THE SECONDARY MARKET FOR LIFE INSURANCE IN THE U.K., GERMANY, AND THE U.S.: COMPARISON AND OVERVIEW

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Abstract

In this paper, we identify key characteristics and implications of the secondary market for life insurance. We examine the oldest secondary market, which is the market in the United Kingdom, the relatively young market in Germany, and the controversial U.S. market. We summarize available data to describe the current market situation and market potential, which strongly depend on developments in the primary markets and capital markets, as well as on regulatory and legal aspects. Next, we discuss benefits and risks associated with a secondary market, which depend on each market's unique features. The three markets considered in this paper are fundamentally different, and the comparative assessment is intended to offer insight into their functioning and key factors.

1. Introduction

In the secondary market for life insurance, policies are purchased by life settlement providers, market makers, or auctioneers, and are then optionally placed in closed funds (trusts) for life settlement securitization or kept in the buyer's own books. The payment to the selling policyholder is above the surrender value offered by the primary insurer. The investor continues to pay premiums until the contract matures due to death or reaching a fixed term and then receives the contract's payoff. The benefits and detriments of secondary market activities are controversial and, additionally, they depend on the characteristics of the respective market. In this paper, we contribute to the literature by providing a comparative and comprehensive study of the U.K., the German, and the U.S. life settlement market. We identify key characteristics, market situation, and market potential. Furthermore, we discuss implications as well as associated benefits and risks, all of which depend on the marketplace.

A secondary market for life insurance cannot emerge in every country as it—along with legal and other factors—requires, at the least, a sufficient number of target policies in the primary market. Hence, secondary markets exist in the larger worldwide life insurance markets, such as the United States (ranking first in 2006 in premium volume),[1] the United Kingdom (ranking third), and Germany (ranking fifth). Japan (ranking second) has recently become the target of life settlement firms, but the market in that country faces legal obstacles[2] similar to the

[1] See SwissRe (2007).
[2] See, e.g., French (2006).

French market (ranking fourth). Hence, our analysis focuses on the well-developed markets in the United States, the United Kingdom, and Germany.

The specific characteristics of the secondary market differ substantially for each country. An important aspect concerns the type of target policy. In the U.S. senior life settlement market, for instance, life insurance policies of senior citizens above age 65 with below-average life expectancy are traded.[3] In the United Kingdom and Germany, target policies are mainly limited to with-profits and participating endowment contracts with fixed time to maturity.[4] Attitude toward the secondary market among the three countries is also diverse. In the United Kingdom, the secondary market is firmly established and broadly accepted, being regulated by the Financial Services Authority (FSA). The outlook for the German secondary market is cautious since current tax advantages will disappear after January 2009. In the United States, the considerable volume and predicted growth of the life settlement market has aroused both concern and enthusiasm. In September 2007, for instance, Fitch Ratings published an article about the potential risks accompanying the current "gold rush atmosphere" in the secondary market.

The emergence of secondary markets for life insurance is an issue of interest to both practitioners and academics, but the focus of the literature so far has been mainly restricted to the U.S. market. Articles often originate from industry providers or practitioners. Focusing on the U.S. market, Doherty and Singer (2002) examine the benefits and welfare gains induced by the life settlement market from the policyholder's perspective. In Doherty and Singer (2003), possible regulatory actions to protect policyholders and investors are discussed. Kohli (2006) provides an overview of the U.S. life settlement industry and the current regulatory environment, and then examines the model laws proposed by the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL).

To date, no comprehensive studies of life settlement markets in countries other than the U.S. have been conducted. Moreover, the last major U.S. study on this rapidly changing and growing marketplace was conducted in 2002 by Doherty and Singer. In this paper, we broaden the scope of previous analyses to present and compare the main characteristics of secondary markets in the U.S., the United Kingdom, and Germany. These markets are fundamentally different, and the comparative assessment is intended to offer insight into their functioning and key

[3] See, e.g., Doherty and Singer (2002, p. 4). In this analysis, we do not explicitly consider the viatical market, where only policies of terminally ill insureds are traded. For a critical discussion and market description on the shrinking viatical transaction volume and also the life settlement market, see Belth (2002). Bhattacharya, Goldman, and Sood (2004) also focus on the U.S. viatical settlement market. They empirically analyze welfare losses due to price regulation in the United States for a sample of HIV patients.

[4] See, e.g., BVZL (2006), www.apmm.org (Association of Market Makers).

factors. Wherever available, we provide data estimates to tentatively assess the market potential. We also discuss general benefits and detriments of secondary markets. In this analysis, we take a look at several issues that are specific to the U.S. market, originating from its unique characteristics, meaning that the findings cannot be generalized to other markets. Our results indicate that there is substantial growth potential in the U.S. market, whereas the growth potential in the United Kingdom and Germany is possibly more limited.

The remainder of the paper is structured as follows. Section 2 presents characteristics and market situation of the life settlement markets in the United Kingdom, Germany, and the United States. Implications, including benefits and risks, are discussed in Section 3. Section 4 summarizes.

2. The Life Settlement Market in the United Kingdom, Germany, and the United States

An important prerequisite for a secondary market for life insurance is a sufficient size of the primary market. The largest life insurance market worldwide is the U.S. market, which made up 24.2% of the global premium volume in 2006. The United Kingdom reached 14.1% and Germany 4.3% of worldwide premium income (total 2209 billion USD).[5] If policyholders decide against keeping their policies in force, they can either let the policy lapse or surrender it in return for the surrender value.[6] A third alternative is provided by the life settlement market, which allows selling the policy to third-party investors. Insurance companies calculate the surrender value based on actuarial methods that satisfy regulatory and legal requirements and account for expenses, but do not take into account the insured's health status. Thus, the surrender value may differ from the actual economic value of the policy, which enables life settlement firms to offer higher purchase prices.[7] Life settlement providers buy policies and either keep them on their own books or resell them for fees and commissions. Life settlement providers are not the only players in this market, however; quite often these policies are purchased by closed-end funds or institutional investors that provide the necessary equity capital for purchases. Thus, the market not only depends on the supply of enough target policies, but

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5 See SwissRe (2007).

6 Actively exercising the surrender option implies that the cash surrender value of the policy is paid out. In the case of lapsation, this may not be the case as some policies (e.g., universal life) deduct outstanding premiums from the cash value (reserves) until the cash value is exhausted. Hence, the contract is terminated without payout to the policyholder. In contrast, policies with nonflexible premiums lapse if a premium is not paid (typically after a grace period of 30 days), in which case the surrender value is paid out as well (Trieschmann, Hoyt, and Summer, 2004, pp. 325, 341).

