

A Free Market for Life Insurance

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The emergence of a free market for life insurance policies is not only a major business opportunity, it's a step toward greater fairness in the life insurance business.

IT'S AN OVERSTATEMENT, BUT ONLY A MOD-EST ONE, to say that modern life insurance came into existence in 1844 when, on a trip to London, Elizur Wright turned his impressive intellect and virtually unlimited energy to its reform. Now referred to in insurance textbooks as "the father of legal reserve life insurance," Wright was, before his London visit, a Massachusetts social reformer, abolitionist, and publisher. On that visit to London, he breakfasted one morning with Robert Browning, Elizabeth Barrett, and other luminaries of the British literary and social scene. Wright was asked what he had found most interesting in London; he replied:

... the most interesting to me has been the Sun Life Office, where I have learned a good deal about life insurance that was new to me.

"Life insurance," broke out Mr. Procter, "it's the greatest humbug in Christendom."

I was quite thunderstruck, but managed, after a little hesitation, to say, "You surprise me, Mr. Procter. If I had not taken a policy from a life company... I should not have dared to cross the water, leaving a wife and five children on the other side.

"Go to the Royal Exchange," said Mr. Procter, "Thursday afternoon at three o'clock, and you will see what I mean."

I assured him I would do so, and did. What I saw... was a sale of several old policies on very aged men to speculators... to be kept up by them by their paying annual premiums to the company till they decease. This was done, I was told, because the companies made it a rule "never to buy their own policies." A poor rule it seemed to me! I had seen slave auctions at home. I could hardly see more justice in this British practice. If I should ever become old myself, I thought, I should not like to have a policy on my life in the hands of a man with the slightest pecuniary motive to wish me dead. I resolved, if I ever returned to America, it should be otherwise here, if my voice could avail.

Wright's voice did, in fact, avail; he became the first insurance commissioner in the United States and the moving force behind the first nonforfeiture laws in the nation. Ironically, though, the reforms he pioneered have today become the catalyst for the development of a controversial new market for the sale of life insurance policies. Criticisms of this new market include the following:

- It doesn't respect the principle of insurable interest.
- It's unfair to insurance companies.

- It's prone to fraud and abuse.

Despite the controversy, that reborn market—far from the "slave market" Wright witnessed—offers the potential for greater fairness to policyowners and meaningful benefits to all its participants. Its development should be welcomed, encouraged—and regulated.

Wright remedied the injustice he witnessed by regulating the price at which life insurance policies would be sold and the market in which they would be bought. He did this by establishing rational means for determining the market value of a life insurance policy—which came to be known as the cash-surrender value—and then requiring life insurance companies to repurchase their own policies for that price.

In effect, he created a monopsony—a market situation in which a seller can sell to only one buyer. This obviously has the potential to put sellers at a disadvantage, but Wright's regulated pricing prevented that from occurring. Indeed, guaranteed repurchase at rational, regulated prices dried up, for about a century and a half, the free market for the sale and purchase of life insurance policies.

Nevertheless, the potential was always present for the market to reappear if the regulated price (i.e., the cash surrender value) was below what others were willing to pay. After all, even though the law required insurance companies to repurchase life policies for the cash surrender value, no law required policyholders to accept that price, and no law prohibited another party from offering a higher price.

During the 1990s, the market did, in fact, reappear. AIDS caused many young individuals with severely shortened life expectancies to suddenly be faced with a need for cash to pay medical bills and to live out their lives in dignity. The need for cash caused many AIDS patients to turn to their life insurance policies; and the shortened life expectancies caused investors to be willing to offer more than the cash surrender value to purchase the policies. In other words, the monopsony dissolved and the free market was reestablished when the market price for life insurance policies exceeded the regulated price.

