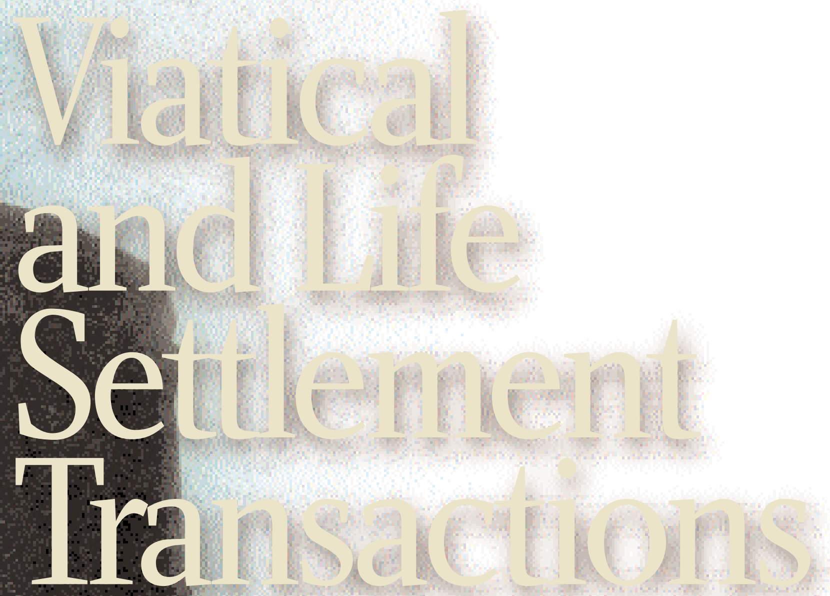


Viatical and Life Settlement Transactions

By Joseph M. Belth

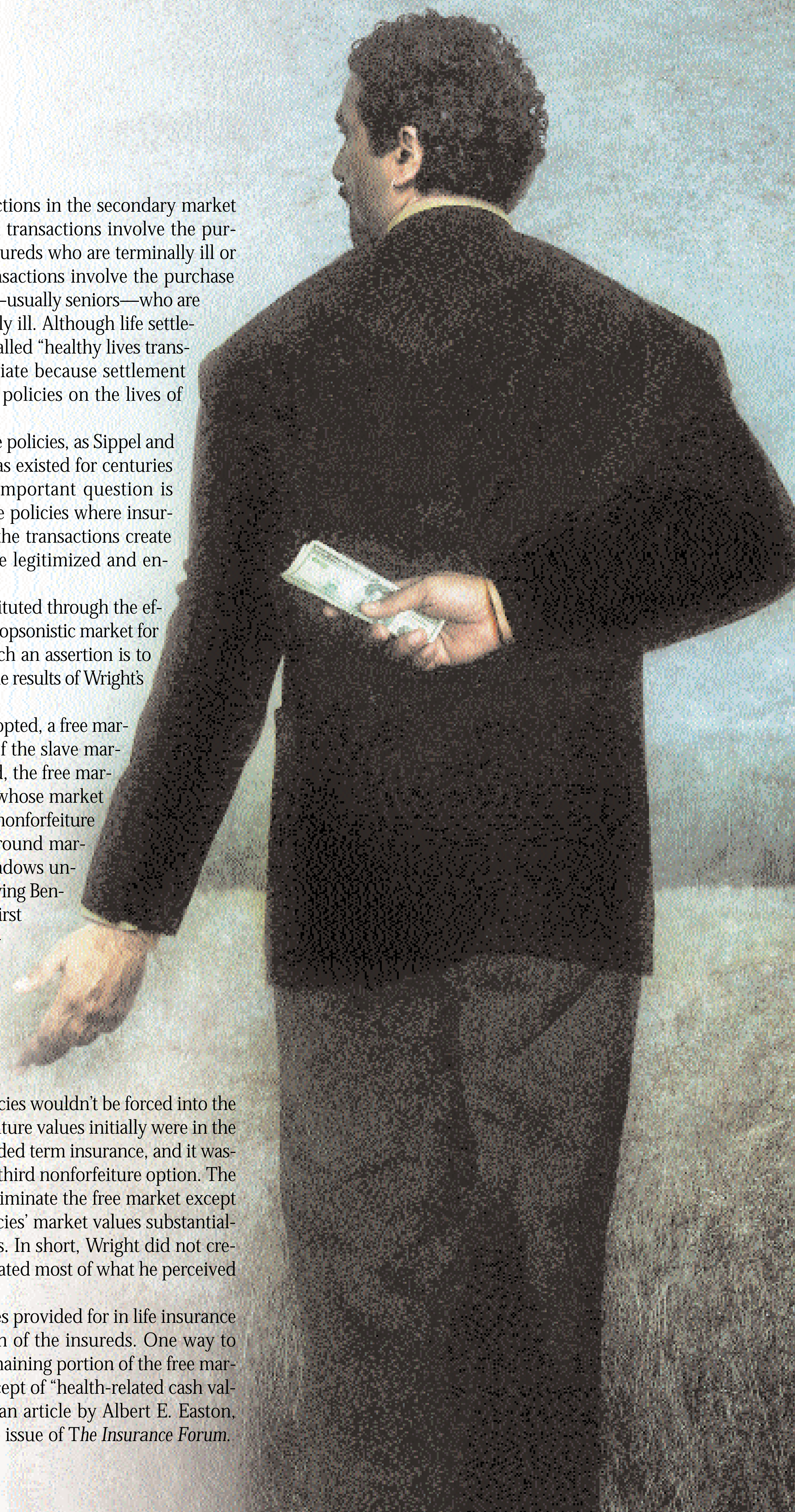
The Frightening Secondary Market for Life Insurance Policies

