Development of Secondary Market in Life Insurance Products: International Survey and Potential in India

Synopsis

1. Introduction:

Secondary market is defined as the market for resale and repurchase of a financial instrument, a service or a commodity. Secondary market is commonly associated with the secondary market in securities or stock market. This thesis deals with a distinct concept of secondary market, that is the secondary market in life insurance. The life insurance contract is generally a long term contract. Hence it is possible that the preferences of the policyholders change with the change in circumstances and he prefers liquid cash instead of life insurance benefits. In this case in the primary market the life insurance firms offer a surrender value for the policies if the policyholder has paid premiums for a specific minimum period of time. eg. 3 years in case of LIC of India policies. This is the arrangement in the primary market. However if the policy rights are transferred in exchange of a cash value to a third party firm then it is a secondary market arrangement. The third party firm would continue paying the premiums and receive the policy benefits. The policy can be sold and resold in the secondary market. This market exists in official segment in some countries like USA, Canada, UK, Singapore since 1990s. In India a few short-lived attempts have been made in the formal sector by some firms. However the trading in life insurance policies continues to exist in the informal sector. This study discusses the potential for secondary market trading in life insurance in India by addressing two questions:

1. Is the trading in life insurance legally permissible in India?
2. Is the trading in life insurance economically viable in India?

These basic research problems are disintegrated into specific objectives.

2. Objectives:

1. To identify the countries where the official secondary market for life insurance products exists with the purpose of examining these markets with respect to evolution, working, growth and regulatory aspects.
2. To verify the legal permissibility of secondary market trading in India.
3. To examine the need for secondary market trading in India in spite of the existence of the primary market arrangements.

4. To identify the proxy variables to estimate the potential demand for secondary market trading in life insurance in India.

5. To define the criteria for economic viability of secondary market trading in life insurance in India and to assess the financial viability of the secondary market trading in life insurance.

6. To examine the earlier attempts to establish this market in India to generate discussion on the response of life insurance firms and implications of the market for various market participants.

3. Data:
The study relies on diverse data sources:

- The Literature survey: The literature from academic, commercial and regulatory sources is available with respect to the markets existing in other countries. The case law and statute law sources are also used. The literature pertaining to the economics of life insurance firm is studied.

- The Secondary data on surrender and lapse/ forfeited policies is used from LIC of India, Annual Reports. The LIC of India data is used throughout the study as it is the largest life insurer in India with wide customer base hence it represents the Indian life insurance sector. The reliable data is easily available for a longer time period to apply statistical procedures.

- The Primary data collected through the interviews with the actuaries, legal experts in the life insurance field and the life insurance officials.

- A case study of the third party trading firm, Insure Policy Plus Services Ltd.

Since several diverse data sources are used for various objectives, a detailed discussion of the data sources is provided in the course of discussing the methodology.

4. Methodology:

4.1 The conceptual background and the taxonomy of the secondary market in life insurance is based on the literature review. The literature survey led us to identify the countries where the official secondary market trading in life insurance exists. Based on the survey of literature we have selected USA, Canada, Singapore, and UK for the purpose of studying the
official market. This selection is based on the criterion of the extent of the official market and availability of information, data and literature. The overview of the markets existing in these countries with respect to the evolution, growth, regulatory aspects is based on the analysis of the literature on the secondary market trading in life insurance in these countries.

4.2 An analysis of various legal sources, the statute law as well as the case law or judicial precedence is used to verify the legal status of trading in life insurance. The arguments about the transferability of life insurance in the name of the third party are based on the provisions in Insurance Act 1938, the Contract Act 1872, The Transfer of Property Act 1882, the Insurance Bill 2002, and the Mumbai High Court Judgement 2007. The survey of judicial evidence is supplemented by the in depth interviews with the legal experts in this field based on unstructured interview schedules.

