

THE BENEFITS OF A SECONDARY MARKET FOR LIFE INSURANCE POLICIES

NEIL A. DOHERTY†

HAL J. SINGER††

In this article, we examine the benefits that accrue to policyholders and incumbent insurers from an active secondary market for life insurance policies. We begin by examining the benefits of secondary markets in other financial service industries, including home mortgages, catastrophic risk insurance, and Nasdaq-listed securities. Next, we outline the economic theory of a life insurance market both before and after the introduction of a secondary market. Without an active secondary market, the equilibrium quantity of impaired policies that is surrendered is inefficiently low. Although competition among insurance companies in the primary market leads to reasonably competitive surrender values given normal health, surrender values based on normal health do not appropriately compensate individuals with impaired life expectancies for the resulting appreciation of their policies. If there is no external market for reselling policies, insurers have no incentive to adjust their surrender values for impaired policies to competitive levels because they wield monopsony power over the repurchase of “impaired” policies. Viatical and life settlement firms erode this monopsony power. Finally, we examine the benefits of an active secondary market for life insurance policies to policyholders and incumbent insurers in the primary market. The magnitude of the benefits is positively correlated to the quantity of coverage sold to life settlement firms and to the improvement in the terms of accelerated death benefits offered by incumbent carriers. We conclude that the incumbent life insurance carriers’ efforts to deter entry by life settlement firms are motivated by the anticompetitive desire to maintain monopsony power over policyholders.

| | |
|--|----|
| I. INTRODUCTION..... | 2 |
| II. THE BENEFITS OF SECONDARY MARKETS IN FINANCIAL SERVICE INDUSTRIES..... | 7 |
| A. Home Mortgages..... | 9 |
| B. Catastrophic Risk Insurance..... | 11 |
| C. Nasdaq-Listed Securities..... | 12 |
| D. Analogues to the Life Insurance Industry..... | 15 |
| III. THE BENEFITS OF THE SECONDARY MARKET FOR LIFE INSURANCE POLICIES..... | 15 |
| A. Surrender Values Are Set in the Primary Market under Normal Health Conditions..... | 16 |
| B. The Monopsony Power of Incumbents over Policyholders Who Experience Negative Changes in Health..... | 17 |
| C. The Effects of Surrenders on Incumbents’ Costs..... | 20 |
| D. Benefits to Policyholders from an Active Secondary Market..... | 24 |
| 1. Theoretical Analysis..... | 25 |
| 2. Empirical Analysis..... | 28 |

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

†† Senior Vice President, Criterion Economics LLC. Financial support for this report was provided by the Coventry Center for Financial Professionals.

| | |
|--|----|
| <i>E. Other Beneficiaries from an Active Secondary Market</i> | 29 |
| 1. <i>Benefits to Insurance Agents</i> | 29 |
| 2. <i>Benefits to Incumbent Insurance Carriers</i> | 30 |
| IV. THE RENT-SEEKING BEHAVIOR OF INCUMBENT LIFE INSURANCE COMPANIES..... | 30 |
| <i>A. Life Insurance Companies Compete with Life Settlement Firms in the Secondary Market for Impaired Life Insurance Policies</i> | 31 |
| <i>B. The Regulatory Environment Confronting Viatical and Life Settlements</i> | 33 |
| <i>C. Strategies of Incumbent Life Insurance Carriers to Maintain Monopsony Power</i> | 36 |
| V. CONCLUSION..... | 38 |

I. INTRODUCTION

The emergence of a robust secondary market for life insurance is a relatively recent phenomenon.¹ The modern market arose in the late 1980s in response to the AIDS epidemic, as many young people were faced with the sudden need for money to pay for medical treatment and maintain their standard of living. These individuals sought liquidity from any long-term assets that they owned, including life insurance policies. The shortened life horizons of those living with AIDS meant that the actuarial values of their policies—that is the risk-adjusted value of the death benefit, taking into account future costs—had come to significantly exceed the policies’ surrender values.²

Unfortunately for these individuals, incumbent life insurance companies wielded monopsony power³ over the repurchase of their own

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

2. When a policy becomes impaired, the present value of the death benefit increases because it 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.

3. 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.

policies. As a result of this imbalance of bargaining power,⁴ the insurance companies have historically earned economic rents on the repurchase of impaired policies⁵ In the case of the lapse of a term-life policy, a policyholder who could no longer afford premium payments simply lost his insurance coverage and received nothing. In the case of the surrender of a universal- or whole-life policy, the pre-determined schedule of surrender values offered by the insurance company (representing at most the reserve set aside to fund future insurance costs at standard rates) did not compensate a policyholder for the full actuarial value of the impaired policy. Investors who did not share the same liquidity constraints as the policyholders were willing to purchase those policies for substantially more than the pre-arranged termination terms offered by the insurance companies. Viatical firms emerged to facilitate these sales, and the secondary market for life insurance was born.

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

PERLOFF, MODERN INDUSTRIAL ORGANIZATION 105-07 (Addison-Wesley, 3d ed. 2000).

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

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 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.

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

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

8. The annual rate of return on a life insurance policy purchased by a viatical firm is the excess of the policy's face value over the price offered to the policyholder, divided by future lifespan of the individual insured by the policy. The risk associated with the purchase of policies is the probability of unexpected

The market responded to this shortcoming when, around the millennium, “life settlement” firms emerged to create access to the market for substantially more policyholders. The rise of life settlements in an industry that had previously focused primarily on the policies of AIDS patients can be traced to the fact that better AIDS drugs in the mid 1990s increased the lives of afflicted individuals and made the purchase of these policies less profitable. This change in the financial calculus of viatical settlements led to a search for new areas of growth.⁹ Life settlement firms have developed more sophisticated underwriting models that allow them to purchase policies from individuals who are not terminally ill. In fact, life settlement firms do not purchase policies from individuals who are terminally ill.¹⁰ Rather, life settlement firms purchase policies from individuals who are over the age of 65, have experienced a decline in health, and have remaining life expectancies of between six and twelve years (although in some cases life expectancies outside this range are considered).¹¹ Given the relative infancy of the life settlement industry, it is plausible that as the industry matures life settlements will become available to even more policyholders.

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

longevity on the part of the insured, which spreads the “gain” from the policy’s purchase over a larger number of years, thus reducing the rate of return. Breakthroughs in AIDS treatments in the mid nineties significantly increased the life expectancies of individuals living with AIDS, and created a greater variance in the risk associated with what had previously been a fairly predictable disease.

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

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

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

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

billion, which means that the potential market for life settlements is close to \$100 billion.¹³

Life settlements are one of several life insurance innovations through which companies that develop innovative actuarial analyses have been able to glean profits through their superior ability to assess mortality and other risks. In this sense, life settlements are essentially similar to innovations introduced in prior generations, such as the differentiation between smokers and non-smokers that began in the 1980s. However, unlike most prior innovations in the insurance industry, which sought to “skim” the healthiest (that is, the least risky) patients from the pool, life settlements actually benefit those who have become greater-than-average risks.¹⁴ Moreover, because the existence of a secondary market for life insurance has improved the liquidity of all life insurance policies that might potentially qualify for settlement, the secondary market makes policies in the primary market more valuable for all consumers, regardless of their current state of health.

As more policyholders become aware of the opportunities presented by viatical and life settlements, and as it becomes possible for more policyholders to obtain the fair market value of their policies, consumers will perceive an increase in the *quality* of life insurance, which will have a positive effect on the demand for life insurance.¹⁵ This observation is fairly intuitive—consider how the demand for housing would decrease if purchasers could sell their house back to only the original seller. The secondary market for life insurance effectively removes such a restriction on resale. Thus, the benefits of the secondary market are not limited to consumers in the secondary market, but also include consumers, insurance agents, and life insurance companies in the primary market for life insurance. In this paper, we refer to this effect as the “pro-competitive” hypothesis.

The incumbent life insurance companies offer an alternative, anti-competitive hypothesis. The incumbent insurance carriers claim that the secondary market, by denying them the returns—that is, economic rent on

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

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

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

lapsing or surrendered policies of no-longer standard insureds—they formerly received, increases the costs of providing policies in the primary market. The incumbent carriers allege that these costs will either be passed on to consumers in the form of higher premiums, or absorbed by the incumbents as a result of an “unhealthy” level of competition fostered by the robust secondary market for life insurance policies. Such “unhealthy” competition, the carriers assert, could lead to insolvency in the life insurance industry. Either way, the incumbent carriers claim that consumers will be made worse off, on net.

