Cashing Out Life Insurance:
An Analysis of the Viatical Settlements Market

Neeraj Sood
Abstract

People near the end of their lives are too frail to work, have low incomes and often lack health insurance coverage. Consequently, these people are often under extreme financial stress – they need cash now to buy life saving treatments and but do not have enough income or liquid assets to pay mounting prescription and doctor bills. Such people are increasingly using a new financial vehicle called a viatical settlement. These settlements which first arose in the context of HIV, allow policyholders to convert their previously non-liquid life insurance policies into cash at a discount to the policies’ face value. (The discount depends on life expectancy.)

Despite its growing importance, there has been little scrutiny of the viatical settlements market. This dissertation fills this information gap by conducting two separate analyses of the viatical settlement market using a unique database of viatical settlements involving HIV+ patients.

The first analysis, evaluates the impact of existing minimum price regulations in the viatical settlements market. These price floors are perhaps the most controversial of the current regulations, thus a good candidate for analysis. The viatical settlement industry argues that the price floors are set too high and thus make it unprofitable to buy policies at the minimum mandated prices. On the other hand, insurance regulators argue that price floors are necessary to guarantee a fair rate of return to the sellers in these market who otherwise might fall prey to high-pressure marketing tactics of viatical settlement firms. The results of this analysis show that price floors bind on HIV patients with greater than 4.5 years of life expectancy. Furthermore, HIV patients from states with price floors are significantly less likely to viaticate than similarly healthy HIV patients from other states. Finally, the magnitude of welfare loss from these blocked transactions would be highest for consumers who are relatively poor, have weak bequest motives and have a high rate of time preference.

The second analysis, evaluates consumer decisions in the viatical settlement market. In order to make optimal decisions, consumers deciding between selling their life insurance and borrowing should be able to do two things (1) accurately assess their
mortality risks (2) compare the real (rather than nominal) cost of selling life insurance to the cost of borrowing. This analysis tests whether consumers can perform the above two tasks well. The results of this analysis suggest that consumers do make mistakes in deciding between selling their life insurance and borrowing. The empirical evidence is consistent with two hypothesis motivated by the psychology and behavioral economics literature – (1) relatively unhealthy consumers are too optimistic about their mortality risks (2) consumers tend to focus on the nominal prices, rather than on real discounted expected price.