Fin. Insts. Center Working Paper No. 96-18, 1996).

purchasers of catastrophe risk liability in the primary market—to retreat more easily 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. Consumers know that should they need or desire to sell their policies in the future, they will not have to accept amounts 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 up a surplus from which future premiums can be subsidized.²⁸ If we assume 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.²⁹

But what if a policyholder's preferences change and he no longer needs the policy he purchased? The policyholder naturally would wish to receive payment for the value that has built up in the policy by virtue of the policyholder's surplus payments. Indeed, if it were not possible to cash out a policy that was no longer needed, uncertainty about future insurance preferences would decrease the value of whole-life insurance to consumers. Because life insurance carriers recognize this, 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.³⁰

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. However, competition in the primary market prevented the incumbent from exercising this power in the repurchase of normal policies—policies for which the insured is of normal health. Primary market competition did not eliminate this monopsony power for

²⁸ This surplus also is calculated to create an endowment equal to the face value of the policy at a maturity age (typically 100).

²⁹ 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.

³⁰ Universal-life policies also include the option for a policyholder to surrender the policy to the issuing insurer for a cash surrender value.

impaired policies, and life insurance carriers historically have 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 usually are specified in the insurance contract, and thus, they are determined in the primary market for life insurance. The primary market typically is characterized as having a relatively high degree of competition, which means the premiums and terms of life insurance policies are set at roughly competitive levels. Furthermore, surrender values are set to correspond roughly to the surplus value that builds up in policies over time, assuming the health of the policyholder unfolds on a normal path.³¹

The existence of a surrender value for a policy does not obligate an individual wishing to resell a policy to resell to the issuing insurance carrier. Indeed, life insurance policies are typically assignable, which means policyholders are free to transfer their ownership of the policies to other people. A policyholder's right to assign the policy to someone other than the insurance carrier has existed for some time, which means 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.

Although a few policyholders did sell their policies to individual speculators, most were unwilling to make those 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. Because surrender values are set *ex ante* in the primary market rather than *ex post* in the secondary market, 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.³² In this case, the policyholder buys the policy at age forty. The buildup of policy value assumes that the policyholder's

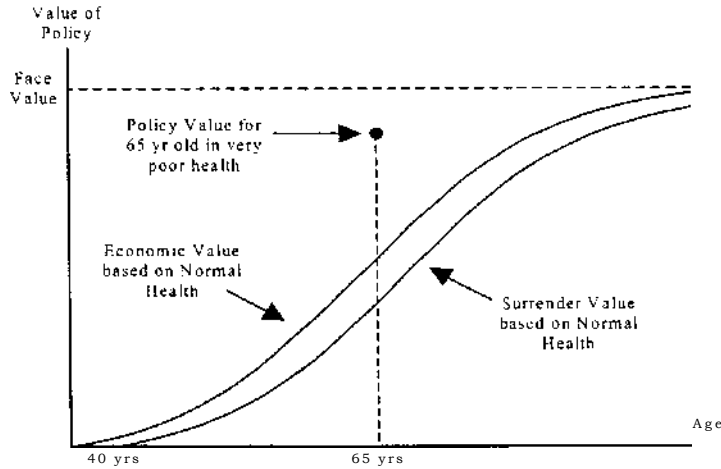
³¹ In the case of a term-life policy, a schedule of premiums is set to cover the projected mortality risk associated with a policyholder over the life of the policy. Because there is no build-up of value in a term policy, the surrender value is zero.

³² See, e.g., Asinof, *supra* note 11, at D2; Sinclair, *supra* note 15, at 1. Individual speculators in life insurance policies are ignored because most policyholders were not willing to sell to speculators and because the effect of these speculators was insufficient to affect the market power of incumbent life insurers.

³³ Figure 1 considers a whole-life policy, but the same mechanism can be applied to a universal-life policy or term-life policy 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.

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 sixty-five. Because the policyholder's life expectancy is curtailed, the present actuarial value of the policy will be much higher than for a sixty-five-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 normal health, the company's surrender terms will be low relative to the actual policy value for an individual with impaired health.