This anticompetitive argument rests on the notion that the introduction of a secondary market will increase the cost of providing coverage for a given premium and surrender value.¹⁶ Although some increase in cost can be expected, the issue of cost is tangential to the issue of consumer welfare, and an increase in cost does not imply any negative effect on consumer welfare. The incumbent carriers’ argument ignores (1) the demand effects of an active secondary market for life insurance policies, and (2) the distribution of a portion of the previous deadweight loss to policyholders.

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

In Part III, we examine the benefits of secondary markets in the life insurance industry. We begin by explaining that, before the advent of a secondary market, incumbent insurance companies wielded monopsony power over policyholders for the purchase of impaired policies. Next, we examine the effects of entry by viatical and life settlement firms on consumers. We perform a theoretical examination of the economic effects of secondary market entry in the life insurance industry, which leads us to conclude that the pro-competitive hypothesis is the valid explanation of such entry. 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),¹⁷ but also does not include the benefits

16. However, if these economic rents obtained by insurance companies are perceived as windfall gains—that is, if insurance companies do not account for profitable lapses when setting premiums—then the introduction of a secondary market for impaired life insurance policies will merely return the profits of insurance carriers to their expected levels, and will not result in higher premiums.

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

the secondary market for life insurance policies generates for customers in the primary market.

In Part IV, we examine the rent-seeking behavior of incumbent life insurance companies. We explain how life settlement firms compete with life insurance companies in the secondary market for life insurance policies. Next, we review the efforts of incumbent life insurance companies to stymie entry into the secondary market. We conclude that the actions of incumbent life insurance companies amount to an attempted boycott of life settlement firms, and represent an effort to maintain monopsony power over their customers in the purchase of impaired policies.

II. THE BENEFITS OF SECONDARY MARKETS IN FINANCIAL SERVICE INDUSTRIES

Microeconomic theory reveals that an efficient secondary market for a particular good or asset will improve the value of that good or asset in the primary market. Professors Dennis N. Carlton of the University of Chicago and Jeffrey M. Perloff of the University of California at Berkeley explain the economic rationale as follows:

When resales are possible, the price that consumers are willing to pay for a durable good depends on both the value of the services of the durable good during the period that consumer owns it and the resale value at the end of that period. That is, consumers' expectations about the future resale price affect the initial price.¹⁸

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

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

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

considered in an evaluation of the positive economic effect of secondary market entry.

18. CARLTON & PERLOFF, *supra* note 3, at 485.

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

| | Home Mortgages | Catastrophe Risk Insurance | Nasdaq-listed Securities | Life Insurance |
|-------------------------------------|--------------------------------------|---|---|--|
| Primary Market | Home Mortgages | Catastrophe Insurance Policies | Initial Public Offering of Nasdaq-listed Securities | Life Insurance Policies |
| <i>Consumers</i> | Mortgage Lenders | Insurance Companies | Institutional Investors | Policyholders |
| <i>Suppliers</i> | Homebuyers* | Policyholders* | Companies Issuing Shares | Life Insurance Companies |
| Secondary Market | Resale of Home Mortgages | Resale of Catastrophe Insurance Risk | Nasdaq Over-the-Counter Market | Resale of Life Insurance Policies |
| <i>Consumers</i> | Investors | Insurance Companies, Investors | Investors | Life Insurance Companies, Investors |
| <i>Suppliers</i> | Mortgage Lenders | Insurance Companies | Institutional Investors | Policyholders |
| <i>Entrants in Secondary Market</i> | Fannie Mae, Freddie Mac, Ginnie Mae | Chicago Board of Trade, Other Financial Institutions | Electronic Communications Networks (ECNs) | 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 Providing Order-Matching | Enhanced the Secondary Market by Increasing Options |
| Effects of Entry | Procompetitive | Procompetitive | Procompetitive | Procompetitive |
| <i>Demand Effect</i> | Demand for Mortgages Has Increased | Demand for Catastrophe Risk Has Increased | Demand for IPOs 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 Issuing Company's Shares Has Increased | Value of Life Insurance Policy Has Increased |

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

As Table 1 shows, life settlement and viatical firms in the life insurance industry play a similar role to entrants in other financial services industries. Note that, for each industry, the consumer in the primary market becomes the supplier of the asset in the secondary market. For example, in the case of Nasdaq-listed securities, the institutional investor serves as consumer of initial public offerings (IPOs) in the primary market, but serves as supplier of shares in the Nasdaq over the counter (secondary) market. In all four cases, entry in the secondary market increases demand in the primary market and, as a result, increases the price of the asset in the primary market. Moreover, the enhancement of the secondary market adds liquidity, and thereby lowers transactions costs between buyers and sellers.

A. Home Mortgages

The secondary home mortgage market is credited with allowing millions of Americans to enjoy the benefits of home ownership. Before the Great Depression, home buyers were typically obligated to make a down payment of 40 percent of the value of the home and to pay off a mortgage in three to five years.¹⁹ In 1934, Congress established the Federal Housing Authority (FHA) to issue insurance on long-term, fixed rate mortgages. Due to the unpopularity of these types of mortgages with both lenders and investors, Congress established Fannie Mae in 1938 to refinance FHA insured mortgages. Fannie Mae became a private corporation in 1968, but part of the organization was carved out to become Ginnie Mae, which remained a government entity and began offering mortgage-backed securities.²⁰

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. Consider the case of a lending institution that issues home mortgages. If investors were to withdraw savings funds from that institution, the lender could not withdraw from its loan positions in response, absent a secondary market for home mortgages. Thus, before the advent of the secondary market for home mortgages, a mortgage lender faced a high risk of insolvency as a result of its exposure to default by homebuyers, an occurrence referred to as credit risk. A lending institution that faces significant credit risk is not willing to extend the amount of credit of which it was capable because if its lending capacity should decline in the future, it would not be able to withdraw from its current loans.

The government created a secondary market for home mortgages under the theory that, although home purchases are local in nature, such a market would allow regions with a low savings rates to access funds from regions with excess savings. The government hoped that an active secondary market for home mortgages would increase liquidity and cause an outward shift in demand for home mortgage payments by financial institutions. This increased demand was expected to bring more competitors to the market and increase the price paid by financial institutions (which can be stated alternately as lower costs of mortgages for homebuyers).

19. A rudimentary secondary mortgage market developed in the 1920s, but when the Great Depression began, home owners defaulted on their mortgages and the market collapsed.

20. Ginnie Mae, *About Ginnie Mae—History of the Secondary Mortgage Market* (visited Aug. 30, 2002) <<http://www.ginniemae.gov/about/History.asp?Section=About>>.

These hopes were realized many times over. Numerous economic studies have shown that the secondary market for home mortgages has greatly benefited homebuyers. For example, a 2002 Lexecon study found that mortgage rates were lower in markets served by Fannie Mae and Freddie Mac, and that the demand for mortgages in these markets was higher than in markets where the agencies were not eligible to participate.²¹ The authors also observed a discrete decline in the number of mortgages whenever the size of the mortgage exceeded the purchasing limits of Fannie Mae and Freddie Mac.²² In addition, the study found that homebuyers adjusted their financing strategies to take advantage of the lower rates available in Fannie Mae and Freddie Mac markets.²³

The creation of a secondary market for home mortgages provided mortgage lenders with access to other financial institutions who also demanded home mortgage contracts from homeowners. The willingness of these institutions to purchase home mortgages from their original issuers mitigated credit risk to mortgage lenders. Furthermore, the securitization of lenders' positions in home mortgages involved their packaging into less risky assets because the pooling of policies minimized the impact of a single default on the value of the asset. Because mortgage lenders could escape from loans by reselling them for their market value on the secondary market, these lenders were willing to extend greater credit—that is, their demand for home mortgage contracts increased. It was this demand effect that led to the reduction in home mortgage interest rates, but it is perhaps more accurate to think of this reduction in interest rates as an *increase* in the price that mortgage lenders (the consumers) were willing to pay for the stream of mortgage payments by homeowners (the suppliers).²⁴

Several studies have examined the effects of securitization on the various cost aspects of mortgages, such as interest rates, origination fees, and home insurance (which are various aspects of the *prices* paid by financial institutions to acquire streams of mortgage payments from customers). Professor Steven Todd of Loyola University of Chicago examined the effects of mortgage securitization on transaction costs and found that securitization lowers loan origination fees, which results in substantial savings for homebuyers.²⁵ Three professors at Texas A&M University found that securitization reduces the interest rates of home loans: “a 10 percent increase in the level of mortgage securitization as a

21. Dennis W. Carlton, David B. Gross, and Robert S. Stillman, *The Competitive Effects of Fannie Mae*, 1 FANNIE MAE PAPERS 1 (Jan. 2002).

