ETHICAL IMPLICATIONS OF LIFE SECONDARY MARKETS

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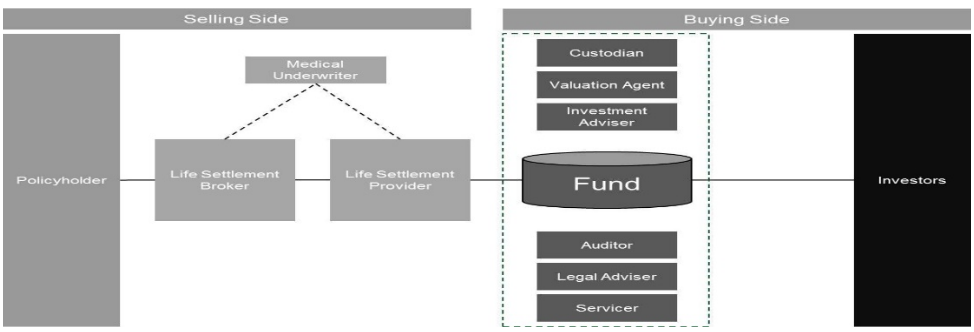
EXTENDED ABSTRACT

A life settlement (LS) is an agreement in which a life insurance policyholder obtains an amount by transferring its ownership to an investor. The buyer acquires the right to obtain the benefits and the obligation to pay the outstanding premiums. The development of life settlement market begins at 80s of the last century with the so-called viatical settlements (VSs) (Giacolone, 2001). The AIDS epidemy that began in that decade, caused to people affected to make their assets liquid to cope with the costly and ineffective existing treatments. The liquidation of the life policies was carried out through the VSs which is the denomination that the LSs have when the insured is a terminal patient. McMinn and Zhu (2017) indicate that in 1990s, due to medical advances, AIDS ceases to be a terminal illness and the VS on this disease decline, starting then the growth of LSs. In the operations of LSs, the insured is not terminally ill, but usually people over 65 years who have a life expectancy below the standard according to their age and sex (Giacalone, 2001). The stimulus to the policyholder for LSs agreements instead of claiming surrender value is given by the higher price that can be obtained with the first option, since they are valued according to the actual life expectancy, which is below the average. On the other hand, the surrender value is calculated with a standard life expectancy.

Figure 1 represents the process of a LS or VS agreement. The policyholder will search for the best price for his policy through a broker. Broker must have informed policyholder on the existence of LSs agreements as an alternative to obtain the surrender value. The intermediaries of the buying party are the suppliers of LSs that acquire insurance on behalf of institutional investors. Latter insurance policies are negotiated in tertiary markets. The complexity of executing LSs implies the intervention of several agents that facilitate the development with maximum guarantees for all parties. A fundamental service is done by the medical underwriters (MU), that quantifies the life expectancy (LE) of the insured.

Figure 1. Life settlement negotiation process



Source: Braun et al. (2016)

Empirical literature outlines the importance of ethical and emotional variables (which often may have been induced by moral considerations) in economic decisions as consumption or the adoption of new technologies (Pelegrin-Borondo et al., 2018; Pelegrín-Borondo et al., 2017). Our paper conducts a conceptual analysis of several ethical and moral problems arising from LSs transactions that will allow evaluating empirically their impact on the possible development of secondary and tertiary markets in less developed insurance markets such as Europeans. In this way Kohli (2006), Blake and Harrison (2008) and Bayston (2015) advice a strict regulation of professional and practice codes for all agents that act in insurance secondary markets. Even some authors like Glac at el. (2012) point out that property right does not imply automatically the right of selling as is the case of second kidneys. So, in their opinion, life insurance policies must fall in this category.

