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How Substantial Are the Benefits of the Life Insurance Secondary Market for Policyholders, and Insurers?

STATUS: In Progress. Completion Expected January, 2010

LEAD RESEARCHERS: Richard Kopcke and Anthony Webb, CRR at Boston College

ISI OVERSIGHT: Paul Siegert, ISI President and CEO

PROJECT DESCRIPTION: This project undertakes a theoretical and empirical investigation of the impact of the life insurance secondary market on the well-being of current and prospective policyholders and on the economics of underwriting life insurance. The project has three main components: 1) a theoretical component that will construct a model to describe the potential benefits and costs resulting from an expansion of the market for life settlements; 2) an empirical component that will quantify these potential effects based on available data; and 3) an evaluation of the regulatory and public policy arguments for intervening in the life settlement market, using the model developed above.

For policyholders who otherwise would have held their policies to maturity, the market for life settlement generates cash benefits, i.e., market value greater than lapse or surrender value, to the policyholder at no cost to the insurance companies. The interests of both policyholders and insurers are served by the development of an active and competitive market. There are two concerns about this view.

First, life settlements pose a greater risk of adverse selection for insurers, a risk that could increase the cost of providing life insurance in the future. To the extent that life settlers buy policies from people with below-average life expectancies who otherwise would have terminated their policies, life settlements reduce the average life expectancy of the pool of people covered by insurance policies. If insurers have priced their policies to reflect the savings they would realize as a result of terminations by people with below-average life expectancies, then their cost of providing insurance would rise. If, on the other hand, insurance premiums have not reflected this favorable selection in the past, then premiums would not need to change in the future. The market for life settlements tends to increase the demand for insurance as policyholders who sell their contracts replace at least a portion of their insurance with new policies. Also, investors who construct pools of life contracts to sell credit market instruments backed by these contracts might present insurance companies with opportunities to insure the mortality risk in those pools.

Second, some have argued that there may be paternalistic grounds for protecting policyholders from predatory behavior and insurers from adverse selection. We understand that policies sold in the life settlements market tend to cover people with relatively low life expectancies. But the market need not be so limited. Life insurance policies represent an investment by policyholders, an investment that they can terminate or sell as their circumstances or opportunities for making other investments change.

The effective development of the market for life settlements depends on its ability to inform policyholders and serve their best interests, while treating policyholders, insurers, and life settlers fairly and equitably. Regulations that allow all parties the freedom to enter into transactions with full access to information could best promote the markets for both insurance and life settlements.

SCOPE OF RESEARCH AND METHODOLOGY: Data will be gathered on the most common types of life insurance contracts, emphasizing the factors influencing their premiums and cash values. The relative values of these contracts will be determined from the viewpoints of insurers, policyholders, and life settlers both at the time of issuance and over time, as cash surrender values evolve, as policyholders' needs and circumstances change, or as rates of return on other investments change. The treatment of surrenders and settlements under current income tax laws will be considered. Data will be collected that describes the characteristics of contracts that are allowed to lapse, are surrendered, or are settled, including the type of policy, the age of the insured, and the age of the policy. This analysis will compare the occurrence of lapses, surrenders, and sales with the economic incentives implied by our modeling of the valuation of life insurance policies. The potential effects of life settlements on the cost of underwriting life insurance and on the potential design of policies in the future will be evaluated, including how a substantial reduction in lapses or surrenders could affect the economics of providing different types of insurance. The consequences of life settlements on current and prospective policyholders' welfare and the effect of regulation will be evaluated.

RESOURCES:

Filings with insurance commissioners' offices
Insurance industry research: Conning Research; LIMRA; Tillinghast Towers-Perrin
Life settlement participants: Insurance Strategy Group, LLC; Advanced Settlements, Inc.
Life settlement and premium funding companies: Abacus Settlements; Capital Credit Group; Coventry First; Credit Suisse; Life Partners; Life Equity; Living Benefits Financial Services; Mutual Credit; Peachtree Settlement Funding

Insurance companies: AIG; Berkshire Hathaway (Gen Re); CAN; Fortress; GE Capital; Generali Group; Genworth; Lloyd's of London; Royal & Sun Alliance; Transamerica
Banks: ABN AMRO; Allied Irish Banks; Bank of Ireland; Bank of New York Mellon; Citigroup; Credit Suisse; Deutsche Bank, Goldman Sachs; JP Morgan Chase; Mizuho Financial; Royal Bank of Scotland; Suntrust; UBS; US Bancorp; Wells Fargo
Hedge funds: Cheyenne Capital; DB Zwirn; HBK Investments; HM Ruby Fund; LSF Investment Fund; Lydia Capital; Pentagon Capital Management; Reservoir Capital Management; Ritchie Capital; Silver Point Capital
Ratings agencies: AM Best, Fitch
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TARGET RESULTS AND BENEFITS: This study models the market for insurance to estimate the potential benefits and costs of regulations and consider their likely effects on life insurance premiums and the net benefits of life settlements in the future.

TIMELINE: June 2008 – Early 2010

BUDGET: \$120,000