22. *Id.*

23. *Id.*

24. The highest price which a lender would rationally be willing to pay for a stream of payments is the expected future risk-free interest rate. The more risky a particular stream of payments is, the less the lender will be willing to pay for them, and hence, the higher an interest rate the lender will insist upon for the loan.

25. Steven Todd, *The Effects of Securitization on Consumer Mortgage Costs*, 29 REAL ESTATE ECON. 29 (Spring 2001).

proportion of total mortgage originations decreases yield spreads on home loans by as much as 20 basis points.”²⁶

B. Catastrophic Risk Insurance

It is also possible to draw parallels from the secondary market for catastrophic risk insurance to the secondary market for life insurance. The asset sold on the secondary market for catastrophic risk insurance is the insurance company’s position in a policy—in essence, the excess of the present discounted value of payments by a policyholder over the present discounted value of the potential liability. Insurance companies sell portions of their positions in catastrophic risk insurance on the secondary market primarily for hedging purposes. The securitization of catastrophic risk insurance has improved the liquidity of an insurance company’s position in a catastrophic risk policy, and has thus provided a new financial vehicle to insurance firms to hedge against downside risk. In many ways, this new vehicle, which involves the sale and purchase of catastrophic risk futures, is superior to the previous method of obtaining reinsurance.

The additional hedging made possible by securitization has reduced insurance companies’ exposure to catastrophe risk and allowed issuing firms to extend more insurance than they could previously. Sara Borden and Asani Sarkar of New York’s Federal Reserve Bank explain the benefits simply: “by establishing a direct link between the insurance industry and the capital market, catastrophe risk instruments introduce the strategic advantages of the financial markets to the insurance industry.”²⁷

Catastrophe risk insurance first became securitized in 1992, and in 1993 the Chicago Board of Trade began trading a contract for this risk. Before securitization, the only methods for an insurance company to transfer catastrophe risk were to spread the risk (by allocating it across a large number of policyholders) or to purchase reinsurance.²⁸ In practice however, neither of these options proved particularly effective in managing catastrophe risk. Most insurance companies were geographically diversified already, and attempts to reduce catastrophe risk by increasing premiums or reducing coverage in catastrophe-prone states are constrained by legislation.²⁹

Insurers receive a price on the futures index equal to the present discounted value of their position minus a risk premium, as they are essentially purchasing protection from the risk inherent in their business. Investors, in turn, bear the risk, and are compensated by the risk premium discounted by insurers.³⁰ Individuals and institutions seeking asset

26. James W. Kolari, Donald R. Fraser and Ali Anari, *The Effects of Securitization on Mortgage Market Yields: A Cointegration Analysis*, 26 REAL ESTATE ECON. 677 (Winter 1998).

27. Sara Borden and Asani Sarkar, *Securitizing Property Catastrophe Risk*, CURRENT ISSUES IN ECON. & FIN. at 5 (Aug. 1996).

28. *Id.* at 1.

29. *Id.* at 2.

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

diversification receive additional compensation from catastrophe insurance options by virtue of the fact that catastrophe losses are not correlated with either the stock or bond markets.³¹

The securitization of catastrophic risk insurance generated other benefits as well. Professors Knut Aase and Bert Odegaard of the Norwegian School of Economics observe that securitization has provided improved standardization and liquidity, as well as a substantial reduction in credit risk.³² They point out that “unlike reinsurance, hedging through futures has the advantage of reversibility since any position may be closed before the maturity of the contract.”³³ Before securitization it was difficult and costly to scale back on reinsurance. This illiquidity forced insurance carriers to either purchase a less-than-optimal quantity of reinsurance, or risk paying for reinsurance that was no longer necessary. Securitization eliminated the latter risk, and thus made it possible for firms to purchase optimal levels of hedges. Professors Aase and Odegaard conclude that an insurer may effectively trade off between risk coverage and upside potential by using the efficient secondary market in catastrophic risk insurance.³⁴

The securitization of an asset can be thought of as an enhancement of an existent secondary market. Before this enhancement in the secondary market for catastrophic risk, an insurance company was not able to obtain the market value of its positions by purchasing reinsurance, as demand was constrained by the secondary market purchasers’ own risk considerations. Securitization has mitigated much of this secondary market risk, which has prompted an increase in secondary demand. This demand, in turn, has improved significantly the liquidity of an insurance company’s positions in catastrophic risk policies and increased the valuation that insurance companies place on their positions in these policies. Thus, the enhancement of the secondary market ultimately increased the demand for catastrophic risk in the primary market, and insurers now purchase more risk at a higher price. The producers of this risk—catastrophic risk policyholders—have benefited as well, as the increased demand of insurers has translated into both a greater availability of policies, and lower rates for those policies.

C. Nasdaq-Listed Securities

The primary market for a security is the market in which a company makes its initial sale of shares, or “initial public offering.” Participation in the primary market is usually limited to institutional investors, such as

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

32. Aase and Odegaard, *supra* note 30.

33. *Id.* at 2-3. The authors note that “a traditional reinsurance contract may be reversed, however in practice reversing a reinsurance transaction exposes the insurer to relatively high transaction costs presumably to protect the reinsurer against adverse selection.” *Id.*

34. Bakshi and Madan, *supra* note 31.

mutual funds, endowments, or pension funds.³⁵ Institutional investors assist underwriters through their various “expressions of interest,” which provide an idea of what the market demand for a particular offering will be. These investors are typically rewarded for this service by receiving allocations of oversubscribed issues.³⁶ After shares of a company have been sold on the primary market, they become available for purchase and resale almost immediately on a secondary market.³⁷

As was the case in our prior example, the advent of a secondary market innovation enhanced the functions of a market that had existed for some time. In this instance, electronic communications networks (ECNs) enhanced the secondary market for Nasdaq securities. Beginning in the mid 1990s, ECNs developed electronic order matching as a means of executing over-the-counter trades more efficiently than by manually searching the screen-based quotations of brokers and market makers.

ECNs use algorithmic innovations to process their customers’ transactions quickly and efficiently.³⁸ ECNs began by providing market makers with the ability to quote prices in increments finer than the minimum quotation increment, and to access one another electronically. Those features were not readily available through Nasdaq’s own trading systems.³⁹ In addition to informational advantages, ECNs offer markedly faster order execution than do traditional exchanges, executing orders an average of seven to ten times faster than traditional exchanges.⁴⁰ ECNs also offer pre-trade and post-trade anonymity to traders, a particularly important offering for institutional investors because it helps protect them from the potential front running of traders and “piggyback trading” of uninformed investors.⁴¹

Monopolists are naturally less inclined to innovate than are competitive firms. Not surprisingly, competition amongst ECNs, and between ECNs and Nasdaq, has been credited with much of the innovation in the order matching business over the past decade. In a June 2000 study

35. *PBS Frontline: An IPO Primer* (visited Aug. 30, 2002) <<http://www.pbs.org/wgbh/pages/frontline/shows/dotcon/thinking/primer.html>>.

36. *Id.*

37. A stock will begin trading on a particular predetermined secondary market after its initial public offering in the primary market. A secondary market is organized either as an exchange, where transactions are made in a physical location (such as the New York Stock Exchange or American Exchange), or an over-the-counter market where buyers and sellers are decentralized and use a mechanism such as a computer network to conduct trades (such as the NASDAQ). See MARK GRINBATT & SHERIDAN TITMAN, *FINANCIAL MARKETS AND CORPORATE STRATEGY* 81 (Irwin-McGraw-Hill 1998).

38. For the remainder of this paper, we use the term “order matching” to refer to algorithmic electronic order matching.

39. DEPARTMENT OF ECONOMIC RESEARCH, NASD, *THE NASDAQ STOCK MARKET: HISTORICAL BACKGROUND & CURRENT OPERATION* 31, (NASD Working Paper 98-01, Aug. 24, 1998).

40. James McAndrews and Chris Stefanadis, *The Emergence of Electronic Communication Networks in the U.S. Equity Markets*, 6 *FED. RESERVE BANK N.Y.* 3 (2000).