4.3 The economic viability of the potential market is judged on the basis of two fundamental criteria: a) Demand sustainability b) Financial viability

a) Demand sustainability is verified by estimating the potential demand for the market. The proxy variables of number of policies surrendered, lapse/forfeited and total discontinued indicates the market size in terms of potential volume. The surrender value paid by LIC of India per annum indicates the market size in terms of value of the turn over.

We use Log Linear Regression analysis for projecting the potential market size. The Microsoft Excel software is used for the regression analysis.

b) Financial Viability is defined with the help of calculating internal rate of return on various LIC of India actual cases of policyholders. Twenty five such examples are worked out with diverse plans. The cases are selected randomly from the endowment plans of LIC of India.

The life insurance statistics on surrender value, maturity value, paid up value is calculated with the Visual Magic (LIC) software specially designed for LIC of India products.

The IRR is calculated with the Microsoft Excel software.

4.4 The working of the third party firm in India, the reaction of the life insurance companies, the response of the policyholders, and the practical difficulties are analysed with the help of the case study of the pioneering third party firm in India, Insure Policy Plus Services Ltd.
5. Chapter Scheme

Chapter 1
Introduction
This chapter provides an overview of the concept, the meaning and the taxonomy of trading in life insurance products. The survey of literature reveals the scarcity of literature on the subject. Even in those countries where the market exists, the academic treatment of the subject is rarely found. The sources available are mainly informative commercial literature by the firms operating in the market or the literature for the purpose of consumer/investor information by the regulators. The study classifies the literature according to the source of literature namely, academic, commercial and regulatory.
Almost all the literature is pertaining only to viaticals and life settlements except for a few papers from UK on trade in endowments. In India, the volume of endowment products has been large enough (approximately 85% of the Life insurance market) for the survival of secondary market in endowment products. This is the key argument analysed in the study.

Chapter 2
International Survey
The International survey of secondary market trading in Life Insurance Products brings out a overview of markets existing in the selected countries. Interactions with the life insurance experts in various countries revealed that the unofficial market exists in almost all the countries. However, the data and reliable information on these markets is not available. Even for the countries where the regulated official markets exist, an unbiased, academic treatment of the subject is rarely found. This fact compels us to select a limited number of countries viz. USA, Canada, UK and Singapore. This chapter reviews various aspects of the secondary market for life insurance prevailing in these countries. The chapter is divided into six sections. After the introduction and literature review, the chapter proceeds to discuss the evolution and history of secondary market for life insurance products in various countries. At the outset, the market is classified into viaticals and life settlements on one hand and tradable endowment products on the other hand. It also reviews the viaticals and life settlements industry bringing out the product, industry composition, growth profile and regulatory framework.
This chapter further provides the overview of trading in endowment products on the same lines, viz. the product and industry composition,
growth profile and regulatory framework. It also presents the market realities in these countries based on the news and regulatory literature. The objective of this chapter is to get an idea of how the market actually looks like and to learn from the mistakes and experiences of the market players and regulators in these countries. We observe that the market in these countries is well developed and mature, there are some cases of fraud which are mostly by the policyholders affecting the firms. The regulators are insisting that the policyholders should be made aware of the options available to them in form of trade of life insurance.

Chapter 3
Legal Aspects of Secondary Market trading in Life Insurance Products
This chapter discusses the ‘possibility’ of existence of the secondary market in life insurance products in India. Unless the trading in life insurance is legally permissible, the discussion about economic feasibility is futile. Beginning with the concept of life insurance contract, the chapter proceeds to discuss the principles of life insurance. The principles of insurable interest, indemnity, the concept of wagering have serious implications for the transferability of policy rights and benefits involved in the secondary market trading. It also discusses the provisions regarding the transfer of life insurance and assignment. The Life Insurance Regulation in India including the relevant discussion of the Insurance Act 1938, the Insurance Amendment Bill 2002, and the recent Mumbai High Court decision in March 2007 on the transferability of life insurance products, are the highlights of this chapter. Section 38 of the Insurance act 1938, categorically mentions the provision for the transfer of policy rights in the name of a third party by way of absolute assignment. The analysis leads us to the conclusion that the trade in life insurance products is legal in India.