7 See, e.g., Doherty and Singer (2002) and Russ (2004). The economic value is given by the difference of expected discounted future benefits less expected discounted future premium payments and expenses.

also on the demand of third-party investors.[8] Overall, the market is not very transparent and often the only statistics available are provided by industry representatives, which are not necessarily reliable. The reason for this lack of transparency is that most life settlement companies are either private, not listed, or not regulated. Hence, it is difficult to obtain information on market volume, market concentration, or monopoly power. Nevertheless, in the sections that follow, data on a market-wide basis are discussed wherever available in an attempt to draw at least tentative conclusions about the development and future of this market.

2.1 The U.K. Life Settlement Market

Characteristics

The first life settlement transaction was an auction of life policies by Foster & Cranfield in 1844, making the United Kingdom the oldest life settlement market in the world. In 1989, the market was successfully established after market makers entered the business, becoming the second institution to be involved in this market, auctioneers being the first.[9] Auctioneers bring together the seller of a policy and potential investors willing to bid on the policy and receive a commission on the purchase price from the highest bidder.[10] In contrast, market makers purchase (and thus also own) life policies and later either resell them to investors for a fee, or keep them in their own books.

Target policies for life settlements in the United Kingdom are exclusively traditional with-profits endowment contracts, which is why the market is also called the "traded endowment policy" (TEP) market. These types of contracts contain three main components: a guaranteed sum assured, already known at the beginning of the contract term; annual "reversionary" surplus that is credited to the reserves and then becomes part of the guarantee (cliquet-style); and terminal bonus participation that depends on the performance of the primary insurer's investment portfolio. British insurers only need to ensure that the guarantee is covered by the reserves and are otherwise free to decide how much stock they will retain within their asset allocation. Thus, investments in stocks have exceeded 50% in the past, which can be attractive from the investor perspective due to the chance of participating in positive market developments.[11] These policies also contain a smoothing mechanism, which is often stated to be an important additional advantage because it reduces the volatility in the bonus component.[12]

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8 On life settlement securitization, see, e.g., Modu (2004) and Stone and Zissu (2006).

9 See BVZL (2006, p. 6), McGurk (1996), www.apmm.org (Association of market makers).

10 See McGurk (1996, p. 2).

11 In Germany, for instance, the portion invested in stocks is limited to 35%. See BVZL (2006, p. 9).

12 See McGurk (1996), Preferred Asset Management (2005), UK Endowments Limited (2003), www.withprofits.de, www.britischepolicen.de. "Smoothing" is the process of not paying out the entire investment surplus but, instead, crediting a relatively stable annual surplus to the policies. The remainder is kept as a reserve for times of bad investment returns to ensure stable bonus rates.

Among the main reasons for taking out endowment contracts in United Kingdom is the repayment of mortgages.[13] Surrender rates of endowment contracts are around 30% in the first few policy years and 40% in the midterm.[14] Thus, only 30% of these contracts are kept until maturity, and surrender rates have been increasing in recent years.[15] The degree of popularity of the life settlement market among policyholders is estimated to be around 85%.[16] This is because starting in 2002, the Financial Services Authority (FSA) imposed a requirement that policyholders willing to surrender must be informed about the possibility of selling their policies on the secondary market. In general, auctioneers and market makers in the United Kingdom are supervised by the FSA. Thus, the life settlement market is regulated and can be considered transparent, and safe for policyholders and investors.

For a policy to be eligible for purchase, it should typically have been in force for at least 5 years with a surrender payout of more than 3,000 GBP (≈ 6,000 USD).[17] The most attractive features for purchasers in the TEP market are the guarantees that accumulated in the first 5 policy years, as well as the optional terminal bonus payment. In addition, after the first years, charges and fees have generally already been paid off by the original policyholder. This is one reason why there is no demand for unit-linked or unitized with-profit policies in the market.[18] According to the Association of Policy Market Makers, the average payment is 10–15% above the surrender value.[19] The investor in the contract receives the living benefit, which mainly depends on the performance of the insurer's investment portfolio (i.e., annual and terminal bonus payments). Therefore, although the payout date is deterministic, the payout

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13 See McGurk (1996, p. 62), UK Endowments Limited (2003).

14 See Smith (2004, p. 13), BVZL (2006, p. 9).

15 Reasons for surrendering a policy mainly include domestic and martial circumstances (e.g., house move, change in mortgage arrangements), financial distress, and change in employment, see Smith (2004, p. 13, 29).

16 This means that 85% of policyholders are informed about the option to sell their policy to the secondary market. See German Life Settlement Association BVZL (2006) (estimates from 2008) and www.britischepolicen.de.

17 Therefore, the time to maturity of the purchased contracts is typically between 6 months to 20 years. See McGurk (1996), Preferred Asset Management (2005), UK Endowments Limited (2003).

18 McGurk (1996) further points out that the surrender value discount of these contracts is lower compared to traditional with-profit endowments and that technical difficulty may arise in pricing, see McGurk (1996, p. 62). Moreover, unit-linked products do not contain guarantees accumulated from the past policy years to be taken over at the time of purchase. Instead, the performance directly depends on the development of the underlying fund and starts at the purchase date. Unit-linked products do not provide optional terminal bonus payments either, which can substantially increase the maturity payout, see http://www.sellinganendowment.co.uk/endowment_policy_types.html.

19 See Association of Market Makers, www.apmm.org. Often, the price is below the guaranteed sum assured. Mortality assumptions are not included in the pricing process, since investors intend to hold the contract to maturity and generally do not verify or report whether the insured has died before then (see McGurk (1996, p. 14)). Hence, no death benefit is in general paid to the new policyholder.

amount is not. The downside risk for investors is restricted to the case where no additional bonus payments are credited to the policy reserves. In addition, investors are partly protected against the primary insurer's insolvency by the Financial Services Compensation Scheme (FSCS), which ensures that at least 90% of the policy value will be paid.[20] The correlation of the maturity payout with the stock market is generally high due to the high stock portion in the portfolio. Due to the decline in stock markets at the beginning of this decade, bonus payments have been substantially reduced by British life insurers since reserves were depleted after the bear market phase from 2000 to 2003.[21] Preferred Asset Management (2005) estimates past average yields on 10-year with-profit endowment policies to be 9.9% in 1996 (real return net of inflation: 5.1%) and 2.7% in 2005 (real return after inflation: 0.1%).

Market and market potential

Due to extensive marketing and the subsequently increasing awareness of the TEP market among policyholders, the British secondary market for life insurance grew substantially in the 1990s from a purchase price volume of 10 million GBP in 1989 to 200 million GBP in 1996 (20,000 policies), as shown in Table 1.[22] In 2001, the volume reached 500 million GBP. Since then, the market has been fairly stable, with approximately 200,000 policies being traded annually with a volume of around 500–600 million GBP (≈ 1–1.2 billion USD) in 2007.