Is the secondary market for life insurance policies a win-win deal for insureds and investors, or is it an invitation to skullduggery?

In a viatical or life settlement transaction, or what is sometimes called a "secondary market" transaction, ownership of a life insurance policy is sold for cash to someone who doesn't have an insurable interest in the insured's life. Moreover, as a consequence of the transaction, the buyer of the policy acquires a financial interest in the insured's early death. Thus a viatical or life settlement transaction creates an incentive for murder. Also, there have been many allegations of fraud against investors in the transactions, and many allegations of fraud against life insurers.

The life insurance policyowner who sells the policy in a viatical or life settlement transaction may be an entity or a person other than the insured. This article, however, assumes that the insured is also the owner who sells the policy.

Jonathan Barkat



Some Historical Background

There are two categories of transactions in the secondary market for life insurance policies. Viatical transactions involve the purchase of policies on the lives of insureds who are terminally ill or chronically ill. Life settlement transactions involve the purchase of policies on the lives of insureds—usually seniors—who are neither terminally ill nor chronically ill. Although life settlement transactions are sometimes called "healthy lives transactions," that phrase is inappropriate because settlement firms do not knowingly purchase policies on the lives of healthy insureds.

A "free market" for life insurance policies, as Sippel and Buerger ("S&B") use the phrase, has existed for centuries and will continue to exist. The important question is whether a market for life insurance policies where insurable interest is absent and where the transactions create an incentive for murder should be legitimized and encouraged.

S&B assert that the reforms instituted through the efforts of Elizur Wright created a monopsonistic market for life insurance policies. To make such an assertion is to misrepresent and seriously distort the results of Wright's work.

Before Wright's reforms were adopted, a free market existed, and it reminded him of the slave market. After his reforms were adopted, the free market continued to exist for policies whose market values substantially exceeded their nonforfeiture values; however, it was an underground market that didn't emerge from the shadows until 1989. That was the year when Living Benefits, Inc. (Albuquerque, NM), the first firm in what is now the viatical industry, announced it was going to buy policies on the lives of insureds who were terminally ill.

Wright's reforms required insurers to include nonforfeiture values in their policies so that insureds who discontinued their policies wouldn't be forced into the free market. The required nonforfeiture values initially were in the form of paid-up insurance or extended term insurance, and it wasn't until later that cash became the third nonforfeiture option. The result of Wright's reforms was to eliminate the free market except for those situations where the policies' market values substantially exceed their nonforfeiture values. In short, Wright did not create a monopsony; rather, he eliminated most of what he perceived as a distasteful free market.

