

The Secondary Market For Life Insurance Policies: Uncovering Life Insurance's "Hidden" Value

Neil A. Doherty

Brian A. O'Dea

Hal J. Singer

Follow this and additional works at: <http://scholarship.law.marquette.edu/elders>



Part of the [Elder Law Commons](#)

Repository Citation

Doherty, Neil A.; O'Dea, Brian A.; and Singer, Hal J. (2004) "The Secondary Market For Life Insurance Policies: Uncovering Life Insurance's "Hidden" Value," *Marquette Elder's Advisor*: Vol. 6: Iss. 1, Article 4.

Available at: <http://scholarship.law.marquette.edu/elders/vol6/iss1/4>

This Article is brought to you for free and open access by the Journals at Marquette Law Scholarly Commons. It has been accepted for inclusion in Marquette Elder's Advisor by an authorized administrator of Marquette Law Scholarly Commons. For more information, please contact megan.obrien@marquette.edu.

THE SECONDARY MARKET FOR LIFE INSURANCE POLICIES: UNCOVERING LIFE INSURANCE'S "HIDDEN" VALUE*

Neil A. Doherty**

Brian A. O'Dea***

Hal J. Singer****

In this article, we examine the benefits that an active secondary market for life insurance policies provides to the policyholder. We begin by briefly explaining the development of the secondary market for life insurance and the economic consequences of that development. Most notably, although insurance carriers typically offer reasonably competitive surrender values for policies, those carriers were monopsony repurchasers of life insurance policies before the advent of the secondary market. As a result, individuals with impaired health were unable to receive appropriate compensation before the development of viatical and life settlement firms. Viatical and life settlement firms erode this monopsony power and generate positive consumer welfare gains. Next, we evaluate the benefits and risks to individual policyholders associated with secondary market transactions and estimate the aggregate benefit of the secondary market to policyholders. The current consumer benefit from the secondary market is less than it could be because policyholders in many cases are not aware the market even exists. Indeed, 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. Finally, we describe the evolving regulatory environment in which the secondary market functions.

* Two of the authors published a similar article in Neil A. Doherty & Hal J. Singer, *The Benefits of a Secondary Market for Life Insurance Policies*, 38 REAL PROP. PROB. & TR. J. 449 (2003).

** Ronald A. Rosenfeld Professor of Insurance and Risk Management, The Wharton School, University of Pennsylvania.

*** Senior Consultant, Criterion Economics, L.L.C.

**** Senior Vice President, Criterion Economics, L.L.C.

I. INTRODUCTION	96
II. ANALYSIS OF THE SECONDARY MARKET FOR LIFE INSURANCE..	99
A. <i>THE PURCHASE OF IMPAIRED POLICIES BY INCUMBENT CARRIERS.</i>	101
B. <i>SECONDARY MARKET ENTRY BY VIATICAL AND LIFE SETTLEMENT FIRMS.</i>	103
C. <i>THE COMPETITIVE RESPONSE OF INCUMBENT CARRIERS: ACCELERATED DEATH BENEFITS</i>	106
III. THE BENEFITS OF THE SECONDARY MARKET FOR LIFE INSURANCE.	108
A. <i>SPECIFIC BENEFITS OF SECONDARY MARKET TRANSACTIONS TO INDIVIDUAL POLICYHOLDERS</i>	109
B. <i>SPECIFIC RISKS OF SECONDARY MARKET TRANSACTIONS TO INDIVIDUAL POLICYHOLDERS.</i>	111
C. <i>AGGREGATE BENEFITS OF THE SECONDARY MARKET TO POLICYHOLDERS</i>	113
IV. KNOWLEDGE OF THE SECONDARY MARKET FOR LIFE INSURANCE	117
A. <i>THE EFFECTS OF SUBOPTIMAL DECISION-MAKING.</i>	117
B. <i>BARRIERS TO CONSUMER KNOWLEDGE OF THE SECONDARY MARKET FOR LIFE INSURANCE.</i>	119
V. REGULATION OF THE SECONDARY MARKET FOR LIFE INSURANCE	120
VI. CONCLUSION	122

I. INTRODUCTION

It is common to think of a life insurance policy as a risk management tool that generates value upon the death of the policyholder. A life insurance policy, however, is also a financial asset. As a financial asset, a life insurance policy can have a positive actuarial value—often a substantial positive

value—while the policyholder is still living.¹ The shorter the remaining life expectancy of an individual, the closer the actuarial value of his policy will be to the face value of the insurance coverage. Thus, as an individual grows older, his insurance policy becomes a more and more valuable asset.

Though valuable, a life insurance policy was a relatively illiquid asset until recently, due in large part to the monopsony position of life insurance carriers over the repurchase of life insurance policies that they had issued.² Whereas a car owner has always been able to sell a car that no longer fits his needs to a variety of different buyers, a life insurance policyholder has traditionally had few choices; either allow the policy to lapse or sell the policy back to the issuing carrier for its surrender value.³

Surrender values are set *ex ante* in the primary market for life insurance, which is characterized by a moderately high degree of competition. The surrender price, however, is based on an assumption of normal health. Because of the issuing insurance carriers' monopsony positions in the secondary market, individuals who experienced negative shifts in life expectancy could only liquidate their life insurance policies at very unfavorable terms.⁴ Many consumers with impaired health were economically compelled to surrender their policies, and life insurance carriers earned economic rents from these surrenders.⁵

The emergence of viatical and life settlement firms allows

1. The actuarial value of a policy is the face value of a policy's death benefit discounted for the remaining life expectancy of the individual covered by the policy.