Chapter 4
Economics of Life Insurance and Trading
This chapter examines the economics of the life insurer in the primary market and the restrictions on providing liquidity to the conventional life insurance product. This chapter sets ground for the discussion on economic viability of the secondary market trading in India by explaining various concepts in Life Insurance that are relevant for this discussion. The economics of life insurance brings out the fact that the insurer cannot offer a higher surrender value to the policyholder. The asset share calculation, surrender value calculation and various approaches to the treatment of the
withdrawing policyholder give the economic reasoning for the low surrender value offered by the insurer. This chapter provides a theoretical basis for the existence of the third party firms.

Chapter 5  
**Economic Viability of Secondary Market trading in life insurance**

This chapter analyses the potential for trading in life insurance from viewpoint of the investor/provider who is concerned about the profitability of the investment. To assess the profitability, the existence of the demand and the rate of return are two important considerations.

Estimation of Potential Market Size: We try to predict the demand for trading in life insurance with the help of Log Linear Regression analysis. The proxy variables of number of policies surrendered, lapsed/forefeited and total withdrawn and the surrender amount paid by LIC of India per annum are identified to represent the potential volume and value of turnover of the secondary market. The details are provided in the section on methodology (section 4.3 a)

The summary of Log Linear Regression is given below in Table 1:

**Table 1**

**Summary of the Log Linear Regression Analysis**

<table>
<thead>
<tr>
<th>Series</th>
<th>$\beta_0$</th>
<th>$\beta_1$</th>
<th>$t$ value for $\beta_1$ ($p$ value)</th>
<th>$R^2$</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of policies Surrendered ${y_1}$</td>
<td>-100.43</td>
<td>0.0569</td>
<td>12.18521(0.000)</td>
<td>0.80057</td>
</tr>
<tr>
<td>No. of policies Lapse/forfeited ${y_2}$</td>
<td>-140.58</td>
<td>0.078</td>
<td>14.96127(0.000)</td>
<td>0.85815</td>
</tr>
<tr>
<td>No. of policies withdrawn ${y_3}$</td>
<td>-130.66</td>
<td>0.0733</td>
<td>19.6548(0.000)</td>
<td>0.9126</td>
</tr>
<tr>
<td>Surrender amount paid ${v_t}$</td>
<td>-282.49</td>
<td>0.1527</td>
<td>36.6739(0.000)</td>
<td>0.9746</td>
</tr>
</tbody>
</table>
The business projections based on the proxy variables, upto the year 2012 are as follows:

Table 2

Business Projections for the Secondary Market Trading in Life

<table>
<thead>
<tr>
<th>Years</th>
<th>Number of surrenders</th>
<th>Number of Policies Lapse/forfeited</th>
<th>Number of total policies withdrawn</th>
<th>Surrender amount paid per annum(Rs, Lacs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>1007719</td>
<td>9285829</td>
<td>15042649</td>
<td>302148.69</td>
</tr>
<tr>
<td>2009</td>
<td>1066721</td>
<td>10039120</td>
<td>16186692</td>
<td>351995.80</td>
</tr>
<tr>
<td>2010</td>
<td>1129177</td>
<td>10853520</td>
<td>17417744</td>
<td>410066.46</td>
</tr>
<tr>
<td>2011</td>
<td>1195291</td>
<td>11733986</td>
<td>18742421</td>
<td>477717.35</td>
</tr>
<tr>
<td>2012</td>
<td>1265275</td>
<td>12685878</td>
<td>20167844</td>
<td>556528.98</td>
</tr>
</tbody>
</table>