Table 1: Market and market potential of the U.K. TEP market[23]

In million GBP	1989	1996	2001	2003	2007
TEP market (purchase price) volume	10	200	500	500	500-600
Total volume of tradable contracts (surrendered and traded)	-	-	1,000	1,200	-
Trading volume in % of surrender volume of tradable policies	-	-	50.0%	41.7%	-
Number of policies traded	-	20,000	-	200’000	-

Market potential is limited by the surrender volume of the target policies, which in 2001 reached 1 billion GPB. UK Endowments Limited (2003) estimates the volume of tradable policies to be around 1.2 billion GBP. The trading volume thus already makes up between

20 Established by the Financial Services and Markets Act 2000 (effective December 1, 2001), see Preferred Asset Management (2005).

21 See UK Endowments Limited (2003).

22 The available data are very sparse and stem from different sources: McGurk (1996) presents data from 1989 to 1996, the FSA (2001) published a report that includes numbers for 2001, UK Endowments Limited (2003) estimates data in 2003, and the 2007 TEP market volume is estimated by the German Life Settlement Association.

23 For “1989” and “1996,” see McGurk (1996, p. 4); for “2001,” see FSA (2001); for “2003,” see UK Endowments Limited (2003), www.withprofits.de; and for “2007,” see German Life Settlement Association (January 2008), www.bvzl.de.

42% and 50% of the tradable policy market. One fundamental problem in the British secondary market is the decline in new business of the target policy type, i.e., with-profits endowment contracts. Even though endowment contracts still represent a market with large volume, new business has been substantially reduced and is actually insignificant:[24] from 1998 to 2005, new premium volume declined from 965 million GBP to 59 million GBP. On the other hand, persistency rates (i.e., the counterpart to surrender and lapse) have declined as well, i.e., surrender and lapse rates have increased.[25] In summary, the market appears to be stable but limited, as long as with-profits business does not increase.

2.2 The German Life Settlement Market

Characteristics

The German life settlement market was established in 1999 and then grew to be 28 times its initial size by 2007 (from 0.05 billion Euro to 1.4 billion Euro in 2007).[26] In Germany, it is mostly participating endowment contracts with fixed time to maturity and annuities that are purchased. These contracts are similar to U.K. with-profits contracts, but they do not exactly provide a fixed guaranteed sum assured in case of death or survival. Instead, a guaranteed interest rate and surplus are annually credited to the policy reserves, which raise the guaranteed death and survival benefit. As in the case of with-profits endowment contracts, an optional terminal bonus is provided that may further increase the payoff. Hence, in contrast to U.K. endowments, the benefit payment is not fully known at policy inception. The maturity payment is stochastic and depends on surplus participation, whereas the payment date is deterministic. Target policies usually must have a time to maturity of at most 15 years and a surrender value of at least 5,000 Euro (≈ 7,500 USD).[27] The shorter the time to maturity and the higher the maturity payment, the more desirable is a policy.

In Germany, surrender rates are around 30% for 12-year policies, 50% for 20-year policies, and 76% for 30-year policies.[28] The degree of popularity of the secondary market among policyholders is estimated to approximately 20% and only institutional investors can trade; private transactions are not conducted.[29] In contrast to the United Kingdom, insurers are not

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[24] See ABI (2007, pp. 9, 12).

[25] See FSA (2006).

[26] See BVZL (2006, p. 7).

[27] See www.bvzl.de. As in the U.K. market, unit-linked products are currently not traded due to insufficient safety in calculations. However, some life settlement firms have recently begun purchasing unit-linked policies (e.g., cash.life, CFI Fairpay).

[28] See www.bvzl.de, data from the German Insurance Association. In 2006, a survey by the Institut für Demoskopie Allensbach revealed that the chief reason for surrender in Germany is repayment of credit and debt (36%), followed by unemployment (18%) and better ways to invest money (14%) (see BVZL (2006, p. 8)).

[29] See www.bvzl.de.

required to inform their policyholders of the option to sell the contract to the life settlement industry and regulators recently explicitly decided not to pass such a requirement into law.

According to the German Life Settlement Association, sellers receive up to 7% more than the surrender value.[30] In contrast to the U.K. or the U.S. market, the purchaser may additionally pay a reduced death benefit in case of premature death of the insured.[31] Relevant pricing factors include the type of policy, time to maturity, and expected investment performance of the insurance company. Reported returns lie between 4–6%, with a positive correlation with capital markets, which is also due to the limitation on stock investments.

Market and market potential

The size and potential of the German market are currently undergoing substantial change due to adjustments in regulatory frameworks and tax law reforms. A comparison of the volume of surrender payouts with the purchase volume of actually traded policies in the life settlement market shows that there is still potential for growth. In addition, the surrender payout in the life insurance industry is increasing. At the same time, the secondary market trading volume, i.e., the annual purchase volume, has increased considerably since the first introduction of life settlements in Germany in 1999 (see Table 2). The German Life Settlement Association claims that approximately 50% of the surrendered policies are tradable, i.e., they satisfy the desired criteria of investors. This would imply that in 2006, only around 18% of the market potential has been realized, leaving sufficient room for expansion.

Table 2: The German life settlement market[32]

In billion Euro	2000	2001	2002	2003	2004	2005	2006	2007
Traded policy (purchase) volume[33]	0.05	0.15	0.17	0.22	0.40	0.50	1.1	1.4
Total surrender payout in life insurance industry[34]	8.2	8.7	9.2	12.4	12.6	11.5	12.2	-
Trading volume in % of surrender volume of tradable policies (50% of total surrender payout)[35]	1.2%	3.4%	3.7%	3.5%	6.3%	8.7%	18.0%	-

However, several issues give rise to concern regarding the growth potential of the German life settlement market. Until now, policyholders were able to sell their policy tax-free. In case of surrender, in contrast, taxes had to be paid on the surrender payout. This privilege will be lost

30 See BVZL (2006, p. 8).
31 These additional payments amounted to approximately 3 million Euro in 2006. See Bühler (2007).
32 Data from BVZL (2006, p. 7) and www.bvzl.de.
33 Estimate by the German Life Settlement Association. See BVZL (2006) and www.bvzl.de.
34 Data from GDV (2007).
35 Estimate by the German Life Settlement Association. See www.bvzl.de.

after the tax law reform and the introduction of the final withholding tax,[36] effective January 1, 2009, where selling a policy is treated like surrender. In 2008, participating life insurance contracts with a term of less than 12 years can still be sold tax-free, which may create a higher purchase volume in that year. However, if policies are surrendered too early, premium payments already paid into the contract may exceed the surrender payout and thus no income is generated for policyholders, a situation that would limit purchase volume.