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

3. A few policyholders did sell their policies to individual speculators. Such sales, however, provided the speculator with a financial interest in the early demise of the policyholder. As there were no safeguards against those interests, individual policy sales tended to be an option only for those in dire financial need.

4. When a policyholder experiences a negative shift to his or her life expectancy, 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 the 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.

5. 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). "Normal" health refers to the state of an individual's health that is normal relative to that individual's health at issuance. Similarly, the term "impaired" health refers to a state of health that is impaired relative to the state of health at issuance.

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,⁶ the flexibility offered by the secondary market for life insurance policies gives a policyholder the ability to respond to changes in her life situation. There are a multitude of circumstances under which a viatical or life settlement may be welfare enhancing, such as when a policyholder can no longer afford to pay the premiums on the policy, when a policyholder requires funds to pay for medical expenses, when the policyholder no longer needs the policy, or when the liquidation of the policy would further the estate planning or charitable goals of the policyholder.

Viatical and life settlements represent one of several life insurance innovations through which companies that develop innovative actuarial analyses have been able to glean profits due to 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 nonsmokers 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.⁷ 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.

In Section II, we review the purpose of life insurance and 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. We then describe how the advent of viatical and life settlement firms has eliminated the incumbent life insurance

6. Lynn Asinof, *Your Pocketbook: Selling Off Life Insurance: Good Policy?*, WALL ST. J., May 15, 2002, at D2 (quoting Alan Buerger, cofounder and CEO of Coventry First, L.L.C., a leading life settlement firm) ("People shouldn't be selling their policy if they have the means to keep it But the reality is that people drop insurance every day.").

7. 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.

carriers' position as the sole purchaser of their own policies in the secondary market and provided policyholders the opportunity to exercise their assignability rights at competitive rates. This has increased the number of policies sold.

In Section III, we examine the benefits and risks that viatical and life settlement transactions pose to individual consumers. Viatical and life settlement firms benefit individuals living with diminished life expectancies by allowing them to harness the value of their life insurance policies for a variety of purposes while they are still alive. Indeed, the ability to sell a life insurance policy in a competitive secondary market can provide a policyholder with the ability to receive more money when it is needed the most—that is, when a decline in health makes it impractical or undesirable for him to continue to make the necessary premium payments to keep the policy in force. Although there are certain risks associated with viatical and life settlements, the risks to the individual policyholder are minimal, and we explain how they can be avoided. We demonstrate that life settlements, alone, generate aggregate surplus benefits in excess of \$240 million annually for policyholders who exercise their option to sell their policies at a competitive rate. The total annual consumer benefit from the competitive secondary market for life insurance likely vastly exceeds this number.

In Section IV, we explain that the welfare gains associated with the secondary market for life insurance are not as great as they could be, as the lack of information about the secondary market for life insurance prompts policyholders to make inefficient decisions regarding their life insurance holdings. We examine the effects of such suboptimal decisions and explain some of the barriers to greater consumer knowledge about the secondary market.

Finally, in Section V, we briefly discuss the regulatory environment under which viatical and life settlement firms operate.

II. ANALYSIS OF THE SECONDARY MARKET FOR LIFE INSURANCE

The traditional function of insurance is to protect a policyholder from absorbing the full impact of some potential future loss. Technically, optimal life insurance equalizes the marginal utility

of money across all states of nature.⁸ That is to say, a policyholder who is optimally insured will value one additional dollar exactly the same whether the insured event occurs or not.⁹

The idea of insurance is *not* to equate wealth or total utility in all situations. For example, an annuity is designed to give the consumer a fixed amount of money each year and, thus, a relatively constant marginal utility of money. An annuity actually increases the expected variance in a consumer's *total* utility. Consider two identically situated individuals who purchase identical annuities: one dies shortly after buying an annuity, and the other lives longer than expected. The individual who dies early comes out behind in terms of both total wealth and total utility as a result of the annuity purchase, whereas the individual who lives longer comes out ahead in both categories. During the time period in which both individuals are alive, however, their *marginal* utility of money is the same. The annuity makes sense because it protects against the "risk" of longevity. The individual who lives longer has more use for money. Without an annuity, that individual would face ever-decreasing savings and an ever-increasing marginal utility of money.

The motivation for the purchase of life insurance is exactly the opposite. A consumer will purchase life insurance if his marginal utility of bequests in the short term is greater than his marginal utility of money in the long term. This high short-term marginal utility can be the product of a number of factors, but the most common is the desire to provide for a family or other dependents in the case of premature death. Insurance is also a tool for the management of risk. Life insurance protects against the risk of financial hardship for an individual's dependents in the case of that individual's death.

The right of assignability allows a consumer to transfer a policy to another beneficiary. Sometimes this right is used to assign benefits to different family members, but the right also enables the policyholder to name a third party as the beneficiary.

8. This definition assumes that a policy is priced in an actuarially fair manner and that no systematic risk affects a customer's marginal utility of money.

9. Moral hazard may prevent full equalization. For example, if fire insurance makes a building owner indifferent to a fire, he will not take efficient protection measures. There is less moral hazard with life insurance, but arguably a breadwinner might take on more risks if his family is protected by insurance. If behavior is observable then there is no problem because premiums can be conditioned on behavior to induce efficiency.

