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Traditionally, life insurance has been primarily viewed as a legacy paid to designated beneficiaries after the death of the insured. Increasingly, financial planners, estate planners, and other financial advisors are advising clients to consider their life insurance policies as an underutilized asset that can provide significant financial resources to them while they are still alive (Wolk, 1997; Sutherland & Drivanos, 1999; Levy, 1999; Chodes, Tow, & Hoopingarner, 1998).

Viatical Transactions

Definition and Market Origins

A viatical settlement is one in which a terminally ill individual sells his or her life insurance policy for a percentage of the total face value. The person selling the policy is referred to as the viator while the process is known as viaticating the policy (Wolk, 1997). The market originated as an outgrowth of the AIDS epidemic as a means of obtaining critical financial resources for the last days of life. Improvements in the treatment of AIDS that have prolonged the life expectancies of the patients have resulted in a broadening of the array of terminal illnesses that are considered as potential sources of viatical transactions. Cancer, cardiovascular disease, Alzheimer's disease, and ALS (Lou Gehrig's disease) are among them.

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Factors in the Demand for Viatical Settlements

The financial need of terminally ill patients to fund final health-care and living expenses is the major demand factor in the market for viatical settlements. The sale of an insured's life insurance policy is considered an alternative to surrendering the policy for its cash value or obtaining accelerated death benefits from the insurer. Financial hardship is a major consequence of dealing with a life-threatening disease. According to Sutherland and Drivanos (1999), in the largest study of seriously ill and dying patients published in 1994 in the *Journal of the American Medical Association*, nearly a third of families caring for a seriously ill member lose most or all of their life savings. This fact was found to be true even though 96 percent of these patients had health insurance coverage. Another 29 percent of families lose their major source of income. Moreover, patients whose families experience financial hardship were 30 percent more likely to forego life-sustaining treatment. Other demand factors included the need for funds to pay tax liabilities and efficient wealth transfer to heirs and charities. Favorable tax treatment under the 1996 Health Insurance Portability and Accountability Act (HIPAA) has also helped to drive the market and will also be discussed.

Although viatical transactions are most correctly reserved for those cases in which the life expectancy of the insured is two years or less, the term is often loosely used to apply to other segments of the secondary market for life policies. More information about these segments will be discussed later in this paper.

The Supply Side of the Market

The supply side of the market is comprised of viatical brokers and funding sources, including viatical firms and individual investors. Viatical brokers are those who identify potential viators and help them find funding sources. They are usually paid a fee from the funding source for completed transactions, that is, the purchase of the viator's life insurance policy. The funding sources are firms and individuals that purchase the policies as investments in the hope of making a profit. The source of profit is the policy's death benefit that, theoretically, will yield a return greater than the cost of the policy (what is paid to the viator) and the cost of servicing the policy (premiums and other expenses).

The Extension of the Market: Life Settlements

Although the secondary market for life insurance policies originated among the terminally ill, it has evolved well beyond that constraint. A second category of viatical transaction involves the transfer of a policy in which the insured's life expectancy, though shorter than normal due to chronic illness, extends longer than two years. Chronic illness is defined in terms of an individual's ability to perform various activities of daily living (ADL) or a cognitive impairment such as Alzheimer's disease. At least two ADL limitations, from among eating, dressing, toileting, transferring, and bathing, are the standard for chronic illness required for favorable tax treatment under the HIPAA legislation. The Act includes the sale of life insurance policies by both the terminally ill and the chronically ill as viatical settlements and exempts the proceeds from taxation. The statute characterizes "viatical" as a situation in which the patient is certified by a physician to have a 70 percent probability of a life expectancy not exceeding 24 months. Another condition for the tax exemption is that the viatical firm is duly licensed in the viator's state or complies with the conditions stipulated in the Viatical Settlements Model Act (VSMA, 1994) promulgated by the National Association of Insurance Commissioners.

Two other segments of the secondary market for life insurance policies also exist. Though they are sometimes referred to as viatical transactions, they technically are not since the sellers of the policies are neither terminally ill (the original meaning of viatical) nor chronically ill (viatical in the context of HIPAA). The policy sellers may be elderly, but they have normal life expectancies. One of these segments involves high-net-worth transactions, sometimes referred to as senior settlements or life settlements because the sellers are wealthy senior citizens who sell policies they no longer want. The other segment, which is highly controversial, involves the transfer of a newly issued policy, a so-called "wet-ink" transaction. Essentially, these policies are purchased for the express purpose of selling them immediately.

