Chapter 1

Introduction

1.0 Preamble:

A few years ago, Mr. Mahato, a humble labourer from an erstwhile ancillary unit near Pune, was standing in front of me; literally bursting into tears. He had come walking more than twenty kilometres; half-starving with empty pockets, in the hope that he will get a few hundred rupees promised by the moneylender in exchange of his life insurance policy, to buy a railway ticket to go back to his hometown to find some work as his factory had been closed down. When I questioned him further I came to know that there were hoards of his colleagues who had lost their jobs in the industrial slow down, attracted to the lurking moneylenders who purchased their life insurance policies in return for immediate cash. These people were so enthralled by the promise of getting cash in their troubled times against a piece of paper (which had no value for them as the factories giving them the employee insurance were closed and they could not pay the premiums) that the question of whether the valuation of their policy is correct never came to their mind.
Why do these moneylenders agree to purchase the life insurance policies and what do they do with these policies? Is there a market in India where this kind of trading takes place? Is this market legal? What is the economics of this market? What would be the implications of this trading for the life insurance sector?

The above questions motivate this study; however, primarily it is inspired by the tears in the eyes of those thousands of ‘Mahatos’ who are exploited at the hands of the opportunistic moneylenders for a few rupees, in spite of owning a valuable asset- a life insurance policy- that they can rightfully liquidate. When I started with the research on this topic, I discovered that the academic literature on this topic in India is not available in the public domain.

Secondary market is one of the most significant phenomena in the financial sector. Although, the term secondary market is usually associated with the stock market, it is characterised by much wider variety of transactions like derivatives, options, futures, mortgage backed and asset backed securities.

As the High Level Committee on Corporate Bonds and Securitization, (2005) under the Chairman- ship of R.H. Patil, reports, “In India, the other exotic forms of secondary market like reverse mortgage, derivative securities, swaps are still in nascent form and even the academic discussions on these newer financial concepts in the Indian context are rare.”
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.

The survey of literature and the interviews with the experts in the 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. For these reasons the study is exploratory in nature. These considerations provide the courage and conviction to adopt this truly unconventional topic for research.

1.1 Structure of the study

The core work is broadly divided into three parts. First part (Chapter 1 and Chapter 2) reviews the concept and working of trading in life insurance products based on the available literature and the study of secondary market trading in life insurance products existing elsewhere. This is the groundwork to examine the intricacies of the market. Second part (Chapters 3,4,& 5) examines the potential for secondary market trading in India from legal and economic perspectives. Chapter 3 provides a detailed study of the legal aspects of trading in life insurance products. This chapter examines the secondary market trading and the transferability of life insurance products in India in the light of the existing legal framework and principles of life insurance. This is to verify the
legal status of trading in life insurance products, which has been an issue of controversy and confusion in India. Chapter 4 elaborates on the need for the secondary market trading in life insurance based on the economics of the life insurance firm. Chapter 5 deals with the economic viability of the secondary market trading in life insurance products. This chapter also attempts to forecast the demand for secondary market trading in life insurance in India, with the regression analysis of the surrender and lapsation. The log linear model is used for predicting the potential market size. This chapter also examines the profitability of the trading in life insurance in India with the empirical analysis of LIC of India, life insurance products.

Third part (Chapter 6) looks into the implications of secondary market trading in life insurance for various market participants. It also provides a case study of the life insurance trading firm, Insure Policy Plus Services Ltd., that operated in India as a third party provider during the period 2000 -2002.

The study is concluded in Chapter 7.
1.1.1 Chapter Scheme

Chapter 1
Introduction

This chapter provides an overview of the concept in section 1.2, the meaning and the taxonomy of trading in life insurance products (section 1.3). The survey of literature in section 1.4 reveals the scarcity of literature on the subject. Even in those countries where the market exists, the academic treatment of the subject is rare. The sources available are mainly in the form of informative commercial literature by the firms operating in the market or the literature published by the regulators for the purpose of consumer/investor information. 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 is large enough for the survival of secondary market in endowment products. This is the key argument analysed in the study.

Section 1.5 gives an account of the data and methodology. The study uses the primary as well as the secondary data. The secondary data is used for the analysis from the Annual Reports of the LIC of India.

The study focuses on the Life Insurance Corporation of India and the statistics provided is pertaining to the LIC of
India. There are two reasons for limiting the study to LIC of India statistics. First is that the private insurance companies in India have entered the market only recently after 2000–01. Hence, the number of their policies acquiring paid up and surrender value is negligible. On the other hand, the enormous volume of LIC of India policies in the market over last more than fifty years renders the Life Insurance Corporation of India a representative of the Indian life insurance sector as a whole; more particularly for the purpose of this study. Second reason for selecting this insurer is that, the LIC of India data is easily available as compared to the data on other life insurance firms. Moreover, the LIC of India data is available for a reasonably longer period; this facilitates the application and reliability of statistical methods.

The analysis of market demand for the secondary market uses the primary data on the surrender amount paid, number of surrenders and lapse policies. These variables reflect the potential demand for trading in life insurance. This analysis is based on the log linear regression. Internal Rate of Return is calculated for the empirical examples of Life Insurance Products to examine the profitability.

The case study of the provider firm for the period 2000 to 2002 brings out the market conditions faced by the third party investor and the provider firm in the secondary market in India. This chapter in the end sets the objectives of the study (section 1.6).
Chapter 2
International Survey

The International survey of secondary market trading in Life Insurance Products brings out the review of markets existing in the selected countries. This chapter reviews various aspects of the secondary market for life insurance prevailing in these countries. The chapter is divided into six sections. After providing the introduction and literature review in section 2.0 and 2.1, the chapter proceeds to Section 2.2 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. Section 2.3 reviews the viaticals and life settlements industry bringing out the product, industry composition, growth profile and regulatory framework.