This right is valuable because if a policyholder's preferences shift at some point such that his marginal utility of money exceeds his marginal utility of bequests, the policy may well become worth more to a third party, such as a life settlement firm, than it is to the original policyholder.¹⁰

Before the entry of viatical and life settlement firms, however, the life insurance carrier could exercise monopsony power in the secondary market for its own policies. Although 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. As a result, 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. 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.¹¹

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

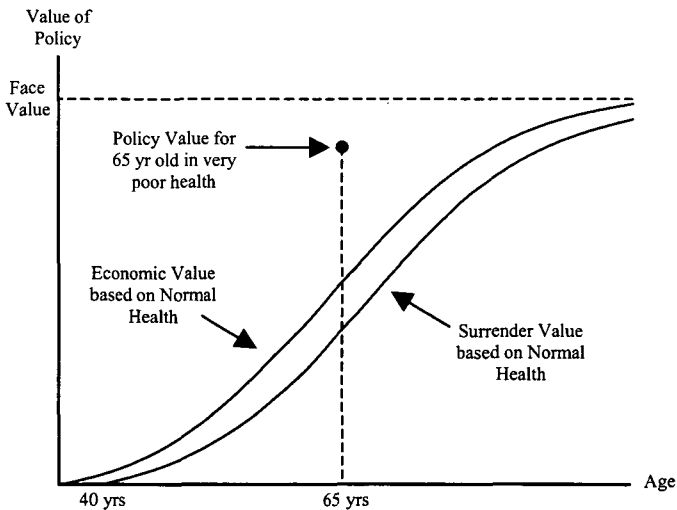
10. Although we focus on the case of reduced life expectancy in this article, the reason that a transfer is valuable is not essential to our analysis. For example, a guaranteed insurance contract that provided an 8% return would be worth more than the immediate value in today's market of a 4% return. A healthy person who lost his job and needed money would benefit from being able to sell such a policy rather than just cashing it in. Nonetheless, in most cases, an individual's health must be impaired in order to sell a policy for more than its cash surrender value. See Jane Bryant Quinn, *Staying Ahead: "Life Settlements" Not Easy Money for Seller or Buyer*, S. FLA. SUN-SENTINEL, May 15, 2001, at 3D.

11. There is no buildup in value for some term life policies, because the schedule of premiums is set to cover the projected mortality risk associated with a policyholder over the life of the policy. The surrender value for those policies is, thus, zero.

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 at the margins.¹²

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.¹³ In this case, the policyholder buys the policy at age forty. 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



12. It was possible for policyholders to use their life insurance policies as collateral for loans from certain financial institutions. However, because the policyholder retained ownership under such a transaction, it was not technically a secondary market transaction.

13. 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 value lies below the curve of the economic value of a healthy policy because of the load factor and the fact that the primary market was not perfectly competitive.

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. The incumbent will still earn supracompetitive rents on the surrender of impaired policies. The incumbent carrier can use those rents to cover the losses it experiences from the surrender of policies by individuals with above-normal health or to improve its competitive position in the primary market by subsidizing premiums. The incumbent carrier may also retain a portion of these rents as profits.

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. This uniform pricing creates a deadweight social loss. Individuals who desire to sell their policies for a higher price than the healthy rate are unable to do so, even if they are willing to accept a price that is less than the competitive market rate. Thus, many individuals will continue to hold policies even though it would be mutually advantageous for both them and the insurance company if the insurance company were to repurchase their policies at a price exceeding the set surrender value of those policies.

If there were a competitive secondary market in which these policies could be resold, however, the surrender value for impaired policies would rise to its competitive level, and a greater number of policyholders would sell their policies.¹⁴ A competitive secondary market would, therefore, eliminate both the monopsonist's rent and the associated efficiency loss.

B. SECONDARY MARKET ENTRY BY VIATICAL AND LIFE

14. 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).

SETTLEMENT FIRMS

The creation of a competitive 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.¹⁵ The emergence of viatical and life settlement firms has led to an increase in the liquidity of life insurance policies and a mitigation of much of the downside risk from the purchase of a life insurance policy in the primary market. An informed 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 set price offered by the insurance carrier.

Entry of viatical and life settlement firms has introduced competition into the secondary market for life insurance and thereby reduced the monopsony power of incumbent life insurance carriers in that market. Viatical firms, which specialize in the purchase of life insurance policies from terminally ill policyholders, emerged in the late 1980s in response to the Acquired Immunodeficiency Syndrome (AIDS) epidemic, as many individuals abruptly found themselves in need of money to pay for medical treatment and maintain their standard of living. These individuals sought liquidity from their long-term assets, 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 when taking into account future costs—had come to significantly exceed the policies' surrender values.¹⁶ Investors were willing to purchase those policies for substantially more than the prearranged termination terms offered by the insurance companies, and viatical firms emerged to facilitate the sales of impaired policies to these investors. The United States Congress, recognizing the value of these

15. See Neil A. Doherty & Hal J. Singer, *The Benefits of a Secondary Market for Life Insurance Policies*, 38 REAL PROP. PROB. & TR. J. 449 (2003) (describing the benefits of the secondary markets to asset holders in the home mortgage and catastrophic risk insurance industry and compares that with the benefits to life insurance policyholders).

16. When a policy becomes impaired, the present value of the death benefit increases because death will occur sooner than originally projected. At the same time, the present value of premium payments decreases, because they 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.

transactions, changed the taxation of sales by policyholders with life expectancies of less than two years so that they would no longer pay a tax penalty relative to those who held their policies to maturity.¹⁷

The viatical industry has grown rapidly since the early 1990s. According to the Viatical Association of America, between \$1.8 billion and \$4 billion of policies were viaticated in 2001,¹⁸ up from \$50 million in 1990 and \$1 billion as recently as 1999.¹⁹

Around the year 2000, another type of firm entered the secondary market for life insurance—the life settlement firm. Whereas viatical firms typically only purchase policies from policyholders with life expectancies of less than two years, 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).²⁰ Life settlement firms use more sophisticated underwriting models than viatical firms and do not purchase policies from individuals who are terminally ill.²¹ Furthermore, 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.²²

More than 20% of policyholders over the age of sixty-five are estimated to hold policies whose economic values exceed their cash surrender values.²³ Conning and Company, an

17. FED. TRADE COMM'N, VIACICAL SETTLEMENTS: A GUIDE FOR PEOPLE WITH TERMINAL ILLNESS (May 1998).

18. Erich W. Sippel & Alan H. Buerger, *A Free Market for Life Insurance*, CONTINGENCIES, Mar./Apr. 2002, at 17, 18 (citing studies by Erich Sippel & Co. and the Viatical Ass'n of America).