41. *Id.*

by the Division of Market Regulation, the Securities and Exchange Commission recognized the competitive importance of ECNs:

Alternative trading systems, known as ECNs, have become integral to the modern securities markets, providing investors with enhanced flexibility and reduced trading costs, as well as competition to the established securities exchanges and the Nasdaq stock market.⁴²

ECNs were able to pioneer these innovations because, as outside firms, they stood to profit from their contributions. Whereas a monopolist's profit from innovation may be hampered by cannibalization of its existing offerings, a competitive firm is, for the most part, unencumbered by such considerations. Because they were not already earning revenue from the majority of Nasdaq traders, ECNs stood to earn returns not only from customers' increased willingness to pay, but also from the customers they induced to switch over to their service.

The order matching innovations introduced by ECNs are credited with significantly narrowing bid-ask spreads for Nasdaq-listed securities and spurring investment in automated trading systems. ECNs have significantly lowered fees and transaction costs for institutional investors. According to *Business Week*, "ECNs have revolutionized trading by bringing down [transaction] costs from as much as 7 cents a share to as little as a half-cent and by helping to reduce bid-ask spreads."⁴³ An October 2000 study by the Federal Reserve Bank of New York found that, in addition to lowering transaction costs, ECNs have contributed to a decline in the bid-ask spread on Nasdaq by more than 40 percent since 1997.⁴⁴ Professor James P. Weston of Rice University conducted both regression and matched-sample analyses of the effects of ECN activity on liquidity, and he concluded that ECNs create an overall improvement in the liquidity of Nasdaq.⁴⁵ According to Professor Weston, ECNs "lower spreads, increase depth, and decrease market concentration."⁴⁶

The more liquid a given security's secondary market, the more valuable the stock is to investors in the primary market. Thus, the enhancements in the Nasdaq-listed secondary market for securities brought about by ECNs benefit not only customers in the secondary market, but also institutional investors in the primary market of initial public offerings.

42. Division of Market Regulation, U.S. Securities and Exchange Commission, *Special Study: Electronic Communications Networks and After-Hours Trading* (released June 2000).

43. Pallavi Gogoi, *Behind Nasdaq's Hissy Fit*, BUS. WEEK at 105 (Mar. 5, 2001).

44. McAndrews and Stefanadis, *supra* note 40, at 2-3 ("In the absence of direct competition from public limit orders, dealers could potentially post lower bid or higher offer prices for stocks, earning excess profits at the expense of investors.").

45. James P. Weston, 22 *Electronics Communications Networks and Liquidity on the Nasdaq*, J. FIN. SERVICES RESEARCH 125 (forthcoming).

46. *Id.*

D. Analogues to the Life Insurance Industry

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

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

Investors in the secondary market for securities are similar to investors in the secondary market for life insurance policies in that they are pursuing attractive financial returns. The ECNs are similar to the life settlement companies in that their innovation increased the liquidity and market depth of the secondary market. This increased liquidity in the secondary market for securities benefits institutional investors who purchase shares in a company in the primary securities market, just as it benefits purchasers of life insurance policies.

III. THE BENEFITS OF THE SECONDARY MARKET FOR LIFE INSURANCE POLICIES

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, a whole-life insurance policy builds up a surplus from which future

premiums can be subsidized.⁴⁷ If we assume that policies are priced in an actuarially fair manner, then for any given policyholder, the value of the payment by the insurance company to the policyholder's beneficiaries is projected to precisely equal the total expected value of the premium payments made by the policyholder.⁴⁸

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

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

A. Surrender Values Are Set in the Primary Market under Normal Health Conditions

Surrender values are set in the primary market for life insurance, which can be characterized as having a relatively high degree of competition.⁴⁹ This competition among insurance carriers in the primary market drives both the premiums and terms of life insurance policies to roughly competitive levels, and surrender values are set to roughly correspond to the surplus value that builds up in policies over time. Stated differently, the "price" that a policyholder receives for the surrender of his whole-life policy is roughly the amount by which the payments he has made to the insurance company exceed the actuarially fair cost of his insurance.⁵⁰

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

48. 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.

49. Although it is by no means a perfectly competitive market, incumbent carriers do not exercise significant market power over policyholders in the primary market, as a monopolist or oligopolist might.

50. 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

Because the actuarially fair rate of insurance is calculated based on the assumption of normal health, the pricing of surrender values will constitute fair rates given normal health.

The existence of a surrender value for a policy does not obligate an individual who wishes to resell his policy to resell to the issuing insurance carrier. Indeed, life insurance policies are typically assignable, which means that a policyholder is free to transfer his ownership of the policy to another person. A policyholder's right to assign his policy to someone other than the insurance carrier has existed for some time, which means that there potentially has been a secondary market for life insurance policies for as long as policies have been assignable. In its early stages, this market consisted of 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 such sales because there were no safeguards against the financial interest of the speculator in the early death of the insured. Thus, for the majority of policyholders, the issuing life insurance company was the only viable buyer in the secondary market.

B. The Monopsony Power of Incumbents over Policyholders Who Experience Declines in Health.

Before the emergence of viatical and life settlement firms, the only buyer for a policy in the secondary market was the life insurance company that had issued the policy, and in the case of term-life insurance there was no buyer at all.⁵¹ Thus, the life insurance company had monopsony power over the repurchase of its own policies in the secondary market for life insurance. However, 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 this monopsony power for policyholders with normal health.

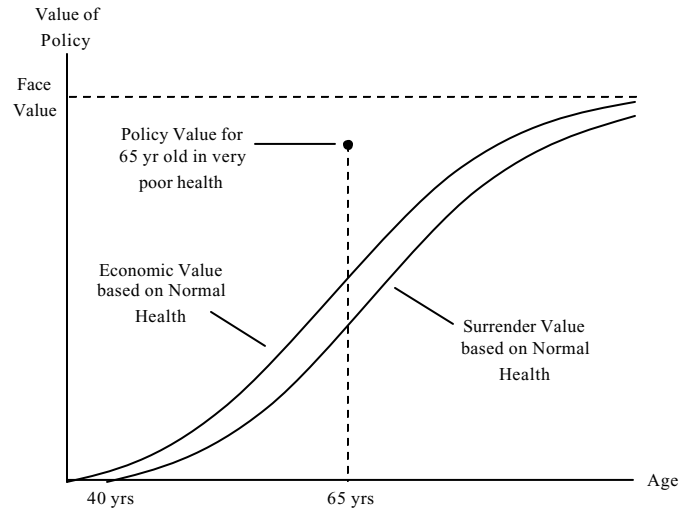
Figure 1 shows how the surplus payments of a whole-life policyholder create economic value in the policy over time, and how the surrender value tracks this increased value.⁵² In this case, the policyholder buys the policy at age 40. The buildup of policy value is based on the assumption that the policyholder's health follows a normal pattern as he ages, and the vertical distance between the two curves represents the economic margin earned by the life insurance carrier on the surrender of a healthy policy, together with an allowance for transaction costs.

policy. Because there is no buildup of value in a term policy, the surrender value is zero.

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

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

FIGURE 1: ECONOMIC VALUES AND SURRENDER VALUE



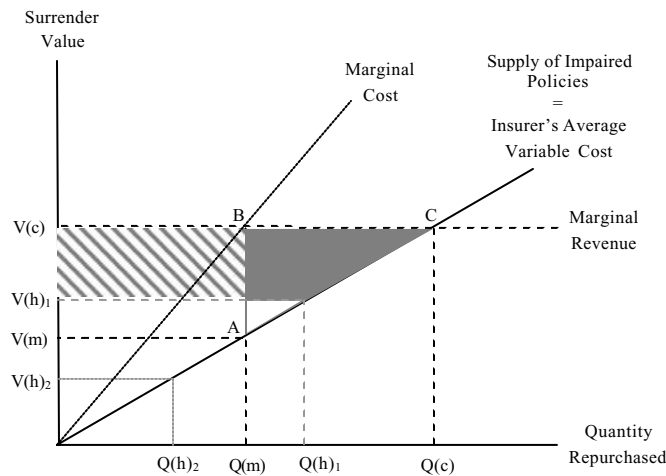
Now consider a policyholder whose health suddenly deteriorates significantly at age 65. Because the policyholder's life expectancy is curtailed, the present actuarial value of the policy will be much higher than for a 65-year-old in normal health. Stated differently, the marginal revenue that the insurance company receives from the repurchase of an impaired policy is substantially greater than the marginal revenue from the repurchase of a normal policy. As Figure 1 shows, if the issuing insurance company creates a single schedule of surrender values based on a uniform assumption of normal health, its surrender terms will be low relative to the actual policy value for an individual with impaired health.

If the insurer is the only repurchaser of its own policies, the policyholder cannot bargain effectively over the surrender value—there is no other potential buyer for the policy. In these circumstances, the policyholder would be forced to either accept an amount that is substantially less than the true economic value or elect not to surrender the policy.