At present, cash surrender values provided for in life insurance policies aren't related to the health of the insureds. One way to eliminate or sharply reduce the remaining portion of the free market would be to introduce the concept of "health-related cash values." That subject is discussed in an article by Albert E. Easton, FSA, MAAA, in the February 2001 issue of T*he Insurance Forum.*

The Life Annuity Analogy

S&B's statement that life insurers violate insurable interest principles by issuing "life-only immediate annuities" involves a poor analogy. In an immediate life annuity with no period certain, the annuitant pays a lump sum to the insurer up front, the insurer makes periodic annuity payments to the annuitant for the remainder of the annuitant's life, and no payment is made upon the annuitant's death. Thus the annuitant's death causes only the cessation of relatively small periodic payments.

By contrast, in a viatical or life settlement transaction, the settlement firm pays a lump sum to the insured up front, the settlement firm makes periodic premium payments to the insurer for the remainder of the insured's life, and the insurer makes a lump sum payment to the settlement firm upon the insured's death. Thus the insured's death not only causes the cessation of premium payments, but also triggers the payment of a relatively large lump sum to the settlement firm.

Insurable interest requirements have been implemented in the case of life insurance to protect the public interest. By contrast, such requirements have been considered unnecessary in the case of life annuities.

The Incentives

An industry cannot grow and prosper without incentives for the participants. The major components of the viatical and life settlement industry are insureds who sell their policies, brokers who find policies, and investors whose funds are used to buy policies.

THE INSUREDS. The insured who decides to discontinue a policy, and whose policy qualifies for a viatical or life settlement, receives more than the cash surrender value of the policy. This is an incentive for the insured to enter into the transaction, but the transaction also involves disincentives that may not be disclosed to or fully understood by the insured.

First, after the insured transfers ownership of a policy, the policy may be transferred again—once or many times—without the consent or even the knowledge of the insured. Thus the insured doesn't know if or when the policy falls into the hands of a disreputable party who thereby acquires a financial incentive to arrange for the insured's early death. As reported in the October 1999 and August 2000 issues of *The Insurance Forum*, an individual who was convicted of murder after hiring a hit man, and who started a viatical firm after he was released from prison on parole, was subsequently convicted of viatical fraud.

Second, when the insured enters into a viatical or life settlement transaction, he or she must provide the buyer of the policy with an authorization for access to the insured's medical records for a long or unlimited time. The reason is that the buyer may decide in the future to resell the policy. Under those circumstances, to negotiate a price, the parties to the resale would need access to the medical records, and would want access without having to obtain a fresh authorization.

Third, receipt of the purchase price by the insured is only one step, and the transaction isn't complete until the insured dies and the death benefit is paid. Consequently, the insured must be "tracked" for the rest of his or her life so that a death claim can be submitted to the insurer in a timely fashion.

THE BROKERS. In 1989, one of the principals of Living Benefits said it would be inappropriate to compensate individuals who find policies for the firm to buy. Today, however, the payment of commissions is standard practice, and some commissions are large. For example, as reported in the June 2000 issue of *The Insurance Forum*, Accelerated Benefits Corporation (Orlando, Fla.) in 1999 paid commissions on 68 policies ranging from 3 percent to 10.4 percent *of the face amount*. The most common commission was 6 percent of the face amount.

The commission paid to a broker in the secondary market provides an incentive for the "unselling" of life insurance, and may dwarf the commissions paid to the agent who sold the policy initially. For example, suppose the premium for a $1 million straight life policy is $20,000 per year. The agent who sold the policy initially might receive a first-year commission of 50 percent of the premium, or $10,000, followed by smaller renewal commissions. The total of the first-year and renewal commissions would be dwarfed by a commission of 6 percent of the face amount, or $60,000, paid to the person who "unsells" the policy by persuading the insured to dispose of the policy in the secondary market. It's ironic that the viatical or life settlement broker may be compensated far more handsomely for an easy selling job—persuading the insured to accept cash for a policy—than the life insurance agent was compensated for a tough selling job—persuading the insured to buy the policy.

THE INVESTORS. Advertisements directed at investors in the secondary market for life insurance policies often exaggerate and improperly characterize the returns investors may anticipate. For example, an investment in a policy on the life of an insured who is expected to die at the end of three years may be described deceptively as providing a "42 percent profit" rather than a 12.4 percent annual rate of return.