Section 2.4 gives an overview of trading in endowment products on the same lines, viz. the product and industry composition, growth profile and regulatory framework. Section 2.5 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 to learn from the mistakes and experiences of the market players and regulators in these countries.
Chapter 3
Legal Aspects of Secondary Market trading in Life Insurance Products

This chapter is one leg of the thesis that 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 (Section 3.2), the chapter proceeds to discuss the principles of life insurance (Section 3.3). 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. This chapter also discusses the provisions regarding the transfer of life insurance and assignment. Section 3.1 discusses the Life Insurance Regulation in India including the relevant discussion of the Insurance Act 1938, the Insurance Amendment Bill 2002, and section 3.5 discusses the recent Mumbai High court decision in March 2007 on the transferability of life insurance products.

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, which are relevant for this discussion. The economics of life insurance brings out the fact that the insurer cannot offer 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.

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. The volume of surrenders and the demand in the informal sector show the demand for the market. We try to predict the demand for trading in life insurance with the help of Log Linear Regression analysis. 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 a competitive return without taking into account the death benefit.
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 a 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
This chapter summarises the findings and concludes the study.

1.2 Overview:

Secondary market is defined as a market for resale and repurchase of any commodity or service or financial asset, involving a wider variety of market players than the primary market.

On a broader note, ‘secondary market can refer to the market for any kind of used goods.’

However, the literature pertaining to financial markets frequently uses the term ‘secondary market’ with a limited application only to mean the secondary market for ‘equity’ or ‘stock market’. Even more neglected is the welfare contribution of secondary markets. Secondary markets are more often associated with speculation rather than investment. The contribution of secondary market is providing the ‘liquidity services’. This leads to reduction in the cost of capital and price discovery leading to impact on primary markets and investment.

Since 1980s, newer instruments, products and concepts are being introduced in the secondary equity and debt markets worldwide. Some of these products are developing in the equity markets in India in the form of derivatives, options, futures trading, and over-the-counter market. The debt market is relatively lagging far behind in adopting and assimilating the newer concepts of securitization, swaps, asset-backed or mortgage backed securities. On this backdrop, the present study tries to provide analysis of secondary market in life insurance products with the objective of examining its potential for India. In India, this product is an unknown financial phenomenon not only for the layperson but also for many of the veterans in the life insurance sector.

This study explores the possibility of turning this ‘novel’ concept into a ‘financial innovation’. (Please refer to Box 1.1)
Like any innovative product or process, a new financial product or service earns the right to be called innovative rather than just new or novel, when it is widely accepted, supplanting or significantly supplementing an established financial instrument, institution or process.’(Sametz, 1992). For financial innovation to occur in a market economy, the innovation must attract demand at a price that yields the return over costs (profit) required by the innovative suppliers. In case of tradable insurance products, the study strives to verify the demand and profitability in Indian life insurance environment. There is no substantial, freestanding theory of financial innovation. The analysis of new financial products or processes adopted by financial firms is based on the microeconomic foundations of a profit-maximizing firm. The factors determining or supporting innovative process invariably include the financial regulation especially important in the earlier stages, technology as facilitator of innovation, and taxes. All the above factors specified in the financial innovation theory are vitally important for the emergence of the tradable life insurance market.
The tradable life insurance product in a secondary market would be parallel to an asset-backed security. Hence, the scope of the definition of secondary market for the purpose of this study is broader than the equity market but confined to the secondary market in securities. In case of the trading in certain Life Insurance Corporation of India products, where the bonus is guaranteed, it would be a fixed income security comparable to a gilt-edged security as the Life Insurance Corporation of India with its sovereign guarantee has the least risk of default.

The tradable life insurance can be considered an asset-backed security, with the life insurance as an underlying asset. This would be a novel financial instrument for the Indian investor.

According to the report of the High Level Expert Committee on Corporate Bonds and Securitization, (2005) under the Chairman R.H. Patil, ‘Once the investors are convinced that they are assured of liquidity in the market their willingness to shift from the currently popular fixed income assets like bank deposits to tradable debt instruments like corporate debentures would be greater. ..Therefore, it is more a matter of developing investors’ tastes for such instruments before the fixed income oriented investors willingly start investing in them. In the early stages of development of the debt market, it would be both desirable and necessary to introduce active market making so that investors are assured of liquidity for the debt instruments.’ These comments about
developing the investor tastes can be also indirectly applicable to a derivative product like tradable life insurance.

Patil committee also points out that, Indian investor in the debt market is accustomed to low risk investment and looks for fixed income assets like bank deposits where the principle as well as the return is ‘protected.’

The Indian Investor is less novelty–shy in as much as the market is well regulated and institutionalised as he is used to the paternalistic protection by the Government.

Given these observations, it is to be examined whether the secondary market trading in life insurance products can provide an investment option that suits the preferences of the Indian investors.

1.3 The Concept

1.3.1 The Generic nature of Life Insurance contract

Insurance may be defined from two perspectives: that of a society and that of an individual. From individual’s viewpoint life insurance is an agreement whereby one party pays a stipulated consideration to the other party, in return for which the insurer agrees to pay a definite amount of money if the person whose life is assured dies or suffers illness or disability during the term of the policy.

Life Insurance defined with a broader perspective is a device whereby individuals transfer the risks associated with
life to the group of individuals and which involves accumulation of funds by a group from these individuals to meet uncertain financial losses.