If competition in the primary market constrains an insurance carrier's monopsony power over the surrender of a normal policy, then why does competition not have the same effect on the surrender of an impaired policy? The answer lies in the regulatory constraints faced by life insurance carriers. If an insurance carrier wished to increase its market share in the primary market for life insurance by offering more competitive surrender values for impaired policies, it would have to offer consumers 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. Life insurance carriers do not offer health-adjusted surrender values, which suggests that these difficulties outweigh the benefits that carriers would obtain by offering health-dependent surrender values to consumers.

The price that an incumbent life insurance carrier pays for the surrender of an impaired policy is significantly lower than the competitive rate for such a policy. The price that a life insurance carrier with monopsony power will pay for an impaired policy is just the market price for the surrender of a healthy policy. Assume that the incumbent carrier has complete freedom in the pricing of impaired policies, *ex post*. Subject only to the constraint that it offers the same surrender value to all similar policies, what level would it choose? To clarify the issue, imagine a block of identical policies with the same face value, covering individuals with the same age and the same level of health impairment. 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.⁵³

FIGURE 2: SUPPLY CURVE OF THE SURRENDER OF IMPAIRED POLICIES



This supply curve is also 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—that is, the change in total repurchase costs as a result of repurchasing one more policy—will be higher than the average cost as shown by the marginal cost curve.⁵⁴ The marginal benefit to the insurer from repurchase is the actuarial value of the policy (the expected present value of the future claims payment, adjusted for future mortality risk) because the insurer benefits by buying out this liability. With our assumptions, the actuarial values of policies in the block are constant and thus the marginal benefit is simply this actuarial value, as depicted by the flat marginal revenue curve.

Assuming it can offer a surrender price *ex post*, the incumbent insurer will maximize its profits by choosing the quantity, $Q(m)$, at which

53. CARLTON & PERLOFF, *supra* note 3.

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

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 deadweight loss from this choice of surrender values is equal to the area of triangle ABC.⁵⁵

If the competitive surrender value for a normal policy is higher than $V(m)$, as depicted by $V(h)_1$, the incumbent carrier will earn a supra-competitive profit to the extent that $V(h)_1$ is less than $V(c)$ —the competitive rate for the surrender of impaired policies. The incumbent insurance carrier will be unable to achieve the monopsony rate for the surrender of the impaired policy, however, because it is contractually obligated to offer the competitive healthy rate. Nevertheless, the insurance carrier earns a supracompetitive rent on the surrender of impaired policies equal to the diagonally-shaded rectangle, and produces a deadweight loss equal to the area shaded in solid.⁵⁶

However, if there were a competitive secondary market on which these policies could be re-sold, the incumbent insurer would lose its ability to set the price in the market.⁵⁷ The surrender value would rise to its competitive level, $V(c)$, with a higher number of policies, $Q(c)$, being resold. The solidly-shaded triangle shows the efficiency loss from allowing the incumbent insurer to hold monopsony power in the repurchase of its impaired policies. This efficiency loss corresponds to the deadweight loss created by a monopoly seller, and is the loss in real income of policyholders that arises because of the reduction in output caused by monopsony power. If there is no external market for the resale of policies, insurers have no incentive to adjust their surrender values to fair levels because they reap supra-competitive profits from the current system and would have to forgo these profits in a competitive environment.

C. The Effects of Surrenders on Incumbents' Costs

The surrender of a policy by different policyholders of differing health affects the incumbent carrier's costs differently, and the carrier must account for the costs of these surrenders. The health of a policyholder who surrenders a policy affects the costs of insurance carriers because it determines the discounted net death-benefit liability from which the carrier is relieved.⁵⁸ Furthermore, the health of a policyholder affects the

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

56. If the competitive surrender value for a normal policy is lower than $V(m)$, as depicted by $V(h)_2$, there are certain financial mechanisms that the incumbent insurance carrier can use to effectively raise its surrender value for the impaired policy to the monopsony rate.

57. 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).

58. This discounted net death benefit liability is the amount by which the net present value of the death benefit liability from which the insurance carrier is

likelihood that that policyholder will surrender his policy, which magnifies or mitigates the effects of surrenders by members of a given health profile.

If surrender values set at the time of issue are based on the assumption of normal health at surrender and are actuarially fair (competitive), any surrender of a policy by an individual with normal health will not affect the insurance carrier's costs. The amount that the insurance company pays to the individual for the surrender of his policy will equal the corresponding discounted net death benefit liability from which the carrier is relieved (with an adjustment for the insured's transaction costs). Stated differently, the surrender of a policy by a healthy individual simply causes the insurance carrier to exchange two equal costs.

An individual with *above-average* health is expected to live longer than an individual with normal health, so the ultimate payout by the insurance carrier is further out on the horizon. The carrier's discounted net death benefit liability for an individual with above-average health is thus less than for an individual with normal health. This means that the surrender of a policy by an individual with above-average health reduces the incumbent carrier's discounted net death benefit liability by less than the cost of repurchasing the policy and is thus a losing proposition for the insurance company.

An individual with *impaired* health, on the other hand, is expected to have a shorter life than an individual with normal health, so the carrier's discounted net death benefit liability is greater than for an individual with normal health. Thus, the surrender of an impaired policy decreases the incumbent carrier's discounted net death benefit liability by more than the cost of repurchasing the policy. Surrenders of impaired policies actually decrease the expected costs to incumbent insurance carriers of issuing a policy.

Health status does not merely affect the cost of a given surrender to an insurance carrier. It also plays a large part in a consumer's decision to surrender a policy. If an individual's health is above-average, then that individual's life insurance is no longer a good value because he is paying premiums based on the average level of mortality risk—a figure which is higher than his actual mortality risk. Because such an individual's positive shift in life expectancy decreases the value he attaches to his policy, he will thus be more likely to surrender his policy than an individual with normal health. This propensity of policyholders to surrender their policies when their life expectancy exceeds the average is known as adverse selection, and is costly to incumbent insurers because it means that the average life expectancy for the remaining pool of policyholders is lower than projected at the time the policies were issued.⁵⁹

If an individual's health is below average, then he is less likely to surrender his policy because an impaired policy is worth more than a normal policy. On the other hand, a negative shift in life expectancy changes the consumption preferences of many individuals (in favor of

relieved exceeds the net present value of the expected future stream of premium payments from the policyholder.

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

current consumption), particularly if the motivating factors for the life insurance policy are no longer relevant.⁶⁰ 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.⁶¹ An individual whose consumption preferences have changed in favor of current consumption values cash more highly at the current time, and thus is willing to accept a lower price for his policy's surrender than he would have when his health was normal. Thus, absent entry by third parties into the secondary market, insurance carriers are able to reap significant gains by underpaying for the surrender of these impaired policies.

Because entrants into the secondary market—both viatical and life settlement firms—are only interested in acquiring policies of individuals with impaired health, entry into the secondary market will systematically reduce the number and value of impaired policies that are surrendered to the incumbent carrier for less than the competitive rate. At the same time, viatical and life settlement firms do not affect the number of individuals with average or above-average health who surrender their policies to the incumbent carrier. It is obvious that, by lowering the number of cost-reducing surrenders to the incumbent without causing any corresponding reduction in the number of cost-increasing surrenders, entrants into the secondary market for life insurance policies cause net increases in incumbents' costs.

The fact that incumbents' costs have risen because of entry by viatical and life settlement firms, however, is not sufficient to demonstrate that consumers in the primary market are made worse off by such entry, as the incumbent carriers allege. For one thing, the increased costs to insurance carriers cannot be passed on, wholesale, to consumers in the primary market. 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.⁶² Indeed, our analysis in the following section demonstrates that consumers in the primary market for life insurance are made better off, on net, from the development of a robust secondary market for life insurance policies.

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

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

62. This is the same principle that applies to tax burden analysis. See, e.g., BAUMOL & BLINDER, *supra* note 57, at 241-42, see generally, EDGAR K. BROWNING & WILLIAM R. JOHNSON, *THE DISTRIBUTION OF THE TAX BURDEN* (American Enterprise Institute, 1979).

Insurance companies claim that as a result of this change in the marketplace, they would be forced to increase the insurance premiums that they charge policyholders. Furthermore, the insurance industry contends that, in the case of term life insurance, there is so much competition that some firms would become insolvent if they were forced to absorb the additional costs imposed on them by a secondary market.