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

20. Asinof, *supra* note 6; Associated Press, *Seniors Should Exercise Caution When Considering Life Settlements* (Feb. 8, 2001) (citing Michael Snowdon, Academic Associate at the College for Financial Planning). See *Retirement Protection: Fighting Fraud in the Sale of Death: Hearing Before the House Comm. on Fin. Servs., Oversight and Investigations Subcomm.*, 107th Cong. 65, 66 (2002) (written statement of David M. Lewis, President of the Life Settlement Institute) [hereinafter *Retirement Protection*].

21. See *Retirement Protection supra* note 20.

22. See 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).

23. Alan H. Buerger, *Life Settlements Come of Age*, TRUSTS & ESTATES, Nov. 2002 at 34, available at <http://www.coventryfirst.com/information/files/TE112002.pdf> (last visited

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.²⁴

Entry of viatical and life settlement firms will eliminate the economic rent that incumbent carriers have previously earned on the repurchase of impaired policies firms, increase their costs, and 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 incumbent carriers' cost increases will be passed on to consumers.²⁵

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 issued the policy. In the early 1990s, after the entry of competitors, life insurance companies developed accelerated death benefits (ADB), which gave policyholders the option of receiving between 25% to nearly 100% of their death benefit while they were living.²⁶ To qualify for an ADB, a policyholder must have a death benefit rider on her 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.²⁷ Although

Oct. 28, 2004).

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

25. 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. This is the same principle that applies to tax burden analysis. See BAUMOL & BLINDER, *supra* note 14, at 241–42. EDGAR K. BROWNING & WILLIAM R. JOHNSON, *THE DISTRIBUTION OF THE TAX BURDEN*, 1979 Am. Enter. Inst. for Pub. Policy Research.

26. FED. TRADE COMM'N, *supra* note 17.

27. LIFE INSURANCE MARKET RESEARCH ASSOCIATION INTERNATIONAL (LIMRA) INTERNATIONAL & AMERICAN COUNCIL OF LIFE INSURANCE, *ACCELERATED DEATH BENEFITS: 1998, 4 (1999)* [hereinafter LIMRA INTERNATIONAL STUDY]. See also *Accelerated Death Benefits Provisos on Rise*, INS. ACCT., Apr. 19, 1999, at 1 [hereinafter

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 2% and 5% 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.²⁸

Accelerated Death Benefits were developed as a competitive reaction to the emergence of viatical firms.²⁹ 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 Life Insurance Market Research Association International (LIMRA), approximately 39.9 million life insurance policies contained ADB provisions in 1998, which was more than double the number of ADB policies in 1994.³⁰

Accelerated Death Benefits have also become cheaper and more easily available over the last decade. In 1990, nearly 90% of ADBs required additional premium payments or cost of insurance.³¹ By 1998, however, only 13% of policies with a death benefit rider involved a higher premium or an otherwise increased cost of insurance,³² and over half of ADB features available on individual policies were automatically offered to eligible policyholders by insurance companies.³³

Analyses of the life insurance industry indicate that viatical settlements and ADBs are close substitutes.³⁴ ADBs are not close

ADB Provisos].

28. LIMRA INTERNATIONAL STUDY, *supra* note 27, at 7 (reporting that a full 73% of the ADBs examined in the LIMRA study required a life expectancy of one year or less, and another 21% required a life expectancy of six months or less). See Am. Family Life Assurance Co., *How to Read Your Policy*, at http://www.aflac.com/policy_services/understand_policy_read.asp (last visited Oct. 28, 2004).

29. Chuck Jones, *Living Benefits More Popular Add-On*, 95 ADVISOR TODAY 36 (2000) (stating that the accelerated death benefit was "conceived more than a decade ago largely in response to the creation of viatical settlements").

30. LIMRA INTERNATIONAL STUDY, *supra* note 27, at 19. At least 245 life companies, which held 78% of the life insurance in force in the United States, offered policies with some form of ADBs in 1998. *ADB Provisos*, *supra* note 27, at 1.

31. LIMRA INTERNATIONAL STUDY, *supra* note 27, at 10.

32. *Id.* at 10 (stating that of 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).

33. LIMRA, *supra* note 27, at 8.

34. FED. TRADE COMM'N, *supra* note 17; Carolyn T. Geer, *1996 Cashing in Your Chips (Selling Life Insurance Policies for Cash)*, FORBES, June 17, 1996, at 208.

substitutes for life settlements, because the eligible life expectancies for the two products do not overlap. By 2001, however, 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 (The Department) 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."³⁵

III. THE BENEFITS OF THE SECONDARY MARKET FOR LIFE INSURANCE

The emergence of viatical and life settlement firms has generated an increase in the liquidity of life insurance policies. The secondary market for life insurance mitigates the downside risk from the original purchase of a policy in the primary market. An informed 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 supracompetitive price offered by the insurance carrier. Indeed, if a policyholder's health declines, the value of his life insurance policy actually appreciates. This mitigation of downside risk makes life insurance a more attractive asset and should, therefore, be expected to cause consumers in the primary market for life insurance to demand a greater quantity of coverage. Although life insurance is primarily a tool for the management of mortality risk, as we explained in the previous section, the development of a competitive secondary market endowed life insurance with the additional function of hedging against serious health impairments.

