e-Resources Module-VI

Paper No. : DSE-xiii

Paper Title: Money and Financial Markets

Course: B.A. (Hons.) Economics, Sem.-VI Students of S.R.C.C.

CREDIT RISK INSURANCE AND VIATICAL SETTLEMENT

This e-Resource Module is designed to further clarify students on issues relating to the functioning of financial markets. In particular, it focusses on the role of private insurance companies in bearing the risk of default associated with loans and non-insurance companies in "viatical settlements" i.e., purchasing the life insurance policies of those with fatal disease and terminal illness by paying the discounted value of the concerned policy. Both these issues are closely linked to asset securitization which in turn can be considered to be a major financial innovation in its own right. Typically, financial intermediaries pooling together their loans for issuing asset-backed securities have been observed to hire the services of various agencies including insurance companies for covering the credit risk associated with loans. Likewise, the viatical companies have been observed in actual practice to issue securities backed by life insurance policies purchased from individuals with terminal illness. It has been empirically observed that issues backed by viatical settlements are generally well received by potential investors thereby leading to the success of such an "asset securitization".

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CREDIT RISK INSURANCE

Under traditional system of financing, the lending agency *i.e.*, financial intermediary such as a commercial bank typically bears the risk of default associated with the loan. But under asset securitization, this is not necessarily the case as a private insurance company may instead be asked to bear this "credit risk" or the risk of default. Hiring the services of an insurance company in this context is quite similar to hiring the services of specialised agencies for the servicing of loans and hiring the services of a "securities firm" for distributing the asset-backed securities to potential investors. In fact, the collection or pooling of loans by financial intermediaries under asset securitization has typically been observed to be associated with hiring the services of various such agencies with a view to effectively implementing asset securitization.

VIATICAL SETTLEMENT

Depending upon the terms and conditions of the life insurance policy, the Life Insurance Companies typically give a specific sum of money to the intended beneficiaries only upon the death of the insured person. If, however, the insured person is found to suffer from a fatal disease or terminal illness, then some non-insurance companies may come forward to purchase his life insurance policy by paying its present discounted value even prior to the death of the insured person. Once this happens, it is called a “viatical settlement” and such viatical settlement companies can then issue securities backed by insurance policies purchased from individuals with terminal illness as has actually happened in some countries like the U.S.A. In actual practice, it has been observed that issues backed by viatical settlements are generally well received by potential investors thereby leading to the success of such an “asset securitization”.