Increasingly, financial planners, estate planners, and other financial advisors are advising clients to consider their life insurance policies as underutilized assets that may provide significant financial resources while they are still alive. Thus, a growing need for such financial professionals to learn about viatical and life settlements if they are to properly serve their clients has arisen.

Limitations on the Market

Consumer Issues

Consumer issues range from basic concerns about fair pricing of insurance policies (Wolk, 1997) to the possibility of foul play due to the purchaser's lack of insurable interest in the life of the insured (Belth, 2000a). The latter issue derives from the fact that, historically, beneficiaries of life insurance policies were expected to have a close tie to the insured, an "insurable interest," to the extent that they wanted the life of the insured to be preserved. Since in a viatical transaction the investor has no such insurable interest and an early death of the insured serves to maximize an investor's return, Belth (2000a) contends that this situation invites the possibility of homicide. Belth (2000a) argues that this risk is heightened when subsequent transfers of the policy in the secondary market occur. Though no cases have been reported, Belth does not dismiss the possibility and calls for tight regulation of both brokers and viatical firms as well as a high degree of anonymity for the policy seller's identity. Such a scenario may seem to be extreme, but it reflects the fact that the key participant in a viatical transaction is in a very vulnerable physical and mental state and, therefore, requires and deserves a high degree of consumer protection. *Newsweek* columnist, Jane Bryant Quinn, recently brought these issues to widespread public attention (Quinn, 2001).

A more pertinent consumer issue involves the proceeds received from the sale of a life policy. Those proceeds may range anywhere from as little as 30 percent of the face value to as much as 85 percent of the value. The amount varies inversely with the life expectancy of the insured. Policies with "waiver of premium" riders are also considered more valuable. Other influencing factors include the existence of policy loans, the rating of the policy issuer, the remaining premiums, and the cost of money (Sutherland & Drivanos, 1999). Unlike the pricing of new life policies, the price paid for a policy in the secondary market is not based on actuarial data (Belth, 2000a). Thus, the amount offered by different buyers varies widely, and the determination as to whether the offer is fair may be difficult. Consumer advocates for viators recommend that at least three bids be solicited for policies (Wolk, 1997).

Another consumer issue relates to the tax implications of a viatical settlement. Under the Health Insurance Portability and Accountability Act (1996), only the proceeds of viatical transactions that meet the strict definitions of terminally ill or chronically ill are tax exempt, any assertions to the contrary notwithstanding. Thus, other policy sellers must be aware of the tax liability that may be incurred.

Investor Issues

Investors in viatical transactions are also vulnerable to misrepresentation and possible fraud with respect to the risks involved. For example, "wet-ink" transactions, in which individuals are induced to purchase a life insurance policy and immediately re-sell it, are especially susceptible to fraud. In such cases, the insurability of the prospect may be distorted so as to make it contestable by the insurance company. This possibility creates a significant risk for investors who buy such a policy. In general, investors should carefully ascertain that the policies in which they are investing are beyond the contestability period, normally two years.

Contestability is only one from a possible array of risks that may not be disclosed by brokers and viatical firms. Other risks may include the assignability of the policy, the sanity of the viator, the existence of a waiver of premium rider, suicide exclusions, and the quality of the insurer (Sommer, Gustavson, & Trieschman, 1997). Since such disclosures are not legally required, potential investors must be extremely wary and must ask the right questions.

Regulatory Issues

At this time, the industry is very loosely regulated. However, consumer and investor concerns have sparked a call for a higher degree of regulation, over the objections of viatical firms (Belth, 2000a and 2000b; Wolk, 1997; Wolk, Wood, & Taylor, 1998). Such regulation is perceived by the industry as a factor negative to its future growth. A major stumbling block in regulating the industry is determining which authorities, if any, have proper jurisdiction of the industry. Since the product involved is an insurance policy, some argue that viatcial transactions fall under the jurisdiction of state insurance departments. Others contend that viaticating a life insurance policy, especially when it is divided and sold as fractional shares, makes the policy a security and should, therefore, be under the jurisdiction of the Securities and Exchange Commission.