35. N.J. Admin. Code § 11:4-30.3, *proposed amendment* (2002), available at www.state.nj.us/dobi/acrobat/pn02_324.pdf (last visited Oct. 28, 2004).

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.

A. SPECIFIC BENEFITS OF SECONDARY MARKET TRANSACTIONS TO INDIVIDUAL POLICYHOLDERS

Life insurance is a valuable asset and it is generally a good investment. Although it does not make sense for most policyholders to surrender their policies at the market value,³⁶ the sale of a policy to a viatical or life settlement firm is often the best option for an individual policyholder who has a high current need for income. We turn now to an examination of the specific situations in which the secondary market sale of a policy by an eligible individual may be welfare improving:

- The policyholder can no longer afford to pay the premiums on the policy, and it is not feasible for him to keep the policy in force by using any program offered by the insurance carrier (such as borrowing the premium against the death benefit of the policy).
- 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, with a long-term care insurance policy, or with funds for long-term

36. Asinof, *supra* note 6.

care.

- The policyholder requires funds to pay for medical expenses or for new and experimental treatments for herself or someone close to her.
- 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.³⁷

The examples listed above detail the many situations in which a policyholder might wish to sell her life insurance policy. Although it has always been possible for a policyholder to sell his policy to the incumbent life insurance company, 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 for his policy.³⁸ In many cases, the difference between selling a life insurance policy and the "second-best" option is striking. For

37. See Kaja Whitehouse, *Getting Personal: Viaticals Mature, But Risks Remain*, DOW JONES NEWS SERVICE, Jan. 14, 2002, at 15:12:00 (citing Martin Nissenbaum, Nat'l Director of Retirement Planning at Ernst & Young, L.L.P.).

38. See Erich W. Sippel & Alan H. Buerger, *Viatical Response*, CONTINGENCIES, July/Aug. 2002, at 6, 6 ("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.").

example, companies are now using life settlements on key-man policies to improve liquidity and respond to short-term cash flow challenges without cutting jobs or employee benefits.³⁹

On an *ex ante* basis, the ability of a policyholder to sell an impaired policy for its market value makes life insurance an effective tool to protect against the financial risk of terminal illness or general poor health. Thus, although life insurance is primarily a hedge against mortality risk, assignable policies provide consumers with the added value of a hedge against serious health impairments.⁴⁰

B. SPECIFIC RISKS OF SECONDARY MARKET TRANSACTIONS TO INDIVIDUAL POLICYHOLDERS

The following are the three most commonly mentioned risks to individual policyholders from participation in a secondary market transaction: (1) the company that purchases the policy fails to pay the policyholder; (2) the policyholder is persuaded to sell a policy even though such a sale is not in the policyholder's best interest; and (3) the policyholder becomes "worth more dead than alive" after selling his policy and ostensibly is, thus, at a heightened risk to be the victim of foul play.⁴¹ The first two risks are not specific to the secondary market for life insurance. Indeed, they apply to almost any contractual arrangement where one party makes payment to another. The third risk, though sensational, is not a valid concern in the modern secondary market. Indeed, many of the top life settlement firms now aggregate policies into diversified pools, a procedure that prevents investors from knowing the individual identities of the individuals whose policies they now hold.⁴²

To be certain, there have been abuses in the secondary market for life insurance. Those abuses, however, have tended

39. Jolene D. Fullerton, *Life Settlements: A New Way to Free Up Cash*, 24 AFP EXCHANGE 58 (Mar. 1, 2004).

40. Whole life and universal life policies also have some tax deferral benefits and have use in estate planning. Indeed, there is concern in the industry that the Bush savings plan proposals will sharply reduce the tax incentives for using life insurance instead of other savings vehicles.

41. See *Creativity - A Blessing and a Curse*, NAT'L UNDERWRITER LIFE & HEALTH-FIN. SERVS. EDITION, Oct. 23, 2003 (providing an example of the "worth more dead than alive" objection to secondary market transactions).

42. Asinoff, *supra* note 6.

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.⁴³ In contrast, there have been relatively few instances in which *policyholders* have been the targets of fraudulent practices. Indeed, in a March 2002 letter to the House Subcommittee on Oversight and Investigations, National Association of Insurance Commissioners (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.”⁴⁴ Nonetheless, policyholders can protect themselves by checking with their state insurance regulator and dealing only with established firms in the viatical and life settlement industry.

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.”⁴⁵ In October 2001, Warren Buffet’s Berkshire Hathaway arranged to invest up to \$400 million in Living Benefits Financial Services, L.L.C.⁴⁶ In a more recent example, on April 30, 2004, Merrill Lynch arranged a private placement of \$70 million in bonds by Legacy Benefits Corporation backed by the company’s life

43. Joseph Gerth, *Kentucky Pulls Viatical Company's License*, COURIER J., July 25, 2002, at 6C (stating that 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); Michelle Singletary, *The Color of Money: A Foolish (And Ghoulis) Investment*, WASH. POST, Mar. 10, 2002, at H1 (providing a description of the first and most common type of fraud, “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.”).

44. *Hearing Before the House Comm. on Fin. Servs., Oversight and Investigations Subcomm.*, 107th Cong., Mar. 27, 2002 (letter from Terri Vaughan, president, NAIC, to Sue Kelly and Luis V. Gutierrez, chair and ranking member (respectively), criticizing 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).