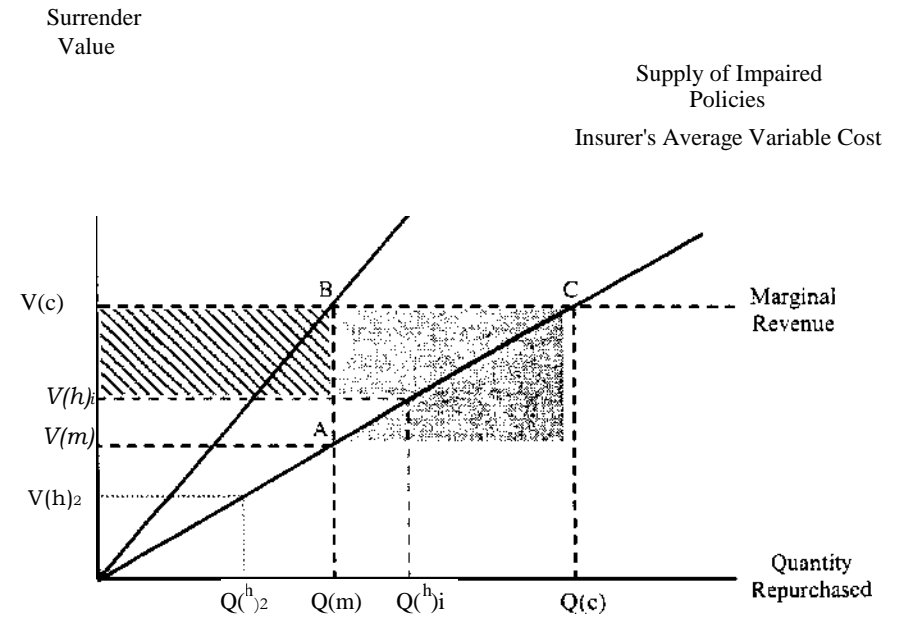
A policyholder with impaired health cannot bargain effectively for a more generous surrender offer *ex post* because the issuing carrier is the monopsony repurchaser of the policy. The policyholder would be forced either to accept an amount that is substantially less than the true economic value or to 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 of enforcing such *ex ante* conditions likely would be high and laden with moral hazard.

This is a good illustration of what economists call unenforceable contracts and such precommitment has not been forthcoming. While it is true, as examined later in this Article, that insurers have made concessions for the surrender of impaired policies (ADB's), the timing of this development suggests that it resulted from competition in the secondary, and not the primary, market.

For example, consider the price 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 of the same age and the same level of health impairment. Figure 2 shows the price level 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.³⁴ This supply curve

³⁴ See, e.g., CARLTON & PERLOFF, *supra* note 2, at 105-07 (explaining how a

also is the average variable cost to the insurer of repurchasing 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—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.¹⁵ 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 these 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.^{3b}

Now suppose that the insurer already has committed to a competitive surrender value based on normal health, $V(h)$. If the established surrender value for a normal policy is higher than $V(m)$, as depicted by $V(h)$, the incumbent carrier will be unable to achieve the monopsony price for the surrender of the impaired policy because it has a contractual obligation to offer the competitive healthy rate.^{3c} Nevertheless, the incumbent still will earn supracompetitive rents on the surrender of impaired policies. The sum of those rents is equal to the diagonally-shaded rectangle, and it produces a deadweight loss equal to the solidly-shaded area.

If there were a competitive secondary market on which these policies could be resold, however, the incumbent insurer would lose its ability to set the price in the secondary market.^{3d} The surrender value would rise to its

monopsonized market functions).

The marginal cost is higher than the average variable cost because obtaining a marginally higher quantity of impaired life insurance requires the carrier to offer a higher price not only to the marginal seller but also to all sellers.

For a discussion of deadweight loss, see PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 182-83 (16th ed. 1998).

By virtue of its impairment, $V(h)$, 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 $V(h)$. If the surrender value is lower than $V(m)$, 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 effectively to raise its surrender value for the impaired policy to the monopsony rate.

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,

competitive level, $V(c)$, with a higher number of policies, $Q(c)$, being resold. Therefore, the entry of competition into the secondary market would eliminate both the monopsonist's rent and the efficiency loss identified above.