The only “costs” imposed on an incumbent carrier by firms in the secondary market for life insurance policies, however, are the costs associated with the incumbent’s continued honoring of the terms of its original policy—that is, the costs that the incumbent should reasonably have expected to pay in the absence of profitable lapses. If the incumbent carrier accurately accounts for these costs in the pricing of a given policy, secondary sales of policies will not cause the carrier to lose money on the policies. Secondary market transactions, by themselves, can only cause a carrier to lose money on its policies if that carrier under-priced the policies in anticipation of high rate of profitable lapses—a practice known as “lapse-supported pricing.” Although incumbents are no longer supposed to use lapse-supported pricing,⁶³ many insurers still have such policies outstanding from when the practice was allowable. Some even maintain that certain carriers continue to engage in the practice.⁶⁴

In a perfectly competitive market, an increase in cost could lead to insolvency among certain firms in the industry.⁶⁵ The doomsday projection of the incumbents, however, ignores two important points: first, the life insurance industry is not perfectly competitive, and second, a robust secondary market will increase customers’ *valuation* of life insurance policies. Economic theory holds that an active and efficient secondary market for a good improves the liquidity of the good as an asset, and thus increases the value of the good to consumers. Indeed, this very phenomenon was observed in all three financial service industries considered in this paper. Such an increase in the valuation of life insurance policies would—other things equal—shift the demand for life insurance outward and to the right, which would lead to an increase in premiums for life insurance.

63. It has been shown that lapse-supported pricing can foster a perverse relationship between the insurance company and policyholder by creating a situation in which the insurance company would benefit if all policyholders dropped their policies. Because the insurance company can adjust its pricing after the fact in such a situation, it is the *policyholder* that bears the lapse risk for a lapse-supported policy—a clear reversal of roles. See Glenn S. Daily, *Lapse-Supported Pricing: Is It Worth the Risks?*, GLENN DAILY.COM INFO. SERV. (Sept. 19, 2002).

64. See Holman W. Jenkins Jr., *Business World: Back to the Future When Life Insurance Was Fun*, WALL. ST. J. at A23 (Mar. 14, 2001).

65. Indeed, as William J. Baumol of NYU and Alan S. Blinder of Princeton University explain about the analogous situation of why a perfectly competitive industry objects to a tax increase: “[b]ecause, with a negatively sloped demand curve, a tax will cut into sales, cause short-term losses, and force some firms out of the industry. That is not a pleasant prospect for incumbent firms.” BAUMOL & BLINDER, *supra* note 57, at 242.

D. Benefits to Policyholders from an Active Secondary Market

A secondary market for life insurance policies erodes the ability of insurance companies to extract monopsony rent from policy terminations policyholders who have experienced a decline in health. An insurance company is forced to either compensate a policyholder for the surrender of his policy according to the market value of that policy, or face the prospect of the policyholder selling his policy to a third party (such as life settlement firm), in which case the insurance company's liability deriving from the policy would remain intact.

Viatical and life settlement firms allow policyholders who have experienced a negative shift in life expectancy to obtain the fair market value for their life insurance assets. Although it does not make sense for most policyholders to surrender their policies at the market value,⁶⁶ the flexibility offered by the secondary market for life insurance policies gives a policyholder the ability to respond to changes in his life situation.

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

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

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

? The policyholder wishes to donate highly appreciated assets to charity, but would be faced with liquidity constraints as the result of such a donation.⁶⁷

The many examples listed above detail situations in which a policyholder might wish to sell his life insurance policy. Although it has always been possible for a policyholder to sell his policy to the incumbent life insurance company, in cases where the policyholder had experienced a decline in health, the underpayment by the insurance company restricted the policyholder's ability to meet the above goals. The secondary market for life insurance policies gives the policyholder the economic freedom to choose between a number of buyers and, in so doing, to receive the fair market price of his policy.⁶⁸

1. Theoretical Analysis

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

The premiums paid by a policyholder for a life insurance policy with a particular face value might intuitively appear to be the appropriate measure of price. Premiums, however, prove deficient as a price measure because in insurance markets, most of the premiums are returned to the policyholder in the form of claims payments or surrenders. Economists and industry analysts thus uniformly view the price of insurance as the spread between the premium paid and the amount that insured expects to have returned on average in claims and surrenders.⁶⁹

The spread is the amount paid to the insurer for the service of transferring risk. Almost all empirical studies of insurance markets use the spread as the appropriate price that equates supply and demand.⁷⁰ The

67. Sinclair, *supra* note 51, at 2-3; Kaja Whitehouse, *Getting Personal: Viaticals Mature, But Risks Remain*, DOW JONES NEWS SERVICE (Jan. 14, 2002) (citing Martin Nissenbaum, national director of retirement planning at Ernst & Young, LLP).

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

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

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

following ratio represents the typical method of measuring this spread for a particular life insurance product:

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

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).⁷¹

An insurer will increase its supply of insurance in the primary market if by doing so it can generate returns that, when adjusted for risk, exceed its cost of capital. These returns do not depend on the dollar value of the premiums but on the markup over costs accruing to the insurer when selling its policies; the higher this markup or spread, the higher the return on capital. Thus, other things being equal, the supply of insurance will increase as the spread increases.

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

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

$$(P_1 - C_1 - S_1) / (C_1 + S_1) = (P_2 - C_2 - S_2) / (C_2 + S_2).^{72}$$

71. 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.

72. One can see this simply by increasing the values P_1 , C_1 and S_1 each by the same constant percentage.

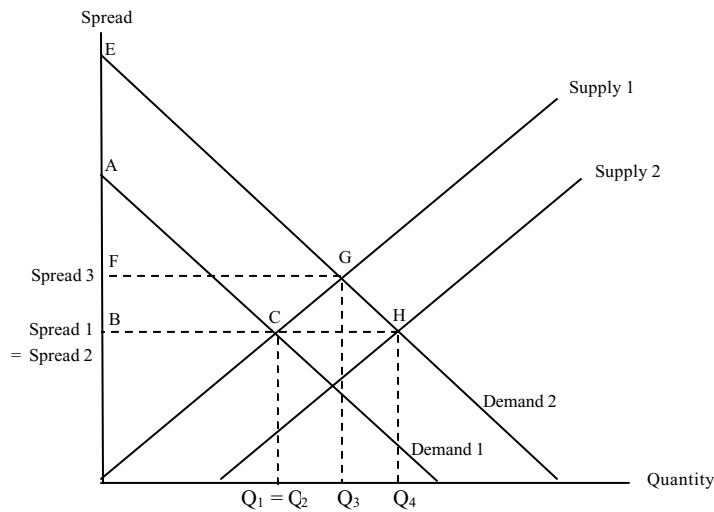
Thus, we should not expect entry to have a material effect on either supply or demand in the primary market. The volume of primary insurance would change little and any increase in dollar premiums would be matched by an increase in surrender or settlements to policyholders. If we consider *only* the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

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

At any price spread consumers will demand more of a product whose payouts are less risky. Thus the demand curve will shift outward, as shown in Figure 3.⁷³ The demand before entry is represented by the curve “Demand 1” and the supply is denoted by the curve “Supply 1.” The market price or spread is therefore “Spread 1” and the quantity is Q_1 . The entry of viaticals and life settlement firms does not affect the spread. The market price “Spread 2” will be the same as “Spread 1” and the quantity will also remain unchanged at Q_2 . However, the improvement in product quality will increase demand to “Demand 2”. In the short run, entry will cause excess demand and increase the price to “Spread 3” with a higher quantity, Q_3 . 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 2” and the volume of insurance will increase further to Q_4 . Thus, the cumulative effect of entry into the secondary market for life insurance is a larger but equally competitive primary industry.

73. By this, we do not mean to imply that the total demand for life insurance will necessarily increase. Indeed, the demand for life insurance has been declining for the last decade because of lifestyle, cultural, and demographic conditions, and because individuals have been increasingly willing to use mutual funds to accomplish goals which had previously been met primarily through the purchase of life insurance. See ERICH W. SIPPEL, LIFE INSURANCE 1990-2010: FINANCIAL INDUSTRIES TO INFORMATION SERVICES AND E-BUSINESS 9-10 (Erich Sippel & Co., 2000). Rather, we demonstrate that demand will increase relative to what it *would have been* absent a secondary market. Thus, although it is entirely possible that the total demand for life insurance will continue to decline, the total demand will still be higher than it would have been without a secondary market for life insurance policies.