45. *Id.*

46. John Hoogesteger, *Berkshire Unit Lends \$400M to Startup*, THE BUS. J. (Minneapolis/St. Paul), Feb. 1, 2002, at 1, <http://www.bizjournals.com/twincities/stories/2002/02/04/story1.html> (last visited Oct. 28, 2004).

insurance policies.⁴⁷ 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.

The greatest risk to an individual policyholder, therefore, is that he does not completely understand his financial situation or misjudges his need (or lack thereof) for a particular policy and participates in a viatical settlement, life settlement, or ADB based on incomplete knowledge of what he is doing. This risk is one that can be prevented through consultation with the policyholder's insurance agent or financial planner and illustrates how important it is that insurance agents and financial planners possess up-to-date knowledge of the secondary market.

C. AGGREGATE BENEFITS OF THE SECONDARY MARKET TO POLICYHOLDERS

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 the policyholder 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.⁴⁸ Although secondary market entry will likely drive life insurance premiums higher, secondary market entry is unlikely to have a material effect on the spread for life insurance.⁴⁹ Instead of

47. Christine Richard, *With \$70M Bond Deal, Wall St Manages To Securitize Death*, DOW JONES CAP. MARKETS REP., Apr. 30, 2004.

48. See David F. Babbel, *The Price Elasticity of Demand for Whole Life Insurance*, 40 J. FIN. 225, 228 (1985).

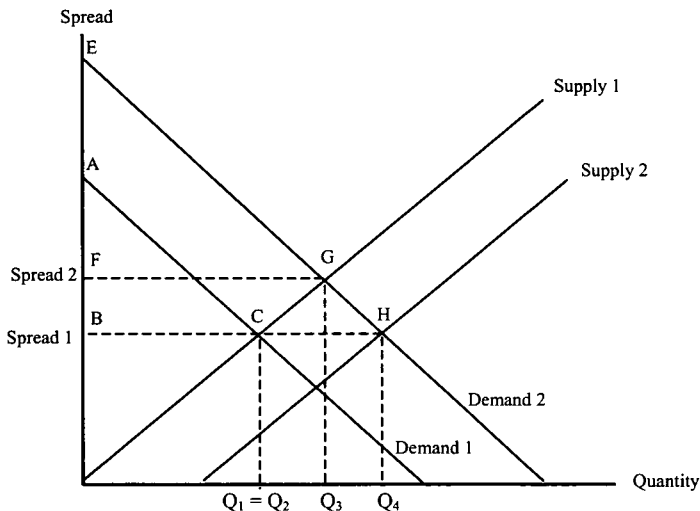
49. Doherty & Singer, *supra* note 15, at 470-72 (providing a more thorough

buying a less liquid and, hence, inferior product at a lower premium, consumers 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 from a product whose payouts are less risky. Thus, the demand curve will shift outward, as shown in Figure 2. 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 "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 will 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, thereby increasing supply to "Supply 2." This higher margin will restore the spread to roughly 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 2: 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.

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 1 estimates the welfare gains earned by policyholders in 2002 from the exercise of life settlement options.

TABLE 1: 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 1 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 (i.e. enhanced surrender values) for those demonstrating reduced life expectancy. The magnitude of this response is such that the numbers shown in Table 1 vastly underestimate the benefits to consumers from the new secondary market.

IV. KNOWLEDGE OF THE SECONDARY MARKET FOR LIFE INSURANCE

The secondary market provides considerable benefits to life insurance policyholders. The associated increase in consumer welfare, however, is only a fraction of what it could be if policyholders were better informed about the secondary market. It is the role of life insurance agents and financial planners to ensure that their clients possess the best possible information to make decisions regarding their financial futures. It is, therefore, incumbent upon such professionals to make policyholders aware of the value of secondary market transactions where such a transaction might potentially be helpful to their clients.⁵⁰ Lack of information about the secondary market for life insurance prompts policyholders to make inefficient decisions regarding their life insurance holdings. In this section we examine the effects of such suboptimal decisions and explain some of the barriers to greater consumer knowledge about the secondary market.

A. THE EFFECTS OF SUBOPTIMAL DECISION-MAKING

It is common for uninformed consumers in financial markets to unknowingly subsidize savvy consumers. Because of suboptimal decisions by policyholders in the purchase and surrender of life insurance policies, the market prices of policies are lower than if all purchase decisions were rational and informed.⁵¹ This phenomenon is similar to the observation that home mortgage rates are lower than they “should” be because of the common failure of homeowners to refinance their mortgages when it would be financially advantageous to do so.

In the market for life insurance, policies are presumably

50. At the same time, a life insurance agent or financial planner should ensure that her clients do not engage in secondary market transactions based on incomplete knowledge, as such transactions are not in a policyholders best interests where a policyholder does not have a discernable reason to eliminate the policy.

51. The effect of such decisions in the market for life insurance is particularly strong because of the high share of life insurance policies that are disposed of before maturity. Milliman USA estimates that nearly 90% of universal life policies do not end with a death claim. Letter from Timothy C. Pfeifer, F.S.A., Consulting Actuary & Principal, Milliman, USA to Alan S. Lurty, Vice President, Coventry Financial, L.L.C. (Apr. 24, 2002) [hereinafter *Milliman Letter*] (on file with authors).

priced on the basis of some uneconomic lapse expectation. It is always in the interest of insurance carriers, given an installed base of policies, for consumers to learn as slowly as possible about their assignability rights, just as in the mortgage market it is in the interests of lenders for the percentage of consumers who understand refinancing to grow as slowly as possible. Full information about assignability rights and the benefits of the secondary market would squeeze all of the incumbents' remaining margins from secondary market surrenders. Life insurance carriers, therefore, have an incentive to try to hide the assignability feature from their policyholders and to discourage their agents from keeping consumers well informed.