Further, changes in pension schemes may decrease the market share of participating life insurance contracts and increase the share of subsidized pension products, resulting in a lower surrender volume of target policies.[37] In contrast to endowments, stronger growth rates were observed in the unit-linked and annuity product sector from 2005 to 2006. The potential for unit-linked policies becomes obvious when comparing the share of new premiums in unit-linked products with respect to new premiums in Europe, which is far below the European average.[38]

Lastly, the attractiveness of participating and with-profits endowment contracts for investors is very sensitive to changes in interest rates. Investors prefer to invest in the capital market when interest rates are high instead of buying life policies. However, when interest rates are low, investment in life insurance policies becomes more attractive.

2.3 The U.S. Life Settlement Market

Characteristics

The U.S. secondary market for life insurance developed in the 1980s with viatical settlements of policies owned by terminally ill policyholders who had life expectancies of less than two years,[39] mainly insureds with HIV/AIDS as no medical treatment was available at that time. Policyholders were often in financial distress due to high medical expenses and thus sold their policies for a discount of the death benefit but for more than the cash surrender value. The actuarial net present values (difference between expected discounted death benefit payment and expected discounted premium payments) of their policies substantially exceeded their surrender values due to their impaired health status and was thus profitable to investors.[40] After new successful medical drugs and treatments for HIV/AIDS were presented at the AIDS conference in Vancouver in July 1996, the viatical market lost substantial volume.[41] To take its place, the so-called senior or life settlement market emerged in the late 1990s, targeted at

[36] Paragraph 52a, Abs. 10 Satz 5 EstG (income tax law "Einkommensteuergesetz").
[37] See development of market share of endowment contracts, GDV (2007).
[38] See CEA (2007, p. 73).
[39] For an overview, see Giacolone (2001) and Ziser (2006, 2007).
[40] See Doherty and Singer (2002).
[41] See Stone and Zissu (2006, pp. 66–67).

policies of insureds above the age of 65 years with a life expectancy of 2–12 years and impaired health.[42] This market comprised a much larger number of policies and a greater growth potential and will be the focus of the following discussion.

The most distinct characteristic of the U.S. life settlement market is that—in contrast to the British and German markets—the great majority of the trading in this market involves (lifelong) permanent universal, variable, and whole life policies as well as—but rarely—term insurance with fixed death protection of insureds with reduced life expectancy. Among these, universal life is the most important segment.[43] Whole life contracts have level premiums, whereas universal life policies allow for flexible premium payments as long as the cash value (policy reserve) remains positive, which is an attractive feature from the perspective of life settlement firms and investors. While the payment amount (the face value) is known, the payment date is stochastic as it depends on the insured's date of death. The longer the insured lives, the more premium payments have to be made and the later the death benefit is paid out. Thus, investors have a financial interest in early death of the insured person, which in the past has raised serious ethical issues, especially due to questionable sales practices of agents.[44]

Policyholders surrender their contracts for new and more attractive policies or when they are in financial distress (e.g., to pay medical expenses).[45] The degree of popularity of the U.S. life settlement business is estimated to be only around 20% among policyholders according to the German Life Settlement Association.[46] If an insured's health status has deteriorated since policy issuance, the policy is more valuable to the owner. Thus, estimating the life expectancy, including longevity risk, is the most important pricing factor and is conducted by underwriters. The four largest life expectancy providers in the U.S. market are 21st Services, AVS, EMSI, and Fasano.[47] In 2005, the purchase price was 20% of the death benefit on average, according to the partial survey by LISA (2007), and 2.7 times more than the cash surrender value.[48] Fees and commissions paid to agents are included in the proceeds paid to sellers and

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42 See Doherty and Singer (2002, p. 4).

43 In the partial study of LPD (2006, 2007), the share of universal life among purchased policies is approximately 80–85%.

44 See Doherty and Singer (2002) and Fitch Ratings (2007). For details on the selling process in the U.S. market, including transaction players, see, e.g., Casey and Sherman (2007).

45 The white paper published by LISA also revealed that the purchase of a more attractive policy is one of the main reasons for selling the original policy to the secondary market (instead of surrendering), see LISA (2006).

46 See www.bvzl.de.

47 See Russ (2005) for an overview of the methods used in life expectancy estimation and a discussion on the goodness of estimates.

48 A preliminary report in 2007 by Life Policy Dynamics LLC (LPD, 2007) showed that the average accepted gross offer for the brokers for all policies was 22% of the death benefit in 2007, see Fitch Ratings (2007). For universal life policies, the offer was 31% of the death benefit and 15% for term policies, with an overall average death benefit of 1.9 million USD per policy and an amount 26%

can make up a substantial part of the premium paid by buyers. The contracts are well suited for diversification purposes since the payout is not correlated with capital market developments. Return on the policies is estimated to be 8–12% per year.[49] However, recent analysis shows that the actual returns fall short of the promised rates because underwriters consistently underestimated life expectancies.[50] Regulation of the U.S. life settlement market varies by state, but is generally light and inconsistent.[51]

Market and market potential

In contrast to the German and U.K. markets, there is more than one data estimate for the U.S. life settlement market. As in the other cases, data are obtained from industry representatives and only allow the indication of basic trends. A summary of published data from four different sources is given in Table 3, including the Life Insurance Settlement Association (LISA, 2007), a Bernstein study by Kamath and Sledge (2005), a survey by Life Policy Dynamics (LPD, 2006, 2007), and estimates from Conning & Company (2007).

Different from Germany and the United Kingdom, the life settlement market volume in the United States is reported in terms of face amount of purchased policies and not in terms of purchase price. In 2007, the U.S. Life Insurance Settlement Association published its first data collection set for the U.S. life settlement market for the years 2004 and 2005. It received data from 11 life settlement providers that it estimated to represent approximately 50% of the U.S. life settlement market. Thus, the data can be considered to indicate some basic pattern for the whole market. The results show that the market size of the 11 firms in terms of death benefits settled increased by 38.3% from 2.80 billion USD to 3.90 billion USD (see Table 3). Kamath and Sledge (2005) estimate the total (accumulated) market size in 2005 at 13 billion USD; Conning Research estimates the size in 2005 at 5.5 billion USD and in 2006 at 6.1 billion USD. The number of policies settled rose by 43.4% to 2,025.

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higher than the cash surrender value on average for all types of policies (which differs from the data by LISA (2007)).