From this definition two key elements of life insurance are highlighted,
1. Transfer of risk from individual to group
2. Sharing of losses by group members.

In addition to this, insurance can be looked upon from a third perspective also, from that of the microeconomics of a life insurance firm.

Primary market in life insurance includes the transactions between the cedant (Potential Policyholder) and the insurer. The cedant pays the premiums and gets the rights to the benefits of the insurance contract in return. This is the primary life insurance market where the transaction takes place between the insurer and the potential policyholder or the cedant.

The generic nature of the contract of Life Insurance is long-term. What if the preferences of the policyholder change due to changed circumstances so that he needs liquidity rather than the policy rights? Naturally, the insured may want to withdraw from the contract due to changing circumstances.

Hence, the provision of surrender of the policy exists in the life insurance contract. If the insured no longer wants to retain the policy contract, he can surrender it to the insurer in exchange of a specified surrender value. This is the arrangement within the primary market as the insurance
contract is surrendered to the primary insurer. This is not the secondary market trading as other than the primary insurer and the insured no third party is involved. The policy owner in this case ‘surrenders’ the policy rights to the insurer and does not’ trade’ it. What happens if the third party firms other than the insurers are allowed to purchase the policy rights from the policyholder?

The following diagram shows the structure of the secondary market vis a vis the structure of the primary market.

**Primary Market**

- **Preimums**
  - Insured → Insurer

- **Policy rights**
  - Insured ↺ Insurer

- **Surrender of policy rights**
  - Insured ← Insurer

- **Surrender value**
  - Insured → Insurer

**Secondary Market**

- **Third party investor**
  - Capital ↓ Returns ↑

- **Policy rights**
  - Insured → Third Party Firm, (provider)

- **Cash value**
  - Insured ← Third Party Firm, (provider)

- **Premiums**
  - Third Party Firm, (provider) → Insurer

- **Policy benefits**
  - Insurer ← Third Party Firm, (provider)
Since the life insurance contract is a long term financial instrument the insurer recognizes the possibility of changed preferences. Hence, there is an option of surrender of the policy to the insurer in return for a surrender value. Cash surrender value is that amount which is available for the policy owner upon voluntary termination of the policy\(^1\). In the primary market, the transaction is between the insurer and the insured. In case the insured wants to discontinue the policy, the insurer is the sole ‘re-purchaser’ of the policies, and the policyholder would take the price quoted by the insurer i.e. the surrender value. This type of market is the monopsony market where there is the single purchaser and a large number of sellers. Therefore, the purchaser has the power to decide the price while the seller has to accept the price.

The secondary market comes into existence when the policy owner sells his ownership rights to a third party investor in exchange of a cash value and the third party investor receives further benefits of the policy. The rights to the life insurance policy are assignable. The participants in the elementary level secondary market are the provider i.e. the firm other than the insurer and the investors who invest in these policies.

The third party firms make slots of the policies and sell them to the third party investors. At more advanced versions, more participants would be involved when complete

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\(^1\) Terminating policy owner may be afforded options as how to utilize the cash value. In India, the private life insurance companies offer the automatic continuation of policy by deducting the premiums out of the surrender value of the policy.
ecuritization structure evolves, with the life insurance bond trading and ‘tradable life insurance –backed securities’.

This is repackaging the financial asset and selling it to the investors seeking returns from the cash flow received by the original asset that is the life insurance product.

1.3.2 Secondary Market trading in Life Insurance in India- A Financial Innovation:

The potential for secondary market trading in India is worth considering because it leads to a unique financial product that is not only revolutionary in the Indian context but also different in its risk and return attributes than its counterparts in other countries.

The tradable life insurance product would be a life insurance–backed security. The asset backed securities existing in India and other markets are characterised by their riskyness determined by the underlying debt or asset. In case of tradable life insurance in other countries, the life insurance as an underlying asset has certain risk element because a private life insurance firm issues the product.

The privatised liberalised life insurance markets in other countries have risks of default in payments of benefits/claims, risk of bankruptcy of the insurance firm. On the contrary, in India, the primary life insurance market is well regulated and dominated by the public sector life insurance giant.
The Life Insurance Corporation of India products have the ‘sovereign guarantee’. These facts render the tradable life insurance products of the LIC of India almost at par with the gilt-edged securities. If the life insurance trading were established, in India, it would lead to an innovative financial asset, having a unique risk-return mix of near zero risk and comparatively high return.

1.3.3 Evolution and growth of Secondary Market in Life Insurance products:

‘It seems that as long as there has been life insurance, there have been insured people willing to sell their policies for cash’. (Quinn, 2005)

There are two categories of transactions discussed widely in the literature on the secondary market for life insurance policies, viaticals and life settlements. Viatical\(^2\) transactions involve the purchase of policies on the lives of insured that are terminally ill or chronically ill. Life settlement transactions involve the purchase of policies on the lives of insured—usually seniors—that are neither terminally ill nor chronically ill.

A “free market” for life insurance policies, as Sippel and Buerger (2002) use the phrase, has existed for centuries and will continue to exist. In 1844, Mr. Elizur Wright the first

\(^2\) Viatical is derived from a Greek word ‘viaticum’ meaning provisions for a ‘long journey’. 
insurance commissioner of USA created a monopsonistic market by compelling the life insurers to purchase the policies for an actuarially specified cash value. Before Wright’s reforms were adopted, a free, ‘underground’ market existed. Wright’s reforms required insurers to include ‘non-forfeiture values’/surrender values in their policies so that insured that discontinued their policies would not be forced to sell their policies in the free/informal market.