The lack of assignability, or the widespread lack of consumer knowledge of assignability, would create two kinds of inefficiencies. Although one of these inefficiencies would lead to a lower initial premium in the primary market for life insurance, both inefficiencies would lead to lower consumer welfare.

The first inefficiency involves the policyholder who would be willing to sell his policy for its true economic value but retains the policy because he is not willing to accept the set surrender value offered by the incumbent carrier. Coventry First, a leading life settlement firm, reports that, on average, the surrender values for the policies it purchases represent only 4% of the face value of those policies.⁵² So, for example, a policy with a \$500,000 face value might have a cash value of \$20,000, but an economic value of \$80,000 if the consumer has a life expectancy of six to twelve years. If the consumer would be indifferent between retaining his policy or selling it for a price of \$45,000, then her inability to assign the policy would force her to forgo a \$35,000 surplus from the sale of the policy (equal to the \$80,000 she would receive for the policy in a competitive secondary market less the \$45,000 for which she would be willing to sell it). Because the policyholder in this case would hold her policy to maturity, the insurer is no better off than if the policy had been sold to a third party. The first inefficiency from the restriction of assignability, thus, generates a pure deadweight loss, with no offsetting gain to insurance carriers that could be used to subsidize premium rates.

The second inefficiency involves the policyholder who is so

52. This also means that borrowing against the policy, which can never exceed the face value, is not a way to raise much money.

in need of money that he will surrender the policy to the incumbent carrier for \$20,000 even if the economic value of the policy is \$80,000. In this case, the policyholder is made \$60,000 worse off by his inability to assign the policy to a third party for its economic value, but the insurer gains \$60,000 from the consumer's lack of knowledge about the secondary market.

The whole purpose of buying insurance is to pay money at times when the consumer has less utility from extra money in return for the receipt of money in times where the utility from extra money is very high. A consumer would surrender a policy for less than a third of its economic value only if his current need for money was extremely high. Therefore, a system in which policyholders lack knowledge of their secondary market options takes money away from consumers in a state where they potentially have a very high marginal utility of money to subsidize them when they are making premium payments and, presumably, have a low marginal utility of money. Such a system unambiguously reduces consumers' expected welfare.

Lack of knowledge on the part of policyholders about the secondary market for life insurance policies, therefore, creates two major types of distortion, both of which reduce consumer welfare. The first type costs the consumer money upon liquidation without reducing premiums. The second type leads to an equal reduction in premiums if the insurance market is fully competitive but still leaves consumers worse off.

B. BARRIERS TO CONSUMER KNOWLEDGE OF THE SECONDARY MARKET FOR LIFE INSURANCE

At least in the short term, carriers have resisted the entry of viatical and life settlement firms by a variety of tactics.⁵³ Establishing entry barriers is not surprising. Incumbent life insurance carriers stand to lose money in the short term as a result of the decreased likelihood of profitable lapses on policies that were issued before the emergence of a competitive market for life insurance policies. Additionally, carriers have earned a substantial portion of their margins from surrenders by policyholders with diminished life expectancies and likely retained a portion of those margins as profits. To the extent that incumbent carriers recognized profits, on net, from the pre-

53. See *New Lease on Life*, THE ECONOMIST, May 17, 2003, at 86.

existing surrender system, the carriers' actions may be an example of what economists describe as rent-seeking behavior.⁵⁴ The carriers are attempting to prevent losses on previously issued policies and may also be attempting to protect the profits that they derived from their monopsony position in the secondary market.

Incumbent insurance carriers have a clear economic motive to eliminate viatical and life settlement firms from the secondary market for life insurance policies.⁵⁵ This motivation explains why life insurance carriers have lobbied for regulations on viatical and life settlements that are unfavorable to *any* secondary market transactions. There is evidence that incumbent carriers have pressured their agents to shun the secondary market for life insurance and prohibited agents from dealing with viatical and life settlement firms.⁵⁶ The incumbents' strategies can be best understood in light of their economic interest in re-establishing monopsony positions in the secondary market.

V. REGULATION OF THE SECONDARY MARKET FOR LIFE INSURANCE

As of September 2002, viatical and life settlements were governed by a patchwork of state and federal regulations. In 1996, the Securities and Exchange Commission's (SEC) bid to regulate viaticals under federal securities law was rejected by the District of Columbia Court of Appeals.⁵⁷ But even though they were not considered to be securities under federal law, many states classified viatical settlements as securities and

54. See generally TOWARD A THEORY OF THE RENT-SEEKING SOCIETY (James M. Buchanan et al. eds., 1980).

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

56. Doherty & Singer, *supra* note 15. See *New Lease on Life*, THE ECONOMIST, May 17, 2003, at 86.

57. *Sec. & Exch. Comm'n v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996); Todd Mason, *Firm Barred from Selling Shares of Policies*, FORT WORTH STAR-TELEGRAM (Feb. 27, 2002) (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).

regulated their sale to investors as such.⁵⁸ As of September 2004, thirty-seven states regulated viatical transactions through their insurance regulatory departments, but only twenty-three of these regulated life settlements.⁵⁹

The regulatory environment has allowed certain abuses by unscrupulous companies. As we explained earlier, however, those abuses have targeted individual investors almost exclusively. The top firms in the life settlement and viatical industries 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 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.⁶⁰ 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 themselves.⁶¹ In addition to such self-regulation, the Life Settlement Institute publicly advocates a stricter and improved regulatory environment. The Institute strongly supports strict regulation by state insurance and securities regulators of the viatical and life settlement marketplace⁶² and supports amending the Federal Securities Act of 1933 (The Act) so that interests in pooled life insurance policies sold to individual investors would constitute "securities" under the Act.⁶³

In January 2001, Ohio enacted a law for the regulation of viatical firms modeled after the NAIC's Model Viatical

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

59. See Stone Street Financial, *Compliance: State by State Update (As of October 2004)*, available at <http://www.stonestreetfinancial.com/compliance/compliance.asp> (providing detailed state-by-state information on viatical and life settlement regulation) (last visited Oct. 28, 2004).