49 See www.bvzl.de.

50 See Beyerle (2007).

51 See Fitch Ratings (2007). Some states do not regulate transactions at all, some states regulate viatical transactions but not life settlements, and others require that the settlement broker (seller) and the settlement provider (purchaser) be licensed, see LISA (2006). Such is not the case, however, for variable policies, over which the Financial Industry Regulatory Authority (FINRA) has general jurisdiction as these contract types belong to the class of securities, see FINRA (2007).

Table 3: Comparison of data estimates for the U.S. life settlement market

In billion USD	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Potential
LISA (2007): Data comprises 50% of life settlement market											
Face amount per year	-	-	-	-	-	-	2.80	3.90	-	-	
Number of policies settled	-	-	-	-	-	-	1412	2025	-	-	
Proceeds paid to sellers	-	-	-	-	-	-	0.48	0.74	-	-	
Surrender value of purchased policies	-	-	-	-	-	-	0.17	0.20	-	-	
Bernstein study (2005):[52]											
Face amount per year	0.2	1.0	1.1	1.3	1.4	2.5	5.0	-	-	-	
Total face amount (accumulated)	0.2	1.2	2.3	3.6	5.0	7.5	12.5	-	-	-	160
LPD (2006, 2007):[53]											
Face amount per year	-	-	-	-	-	-	-	-	0.32	0.60	
Proceeds paid to sellers	-	-	-	-	-	-	-	-	0.09	0.13	
Surrender value of purchased policies	-	-	-	-	-	-	-	-	0.012	0.014	
Conning & Company (2007):											
Face amount per year	-	-	-	-	-	-	-	5.5	6.1	-	+1 per year

The potential size of the market will be restricted by the number of tradable (i.e., otherwise terminated) policies of insureds with impaired life expectancy and the corresponding (typically high) face amount. Table 4 contains data for the U.S. individual life insurance sector. In 2006, in-force individual life insurance amounts to 10 trillion USD, comprising approximately 160 million policies, which illustrates the substantial life market size. Development over the last several years shows that while the number of policies is decreasing, the face value is increasing, which can be considered as a positive signal for the life settlement market since the target policies typically have high face values. In addition, target policies are mainly focused on permanent life insurance (see LPD, 2006; 2007). Table 4 shows that new business in permanent insurance is fairly stable; the same holds true for the total in-force business.

52 See Kamath and Sledge (2005).

53 The survey by Life Policy Dynamics LLC in 2007 (see LPD, 2007) is a sample consisting of 21 contributors, including 14 secondary life insurance brokers, 2 providers, and 5 funders. The largest contribution by any one group was 35 policies, making up 15% of the analysis. The analysis represents 239 policies on 220 insureds. These policies were issued by 53 life insurance companies. In 2006, the survey included 13 contributors (see LPD, 2006): 11 secondary life insurance brokers and 2 providers. The largest contribution by any one group was 27 policies, making up 16% of the analysis. The analysis includes 168 policies on 145 insureds, and the policies were issued by 42 life insurance companies.

Table 4: Individual life insurance in USD, voluntary termination rates and surrender pay-outs[54]

	2002	2003	2004	2005	2006
In force (total)					
Face amount (billions) of policies in force	9,312	9,655	9,717	9,970	10,057
Policies (millions) in force	169.4	175.9	167.7	166.1	160.5
Purchases					
Face amount (billions)	1.75	1.77	1.85	1.80	1.81
Permanent in %	-	29.5%	28.4%	29.0%	28.7%
Policies (thousands)	14.7	13.8	12.6	11.4	10.9
Permanent in %	-	52.8%	55.9%	59.9%	58.9%
Average face amount purchased (in thousand $)	115	119	119	147	167
Combined voluntary termination	8.6%	7.6%	7.0%	6.6%	6.3%
Number of policy terminations (in millions)	14.6	13.4	11.7	11.0	10.1
Surrender value paid to policyholders in million USD	31.4	32.9	34.6	37.2	36.8
Benefit payments in billion USD	30.1	31.8	32.2	32.8	34.5

Another important factor for the life settlement market is the voluntary termination rate (see lower part in Table 5), which has ranged between 6.3% and 8.6% from 2002 to 2006 for individual life insurance. In this segment, 10.1 million policyholders terminated their contracts before maturity. The fact that only 2,025 policies with a total face amount of 3.90 billion USD have been settled by the 11 providers in the LISA (2007) survey shows the importance of high death benefits in the target policies. According to this survey, policies with face amounts of around 1.93 million USD on average have been acquired. This target market seems to be highly restricted since the average face amount purchased in the primary market was only 167,000 USD in 2006. The U.S. life settlement market is generally regarded as having excellent growth potential. The Bernstein study by Kamath and Sledge (2005), for instance, estimates the potential market size as 160 billion USD in total face value transactions by 2030. However, estimation is difficult and these calculations are at most approximate and probably overestimate the potential as the analysis is based on various limiting assumptions (e.g., it relates the accumulated total volume of life settlement transactions to the total number of policies in force). Nevertheless, the market potential is still substantial.

3. Implications of a Secondary Market for Life Insurance

This section discusses some often raised issues related to the secondary market for life insurance that are of interest to customers, the insurance industry, and the life settlement industry

[54] See ACLI (2004, 2005, 2006, 2007).

itself. The relevance of these issues depends on the type of target policies and thus on the market. Often, criticisms are mentioned in connection with the U.S. market.

3.1 Opportunities and Threats for the Life Settlement Industry

In Germany and the United Kingdom, life insurance policies are especially attractive if interest rates are low and insurers credit higher policy interest rates to the reserves by way of smoothing. Particularly valuable are cliquet-style features with their lock-in guarantees.[55] Overall, the contracts can gain substantial value if the investment performance of insurers is good. On the other hand, the return on secondary market policies becomes less attractive if interest rates rise (thus, life settlement firms will not acquire sufficient equity capital for purchases). In addition, reduction in tax advantages, as has happened Germany (see Section 2.2), reduces market attractiveness.

The main advantage of life settlement companies that concentrate on U.S. (permanent) contracts is that the underwriting process for these contracts starts later in the contract term, which may, in principle, allow a better assessment of life expectancy.[56] The life settlement industry benefits from this information since it can offer higher proceeds to sellers (knowing that it will still make a profit by “mortality arbitrage”; see Russ (2005)) than the surrender payout of the primary insurer, which is not based on an insured’s health status.[57] However, profits fundamentally depend on good estimations of remaining lifetimes, and the actual quality of life expectancy estimations is questionable.[58] Therefore, it is not clear how well this advantage can in fact be exploited. For instance, results for the first investment funds with U.S. policies are lower than expected, which may have been caused by estimates of remaining lifetimes that were initially too low.[59] The potential advantage of a later underwriting process does not apply in the case of German and British target policies, as the aim of life settlement firms is to purchase policies with substantial accumulated guarantees. For all secondary markets of life insurance, the trading volume is always limited to the volume of targeted life insurance policies available in the market. Thus, developments in the product sector or reduced purchasing volume will also affect the life settlement industry, as will regulatory restrictions.