Even after the Wright’s reforms, for some time, the insurers offered the non-cash benefits like the extended term insurance cover or the paid up value (to be paid at the end of the term and not immediately) rather than the cash value. The free unofficial market continued to exist for policies whose market values substantially exceeded their non-forfeiture values. This underground market came out of shadows only in the year 1989 when Living Benefits, Inc. (Albuquerque, NM), the first firm in what is now the viatical industry, announced it was going to buy policies on the lives of insured that were terminally ill. Nevertheless, the first discussions of trade in life insurance had begun earlier during 1980s in form of viaticals. Rob Worley set up the first Viatical Company in USA in 1989 and the industry got its formal face. Since then, there have been sixty prominent companies in the USA. In late 1990s, the life settlements as another form of trade in life insurance emerged.

The development of viatical or life settlements is not simultaneous or uniform across the countries. In UK, the
industry evolved in 1980s, in USA it developed in 1990s in some states, while in 2000, in some other states. To quote the Viatical Association of America, (VAA) ‘Press reports have estimated that in 1994, viatical settlement companies bought policies having a face value of $380 million. The VAA estimates this value has increased to somewhere between $420 and $450 million in 1995.’

In India, there have been ad-hoc attempts in the organized sector to establish registered firms for trading in life insurance products. While the informal sector trading continues to exist; the attempts in the organized sector trading in life insurance were aborted because of various reasons discussed at length in the course of this thesis.

In 1993-94, Parekh securities attempted trading in life insurance at Surat but it had to wind up. In the year 2000-01, a registered firm, Insure Policy Plus Services Pvt. Ltd. started trading in life insurance products. These firms faced many difficulties mainly due to the lack of awareness about this concept in India. On March 25, 2007, the Mumbai High Court declared that the transfer of life insurance products in the name of the third party for monetary consideration is legal. It is broadly in keeping with these developments that we have structured this study.
1.3.4 Classification of the secondary market for life insurance products:

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 Life endowment.

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<tr>
<th>Types of Secondary Market Trading</th>
<th>Viaticals</th>
<th>Life Settlement</th>
<th>Tradable Endowment</th>
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<tbody>
<tr>
<td>Impaired Whole-life product</td>
<td>Whole life product</td>
<td>Endowment product</td>
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Viatical is derived from the Greek word ‘viaticum’ meaning ‘a provision for a long voyage’. There is no evidence regarding who has given such an apt nomenclature for the financial arrangement that involves providing money to the fatally ill policyholder for his ‘Last journey’. Viaticals are those policies where the owner is terminally ill. The policy is an impaired policy, in the sense that the death will occur sooner than was originally projected. Therefore, the present value of the death benefit increases. At the same time the present value of
premium payments decreases because the policy will not continue for as long as originally projected. Thus, the actuarial value of the policy increases in these cases. The policy owners are interested in the liquidity for the purpose of medical treatment. Therefore, they sell their ownership rights.

Life settlement is a transaction in which the policyholders sell the rights to the death benefits associated with their insurance policies to the third party settlement companies. The typical market for these products includes individuals over the age of 65 with life expectancies of 4-10 years.

Thus, in case of life settlement product the policy is a whole life policy but not an impaired policy. The owner is not terminally ill. The policyholder is generally above 65 years of age and is interested in getting cash when he is still alive rather than his heirs receiving the money after his death. Therefore, the ownership rights are sold in exchange for the cash value.

A settlement firm, representing third-party investors, provides cash payment to the policyholder that exceeds the cash surrender value embedded in the policy. From that point on, the original policyholder does not have any further involvement or association with the policy. The life settlement firm continues to make the premium payments on the purchased policies to the life insurer, until a death benefit is claimed. The death benefit will be collected by the settlement company and passed on to the third party investors.
An interesting feature of these returns is that they are not highly correlated with their other assets and the current rate prevailing in the economy.

Third form of trading is the trading in endowment policies. This is trading in life endowment products by the policyholders who are in need of urgent cash. Neither the policies are impaired nor the policyholders essentially elderly. The focus of the investor is on the policy benefits accruing from financial engineering rather than the death claim. The rights to the policy are transferred in exchange of the pre-specified value.

Above 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. This classification is significant for discussion of the economic aspects of secondary market trading analysed in Chapter 4 and 5.
1.4 Literature Review:

The literature survey reveals that the academic treatment of this topic is conspicuous by its scarcity. During the literature review it is observed that the purpose and the source of reference (who has written and published the piece of literature) is extremely important, because the focus, the quality of discussion and the arguments are heavily dependent on the purpose for which the studies are made. For example, the literature sourced from a provider firm invariably, argues about the advantages of secondary market trading in life insurance.

Hence, this study classifies the literature into following categories.

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<th>Literature Sources</th>
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<tr>
<td>Academic</td>
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<td>Commercial</td>
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<td>Regulatory</td>
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1) Academic Sources:

About hundred references in this category were reviewed including books and journal articles. It was observed that going against the usual norms of academic literature, this subject attracts paternalistic comments and judgmental views of the researchers. These studies either tacitly or overtly, but invariably, try to prove either the so called ‘evils’ or the ‘blessings’ of the market. For example, Trinkaus and Giacalone (2002) gives an aggressive title to
their paper on viaticals ‘Entrepreneurial “Mining” of the Dying: Viatical Transactions, Tax Strategies and Mind Games’. On the other hand, Viatical Association of America states, “Some media reports suggest that there is a "ghoulish" aspect to the viatical settlement process. What nonsense! Facing one's own mortality is a serious proposition, perhaps something all of us should do more often. There is absolutely nothing wrong with looking at ways to live the last few months or years of one's life with relative comfort and dignity. Viatical settlements are about living, not about dying.”