Similarly, the "42 percent profit" may be described deceptively as "contractually guaranteed" without disclosure that the date of the insured's death is unknown and that there's no assurance the policy will be in force when the insured dies. As reported in the May 2000 and April 2001 issues of *The Insurance Forum*, it may be difficult for life settlement investors to obtain reasonable annual rates of return.

Pricing methodologies in the secondary market for life insurance policies are shrouded in secrecy. Settlement firms use strange calculations, and deny that actuaries are needed. Instead of deriving prices from year-by-year probabilities of death and survival in the conventional manner, settlement firms use life expectancies. Moreover, "life expectancy" is defined erroneously as the point at which 80 percent or 85 percent of those in a group are expected to be dead. Thus decisions in the secondary market may be based on fallacious reasoning. It's interesting that what may be the first two articles on this subject in

regulate the secondary market for life insurance policies.

an actuarial publication—S&B's article and this article—are written by non-actuaries.

Most investors in viatical and life settlement transactions don't want to be identified. Their reluctance may stem from a concern that their reputations would be damaged if it became publicly known that they're associated with the secondary market for life insurance policies. An exception is CNA Financial Corporation (Chicago). It owns Viaticus, Inc., one of the largest investors in life settlements. Following several years of substantial losses, CNA announced more than a year ago that it wanted to sell Viaticus, but it was unsuccessful in doing so. On July 9, 2001, Viaticus announced to its field force that it had "decided to cease purchasing new policies for an indefinite period of time."

A Regulatory Quagmire

Effective regulation of the secondary market for life insurance policies isn't likely to occur, notwithstanding S&B's assertion that the industry's problems can be solved through regulation. Viatical and life settlement transactions don't constitute the business of insurance, according to several court decisions. Therefore, in the absence of federal legislation similar to the McCarran-Ferguson Act for insurance, state insurance regulators don't have the authority to regulate the secondary market. Yet the National Association of Insurance Commissioners and some states are busy drafting laws and regulations, apparently oblivious to their lack of authority to regulate the secondary market.

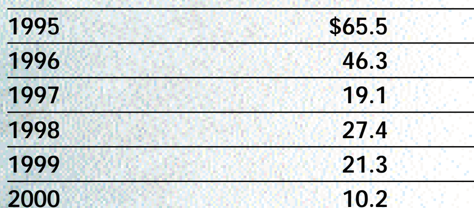
A Shrinking Market

Although S&B present some self-serving projections to suggest that the secondary market for life insurance policies is growing, available hard data suggest the opposite. With regard to viatical transactions, available data suggest that the market has been shrinking recently. Here are data filed with the Texas insurance department by Life Partners, Inc. (Waco, Texas), one of the largest of the viatical firms, showing face amounts (in millions) of transactions handled by the firm from 1995 through 2000 (see Figure 1).

A similar picture emerges from data filed with the Florida insurance department by the eight viatical firms licensed there. (Life Partners is not one of them.) Here are data showing face amounts (in millions) of transactions handled by the eight firms combined from 1995 through 2000 (see Figure 2).

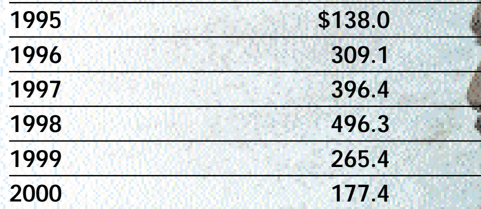
With regard to life settlement transactions, there are no hard data available yet. Some states have taken steps to require firms to file information about life settlements, but the first data won't be available until at least the spring of 2002. Meanwhile, the withdrawal of Viaticus from the life settlement business, as mentioned earlier, and recent securities filings by Life Partners indicating that the firm has yet to consummate its first life settlement transaction, raise serious questions about S&B's rosy projections.

FIGURE 1. Transactions by Life Partners, 1995–2000



Year	Amount
1995	$65.5
1996	46.3
1997	19.1
1998	27.4
1999	21.3
2000	10.2

FIGURE 2. Transactions by 8 Florida Firms, 1995–2000



Year	Amount
1995	$138.0
1996	309.1
1997	396.4
1998	496.3
1999	265.4
2000	177.4

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