B. Entry into the Secondary Market for Life Insurance

Health status plays a large part in a consumer's decision to surrender a policy. When a policyholder's health is above average, then that individual's life insurance is no longer a good value because she is paying premiums based on the average level of mortality risk—a figure that is higher than her actual mortality risk. Because the policyholder's positive shift in life expectancy decreases the value they attach to their policies, they thus will be more likely to surrender their policies than individuals 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 the average life expectancy for the remaining pool of policyholders is lower than projected at the time the policies were issued.³⁹

If an individual's health is below average, then he is less likely to surrender his policy because impaired policies are worth more than normal policies. 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.⁴⁰ 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.⁴¹ Individuals whose consumption preferences have changed in favor of current consumption value cash more highly at the current time, and thus are willing to accept lower prices for their policies' surrender than they would have when their health was normal. Absent entry by third parties into the secondary market, insurance carriers will thus be able to reap significant gains by underpaying for the surrender of these impaired policies.

ECOINOMICS: PRINCIPLES AND POLICY 272 (6th ed. 1994).

supra For a more thorough examination of the adverse selection phenomenon, see George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. VON. 488 (1970).

The concept of health-state dependent preferences has been explored in numerous economic articles, including one written by one of this Article's authors. See Neil Doherty & 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) unpublished working paper, on file with authors).

As noted earlier in this Article, 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.

Because entrants into the secondary market—both viatical and life settlement firms—are interested only 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. 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 an incumbent's costs. The increase in costs may not come solely from the loss of rents from surrenders, but also may result from higher surrender values offered for impaired policies by incumbents themselves through the use of provisions such as ADBs. If the viatical and life settlement firms pressured the incumbent carriers to make competitive offers for impaired policies, those carriers still would lose that portion of the return that was supracompetitive.

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

Furthermore, only a portion of an incumbent carrier's 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 a cost increase the incumbent insurer will be able to impose on consumers.⁴⁴ Finally, any quality improvements because of increased liquidity likely will 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: ADBs

Before the entry by viatical and life settlement firms, the only buyer in the secondary market for a life insurance policy was the insurance company that had issued the policy. After entry by competitors in the early 1990s, life insurance companies developed ADBs, which give policyholders the option of receiving from twenty-five to nearly one hundred percent of their death benefit while they are still living.⁴⁵ 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, either must 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. Early on, either dread diseases or long-term care triggered a large percentage of ADBs, however, by 1994 terminal illness was the overwhelming condition necessary for the exercise of an ADB.⁴⁵ 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 policyholders with life expectancies of greater than one year to accelerate their death benefits.⁴⁶

ADB were developed as a competitive reaction to the emergence of viatical firms.⁴⁷ 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 the LIMRA Int'l Study, 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 thirty-five times the number of ADB policies in 1991.⁴⁸

TERMINAL ILLNESSES 2 (1998), available at http://library.lp.findlaw.com/articles/file100002i000962/titlesubjecttopic/insurance/a20law%20life/healthu'filename/insurancelaw_1_227 (last visited Sept. 30, 2003) (on file with authors). ADBs even can 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 those values were lower than the monopsony rate. See also Whitehouse, *supra* note 15 (citing American Express certified financial planner, Thomas A. Endersbe). For example, on its website, New York Life states, "If 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*, at <http://www.newyorklife.com/NYL2/DisplayOne/0,1237,9247-22-76,00.html> (last visited Sept. 33, 2002).

See LIMRA INTERNATIONAL & AMERICAN COUNCIL OF LIFE INSURANCE, ACCELERATED DEATH BENEFITS: 1998, 4 (1999) [hereinafter LIMRA INT'L STUDY]. See also *Accelerated Death Benefit Provisos on the Rise*, INS. ACC'T. Apr. 19, 1999, at 1 [hereinafter *ADB Provisos*].

See LIMRA INT'L STUDY, *supra* note 44, at 3.

⁴⁶ See *id.* at 7. A full 73% of the ADBs examined in the LIMRA Int'l Study required a life expectancy of one year or less, and another 21% required a life expectancy of six months or less. See also *How to Read Your Policy*, at http://www.vsv.aflac.com/policy_services/understand_policy_read.asp (last visited Sept. 16, 2002).

See *Living Benefits More Popular Add-On*, ADVISOR TODAY, Aug. 1, 2000, at 36. As this Article states, the accelerated death benefit "was conceived more than a decade ago largely in response to the creation of viatical settlements." See also *ADB Provisos*, *supra* note 40, at 1 ("The increased trend toward more ADB policies follows the growing popularity of the viaticals option for terminally ill policyholders seeking funds before death~8).