One can more or less categorize the literature into two camps, an ‘against’ trading camp and a ‘for’ trading camp! Out of these references, only one paper, deals with the trade in endowments. This paper by McGurk, (1996) presented to Staple Inn Actuarial Society, is a rare piece of work on tradable endowment products. This paper presents a vivid picture of trade in endowments, management of the firms, and regulation of the market. All other papers and books are on viaticals and life settlements. Even in academic literature on the subject a rigorous theoretical base for the arguments is rarely provided barring a few exceptions like Doherty and Singer (2003).

increasing the demand for the primary market commodity due to increased liquidity and profit in the resale market. They state that in the life insurance industry where the long-term nature of life insurance makes a potential policyholder think twice, the secondary market offering liquidity would increase the demand. Hence, the secondary market would be beneficial for the incumbent insurance firms.

Doherty and Singer (2002) also compares the effects of enhancements in the primary markets for home mortgage market, catastrophic risk and NASDAQ–Listed securities, after the advent of the secondary market.

According to the study, “....for each industry the consumer in the primary market becomes the supplier of the asset in the secondary market. For example, in the case of NASDAQ-listed securities, the institutional investor serves as the consumer of initial public offerings (IPOs) in the primary market, but serves as the supplier of shares in the NASDAQ over the counter (secondary) market. In all four cases, the entry in the secondary market increases the demand in the primary market and as a result, increases the price of the asset in the primary market. Moreover, the enhancement of the secondary market adds liquidity, and thereby lowers transactions costs between buyers and sellers.”

In addition to analyzing the benefits accruing to various market participants like incumbent insurers, policyholders, investors and the agents, Doherty and Singer also point out that the regulatory environment looking after this industry
needs to have certain regulations to avoid frauds against the investors. Contrary to the common belief that the policyholders would be at the receiving end of fraudulent practices, the study notices that the investors need more protection.

In spite of providing an exhaustive academic discussion of the Tradable Insurance Products (TIP) market, the Wharton study has the inherent feature that the analysis limits itself to the socio economic environment in USA. The analysis is not readily applicable to the less developed overpopulated countries like India. It gives picture of the market where the consumer and the firms are essentially operating in well-regulated, well-informed conditions. The U.S. life insurance sector at the backdrop of the Wharton study is very different from the life insurance sector in India. For instance, the study argues that the incumbent firms would be opposing the secondary market to protect their profits. On the contrary, in the Indian context, the dominant insurer is a state–owned firm, hence the reaction of the life insurer is motivated primarily by the concern about the policyholders’ interest as revealed in the interviews with the life insurance experts.

The Wharton study focuses mainly on viaticals and does not even mention the trade in endowments.

In their second paper ‘Regulating the Secondary Market for Life Insurance Policies’; apart from discussing the benefits of trading in life insurance, Doherty and Singer (2003)
elaborately discuss the strategies adopted by the ‘incumbent’ firms. The case study of the third party trading firm in India (Chapter 6) shows that there is an interesting similarity between the way the life insurers in India responded to the entry of this firm and the strategies described by Doherty and Singer. In India, the life insurers refused to deal with the third party provider firm.

The dissertation by Sood (2003) on ‘Cashing Out Life Insurance: An Analysis of Viaticals Market’, is a vivid and elaborate analysis of the consumer behaviour, decision-making and price regulations in the viaticals market. According to Sood, the empirical observations lead to the finding that the consumer perception of the pricing under uncertain conditions is not correct. In case of viaticals the probability of death of the policyholder, determines the price of the policy. The higher the price quoted implies the higher the estimated probability of early death. Sood’s study provides insights into the consumer perception and valuation of the life insurance products in secondary markets.

Another study by Sood, Alpert, Bhattacharya (2005), titled ‘Technology, Monopoly, and the Decline of the Viatical Settlements Industry’, examines the changing conditions faced by the viatical firms after the higher longevity of the HIV positive policyholders due to technological advancements.

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3The use of the term ‘incumbent firm’ is a misnomer because it implies that the life insurer is ‘the already existing purchaser of the life insurance product’, competing with the third party providers. This is not the case as life insurer cannot be regarded as the competitor to the third party firms even if surrender provision exists.
Giacalone (2001) analyses the benefits of viatical and life settlements. The focus is on regulation and consumer grievances. Although the paper touches many aspects of viatical and life settlements industry, it does not mention trade in endowments.

One of the papers criticizing the trading in life insurance is by Quinn (2002). This paper is an exhaustive critique of trading in life insurance from a sociologist’s viewpoint. In introduction it states (Quinn, p.3), ‘As you might expect of a business that derives profits from the death of strangers, the burgeoning market was seen by many as exploitative, ghoulish and immoral’. It further states that, (Quinn, p4) ’By thus tracing the moral life of a particular market, over time and on a variety of fronts, I hope to show that people use cultural arguments to promote specific financial interests within specific institutional environments.’ This study in the ‘against’ TIPs camp, concentrates on the morality of trading and circumvents the economics of trading.

A study by Greipp (1999), published in American Journal of Hospice and Palliative Medicine, also discusses the viaticals from ethical perspective.

Most moral arguments revolve around the ethics of the third party provider or investor deriving the financial benefits in the event of the death of the policyholder. In fact, this seems to be the only major argument presented against the trade in these papers.
An interesting paper again in the ‘against TIPs’ camp is by Deloitte consulting and the University of Connecticut, (2005) presents a comparison between consumer welfare in case of the sale of the policy as against the life insurance policy which is continued. In spite of the fineness of the actuarial calculations, the study does not provide fruitful analysis because the comparison of these two cases is meaningless. It is comparing the primary market transaction with the secondary market transaction. The report calculates the Consumer Value as the Intrinsic Economic Value (IEV).