A first ethical concert is due to LSs and VSs modifies the economic purpose of life insurance. The objective of giving an economic protection to policyholder's beloved persons turns into a bet on a death date. This issue may produce several consequences:

1. As it is pointed out by Nurnberg and Lackey (2010), a clear implication was the raising of fraudulent contracts known as STOLIS. STOLIs are new policies that were initially taken out with the financial encouragement of and loans provided by investors, with the intention of being purchased by these investors in satisfaction of the loans at the end of the contestability period, usually 2 years. Unfortunately, in practice it is not easy to demonstrate in a Court tan an STOLI is actually an STOLI.
2. Likewise, despite in 99% times the contracts in the primary market may have an insurable interest, Leimberg (2005) points out that in the secondary and tertiary market insured persons are reduced to financial assets like stocks or bonds.
3. Another consequence, as it is indicated by Gene et al. (2012), is that the definitive beneficiary of the insurance is not designed by the insured person. So the emotional and love link between policyholder and beneficiary implied in primary insurance markets is lost.
4. Braun et al. (2019) point out the possibility that the expansion of LS and VS transactions might trigger widespread increases of insurance premiums and so young families and small business with a fragile financial situations are expelled from primary insurance markets. That is why insurance companies although sometimes denies it, included lapse rates in their policy pricing. LSs market lowered policy lapse rates and reduce insurance companies' margins and so, insurers may raise premiums to balance profit levels.

The second reason to ague is that conventional financial investment generates "good wishes" in the investor. The investor in bonds or stocks is benefited by issuer's business success. On the contrary, the buyer of life insurance policies is benefited by an early death of policyholder. Of course, from the perspective of a large portfolio of LSs it can be argued that the investment is not on a single life death date but on a statistical average (Nolan and Knott, 2013). However, it is also undoubtable that good news as medical advances are always bad news for LSs buyers.

Thirdly Nurmberg and Lackey (2010) and Glac et al. (2012) point out that LS and more specifically VSs transactions in secondary market are done under a policyholder's emotional high stress situation. The originator usually has a terminal ill and needs urgently cash to pay expensive medical cares. So, it is reasonable to suppose that seller's emotional situation is not good to negotiate a fair insurance price. However, LSs and VSs transactions eliminate life insurance monopsony over secondary life insurance markets and so, it is easier for the policyholder to obtain a fair price (Doherty and Singer, 2004). Likewise, due to in the secondary transactions do not act uniquely policyholders and investors but also other agents (see figure 1), whose income usually are a proportion of transaction prices, it is ensured the price agreed is close to the “fair price” (NordShip Association, 2016). In any case, market agents are under an interest conflict (Kohli, 2006) given that they have incentives to facilitating life insurance transactions and so sometimes might hide information to policyholders on possible better alternative sources to obtain cash as surrounding the policy by the facial value (in some exceptional situations) or borrowing founds against the policy.

The fourth consequence is that policyholder losses a great amount of privacy (Glac et al., 2012). On one hand, a great amount of medical information must be provided by the policyholder to price the policy in secondary market. Subsequently, seller’s life is scrutinized until the death date. That is because the policy can be resold (and so, repriced) in the tertiary market and also, of course, because the investor wants to get insurance facial value as soon as possible. For an empirical example on this matter see Dolan (2013).

Another concern is the high moral hazard level existing in LS and VS transactions. It exists in both buyer and seller sides of the market. Agents that are interested in LSs transactions have a greater amount of knowledge and information in insurance issues than policyholders. On the other hand, policyholders have a better knowledge of their health and habits. In this way Glac et al. (2012) expose cases where the seller acted consciously against his health to obtain a better price for the policy.

Blake and Harrison (2008) expose moral objections from non-professional investors (savers) point of view. On one hand, the profit of these assets depends on mortality trends and is not correlated with conventional financial asset prices. Thus small investors may not have information and knowledge enough on LS and VS risks. Likewise, often the decision on investing in these assets is taken by collective found managers and not directly by found owners. So, the possible moral objections against this kind of investment by actual investors are avoided because of a lack of transparency. A further critical factor for investors is the reliability of the LE report since MU are also under a conflict of interests (Kohli, 2006). MUs are under the pressure to make easier LS and VS transactions by underestimating LEs. In this way, notice that several authors as Bauer et al. (2017) or Xu (2019) show that life expectancies provided by medical underwriters have been traditionally possibly underrated.

KEYWORDS: life insurance, insurance secondary markets, life settlements, viatical agreements.

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