60. See *Retirement Protection supra* note 20, at 65.

61. *Institute to Track Viatical, Life Settlement Fraud*, BEST'S INS. NEWS, July 12, 2002.

62. See *Retirement Protection supra* note 20, at 68.

63. *Id.* at 66 (stating 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").

Settlement Act.⁶⁴ The Ohio law extends the definition of viator to include individuals who participate in life and senior settlements, mandates disclosures of pertinent information to policyholders, protects the identity of viators, and provides a viator with an unconditional 15-day right to rescind on his or her contract after receiving the proceeds of a settlement.⁶⁵ The law stipulates that viatical and life settlement providers must present "an anti-fraud plan that describes how they will prevent, identify, and report fraud" to obtain licensing with the state.⁶⁶ Violators of the law are subject to criminal and administrative penalties.⁶⁷

As of February 2002, only twenty states regulated the sale of interests in viatical or life settlements to individual investors, but there is movement in the right direction.⁶⁸ Some states engage in heavy regulation of the secondary market for life insurance. For example, Kentucky mandates that a life insurance agent 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 dollars before he is allowed to broker a life settlement with a client for whom such a settlement might be the best option.⁶⁹ In such jurisdictions, participation in viatical and life settlement transactions can be almost prohibitively costly.

VI. CONCLUSION

Secondary markets for financial products provide liquidity and thereby enhance the value of those products. The emergence of viatical and life settlement firms and the growth of ADBs has created a competitive secondary market for life insurance. Participation in a viatical or life settlement does not make sense for the majority of life insurance policyholders. There are a variety of circumstances, however, in which a policyholder

64. News Release, Ohio Department of Insurance, Michael Fulwider, Director of Communications, Robert Denhard, Communications Manager, Covington Backs New Law Regulating Viatical Settlements (Jan. 12, 2001), at <http://www.ohioinsurance.gov/Newsroom/scripts/Release.asp?ReleaseID=784> (last visited Nov. 12, 2004).

65. *Id.*

66. *Id.*

67. *Id.*

68. See *Retirement Protection supra* note 20, at 67.

69. Viatical Settlement Broker License, 806 KY. ADMIN. REGS. 9:310 (2003).

could be made better off by his policy in the secondary market.

Most life insurance customers, however, lack detailed knowledge about the particular products and features available or are unable to accurately assess the value of such features. The volume and complexity of information necessary to achieve optimal life insurance holdings precludes consumers from acting with full and complete information.⁷⁰ According to a June 2003 poll commissioned by the NAIC, only thirty-four percent of insurance policyholders believed that they understood the details of their insurance coverage “very well.”⁷¹

Moreover, uninformed consumers and policyholders are unlikely to understand the assignability features on their own. Some consumers undoubtedly underestimate the risk of developing a terminal illness and being unable to obtain the actuarial value for a policy by selling it back to the issuing insurance company. Indeed, many who find themselves in that situation are unaware of the resale possibilities.

The role of the life insurance agent is to provide information to consumers so that they can make informed choices in the purchase of life insurance in the primary market.⁷² Life insurance carriers, themselves, emphasize the value of their advisory services, delivered through agents, to consumers.⁷³ Consistent with this role, life insurance agents should understand the set of available secondary market offerings and should advise those policyholders who intend to liquidate their

70. See, e.g., Michelle Singletary, *The Trick to Insurance is Grasping the Details*, WASH. POST, Mar. 13, 2003, at E3 (stating that it is easy for consumers to be overcome by the complexity of life insurance and that the purchase of life insurance is “rocket science”).

71. FLEISHMAN-HILLARD KNOWLEDGE SOLUTIONS, NAIC, PUBLIC PERSPECTIVE ON INSURANCE 6 (June 2003).

72. INS. INST. OF IND., INDIANA INSURANCE FACTS 61 (2003-04) (stating that “one of the first steps in obtaining life insurance coverage should be to contact a life insurance agent” and urging consumers to know what a potential policy provides by “mak[ing] sure the agent explains items you don’t understand”).

73. See Press Release, GenAmerica Financial Corporation Introduces American Vision Term Product Portfolio (Feb. 21, 2001) (declaring that GenAmerica Financial’s mission is “to create exceptional financial outcomes for its clients through top-flight advice, products, and services”), <http://www.genamerica.com/pubsite/genamweb.nsf/index.htm> (last visited Oct. 28, 2004). The Principal Financial Group asserts that it will assist consumers in making informed insurance purchase decisions “[t]hrough comprehensive needs analysis, we help you to identify the most appropriate tax-saving strategies, estate-planning options, and insurance protection plans needed to meet your long-term goals. From term life to survivorship whole life, we work with you to help you select the insurance coverage that’s right for you and your family.” Principal Financial Group, *For Individuals*, available at <http://www.principal.com/ind.htm> (last visited Oct. 28, 2004).

policies of the best products for their particular needs.

The secondary market for life insurance provides policyholders with unambiguous benefits. Access to complete and current information regarding their secondary market options would allow policyholders to make optimal decisions regarding their insurance coverage and enable the secondary market to reach its full potential in terms of the welfare gains it provides to consumers.