The reply to this paper by Singer and Stallard (2005) states that the IEV calculated is just a theoretical value unattainable in the market place. Moreover, it is based on the assumed mortality table. Assuming a standard mortality table is wrong because in the life settlement business the mortality experience varies depending upon the mortality risks.

Singer and Stallard (2005,p11) also point out that the taxation assumptions are misleading, the mathematical formula for IEV is not correct as it assumes that the loaded premium is paid for a fixed period while the premiums are paid as long as the person is alive. The elementary flaw in the argument by Deloitte (2005) is that, it provides meaningless comparison between the primary market value with the secondary market. One cannot compare the retained life insurance policy with the benefit in the secondary market. It is very clearly and obviously beneficial to continue the product. The points is, if the policy cannot be continued due to some reason or if it is in
lapsed condition, then what kind of benefit the policyholder gets.

Trinkaus and Giaclone (2002), argue that ‘It is possible for the terminally ill to sell the life insurance policies wherein the unintended consequence can be a detrimental effect on morally entitled others or the initial beneficiaries. Policy transfers can be made by the insured aged 65 and older, for many reasons, some of which may not be well thought out and even frivolous.’ This is highly paternalistic and biased view of the policyholders’ decision about their own assets.

A paper in the ‘For TIPs’ camp is by Kamath (2005). The paper analyses the growth of viatical and life settlements industry based on statistics and claims that the industry will grow more than tenfold to $160 billion over the next several years. It examines the risks and rewards of this market to conclude that the rewards are greater than the risks in a regulated market.


A paper in ‘against TIPs’ camp by Belth (2002), criticises the viatical and the life settlements on moral grounds. Parker, Rubin, Winslade (2004), brings out a distinct issue by pointing out that the ‘Physician – assisted ‘death by desperate patients could be avoided if the viaticals are provided.
Apart from the papers discussing the morality of the trade, there are a few papers on the regulation of viatical and life settlements. The paper by Glick, (1993) discusses the nature of viaticals as financial instruments and the issue of its regulation.

Morlang (2001) discusses the issue of health information disclosure by the policyholders and the privacy of this information. Actually, the issue does not seem to be as serious as projected because the policies are grouped together in the blocks according to characteristics and these blocks are traded. The name and contact details of the policyholders are not disclosed.

Vivat (2005) focuses on the changes in the life insurance industry and the premium finance industry due to life settlements and emphasizes the need to implement regulation to supervise transactions.

‘Transfer of financial risk and alternative financing solutions Method and system for life settlement contract securitization and risk management’ by Lange (2004) discusses trading in life insurance products and securitization of life insurance risk. This paper explores the role of life settlements as methods and systems for the efficient securitization and also examines risk management of life settlement contracts.

According to Lange, the advantages of the life settlements market include the ability to create securities derived from diverse pools of life insurance related obligations by managing, disaggregating, and recombining the risks of the
underlying life insurance obligations into newly created securities of high credit quality termed Collateralized Life Settlement Obligations ("CLSO"), which can then be offered for sale or as collateral for repurchase (repo) transactions thereby facilitating an efficient and low-cost source of capital for acquiring the underlying life insurance related obligations.


‘Auction system and system of forming investment trust and financial products and funds including viatical and life settlement’ emphasizes the need to enable a commercial trade wherein information about dealing an optional life settlement policy is disclosed transparently and fairly, and deal the life settlement policy at a proper price.

In their article ‘Viatical Settlements Effect on Patients’ Badreshia, Bansal, Houts, Ballentine, (2002) provide empirical estimates of the number of patients benefited from viaticals and their experiences. They put forward the need to inform the patients about this way of financing their medical expenses.
Blake, and Byerly (2004) discusses an important practical issue of the reactions of the family members of the viators to the decision to sell their life insurance for money. The reactions according to the authors are of two types, one is the feeling of relief that the patients themselves are providing for the medical care. In some cases however, family members oppose the decision, because of responsibility toward the patient or because the amount is thought to be less and the heirs want to avail, themselves of the financial return in the future.

Parankirinathan (2006) examines the financial consequences associated with the risk that deaths occurring within a specified period of time in a selected group of insured lives will be less in number than the expected number of deaths or less in amount than the expected amount of death benefits paid. He proposes to transfer this risk. One entity can transfer a financial risk to another entity for the payment of an appropriate premium. The actual number of deaths or the actual amount of death benefits paid during a specified period relative to a selected group of insured lives will be less than the expected deaths or the expected amount of death benefits paid.

The survey of academic sources reveals that,

- The literature does not deal with the distinction among various types of secondary market trading viz. viatical,
life settlements, and tradable endowments and the difference in the profit source. This thesis aims at examining the potential for this market in India with primary focus on the trade in endowment products, which is not discussed in the academic literature at length. The reason is apparently the insignificant market for endowment products in these countries. This study tries to assess the size of the secondary market for endowment products in India and hence, the potential for trade in endowments in India. This issue is unexplored in the literature.

- All of the literature on the subject takes for or against stand and it is taken for granted that the approaches are mutually exclusive. In most of the papers, the reader is almost coaxed into taking one or the other stand on the subject. This study categorically refuses taking any stand on the issue, aims at providing a rational unbiased account of the facts, and expects to draw conclusions subject to these facts only.