Insurance Products based on proxy variables

**Estimation of financial viability:** We look at the profitability by undertaking the financial analysis of the real life insurance cases and calculating the rate of return. The empirical examples of various life insurance products examine the possibility of achieving competitive return without taking into account the death benefit. From 25 examples of various products of LIC of India, we have shown how the return is generated and how it can be increased by policy engineering. Table 3 shows the internal rates of returns on a few of these policies. This return varies according to the policy profile on case by case basis. The third party firm evaluates the policy before purchasing it. This implies that all policies are not equally profitable. The profitability of the third party firm will depend on the costs and the saleable policy block.
Table 3

<table>
<thead>
<tr>
<th>Plan</th>
<th>Return at the end of</th>
<th>IRR</th>
</tr>
</thead>
<tbody>
<tr>
<td>14-15</td>
<td>4th year</td>
<td>12.14%</td>
</tr>
<tr>
<td>112-15</td>
<td>10th year</td>
<td>11.90%</td>
</tr>
<tr>
<td>75-20</td>
<td>7th year</td>
<td>11.55%</td>
</tr>
<tr>
<td>75-20</td>
<td>8th year</td>
<td>13.89%</td>
</tr>
<tr>
<td>14-15</td>
<td>4th year</td>
<td>10.83%</td>
</tr>
<tr>
<td>132-05</td>
<td>4th year</td>
<td>10.76%</td>
</tr>
<tr>
<td>14-25</td>
<td>3rd year</td>
<td>14.28%</td>
</tr>
<tr>
<td>124-15</td>
<td>6th year</td>
<td>10.72%</td>
</tr>
</tbody>
</table>

Return to the Third Party Firm

Chapter 6
Implications of Secondary Market Trading in Life Insurance
This chapter is a medley of various economic, financial, and social aspects of potential for secondary market trading in India. The chapter analyses the effects of trading in life insurance on policyholders, life insurer, investors, and the financial sector. This chapter provides a case study of Third Party Provider Firm- Insure Policy Plus Services Ltd. This chapter also uses the primary data and the interviews with the officials of the third party firm to analyse the experience and the problems faced by this firm.

Chapter 7
Conclusion
The concluding chapter summarizes the observations and findings of the study. These are summarized in the following section.

6. Summary of Findings:

1) Most of the literature on secondary market trading deals with viaticals to the extent that the secondary market trading in life insurance is almost synonymous with the viaticals. Nevertheless, there is a clear-cut difference among various types of secondary market trading in life insurance products. This study classifies the secondary market in life insurance products into three types namely, Viaticals, Life settlement and tradable endowment products. This classification
is apparently based on the type of the policies traded and is seemingly less important because generally a single firm, provider deals with all types of policies. However, this study finds this classification important because the viaticals and life settlements involve speculation about the death of the policyholder as the source of profit while the trade in endowment policies implies that the source of profit is different. The emphasis of the third party investor is not on the death claim as the source of profit in case of tradable endowments.

2) Literature review reveals that the conditions existing in the life insurance sector in India are different than those existing in the countries where the trading at the official level exists. The markets in USA and Canada are mainly for the trade in impaired policies (viaticals) or the life settlements that is the policies of the elders due to the large portion of whole life products in the primary market. The life insurance market in India consists of greater portion of endowment products. The UK model of trading in endowments is more suitable for Indian market conditions.

3) After examining the principles of life insurance, contract of life insurance, the contract act, Transfer of Property Act, and Insurance act, 1938 we arrived at the conclusion that it is legal to transfer the life insurance policy rights in the name of a third party by way of absolute assignment, for monetary consideration. This finding is endorsed by the judgment of the Mumbai High Court.

4) The life insurer cannot offer a higher surrender value because of the restrictions posed by the economics of life insurance firm. The policyholders gain in form of a higher cash value for their policies if a competitive, well-regulated secondary market in life insurance products exists in the organized sector.

5) The projected market size for secondary market trading based on the estimates of surrendered and lapse/forfeited policies and surrender value paid, indicates a highly promising large market favoring existence of a large number of firms. The estimates of market size promise demand sustainability as well as a competitive environment.