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[55] See, e.g., Grosen and Jørgensen (2000).

[56] See Kamath and Sledge (2005).

[57] See Fitch Ratings (2007, p. 5).

[58] See Russ (2005), Ziser (2006).

[59] See Beyerle (2007, pp. 19–20). In November 2004, the life settlement firm Coventry First filed a suit against the medical underwriter 21st Services, claiming that they consistently underestimate life expectancies (see Russ (2005)). The law suit was settled in 2006 when 21st Services' insurer paid an undisclosed sum to Coventry First, and 21st Services implemented an enhanced life expectancy estimation model. However, as demonstrated by the data in LPD (2006, 2007), 21st Services still has the shortest life expectancy estimates among the four large underwriters 21st Services, AVS, EMSI, and Fasano.

3.2 Insurable Interest and Stranger-Originated Life Insurance (STOLI)

One often raised fundamental criticism of the life settlement business is that it implicitly damages the purpose of life insurance, i.e., the insurable interest between insurer, policyholder, and beneficiary is not a given anymore. Thus, life insurance is no longer a vehicle for protecting a family or dependents but, instead, solely an investment product. According to a special report by Fitch Ratings on the U.S. market, this issue may even affect the important tax advantages associated with life insurance, which make up a substantial part of its attractiveness.[60] In turn, a loss in tax advantages would have negative effects on all segments of the life market (primary and secondary markets). Problems and the potential for fraud generally arise if the insurable interest is not given at policy inception.[61]

In the United States, stranger-originated (or investor-initiated) life insurance (STOLI) is considered to be a great problem in the market as it contravenes the insurable interest, which was established by the U.S. Supreme Court in 1911 (*Grigsby v. Russell*).[62] In a STOLI process, the contract is not initiated by the policyholder, but by an investor or third-party lender, who provides the policyholder with funds to cover the premiums and controls the contract as well as benefit payments. Note that STOLI is not the same as the generally common practice of premium financing, which allows persons who perhaps cannot afford premiums but do have an insurable interest to obtain a policy,[63] a practice often engaged in for purposes of estate planning by means of policies with large face amounts. In the case of the newly introduced form of non-recourse premium financing, premiums are financed by using the policy's "market value" (i.e., the price obtained in the secondary market) as collateral for the loan.[64] This type of premium financing can pose a risk to policyholders if it is arranged fraudulently. To clarify this potential risk, consider the following example. At issuance of the contract, the policyholder has prearranged to sell the policy to the investor after expiration of a contestability period of approximately two years. If the insured dies within the first two years, the death benefit less the loan (i.e., the financed premiums), interest, and fees is paid to the heirs, a circumstance sometimes referred to as "free insurance."[65] However, investors may very well decide not to buy the policy after the contestability period because, for example, the insured's health status has changed. In this case, the lender may demand full repayment of the loan,

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[60] See Fitch Ratings (2007, p. 1).

[61] Insurable interest is not violated if policyholders are aware of their option to sell the policy at a later point in time instead of exercising the surrender option.

[62] See Katt (2008), American Council of Life Insurers ACLI "Historical Timeline: Stranger-Originated Life Insurance" at www.acli.com.

[63] See Freedman (2007), Ziser (2007). For premium financed policies see Dunmore (2006), Giacolone (2001).

[64] See Freedman (2007).

[65] See Fitch Ratings (2007, p. 2).

which would otherwise be offset with the transfer of policy ownership. Since surrender values are lower than settlement offers, this represents a financial risk for the policyholder.[66] The life insurance industry considers STOLI to be such a problem that the American Council of Life Insurers (ACLI) publishes a quarterly "STOLI Alert" on its homepage to point out current regulatory developments in the fight against it.[67]

Two proposals to restrain STOLI have recently been developed by state regulators.[68] The National Association of Insurance Commissioners (NAIC) proposed the "Viatical Settlements Model Act," which would prohibit life settlements during the first five policy years. Even though this is a step toward effectively preventing STOLI and enhancing consumer protection, it has the side effect of restricting policyholders' right to sell their policies, at least for those five years, for more than the cash value.[69] On the other hand, other ways of eliminating STOLI are not very promising. For instance, an insurer will hardly be able to prove that a policyholder only took out the policy with the intention of selling it on the life settlement market, especially because premium financing is regularly used by policyholders who actually have an insurable interest.[70] In November 2007, the National Conference of Insurance Legislators (NCOIL) passed the "Life Settlement Model Act," which does not include the five-year ban proposed by the NAIC, but still clearly defines STOLI as a "fraudulent life settlements act."[71] The Model Act prohibits premium-financing companies from owning or being financially involved in the policies they finance. The NCOIL also gives insurers the right to ask whether a potential policyholder has undergone a life expectancy examination or made an agreement to sell the policy.[72] In this respect, the partial survey of Life Policy Dynamics (LPD, 2007) indicated that 16% (39 out of 239 policies in the sample) of the policies purchased were premium financed. Of these policies, 61.5% were not approved by the insurance company. Due to the delicate legal status of STOLI, institutional investors appear to be avoiding buying premium-financed policies.[73]

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66 See Fitch Ratings (2007, p. 3).

67 See www.acli.com.

68 See also Kohli (2006).

69 See www.naic.org, Fitch Ratings (2007, p. 4). The National Conference of Insurance Legislation (NCOIL) is currently developing another model that does not include the five-year restriction.

70 For premium financing, see also www.assetprotectionbook.com.

71 See NCOIL (2007, p. 3).

72 See Fitch Ratings (2007, p. 5), American Council of Life Insurers ACLI "Historical Timeline: Stranger-Originated Life Insurance" at www.acli.com.

73 See Beyerle (2007, p. 17). The Life Settlement Institute, a trade association, has also defined several criteria of premium-financed policies that will make their purchase unethical by the members as the policies violate insurable interest at the time of issuance, such as, e.g., the inclusion of "a requirement that a policy must be sold in the secondary market to satisfy repayment of the loan" (see "Life Settlement Institute Supports Secondary Market Life Insurance Premium Financing Programs" on www.lifesettlementinstitute.org).