National Association of Insurance Commissioners

A minimal attempt at regulation is a licensing requirement imposed by some 19 states on viatical brokers and firms, largely aimed at affording consumers a modicum of consumer protection. In some states, the brokers and funding companies must both be licensed while in others only the funding company must have a license. Of course, as in many industries, a license is no guarantee of fair treatment nor does a licensing requirement preclude unlicensed firms from operating. However, when a broker or a firm subjects itself to licensing requirements, the degree of disclosure and openness is usually higher. Licensing is the main component of the Viatical Settlements Model Act adopted by the National Association of Insurance Commissioners in 1994 (Tomes & Orscheln, 2000).

Although viatical and other life settlements are based on life insurance policies, they are not life insurance policies and do not automatically come under the regulatory jurisdiction of state insurance departments. However, the National Association of Insurance Commissioners (NAIC) has taken the lead and its Model Act has been adopted by 22 states as the basis for regulations pertaining to the viatical industry. The focus of the original model legislation has been broadened from terminally ill sellers to chronically ill sellers and now attention is being focused on protections for healthy purveyors of life insurance policies (Panko, 1999; Tomes & Orscheln, 2000).

Securities and Exchange Commission

The Securities and Exchange Commission (SEC) is of the opinion that the sale of fractional shares in viatical settlements to individual investors involves the sale of unregistered securities and should be proscribed unless they are properly registered. As securities, these settlements would come under the regulatory jurisdiction of the SEC. In 1996, the SEC litigated the matter in federal district court and won. However, in the appeal that followed, the U. S. Court of Appeals ruled that fractional interest in viatical settlements was not a security and, thus, was not subject to SEC regulation. This decision left investors without any federal protection, and some states have enacted legislation that mandates certain disclosures to investors. For example, Iowa has put viatical settlements under the jurisdiction of its securities bureau, and Florida requires that investors receive certain disclosures relative to their risk. Tomes and Orschlen (2000) do not believe the issue of federal regulation is over and expect it to be revisited by the federal courts, possibly even the U. S. Supreme Court.

Thus, currently, the courts have determined that viatical transactions are neither securities nor insurance contracts. Therefore, it has fallen to the states to make their own regulatory determinations.

Self-Regulation via Trade Associations

Viatical companies and industry professionals have attempted self regulation through trade associations as a method of heading off government regulation that might seriously restrict the industry's growth and development (Panko, 1999). Two such trade groups are the National Viatical Association (NVA), founded in 1993, and the Viatical and Life Settlement Association of America (VLSAA). The latter is an offshoot of the NVA and grew out of differences about membership qualifications. Founded in 1994 as the Viatical Association of America, it underwent a name change in 2000 to reflect a broadening of its market beyond the terminally and chronically ill. The NVA claims a membership of about 20 while the VLSAA has a membership roster of about 40. Both groups are located in Washington, DC, presumably to be in a convenient position to lobby on behalf of the industry. Each group maintains a website (www.nationalviatical.org for the NVA and www.viatical.org for the VLSAA) that provides information about the industry, organizations, and their memberships. In general, both groups favor full disclosure to both clients and investors. Both have a code of ethics to which their members must subscribe, and both organizations subscribe to the NAIC Model Act and work with insurance commissioners for its improvement. The VLSAA (1996), however, also commits its members to obtaining a license or other required authorization before doing business in any state where such is required or they must forego buying or brokering policies there. Moreover, the VLSAA (1999) has taken an explicit stand against "wet-ink" transactions.

Sources of Competition

Accelerated Death Benefits

Since 1988, many life insurance companies have made it possible for the terminally ill to access their life insurance through an accelerated death benefit (ADB). At the end of 1997, it was estimated that there were about 40 million individual policies or group certificates that included such an ADB option (Middleton, 2000). Some 77 percent of companies offer ADB as an option while others include it directly in the policy. The life insurance industry uses several "triggers" to initiate the accelerated death benefit. Three-quarters of the companies require a maximum life expectancy in the range of six to twelve months. Other triggers include the occurrence of certain "dread diseases" and the need for extended or permanent confinement to a nursing home. In general, the ADB is limited to about 50 percent of a policy's face value although some companies pay more. Many, however, place a cap on the dollar payout. Payment is usually provided in a lump sum distribution though periodic payments may also be possible. Under the HIPAA legislation, accelerated death benefits are tax free.