6) The empirical study of various real life cases of LIC of India products brings out that this novel product is financial viable for the
investor and the third party firm, given the unique risk-return composition.

7) The study observes that, the secondary market can be financially viable in India nevertheless there can be initial hindrances due to the socio-economic conditions peculiar to Indian life insurance sector. It is observed that,

- In western developed countries like USA, the social security system in these countries enables the third party firm to keep track of the policyholders and claim the benefits in case of death. In India, once the policy is sold to the third party firm it is near impossible to track the policyholder and to know about the death. This creates problem for the third party firm.

- According to the interviews with the life insurance experts, viaticals and life settlements are based on longevity, which seems difficult to be accepted in India on moral grounds. The trading of endowment products can be more acceptable at the same time being profitable for the investor.

- In countries like India, insured are largely ignorant about the working of life insurance and life insurance transfer. It is feared that the secondary market trading will lead to their exploitation.

Proposed suggestions:

- Establishment of a special regulatory body for supervising trading in life insurance products under the already existing authority in life insurance market that is the Insurance Regulatory and Development Authority (IRDA) in India.

- Screening of the third party entrants in the market through licensing to ensure that only reputed, responsible firms can enter the market.

- Close supervision of financial activities of these firms.

- Preventing early, immediate- after- inception transfer of policies in the name of third party to dissuade wagering.

- The trading can be introduced in a phased manner to restrict the existence of underground market. This implies the third party firms benefiting from the financial returns and not the death benefits.
Contribution of the Study:

- The survey of literature and interviews with the experts in life insurance industry indicate that, this research would be the first academic study in India addressing the issue of secondary market trading in life insurance products. The interviews with the life insurance officials reveal that the regulators have assessed the issue of secondary market trading in life insurance; however, the reports are not available in the public domain. In fact, many of the life insurance officials and people related to this field are unaware of various aspects related to trading in life insurance products. Hence, this study is a pioneering attempt to provide a substantial amount of information for anyone who is interested in this area.

- The study provides an international survey of this industry based on the select countries. The academic literature on this subject providing a review of various aspects of this market is rarely found. Most of the literature limits itself to any one country or any one type of product. A simultaneous treatment of all the forms of trading in life insurance viz. viaticals, life settlements and tradable endowments is not available. In fact, the distinct and explicit classification of the market into viaticals, life settlements and tradable endowments is an important contribution of this study.

- This study provides a detailed account of legal aspects of trading in life insurance. There has been a tremendous controversy in India on this issue of legality of trading in life insurance. The study provides an account of all the legal aspects related to the secondary market trading in life insurance, based on the statute law as well as the case law.

- The study provides the estimates of business potential for the trading firms by providing analysis of projected size of the secondary market for life insurance products. The method of regression based on proxy variables for representing the demand for the market is used for this purpose. The study provides actual examples to show how the returns can accrue to the investors by trading in life insurance products. Thus, the study provides not only academic insight into the subject but also can prove to be useful for the industry.

- The study generates discussion on the implications of trading in the life insurance products for the market participants and the life insurance industry. Especially important is the case study of a third
party trading firm in India, which is enlightening not only for the investors, academicians, and the life insurance firms but also for the regulators in India.

The market can be conceptualized as an arrangement for a successful exchange of the product between the buyers and the sellers. If this arrangement is formalized with the support of regulation and institutions, it is the organized market. The prerequisite for existence of any type of market is the demand for the product and the profitability ensuring its survival. The existing need and potential demand for the market cannot be eliminated.

While the experts in India debate on the establishment of the secondary market trading in life insurance, they fear exploitation of the needy policyholders at the hands of third party firms. At the same time, the underground market continues to exist in India albeit in an informal, unregulated, unsupervised form. The absence of organized market invariably leads to the evolution of an unorganized market where the participants and the policyholders with their own exigencies are at the mercy of improper business practices, exploitation, and imperfect market information. In this situation, the regulators should recognize the market demand and provide a set of regulations to govern the working of this market in the official sector.

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