In the United Kingdom, the 1854 case of *Balby v. India & London Life* determined that an insurable interest must be given at policy inception only, and not to subsequent assignees. This practice was previously prohibited under the first insurable interest law, which was passed in 1774 (Life Insurance Act).[74] However, premium financing or STOLI incidents are not expected to occur in the United Kingdom, since with-profits policies are bought after being in force at least five years to ensure that the main part of expenses and commissions have already been paid and that the policy value is high enough (surrender value above around GBP 3,000, see Section 2.1). Thus, this criticism regarding absent insurable interest at policy inception or STOLI does not generally apply in the United Kingdom, and much the same is true for Germany as well.

3.3 Implications for Primary Insurer's Policy Pricing

A major concern raised by primary insurers regarding the impact of a secondary market on their own risk situation is related to policy pricing. Key factors in pricing life insurance policies are assumptions on mortality rates, lapse and surrender rates, interest rates, investment spreads, and expenses. Insurers often base their pricing on lapse and surrender rate assumptions in order to reduce premiums (so-called lapse and surrender supported pricing).[75] In general, insurance companies can make a profit from surrender and lapse due to fees on the surrender value, as well as from the lapse of policies that have a premium deduction from cash value (see Section 2), in which case nothing is paid to the policyholder. In both situations, death or survival benefits are not paid. When a policy is sold on the secondary market, investors continue to pay premiums to ensure that the maturity benefit will be paid. Thus, due to the life settlement market, lapse and surrender rates decrease, possibly resulting in reduced profits for the primary insurers.[76] Such variations from pricing assumptions can imply financial risks for primary insurers in all three of the life settlement markets discussed in this paper and require an adjustment. However, lowered lapse and surrender rates also allow a more stable investment in assets, which is an important advantage for insurers. Thus, on the one hand, the liquidity risk is reduced; on the other hand, investments need reconsideration with respect to longer duration and higher yield.[77]

U.S.-specific pricing implications concern adverse effects in a primary insurer's portfolio, which could occur because it is mostly policies of insureds with substandard health that are traded: Policyholders with impaired health (target policies involve insureds with a below-

[74] See McGurk (1996, p. 6).
[75] See Doherty and Singer (2002, pp. 6, 53) and Kamath and Sledge (2005, p. 11).
[76] See Gatzert, Hoermann, and Schmeiser (2008).
[77] See Fitch Ratings (2007, p. 5).

average life expectancy of 2–12 years) do not surrender their policy or let it lapse, and thus high risks remain in the portfolio while good risks continue to surrender.[78]

Further pricing risk from an insurer's perspective arises from a change of policyholder exercise behavior with respect to options embedded in life insurance contracts. Currently, exercise of options is often driven by personal or financial reasons, such as unemployment or repayment of debt.[79] In contrast, life settlement companies may be better capable of exercising options in a financially rational way in order to maximize their payoff due to their higher degree of financial independence and competence compared to private policyholders. Of course, if options are priced adequately, life settlement activities cannot negatively affect insurance pricing. In addition, secondary market activity will not affect primary insurers' pricing assumptions as long as the size of the market does not exceed a critical limit. However, given the growth potential of the market, these implications are worth considering.

Overall, for insurance companies, the emergence and growth of a secondary market for life insurance can be an opportunity for growth, despite its possible impact on pricing assumptions. A higher fungibility of insurance products may imply increasing demand.[80] Reduced surrender rates will also imply a reduction in liquidity risk. Furthermore, insurers should abandon lapse-supported pricing and offer more attractive features in their contracts so as to compete with the secondary market. Such features include accelerated death benefits (i.e., living benefits with reduced death benefits), guarantees on cash value performance (note, also, the trend toward variable annuities), and living benefits (e.g., buy payout annuities from lump-sum settlements).[81] For consumers, too, this development of products with new options and advanced features will be beneficial.

3.4 Reputation and Litigation Risk

Reputational risk and the potential for litigation are relevant to both primary insurers and the life settlement industry. These risks are likely to be realized since life settlement transactions and the corresponding contractual agreements can be highly complex. In addition, broker compensation is often not transparent. The confusion about and insufficient information on fees and rights, especially in regard to older policyholders, is fertile ground for fraud.[82] Although there is regulation in the United Kingdom, the U.S. market is only lightly regulated and Germany has no regulation at all as discussed in Section 2. A reasonable and consistent regulatory framework for the life settlement market would be one that prevents fraud and in-

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[78] See Doherty and Singer (2002) and Kamath and Sledge (2005).
[79] For the surrender option, e.g., see BVZL (2006).
[80] See Doherty and Singer (2002) and Kamath and Sledge (2005).
[81] See Kamath and Sledge (2005).
[82] See Fitch Ratings (2007) and FINRA (2007).

creases transparency for both sellers and investors, thus strengthening the market's growth potential in a consumer-friendly way.[83] It is important to, first, make consumers aware of all the options available when purchasing a life policy and, second, to encourage both consumers and investors to participate in the life settlement market if desired by ensuring a transparent selling process.[84] More transparency is also a major request by the Institutional Life Markets Association (ILMA), which was founded by institutional investors including Bear Stearns & Co., Credit Suisse, Goldman Sachs & Co., Mizuho International plc, UBS, and WestLB AG.[85] The creation of additional business sector associations will be an important step toward more transparency and professionalism in life settlement markets, both of which are essential for a broader acceptance of the life settlement business and also for life insurance carriers. Costs associated with litigation, as well as monitoring and regulatory costs, mean higher expenses for primary insurers, which in turn affects policy pricing.[86] In addition, negative headlines due to litigation could substantially diminish the attractiveness of life settlements to policyholders and thus slow the growth of the life settlement market.

3.5 Benefits and Risks from a Policyholder Viewpoint

From a policyholder viewpoint, the secondary market is mostly beneficial, but does involve some risk. The major benefit is the possibility of selling a policy with long time to maturity for a higher price than the surrender payout, an attractive alternative to lapse or surrender, making investment in a life insurance contract more valuable and flexible. It is especially those policyholders in need of liquidity who are faced with the choice between taking the cash surrender value or selling the policy on the secondary market who will benefit most from the secondary market.This issue is most relevant in Germany, where the main reason for surrender is repayment of credit/debt and unemployment. In the United Kingdom, the most important motives for surrender are changes in domestic and martial circumstances as well as financial distress (see Section 2.1, 2.2.). In the United States, a survey asking about the reasons for selling a contract instead of surrendering it revealed that most policyholders do so in order to purchase a more attractive policy or because their insurance needs have changed; financial distress plays an important role as well.[87]

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83 This is also called for by the Life Settlement Institute, see www.lifesettlementinstitute.org. For a detailed discussion on costs, benefits, and alternatives regarding regulatory issues in the life settlement market, see, e.g., Doherty and Singer (2003) and Kohli (2006).