Wolk (1997) argues that, in some circumstances, accelerated death benefits may provide a higher payout than a sale of the life insurance policy. So, whenever possible, the ADB option should be compared to the outright sale. Of course, the conditions under which accelerated death benefits will be paid are much more restrictive than those under which a viatical firm would purchase a policy. Terminal illness with a life expectancy of twelve months or less is the usual "trigger" for the ADB whereas even healthy individuals can sell their policies.

Accelerated death benefits will compete favorably with viatical transactions since persons with a life insurance policy already have a relationship with the company. Engaging in a viatical transaction is more complex since it requires the use of other agents (brokers, funders, and investors) to complete the process. However, insurance brokers and subsidiaries of life insurance companies have become involved in the viatical business as well.

Reverse Mortgages

It is widely recognized that home equity is the largest financial asset held by the elderly. Like life insurance, home equity is an underutilized asset for many. The fact that home equity may provide financial resources for the final days of the terminally or chronically ill is obvious. Of course, like life insurance policies that are sold, home equity loans reduce the estate of the owner's original beneficiaries.

The reverse mortgage is a financial arrangement that allows an elderly homeowner to tap the home's equity while allowing the homeowner to continue to reside in the home. The ability to get cash out of the home while remaining a homeowner is an attractive option to some elderly (Kistner, 1999). Lenders make a loan against the appraised value of the home with the loan amount unrelated to the borrower's income or credit standing. The home location and value, the age of the borrower, and the characteristics of the lender are the primary variables. The loan is secured solely by the borrower's home so no other assets are at risk. Normally, the loan does not have to be repaid until the borrower moves or dies, and repayment is usually achieved through the sale of the home. Proceeds can be received in the form of monthly payments, a line-of-credit, or a combination of both. Like a viatical settlement, the proceeds of a reverse mortgage may have some impact on benefits under Medicaid or the Supplemental Security Income program.

Home equity conversion options vary in their terms, tenure, flexibility, costs, insurance arrangements, types of properties eligible, loan amounts, and other considerations. An important advocacy concern is that the elderly considering these financing options do not make hasty, uninformed decisions. By law, counseling is required as part of the application process for a reverse mortgage, and the advocacy groups are committed to keeping their constituencies informed about possible alternatives. Such counseling is also an issue when it comes to full disclosure expectations in viatical transactions.

To date, home equity conversions are still a minor factor in providing financial resources for those who are terminally or chronically ill. However, like accelerated death benefits, reverse mortgages do provide an alternative to the outright sale of a life insurance policy.

The Size of the Market and Its Potential

At this time in its history, reliable data on the viatical industry are not available. The number of firms in the industry is not precisely known. Official membership in the two trade associations is less than 75, but many other unaffiliated brokers and viatical entities seem to exist. Neither trade association collects data from its members on a systematic basis. Both associations place the volume of life insurance policies purchased in the secondary market at close to one billion dollars, up from about two million dollars in 1989, but these estimates are largely anecdotal in nature.

However, since the amount of life insurance in force is huge and this figure is available from life insurance industry sources, the potential for sales in the secondary market is considered to be quite large. Chodes, Tow, and Hoopingarner (1998) cite a 1995 research report by Milliman & Robertson, Inc., that broadly estimated the market potential at $500 billion. A recent, more systematic, analysis estimated the market potential at $134 billion (Conning & Co., 1999). The Conning study divided the market into three segments: AIDS victims aged 25-44, other terminally ill aged 45-64, and the life settlement group aged 65 and over. The $134 billion figure is derived from applying a percentage of the segments that would be open to selling their policies to the amount of life insurance in force for these groups. Though the data for life insurance in force are more reliable, they are far from precise. The estimated percentage of those in each market segment open to selling their policies is a much more tenuous figure that would have to be empirically tested. Despite the admitted limitations of the analysis, the Conning study indicates that the market potential is significantly greater than has been achieved thus far.

The industry is only in the early state of its life cycle. Increased competition from accelerated death benefits and the momentum for increased regulatory oversight are just two of the major challenges the industry must overcome if it is to have long-term viability. However, the key factor is to gain widespread acceptance by consumers that the sale of a life insurance policy can be an intelligent financial planning strategy.

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