Thus was born the viatical settlement business. In recent years, the original impetus—providing funds to AIDS patients—has broadened to include two additional categories: policyholders suffering from other terminal illnesses, and so-called "life

settlements." Life settlements are transactions involving individuals who, though not terminally ill, wish to sell a life insurance policy they no longer need. There are a variety of reasons a policy would no longer be needed: perhaps it was purchased to meet estate planning needs that no longer exist, or perhaps a corporation owns the policy on an executive who has left the company.

During the 1990s—a decade of sluggish growth in the life insurance industry—viatical and life settlements were among the few bright spots. In 1990, approximately \$50 million of policies were viaticated—an amount that grew to about \$1.2 billion by 1999. Erich Sippel & Company projects that between \$1.8 billion and \$2.2 billion were viaticated in 2001; the Viatical Association of America more optimistically estimates that the figure was \$4 billion.

In a 1999 study, Conning & Co. estimated the total size of the market at \$134 billion. The size and growth of the market could be significantly affected by future legislation regarding estate tax reform—an area, despite the recently passed tax reduction bill, of considerable uncertainty. If Congress should unambiguously repeal the estate tax, many additional policies would become candidates for life settlements. In any event, two facts are clear: the market is very large, and it's growing rapidly.

New Players

This burgeoning market wouldn't exist without willing sellers and buyers. Sellers participate in the market to free up assets for purposes they consider higher priorities—and since they're no longer forced to accept the regulated price for their policies, they free up a larger amount of such assets. Buyers anticipate receiving attractive risk-adjusted returns on their investment.

Other market participants—distributors and viatical and life settlement firms—benefit as well. Distributors (e.g., life insurance agents or financial planners), who identify opportunities for the sale of life insurance policies, are paid commissions; and viatical and life settlement firms, which provide the up-front payment to the policyholder, receive a portion of the death benefit. These firms might hold the policies for their own account, or sell them (or shares of pooled policies) to other investors.

Additionally, new players are entering the market by participating in important transactions involving securitization of life insurance policies. They involve, in addition to distributors and viatical and life settlement firms, investment bankers who package pools of life policies into securities with various characteristics and distribute them; reinsurers who credit-enhance the securities; and institutional investors who purchase the investment-grade securities. Many of the institutional investors are life insurance companies that purchase the securities, with their longevity risk, as a hedge against the mortality risk inherent in their business.



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These players are entering the new market for securitized life policies, of course, in the hope of making money. But their participation benefits not only themselves, but also the entire market, by making it more liquid, transparent, and efficient. Moreover, if it's done properly, securitization will confer one more benefit: anonymity. As Wright observed, no one should want another person to have a pecuniary interest in his or her death. Adhering to the principle of insurable interest is one method of achieving that goal, but it's not the only one. (And the industry sometimes violates the principle. For example, a company that issues a life-only immediate annuity has a financial interest in the early death of the annuitant.)

Protecting the identity of insureds is another method of preventing incentives for murder. Securitizers of life insurance policies should be held legally accountable for seeing to it that investors in life insurance-backed securities have no way of knowing the names of the individuals in whose policies they've invested. All information (name, address, telephone number, Social Security number, policy number, etc.) that would enable investors or groups of investors to identify insureds must—and can—be held in strictest confidence.

Fair Treatment

What about one other market participant—the life company that initially underwrote the policy? Most policies that aren't sold would otherwise be lapsed. Isn't the insurance company disadvantaged when its policy is sold, since instead of paying the cash surrender value, it will ultimately pay a death claim—almost certainly a larger amount? And if so, aren't life insurance policy sales unfair to insurers? The answer to both questions is no. By paying the death claim, the underwriting company is simply performing as it promised to do when the policy was sold.

Beyond that, however, consider an important reason the insurance company would prefer for the policy to be lapsed: because it would have "bought back" the policy for less than the market price. By what definition of fairness is any company in any business entitled to obtain anything—life insurance policies or anything else—for less than the market price?