84 See Doherty and Singer (2003).

85 One main goal of ILMA is full disclosure of all fees in life settlement transactions to increase transparency. The association also supports a prudent regulation of the life settlement and premium finance industries, see homepage of ILMA (www.lifemarketsassociation.org).

86 See Fitch Ratings (2007, p. 5).

87 See Life Settlement Solutions (2007, p. 19; survey among licensed insurance agents) and LISA (2007).

However, policyholders also face an opportunity cost when selling the policy since these contracts can become very valuable, which is not fully covered by the purchase price. The opportunity costs are reflected in the difference between the surrender value and the purchase price, including transaction costs. This is of relevance to policyholders who surrender to buy a new policy. In life settlement transactions, fees and commissions are often not sufficiently transparent and policyholders need to be aware that agents and brokers may have a financial interest in both selling a policy and the subsequent purchase of a new policy.[88] That is, agents may be motivated to recommend a life settlement transaction combined with the purchase of a new policy because the agent will receive two commissions, one for buying the old policy and one for selling a new one. Hence, ethical sales practice is something all life settlement associations demand from their members.[89] Financial consequences for policyholders include the loss of tax benefits, since death benefits are generally tax-free, whereas the lump-sum payment by the life settlement firm is typically taxed as ordinary income.[90] Further, the payment may reduce state or federal support, such as Medicaid in the United States.[91] Privacy and confidentiality are aspects that should be considered when selling a contract. In contrast to Germany and the United Kingdom, in the United States, information on an insured's health status and the results of medical screenings and life expectancy examinations will be provided to investors for decision-making purposes.[92]

There are alternatives to lapse, surrender, or sale that will retain the death protection for the family. For instance, policyholders can ask for loans against the policy surrender value or make the contract paid up. In the latter case, the contract remains in force with a reduced sum assured even though premium payments cease. For with-profits endowment contracts, this option offers the chance of participating in annual surplus and receiving a terminal bonus. In the case of whole life contracts, a (reduced) death benefit is retained. Under certain circumstances, either alternative might be a better choice than selling the policy. In the case of permanent insurance as traded in the United States, the concept of accelerated death benefits (ADB) was developed in the 1990s by life insurers as an answer to the viatical settlement market.[93] Policies with an ADB rider offer the option of receiving between 25–100% of the death benefit in the case of dread disease, long-term care, or terminal illness accompanied by a remaining life expectancy of (usually) less than 12 months. Another attempt to successfully compete with the life settlement market involves expanding the ADB rider to cover chronic

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88 See Fitch Ratings (2007) and FINRA (2007).

89 See, e.g., LISA (2006), homepage of ILMA (www.lifemarketsassociation.org).

90 See Fitch Ratings (2007) and FINRA (2007). Starting January 1, 2009, this will also be the case in Germany.

91 See FINRA (2007).

92 See FINRA (2007).

93 See Doherty and Singer (2002, pp. 31–33) and Giacolone (2001, p. 5).

illnesses.[94] Furthermore, FINRA (2007) points out the option of exchanging the old policy for a new one instead of surrendering (policy switching).

Overall, the increased flexibility introduced by the secondary market can be of substantial value to policyholders willing or forced to surrender their life insurance policies, as shown by Doherty and Singer (2002), but decision making should be informed and take into consideration all transaction costs and options. Aspects of the secondary market that are particularly beneficial for policyholders include the development of more competitive products and options (such as ADB riders), as well as potentially higher surrender values.

4. SUMMARY

This article presents characteristics and implications of the secondary markets for life insurance in the United Kingdom, Germany, and the United States. We analyze the market situation as well as risks and benefits. The discussion shows the extent to which these three markets differ and that risks are particularly present in the U.S. case, where policies of individuals above age 65 with reduced life expectancy are traded. In the United Kingdom and Germany, with-profits and participating endowment policies with a fixed term are traded. These policies are valuable due to their accumulated guarantees at the time of sale.

Several factors are essential to the success of the life settlement market, including supply, demand, and regulatory and legal prerequisites. First, the size of the primary market is crucial so that an emerging secondary market will have a sufficient number of tradable policies, i.e., policies that would otherwise be surrendered. In this respect, it is the U.S. market that has the best availability of target policies, while Germany and the United Kingdom are in a state of stagnation. Second, demand is mainly driven by investors, who require adequate compensation. In this context, lower interest rates will lead to a higher amount of equity capital provided to purchase life policies, especially since life settlements are only lightly correlated with capital market developments. A third factor for success is a sound regulatory environment and sufficient transparency, as is the case in the United Kingdom. In Germany and the United States, regulation either does not exist or is inconsistent. Reasonable regulation and transparency of life settlement transactions, including the disclosure of fees and agent commissions, are crucial to encourage market participation by sellers, customers, and investors. Transparency also involves mandatory information to policyholders about their right to sell the policy as an alternative to surrender, as is implemented in United Kingdom.

The overview presented in this paper shows that these key factors are not fully developed in any of the three markets studied. In addition, the available data shows that the growth poten-

[94] See Doherty and Singer (2003, p. 77).

tial varies substantially between the three: the U.S. market has considerable growth potential but the U.K. and German markets are somewhat limited in this respect due to a loss of tax advantages and a decreasing target policy volume.

The implications of a growing secondary market are manifold. One often debated issue is the question of insurable interest between insurer, policyholder, and beneficiary. In the United Kingdom, this issue was settled by a court case in 1854 that determined that insurable interest must be present at the time of issuance, but not for succeeding assignees. In the United States, stranger-originated life insurance is considered a major problem by primary insurers as well as by life settlement associations. In this case, contracts are purchased without insurable interest, initiated and controlled by investors, and with the sole intent of reselling them on the secondary market.

For policyholders, emerging secondary markets represent a welfare gain, as demonstrated by Doherty and Singer (2002). This is particularly true for policyholders in need of liquidity. However, policyholders in the position to make an active decision as to whether to keep or sell a contract need to be well informed about all alternatives to surrender, such as paid-up insurance or policy switching. In this respect, reduced complexity of life settlement transactions and the disclosure of transaction costs would reduce reputation and litigation risk and ensure market participation by consumers. Life settlement markets are currently comparably small compared to primary insurance markets, but strong growth in the life settlement market will force life insurers to reconsider both their risk management and their policy pricing practices, including the abandonment of lapse-supported pricing. Advantages for insurers include a higher demand for life insurance due to a newly introduced fungibility and flexibility, as well as reduced liquidity risk because of reduced surrender rates. For consumers, the secondary market can mean a considerable increase in the value of their investment in a life insurance contract. In summary, debates about secondary markets for life insurance should take into consideration that the benefits and risks principally depend on each market's characteristics and that the extent of the impact depends on the life settlement market's future growth potential.

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