See LIMRA INT'L STUDY, *supra* note 44, at 19. "[A]t least 245 life insurance companies—which [h]eld 78% of the life insurance in force in the U.S. offer[ed] policies with some

⁴²

The same principle applies to tax burden analysis. See, e.g., BAUMOL & BLINDER, *supra* note 38, at 241-42; see generally EDGAR K. BROWNING & WILLIAM R. JOHNSON, *THE DISTRIBUTION OF THE TAX BURDEN* (1979).

⁴⁴ See FED. TRADE COMM'N, VIATICAL SETTLEMENTS: A GUIDE FOR PEOPLE WITH

ADB's also have become cheaper and more easily available over the last decade. In 1990, nearly ninety percent of ADB's required additional premium payments or cost of insurance.⁴⁹ However, by 1998 only thirteen percent of policies with a death benefit rider involved a higher premium or an otherwise increased cost of insurance,⁵⁰ and over half of ADB features available on individual policies were automatically offered to eligible policyholders by insurance companies.

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

[Many] [o]ptions 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, accelerated benefits on your life insurance policy, or a viatical settlement. Many life insurance policies in force nationwide now include an accelerated benefits provision.⁵²

Viatical settlements and ADB's also have been considered substitutes by financial analysts and industry experts.⁵³

ADB's 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 health-impaired individuals seeking to sell their policies; however, they are inferior substitutes.

form of [ADB's]" in 1998. *ADB Provisos*, *supra* note 44, at 1.

⁴⁹ See LIMRA INT'L STUDY, *supra* note 44, at 10.

⁵⁰ See *id.* at 10-11. Regarding policies with a death benefit rider, 36% charge nothing-except, in some cases, an administrative fee-and 46% charge policyholders only if the rider is exercised. 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 will provide roughly 85% of the face value of the policy. See New York Life, Viatical Marketing, at <http://www.newyorklife.com/NYL2/Display0nei0.1237,9247-22-76,00.html> (last visited Sept. 23, 2002).

⁵² See LIMRA INT'L STUDY, *supra* note 44, at 8.

⁵³ FED. TRADE COMM., VIACIAL SETTLEMENTS: A GUIDE FOR PEOPLE WITH TERMINAL ILLNESSES 2 (1998), available at <http://library.lp.findlaw.com/articles/file/00002/000962?title=subject/topic/insurance%20law&lifehealthfile=insurancelaw1227> (last visited Sept. 30, 2003) (on file with authors). 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. This tax action suggests that the United States Congress also views accelerated death benefits and viatical settlements as existing in the same product market.

See, e.g., Carolyn T. Geer, *Cashing in Your Chips*, FORBES, June 17, 1996, at 208.

By 2001, incumbent carriers began to compete more effectively with life settlement firms by lobbying for expanded definitions of "qualifying events" that trigger ADB's. 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."⁵⁴ 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

Entry by firms into the secondary market for life insurance policies 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. Similarly, the secondary market for life insurance mitigates the downside risk from the original purchase of a policy in the primary market. Consumers now know that if they should experience a decline in life expectancy and no longer need (or are no longer able to afford) their life insurance policies, they will be able to sell the policies for their market value instead of having to surrender them 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 likewise should be expected to cause consumers in the primary market for life insurance to demand a greater quantity of coverage.

This Section contains a theoretical analysis of the welfare gains obtained by the emergence of competitive firms in the secondary market for life insurance, and it examines statistical evidence to develop a conservative estimate of the consumer welfare gains from life settlements. In addition, the Section describes the response of the incumbent life insurance carriers to the emergence of viatical and life settlement firms and details the ways in which a robust secondary market benefits those incumbents.

⁵⁴ N.J. ADMIN. CODE tit. 11 § 4-30.3 (proposed amendment 2002).

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 subtle and warrants 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 the insured expects to have returned on average in claims and surrenders. Almost all empirical studies of insurance markets use the spread as the appropriate price that equates supply and demand.¹¹

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).¹²

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 do rely on the markup over costs accruing to the insurer when selling its policies; the higher this markup or spread, the higher the return on capital. 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; the markup or loading to the insurer 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 Article, 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

¹¹ See, e.g., David F. Babbel, *The Price Elasticity of Demand for Whole Life Insurance*, 40 J. Fiv. 225 (1985).

¹² 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.

health.