- The available literature refers primarily to the market conditions existing in developed countries. The market environment in India is different from that prevailing in the countries under purview of the literature; hence the arguments from the available research cannot be readily applied to examine the potential for secondary market trading in life insurance India.
2) Commercial Literature:

There exists a large pool of informative commercial literature published by the trading companies operating in the countries where the official market exists. Out of the several references in this category, most of these articles are apparently informative but intended to market the product. Obviously, the focus is on the benefits of the industry.

The literature published by the firms dealing in trading in life insurance is an instantly available widest source. This literature gives the basic conceptual idea about the working of the market and about the profile of the companies; actually dealing in the market but naturally lacks a rigorous theoretical analysis. This commercial literature is obviously in the ‘For TIPs’ camp as it aims at briefing the prospective clients. Hence, the focus is on information of the concept in simple terms, giving assurance of a beneficial deal and interactive material to let the interested people calculate the approximate cash value of their policy. The utility of this literature for the thesis is limited to get an idea about some aspects of the working of the market.

3) Literature from Regulatory Authorities:

The papers published by the insurance or financial sector authorities for the purpose of consumer (Policyholder) and investor’s enlightenment regarding the operation and risks in this industry characterize this category.
These consultation papers published by the financial regulatory authorities in various countries are an important source of literature on the subject. These papers not only throw light on the position of the insured or the policyholder in this market but also analyze the risks and related policy regulations necessary for the smooth working of the market as well as for the protection of the interests of the market participants.

The most important reference in this category, on which this study draws upon heavily, is the recent Bombay High court judgment on March 25, 2007 with respect to the secondary market trading in life insurance products in India. Apart from these sources of literature, a small but equally important source is the news on trading, frauds and regulations appearing in various newspapers and tabloids. These give an idea about the actual experience of the market in various countries.

The Survey of Literature indicates that,

1. The literature is heavily biased. It either maligns the market as immoral or glorifies it as charitable. All academic papers surveyed are judgmental on the issue either blatantly or tacitly. One can very clearly identify two opposite camps in the literature, labelled ‘for’ TIP and ‘against’ TIP. This study aims at providing all sorts of arguments and issues of conflicts on the subject albeit from the neutral viewpoint of a rational researcher.

2. The literature addresses the viaticals and life settlements to the extent that the industry is synonymous with
viaticals, although it is just one segment of the secondary market trading industry. This study focuses on trade in endowment products.

3. There is no core theory that could be looked upon as a single theoretical foundation for this phenomenon. The concept provides unlimited linkages and possibilities to be explored in the fields like, legal studies, corporate governance, morals and markets, creation of value, medicine (related to viaticals), life insurance theory and lapse rates, alternative risk transfer, and portfolio theory. This study discusses some of these aspects primarily pertaining to the potential for this market in India.

1.5 Data and Methodology

Data:

The study uses the primary as well as the secondary data sources on the life insurance market. Major sources of the data are,

1) Interviews with the policyholders, Life Insurance experts, officials with Life Insurance Firms and officials of the trading firm in India. The study relies heavily on this source for analysis of various aspects of potential for secondary market trading in India, since no literature is available in public domain.

2) Data and information from the Third party trading firm in India for the case study presented in Chapter 6.
3) The study uses LIC of India statistics from 1964 to 2003, for the regression analysis for forecasting demand for secondary market trading in India. Secondary data on surrender amount paid, number of policies surrendered, lapsed and withdrawn is drawn from Annual Reports of LIC of India. The data on number of policies surrendered, lapse/forfeited and withdrawn and the surrender value/amount paid during the year within India is used.

4) The study uses the Life Insurance Corporation of India bonus tables, life tables and surrender factor tables for analysis of viability of trading in life insurance in India.

5) For the international survey of the market, the study relies on the literature survey and the websites of the international insurance regulatory authorities, and third party trading firms as well as actuarial societies.

This is the study of a potential market for trading in life insurance products that existed for a very short while in an ad-hoc manner in the formal sector, in India. Hence, the data availability has been a major constraint. Hence, we have resorted to a variety of data sources, which were used in the following manner:

- International survey of the market in selected countries is based on the extensive survey of literature. The literature from academic sources, commercial sources as well as from regulatory authorities is examined for this purpose. This is supplemented by the interactions with
the experts from life insurance industry from some countries. 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. 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, Viatical, Life settlement and Life endowment.

- Legal permissibility is examined based on the literature survey, discussions, and interviews with the legal and life insurance experts. The statute law, various acts related to the life insurance is studied along with the judicial precedence or case law. Apart from the recent Mumbai High court judgment (2006), there is not a single source of literature available in public domain on the legal status of the trading in the Indian context. We have reviewed the statute law sources like, the IRDA journals, the Insurance Act 1938, the Contract Act 1872, The Transfer of Property Act 1882, the Insurance
Bill 2000, the Mumbai High court judgment 2006. In addition to these sources, the literature on the principles of life insurance and the case law is also referred.

- Empirical analysis of various tradable life insurance products in India is done with the help of LIC of India products. Twenty-five examples of actual LIC of India policies are worked out to explore the profitability in various different ways. Since these are the actual examples, selection is made on random basis but with a view to work out maximum variety of plans. The focus is on Endowment products.

  Economic viability rests on the demand forecasting. The study tries to provide a broad estimate of future market potential based on, the regression analysis of the proxy variables of the surrender amount paid and the number of policies surrendered, lapse/forfeited and total withdrawn. To estimate the value of the potential business the study also analyzes the surrender value/amount paid by the LIC of India per annum.

  The data for surrender and lapsation is from the annual reports of the life insurance Corporation of India. The data is available in annual reports since incorporation of the LIC of India in 1956; however, the data from 1964 is used for the analysis. Before 1964, the data pertains to the calendar year (January to December)
while the data after 1963 is for the financial year (April to March).