On the contrary, if a policyowner is compelled to sell a life insurance policy to an insurance company for less than the mar-

ket price, he or she is unfairly disadvantaged. The presence of alternative buyers in the marketplace is what prevents this compulsion and thus protects the policyowner. Ironically, a free market for life insurance policies—the unfairness of which, in the 19th century, Wright's reforms remedied—has, in another era, become a guarantor of fair treatment of policyowners.

Although the new free market for the sale and purchase of life insurance policies offers benefits to all market participants, it's an immature market and, like many immature markets, subject to fraud and abuse. The business press is replete with stories of naïve investors who were promised high returns that failed to materialize—or even turned to losses. *Consumer Reports* found that 33 of 73 viatical settlement firms operating in 2000 had been in trouble with regulators during the previous two years.

"Cleansheeting" is typical of many of the fraudulent schemes that have cropped up in the marketplace. This is the practice of soliciting individuals in poor health to apply for life insurance (frequently, guaranteed-issue policies) and encouraging them to lie about their condition. When the policies are issued, they're quickly resold to investors.

Much of the criticism of the viatical and life settlement marketplace centers on the existence of these fraudulent practices. But they're readily remedied through regulation, enforcement, and disclosure.

Regulation

Without credible regulation on a nationwide basis, the market will be dogged by lack of confidence on the part of both sellers and buyers; and that lack of confidence will prevent this nascent market from developing in a way that will achieve its potential benefits. Thirty-three states have enacted statutes to regulate viatical and life settlements. These laws deal with issues such as minimum payments to viators based on life expectancy; privacy guarantees; and investor protections. The remaining 17 states should enact similar legislation promptly.

Moreover, at the federal level, the House Financial Services Committee has passed the Financial Services Antifraud Network Act (H.R. 1408), which should be enacted into law. This legislation will create a new computer network to link together the existing state and federal databases of banking, securities, and insurance regulators in an effort to combat fraud in the financial services industry.

Although H.R. 1408 isn't narrowly targeted at viatical and life settlements, it would have the salutary effect of giving regulators one more tool for combating fraud and abuse, thereby helping build confidence in the free market for life insurance policies.

Enforcement and Disclosure

Every state has laws on the books that make fraud a crime. Authorities should vigorously enforce these laws as they pertain to viatical and life settlements.

Buyers should be informed of the real risks and returns regarding purchase of life insurance policies. For example, they need to understand that the risk of policyholders living longer than their life expectancy is a very real one, and that this can cause significant losses to investors.

The industry will also have to think through novel issues that have arisen because of the development of this new market. Jon Gallo, co-chairman of the Life Insurance Committee of the Real Property, Probate, and Trust Law Section of the American Bar Association, has written: "The growth of the secondary market [for life insurance policies] has raised numerous fascinating and troubling questions. . . [For example,] what is the liability of the trustee of an insurance trust who allows a thinly funded policy to lapse if the policy had a value in the after market? And what is. . . [the] liability [of financial and estate planners] for failing to tell the trustee and the insured about the after-market?"

To say that the market's problems can be corrected with regulation, enforcement, and disclosure is to say that the problem is not the market itself, but inadequate regulation, enforcement, and disclosure. Nevertheless, critics often bemoan—often in highly dramatic terms—the very existence of the free market for life insurance.

For example, two executives at a major insurer have recently written, "While the secondary market for insurance is not unscrupulous overall . . . it's unfortunate that . . . [the] very purpose [of life insurance] is being compromised . . . [Viatical and life settlements] negate the concept of insurable risk [and] they have nothing to do with the law of large numbers, which is what insurance pricing is based upon. 'How will this affect the cost of coverage?' they ask ominously. 'Will life insurance become less affordable for those sincerely seeking financial protection for their loved ones?'"

Such overheated criticism of the market itself is both shortsighted and ill-conceived. The emergence of a free market for life insurance policies is not only a major business opportunity, but—more important—a step toward greater fairness in the life insurance business. It would be unfortunate indeed if the ultimate legacy of Wright's reforms were to prevent that step from being taken.

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