With these concepts of supply, demand, and economic price in mind, one now can compare the incumbent insurer's anticompetitive hypothesis concerning the entry of viaticals and life settlement firms with the pro-competitive model. If one assumes that the creation of the secondary market has reduced monopsony rent, and if insurers are 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; 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, C, and S, and the comparable values after entry were P2, C, and S, then the spreads before and after would be:

$$(P - C - S) / (C + S) = (P2 - C - S2) / (C2 + S2)$$

Thus, one 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 now are 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 policyholders to protect themselves more effectively 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 the payouts of which 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, as shown by point C. The entry of viatical 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, Q3, 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 Q4, 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.

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. However, ultimately theater receipts did not decline, and the motion picture industry profited handsomely from the new source of demand created by the secondary market.

A final benefit to insurers lies in their ability to manage risk. Securitization of life settlement portfolios would create financial instruments with payoffs that 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 expanding their capacity to offer more reinsurance.⁶⁰

V. THE FUTURE OF LIFE SETTLEMENTS

Despite some advantages that accrue to insurers from the new secondary market, carriers have resisted the secondary market entry by a variety of tactics. The establishment of 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 they seek to protect those margins. The incumbent carriers' actions more likely are motivated by what economists describe as rent-seeking behavior.⁶¹ 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.⁶² 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 understood best 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 and

directly to a secondary market ... to get a better deal." Such a procession would result in the collapse of the lapse-supported pricing method.

The authors 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.

See generally TOWARD A THEORY OF THE RENT-SEEKING SOCIETY (James M. Buchanan et al. eds., Texas A & M University Press, Economics Series No. 4, 1980).

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

life settlement industries. 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."⁶³ Other large insurers also have prohibited their career agents from dealing with viatical or life settlement companies or providing such services to policyholders. 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 client enter into an arrangement with the viatical or life settlement firm. In a compliance alert letter sent in February 2002, GenAmerica Financial directed its agents to encourage policyholders interested in viatical or life settlements to use "product alternatives" such as ADBs.⁶⁵ Agents were further instructed to refer policyholders to the state insurance department if they insisted on talking with a viatical or life settlement firm. Finally, GenAmerica Financial, New England Financial, and MetLife have expressly prohibited their agents from providing any assistance (beyond that which is legally required) to clients who wish to assign their company contractual death benefits to a life or viatical company.⁶⁶

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.⁶⁸ Principal Life prohibits any broker from participating in a viatical or life settlement transaction involving a Principal Life policy if (1) the policyholder intends to transfer only a portion of the policy to the purchaser, (2) the purchaser sells interests in policies to investors, or (3) if the insured is eligible for accelerated death benefits from Principal Life."

⁶³ Letter from John Lefferts, President of Retail Distribution, AXA Advisors, to all Regional Presidents, Regional Executive Vice Presidents, Regional Vice Presidents, and Analy al Professionals, AXA Advisors (Nov. 14, 2001) (on file with authors).

⁶⁴ Career agents are the most common distribution system of insurance companies. *See, e.g.*, Robert Chamerda, *Conserving Annuity Assets I/R Code 19.00* (LIMRA Int'l, Inc., Hartford, Conn.), 2000, at 3.

⁶⁵ *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).

⁶⁶ *See id.*

⁶⁷ *See id.*

⁶⁸ PRINCIPAL FINANCIAL GROUP, YOUR BUSINESS PRACTICES" (Apr. 30, 2002) (on file with authors).

See id. Furthermore, if the broker is a registered representative, 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.

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, incumbent insurance companies introduced new regulations that mandate that life insurance agents must complete an approved forty hour viatical prelicensing classroom course of study, apply for and obtain a separate license from the state, and pay a fee of \$250 before they are allowed to broker a life settlement with a client for whom such a settlement might be the best option.¹⁰ Although sensible licensing requirements help 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 Security and Exchange Commission's (SEC's) bid to regulate viaticals under federal securities law was rejected by the District of Columbia Court of Appeals.¹¹ But even though viatical settlements were not considered securities under federal law, many states classified them as securities and regulated their sale to investors as such.¹² In February 2002, thirty-five states regulated viatical transactions through their insurance regulatory departments, but only thirteen of these regulated life settlements.¹³ Roughly half the states did not have licensing requirements for viatical selling.¹⁴

The regulatory environment has allowed certain abuses by unscrupulous companies. However, these abuses overwhelmingly tend 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.¹⁵ In

¹⁰ See 806 KY. ADMIN. REGS. 9:310 (2001) (Viatical Settlement Broker License), available at <http://www.lrc.state.ky.us/kar/806/009/310.htm>.