The LIC of India Annual Reports, in the recent years, have certain modifications according to the IRDA rules, hence the statistics on surrender value paid is not explicitly comparable after the year 2001 and the explicit comparable data on surrender and lapse policies is not available in the annual reports after 2003.

Therefore, the period for the regression analysis for number of policies surrendered, lapsed/forfeited, is restricted from 1964 to 2003 while the period of analysis on surrender value paid is restricted from 1964 to the year 2001.

**Methodology:**

1) **International survey of secondary market trading:** For the international survey we have relied on the extensive survey of literature and the interactions with the life insurance experts in various countries.

The survey of literature reveals the scarcity of literature on the subject. Even in those countries where the official market exists, the academic treatment of the subject is rare. Hence, we have selected USA, Canada, Singapore, and UK for the purpose of studying the official market. This is a limitation of this analysis as the selection of countries had to be based purely on the criterion of availability of information and is not representative of the developing or less developed countries.
The conceptual background and the taxonomy of the secondary market in life insurance are 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, and regulatory aspects is based on the analysis of the literature on the secondary market trading in life insurance in these countries.

2) Examination of Legal Permissibility:

The examination of legal permissibility of secondary market trading relies on the literature and the interactions with the legal experts in life insurance field.

The survey of judicial evidence is supplemented by the interviews with legal experts in this field. 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 Judgment 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.

3) Examination of the financial viability:

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

a) Demand sustainability: Demand sustainability is verified by estimating the potential demand for the market. Potential demand can be estimated by analyzing the actual trade in the informal sector. Another way of estimating the potential demand is to use the proxy variables of number of policies surrendered, lapse /forfeited and total discontinued to indicate 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 turnover. The study tries to estimate the demand by using the proxy variables along with the informal sector survey to get the feel of the market.

Estimation with proxy variables: Second set of proxy variables for demand for trading in life insurance in India, is the volume and value of surrenders and lapse policies over the years. The factors leading to surrender and lapsation are the same as the factors that will influence the decision of the policyholders regarding the
selling of his policies in exchange of a cash value. Since the market is nonexistent in the formal sector, statistics on surrender and lapse policies and surrender amount paid by the insurer, serves as a proxy for the potential demand.

The study uses the data on Life Insurance Corporation of India for forecasting the market demand. The reason for selecting LIC of India to estimate the demand is that LIC of India is operating in the life insurance sector for last fifty years, for this reason, this data forms a reliable sample for statistical analysis. Moreover, the LIC of India represents a wide product variety and a wider consumer base.

The private insurers have entered the market after 2000; hence, their accumulated sale being smaller the volume of surrenders is smaller. The data provided by the private insurers is insufficient to get dependable results. The data on lapse and surrender is available in the annual reports and valuation reports of LIC of India. This study is based on the annual reports of LIC of India.

The variables used for indicating the potential demand for trading life insurance are:
1. The number of policies surrendered, lapse/forfeited and withdrawn-indicates the potential volume of demand for trading in life insurance.
2. The surrender amount paid by the LIC of India per annum indicates the value of the potential market for trading. The log linear regression analysis is used to estimate the future market size. The Microsoft Excel software is used for this analysis. Details of the methodology are provided in Chapter five.

Informal sector survey:

Even though the trade does not exist officially in India, selling life insurance policies for money value by way of absolute assignment is a common practice in the informal sector. Since it is an informal trade, statistics on turnover, volume, or pricing (cash values offered for policy) is unavailable. The efforts to interview the moneylenders were failed because of reluctance of the operators to provide detailed answers. To have an idea about the policyholders’ lookout on this matter, we have tried to survey the policyholders with lapsed or surrendered policies. Due to lack of literature and secondary data a field survey of policyholders was conducted to collect qualitative information on the lapsation and surrender or sale of their policies.

The sample was selected on random basis by door-to-door survey of more than 1057 policyholders. We studied 260 cases of lapsation and 25 cases of surrender from various urban, semi-urban and rural areas (in and around Pune,
Ahmednagar, Solapur, Nanded, Baramati, Dhule, Ratnagiri) in Maharashtra.

The detailed methodology of this survey, questionnaires, and the tabulation results are provided in the fifth chapter.

b) Financial Viability: Financial Viability is defined with the help of calculating internal rate of return on various actual cases of LIC of India policies. Twenty-six 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.

Details of the methodology are provided in Chapter five.

4) Case study:

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 analyzed with the help of the case study of the pioneering third party firm in India, Insure Policy Plus Services Ltd.
1.6 Objectives of the study:

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 irrespective 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.

The study aims at examining the potential for the secondary market trading in life insurance products in India. This issue is addressed by asking two questions with respect to secondary market trading in life insurance products; the first question is whether the trading is legally permissible, so that a legal institutionalised structure can be established? Second, is
whether the trading is profitable, so that the market can sustain?

The literature on the subject reveals that a two-pronged approach can be adopted while discussing this topic. One approach is a rational economist’s approach that leads us to think about the life insurance as just one of the long-term financial instruments in the portfolio of an individual’s financial assets and an important source of investment. Second approach is adopting a paternalistic view of the life insurance as the financial support for the dependents of the policyholders.

Referring to the Weber’s distinction between ‘value relevance’ and ‘value judgement’, one can investigate and establish causal relationships between value relevant factors and outcomes. This can be done without permitting the analyst’s own valuation of outcomes to affect the findings. This study aims at discussing the potential and implications of the secondary market trading in life insurance, adopting the ‘Value-free’ approach.