FIGURE 3: CONSUMER WELFARE ANALYSIS



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

2. Empirical Analysis

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

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

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

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

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

As Table 2 demonstrates, life settlement firms improved policyholder welfare by over \$240 million in 2002. This number vastly understates the true positive effect of the secondary market on policyholders, however, because it does not account for the welfare gains generated by viatical firms. Second, our estimate does not incorporate the welfare gains of policyholders from the unexercised option to sell their policies in the future. Unfortunately, this valuable option is difficult to measure.⁷⁴

E. Other Beneficiaries from an Active Secondary Market

An active secondary market for life insurance policies creates positive externalities for groups other than consumers. Although these externalities do not shift the proper focus of the secondary market from the consumer, they are worthy of consideration.

1. Benefits to Insurance Agents

Consumers do not typically deal directly with life insurance companies. Rather, they purchase life insurance from agents, who are often affiliated with particular life insurance companies. The economic well-being of insurance agents is directly tied to their ability to provide their clients with the insurance advice and policies that best fit their clients' needs. By facilitating the sale of his client's policy to the life settlement firm, the agent can earn additional income.

There are several ways in which an insurance agent could potentially earn income from a life settlement. An agent could earn a commission for facilitating the life settlement transaction and from additional life insurance sales that were made possible by funds from the sale of the original policy. Additionally, an agent could continue to receive the renewal commissions

74. Finally, we do not account from the welfare gains of policyholders who have exercised Accelerated Death Benefit (ADB) options. Gains from ADBs should be counted in a calculation of the total policyholder benefits from secondary market entry because ADBs were issued as a response to entry by viatical and life settlement firms.

on a policy which would otherwise have been terminated (if the policy was sold by that agent).⁷⁵ Finally, because an active secondary market indirectly raises the demand for insurance in the primary market, insurance agents as a group benefit from entry into the secondary market.

2. *Benefits to Incumbent Insurance Carriers*

Although life insurers will lose monopsony power and therefore lose economic rent from the termination of policies, the life insurance industry would benefit in the long term from the stronger demand created by the secondary market. Furthermore, by standing as ready purchasers of policies, firms in the secondary market could discourage the repeal of nonforfeiture laws and keep incumbent insurers from the unfair, and ultimately unworkable, practice of using high lapse expectations to underprice certain policies.⁷⁶

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

Securitization of life settlement portfolios would create financial instruments whose payoffs are correlated to mortality risk. By taking positions in such instruments, an incumbent insurer could hedge its pre-existing mortality risk. Whereas some reinsurers resisted the introduction of these instruments in the catastrophe insurance market, others have initiated securitizations as a way of hedging their risk and thereby expanding their capacity to offer more reinsurance.⁷⁷

IV. THE RENT-SEEKING BEHAVIOR OF INCUMBENT LIFE INSURANCE COMPANIES

An incumbent life insurance carrier earns a substantial portion of its margins from surrenders by policyholders with diminished life expectancies, and is thus interested in protecting those margins. The carriers' purported anti-competitive justifications for curtailing the secondary market for life insurance are contradicted by economic theory, evidence about the benefits of secondary markets from other industries, and empirical evidence from the life insurance industry, itself. The

75. Coventry First, *How to Turn a Lapse or Surrender into Five Sources of Income* <<<http://www.coventryfirst.com/resource/files/fivesources.pdf>>>.

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

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

incumbent carriers' actions are more likely motivated by what economists describe as rent-seeking behavior.⁷⁸ The incumbent life insurance carriers are attempting to protect the profits derived from their monopsony position in the secondary market.

A. Life Insurance Companies Compete with Viatical and Life Settlement Firms in the Secondary Market for Impaired Life Insurance Policies

Before the entry by viatical and life settlement firms, the only buyer in the secondary market for a given life insurance policy was the insurance company that had issued the policy. In the early 1990s, after entry by competitors, life insurance companies developed accelerated death benefits (ADB), which give policyholders the option of receiving between 25 percent to nearly 100 percent of their death benefit while they are still living.⁷⁹ To qualify for an ADB, a policyholder must have a death benefit rider on his policy (although in many cases it is not difficult to add such a rider once it is needed) and, depending on the policy, must either have a dramatically reduced life expectancy, suffer from one of a number of specified medical conditions—often called “dread diseases”—or require long-term care.⁸⁰ Early on, a large percentage of ADBs were triggered by either dread diseases or long-term care, but by 1994 terminal illness was the overwhelming condition necessary for the exercise of an ADB.⁸¹ Although the life expectancy required for the exercise of an ADB varies by company, product, and state, twelve months is the most common maximum allowed life expectancy: only between two and five percent of the ADBs on the market triggered by terminal illness allow a policyholder with a life expectancy of greater than one year to accelerate his death benefit.⁸²

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

79. FTC Facts for Consumers, *Viatical Settlements: A Guide for People with Terminal Illnesses*, at 2 (May 1998) (visited on Aug. 12, 2002) <www.ftc.gov>. ADBs can even be offered in the secondary market because it is possible for a whole life policy to be converted to add such features. Thus, ADBs represent one of the mechanisms that an incumbent insurance carrier could have used to raise the surrender values of impaired policies if this value was lower than the monopsony rate, as discussed in footnote 74. See Whitehouse, *supra* note 67, citing American Express certified financial planner, Thomas A. Endersbe. For example, on its website, New York Life states: “[i]f your policy does not contain the LBR (living benefits rider) option, you can add it to your policy now or when you may need it.” New York Life, Viatical Marketing, downloaded on Sept. 23, 2002 at <<http://www.newyorklife.com/NYL2/DisplayOne/0,1237,9247-22-76,00.html>>.

80. LIMRA INTERNATIONAL & AMERICAN COUNCIL OF LIFE INSURANCE, ACCELERATED DEATH BENEFITS: 1998, 4 (1999); see also *Accelerated Death Benefit Provisos on the Rise*, INSURANCE ACCOUNTING (Apr. 19, 1999).

81. *Id.*, at 3.

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

ADB riders were developed as a competitive reaction to the emergence of viatical firms.⁸³ The number of policies with ADB riders has grown in line with the growth of the viatical and life settlement industry, as life insurance carriers added them to policies with increasing regularity during the mid and late 1990s. According to LIMRA International, approximately 39.9 million life insurance policies contained ADB provisions in 1998, which was more than double the number of ADB policies in 1994, and more than 35 times the number of ADB policies in 1991.⁸⁴

ADB riders have also become cheaper and more easily available over the last decade. In 1990, nearly 90 percent of ADB riders required additional premium payments or cost of insurance.⁸⁵ By 1998, however, only thirteen percent of policies with a death benefit rider involved a higher premium or an otherwise increased cost of insurance,⁸⁶ and over half of ADB features available on individual policies were automatically offered to eligible policyholders by insurance companies.⁸⁷

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

Many options exist for people with terminal illnesses when financial needs are critical. For example, you may consider a loan from someone such as the original beneficiary of your life insurance policy. Or, if you've already ruled out less expensive alternatives to raise cash, you might sell your life insurance policy through a viatical settlement. Many life insurance policies in force nationwide now include an accelerated benefits provision.⁸⁸

83. *Living Benefits More Popular Add-On*, ADVISOR TODAY 36 (Aug. 1, 2000). As this article states, the accelerated death benefit "was conceived more than a decade ago largely in response to the creation of viatical settlements." *Id.* See also, *Accelerated Death Benefit Provisos on the Rise*, INS. ACCT. (Apr. 19, 1999) (stating that "[t]he increased trend toward more ADB policies follows the growing popularity of the viaticals option for terminally ill policyholders seeking funds before death.")

84. LIMRA INTERNATIONAL, *supra* note 80, at 19. At least 245 life insurance companies, which held 78 percent of the life insurance in force in the United States, offered policies with some form of ADB riders in 1998. *Accelerated Death Benefit Provisos on the Rise*, *supra* note 83, at 1 (Apr. 19, 1999).

85. LIMRA INTERNATIONAL, *supra* note 80, at 11.

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

87. LIMRA INTERNATIONAL, *supra* note 80, at 8.

88. FTC Facts for Consumers, *Viatical Settlements: A Guide for People with Terminal Illnesses* at 2 (May 1998) (visited on Aug. 12, 2002) <www.ftc.gov>.

Viatical settlements and ADBs also have been considered substitutes by financial analysts and industry experts.⁸⁹

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 a health-impaired individual seeking to sell his policy—they are just inferior substitutes.