¹¹ See *Sec. Exch. Comm'n 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 *Life Partners*, because the firm offered guaranteed repurchase terms, which classified the investment as a security. See Todd Mason, *SEC Bars Fort Worth, Texas, Brokerage Firm's Sale of Policy Shares*, FORT WORTH STAR-TELEGRAM, Feb. 27, 2002, at IC.

¹² Carol M. Ostrom, *A Warning About Fraud in Death-Benefit Sales; \$1.8 Million Lost in St. Louis, Securities Chief Testifies*, SEATTLE TIMES Feb. 27, 2002, at B1.

¹³ See *Written Statement of David M. Lewis*, *supra* note 10, at 67. See Coolidge, *supra* note 7, at 207. 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.

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, the National Association of Insurance Commissioners (NAIC) president Terri Vaughan explained, "In reality, most settlement frauds now involve the investor side of the transaction, not the insurance policyholder side."¹⁶

Previous articles have attested to the need for sensible regulation of the secondary market,¹⁷ and life settlement firms have been supportive of antifraud laws on the grounds that such laws would help 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 can be found at the Life Settlement Institute, a nonprofit trade group consisting of six of the major institutionally funded life settlement providers and financiers.¹⁸ In 2002 the Life Settlement Institute began building an antifraud database for companies to share information of suspicious or fraudulent activity by policy sellers, brokers, doctors, financial advisors, or the insured.¹⁹ In addition to such self-regulation, the Life Settlement Institute has publicly advocated a more strict and improved regulatory environment. Its president, David M. Lewis, stated in written testimony to the U.S. House Committee on Financial Services that "[t]he . . . Institute and its members strongly supported strict regulation by state insurance and securities regulators of the viatical and life settlement marketplace,²⁰ 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 Act²¹"

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 NAIC's Model Viatical Settlement Act.²²

Michelle Singletary, *A Foolish And Ghoulish Investment*, WASH. POST, Mar. 10, 2002, at H1. Although there are no 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. See Joseph Gertl, *Kentucky Pulls Viatical Company's Licenses*, COURIER J., July 25, 2002, at 6C.

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) (on file with authors). In the letter, Vaughan criticized the Committee's staff report for its misuse of NAIC data to imply wrongfully that policyholders are the chief target of fraud in the secondary market for life insurance policies.

¹⁶ See, e.g., Sippel & Buerger, *supra* note 6, at 20.

¹⁷ See *Written statement of David M. Lewis*, *supra* note 10, at 65.

¹⁸ See *generally Institute to Track Viatical, Life Settlement Fraud*, BEST'S INS. NEWS, July W 2002, available at 2002 WL 23010310.

¹⁹ See *Written statement of David M. Lewis*, *supra* note 10, at 66.

²⁰ See *id.* 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."

See OHIO REV. CODE ANN. Cy 3916.01-.06 (Anderson 2003).

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.⁸³

As of February 2002, only twenty states regulated the sale of interests in viatical or life settlements to individual investors.⁸⁴

The industry is trending strongly toward more sophisticated and larger investors, which should diminish the opportunities for investor fraud. As Terri Vaughan explains, "Viatical settlements today are typically pooled together for sale in larger amounts to more sophisticated investors."⁸⁵ For example, in October 2001 Warren Buffet's Berkshire Hathaway arranged to invest up to \$400 million in Living Benefits Financial Services L.L.C.⁸⁶ The due-diligence performed by such investors will have a policing effect on the industry because firms either must meet the necessary investment criteria of institutional investors or fail to acquire such capital.

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 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. Entry by firms into the secondary market for life insurance policies has created competition on secondary transactions and generated welfare benefits and efficiency gains.

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Ohio Governor Signs Viaticals Law, INS. ACCT., Jan. 22, 2001, at 7, available at 2001 WL 2524305.

See *Written statement of David M. Lewis*, *supra* note 10, at 67. Letter from Terri Vaughan, *supra* note 76, at 2. ⁸⁶ See John Hoogesteger, *Berkshire Unit Lends \$400M to Startup; Firm Buys Out Life Policies*, MINNEAPOLIS, ST. PAUL BUS. J. (Feb. 4, 2002), available at <http://twincities.bizjournals.com/twincities/stories/2002/02/04/story1.html> (last visited Sept. 26, 2002).