By 2001, incumbent carriers began to compete more effectively with life settlement firms by lobbying for expanded definitions of “qualifying events” that trigger ADBs. If an incumbent carrier is permitted to offer an ADB for chronic illness, in addition to terminal illness, that carrier can provide a closer substitute to life settlement firms. In September 2002, the New Jersey Department of Banking and Insurance proposed an amendment to expand the circumstances under which an ADB could be exercised to include chronic illness. The Department determined that such an expansion should “positively affect consumers,” and further predicted that “[i]nsurers should benefit since policyholders now have more flexibility in accelerating a portion of their life insurance rather than exercising other life settlement options.”⁹⁰ 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.

B. The Regulatory Environment Confronting Viatical and Life Settlements

As of September 2002, viatical and life settlements were governed by a patchwork of state and federal regulations. In 1996, the SEC’s bid to regulate viaticals under federal securities law was rejected by the D.C. Court of Appeals.⁹¹ But even though they were not considered to be

The FTC’s release also mentions that Congress amended the tax code in 1997 to carve out exemptions for the receipt of both accelerated death benefits and viatical settlements, provided the individual insured by the original policy has a life expectancy of less than two years. *Id.* at 3. This tax action suggests that the United States Congress also views accelerated death benefits and viatical settlements as existing in the same product market.

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

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

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

securities under federal law, many states classified viatical settlements as securities and regulated their sale to investors as such.⁹² In February 2002, 35 states regulated viatical transactions through their insurance regulatory departments, but only 13 of these regulated life settlements.⁹³ Roughly half the states did not have licensing requirements for viatical selling.⁹⁴

The regulatory environment has allowed certain abuses by unscrupulous companies. These abuses, however, have tended overwhelmingly to involve the fraudulent sale of interests in viaticated policies to *individual investors*, or the fraudulent acquisition of new policies for resale to unscrupulous or unsophisticated firms in the secondary market.⁹⁵ In contrast, there have been relatively few instances in which *policyholders* have been the target of fraudulent practices. Indeed, in a March 2002 letter to the House Subcommittee on Oversight and Investigations, NAIC president Terri Vaughan explained that “[i]n reality, most settlement frauds now involve the investor side of the transaction, not the insurance policyholder side.”⁹⁶

Previous articles have attested to the need for sensible regulation of the secondary market,⁹⁷ and the top firms in the life settlement and viatical industries have been supportive of antifraud laws on the grounds that such laws would help to curtail abuses by disreputable firms and inspire public confidence in (and demand for) the services of the industry as a whole.

One example of self-regulation is the Life Settlement Institute, which is a non-profit trade group consisting of six of the major institutionally-

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

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

94. Coolidge, *supra* note 7.

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

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

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

funded life settlement providers and financiers.⁹⁸ In 2002, the Life Settlement Institute began building an anti-fraud database for companies to share information of suspicious or fraudulent activity by policy sellers, brokers, doctors, financial advisors, or the insured, themselves.⁹⁹ In addition to such self-regulation, the Life Settlement Institute has publicly advocated a stricter and improved regulatory environment. David M. Lewis, president of the Life Settlement Institute, stated in written testimony to the U.S. House Committee on Financial Services, that the Life Settlement Institute strongly supported strict regulation by state insurance and securities regulators of the viatical and life settlement marketplace,¹⁰⁰ and supported amending the Federal Securities Act of 1933 so that interests in pooled life insurance policies sold to individual investors would constitute “securities” under the Act.¹⁰¹

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

The new law expands the definition of viator to include life or senior settlements, and requires disclosures at a time no later than the time of the application by the provider or broker. In addition, the law provides a 15-day window for the viator to rescind the contract and protects their identity. To combat fraud, the law provides a clear definition of what constitutes viatical fraud and requires licensed brokers and providers to show a plan to identify and combat fraud.¹⁰²

As of February 2002, only 20 states regulated the sale of interests in viatical or life settlements to individual investors.¹⁰³

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.”¹⁰⁴ As just one such example, in October 2001 Warren Buffet’s Berkshire Hathaway arranged to invest up to \$400 million in Living Benefits Financial Services LLC.¹⁰⁵ The due-diligence performed by such

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

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

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

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

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

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

104. Letter from Terri Vaughan, *supra* note 96.

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

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.

C. Strategies of Incumbent Life Insurance Carriers to Maintain Monopsony Power

Incumbent insurance carriers have a clear economic motive to eliminate viatical and life settlement firms from the secondary market for life insurance policies.¹⁰⁶ This motivation explains why life insurance carriers have lobbied for regulations on viatical and life settlements that are unfavorable to *any* secondary market transactions. The incumbents' strategies can be best understood in light of their economic interest in re-establishing monopsony positions in the secondary market.

In recent years, many incumbent carriers have begun to take steps to curtail the entry of viatical and life settlement firms into the secondary market. For example, in Kentucky, new regulations, which were introduced by incumbent insurance carriers, mandate that a life insurance agent must complete an approved 40 hour viatical "prelicensing classroom course of study," apply for and obtain a separate license from the state, and pay a fee of \$250 before he is allowed to broker a life settlement with a client for whom such a settlement might be the best option.¹⁰⁷ Although sensible licensing requirements help to eliminate fraudulent viatical and life settlement transactions, licensing requirements such as those passed in Kentucky eliminate nearly all viatical and life settlement transactions, and their associated benefits.

In addition to lobbying for regulation, incumbent carriers have pressured their agents to shun the viatical industry. For example, in a November 2000 letter to its financial advisors, AXA explained that its financial professionals were "expressly prohibited from participating in any viatical settlement or life settlement activity."¹⁰⁸ Other large insurers have also prohibited their career agents from dealing with viatical or life settlement companies or providing such services to policyholders.¹⁰⁹ 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

106. See, e.g., Jenkins, *supra* note 64 (explaining that "by selectively keeping in force only the industry's losing policies, investors can't help but screw up the industry's returns.").

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

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

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

viatical or life settlement firm. In a compliance alert letter sent in February 2002, GenAmerica directed its agents to encourage policyholders interested in viatical or life settlements to use “product alternatives” such as ADBs.¹¹⁰ Agents were further instructed to refer a policyholder to the state insurance department if he insists on talking with a viatical or life settlement firm.¹¹¹ Finally, agents of GenAmerica Financial (GAF), NEF, and MetLife have been expressly prohibited from providing any assistance (beyond that which is legally required) to a client who wishes to assign his company contractual death benefits to a life or viatical company.¹¹²

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.¹¹³ Principal Life prohibits any broker from participating in a viatical or life settlement transaction involving a Principal Life policy if either a) the policyholder intends to transfer only a portion of the policy to the purchaser, b) the purchaser sells interests in policies to investors, or c) if the insured is eligible for accelerated death benefits from Principal Life.¹¹⁴

These prohibitions by incumbent life insurance carriers are anticompetitive: they seek to erect a barrier to entry against viatical and life settlement firms for all policies that the incumbents could potentially repurchase. In addition, by forcing agents to restrict their client advice to an incomplete array of options (even when the agent knows that a viatical or life settlement might best meet the client’s needs), these prohibitions risk undermining the credibility of carriers’ life insurance agents and exposing them to legal liability.¹¹⁵ Finally, these prohibitions are overreaching in scope: restrictions on the ability of agents or brokers to assist clients in the sale of life insurance policies issued by other carriers strongly suggests an industry-wide boycott of viatical and life settlement firms.

110. *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).

111. *Id.*

112. *Id.*

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

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

115. Erich W. Sippel, *Do Beliefs Get in the Way? The Uneasy Relationship Between Life Insurance Companies and Life Settlements*, CAL. BROKER, Sept. 2002, at 65.

V. CONCLUSION

The assignability of a life insurance policy is a benefit that a consumer acquires when he or she becomes a policyholder. Life insurance companies are attempting to foreclose the emerging secondary market for life insurance by lobbying for barriers to entry into the market, by boycotting life settlement firms, and in some cases, by preventing their agents from informing policyholders of their right to contract with a life settlement company. All of these actions are designed to interfere with the assignability benefit that policyholders legally acquire upon purchasing a policy from a life insurance company.

Incumbent life insurance carriers argue, somewhat paradoxically, that their efforts to impede policyholders' legal exercise of their assignability benefits will actually improve consumer welfare. This argument is supported by the erroneous and self-serving contention that entry into the secondary market makes consumers worse off. In this paper, we have demonstrated that a competitive secondary market for life insurance policies improves the welfare of both new and existing policyholders. It is therefore in the interest of lawmakers to develop regulations that protect the interests of consumers and investors in the secondary market. Because participation and investment in the secondary market for life insurance policies is pro-competitive, lawmakers should design regulations that encourage, rather than dissuade, such participation or investment.