



# *Policy Note*

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## **BANKS RUNNING WILD: THE SUBVERSION OF INSURANCE BY “LIFE SETTLEMENTS” AND CREDIT DEFAULT SWAPS**

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Oblivious to any lessons that might have been learned from the global financial mess it has created, Wall Street is looking for the next asset bubble. Perhaps in the market for death it has found a replacement for the collapsed markets in subprime mortgage-backed securities (MBSs) and credit default swaps (CDSs).

Recall the principles behind these instruments. An MBS is a bond issued against a pool of hundreds, even thousands, of mortgages. The pool can be “tranching” so that bonds of different ratings can be derived, allowing “investors” to choose the risk-return trade-off desired. Pooling was supposed to reduce risk through diversification; risk raters further reduced risk through careful analysis—allowing 80 percent or more of the derived bonds to carry ratings as high as those enjoyed by the U.S. Treasury. Insurance on the securities added another level of safety. A CDS was one way of buying insurance against losses on the securities, with the seller providing a guarantee in return for a periodic “premium.” Indeed, one could buy CDS “insurance” even if one did not hold the security. Thus, through the CDS market one could effectively take on the risk of an MBS without the inconvenience of actually purchasing and holding a security. This amounted to nothing more than a gamble, with the CDS seller betting against default and the buyer hitting the jackpot if default occurred. Both markets were blown apart by a perfect storm: the risks of subprime mortgages, which were never really assessed, turned out to be far greater than the markets supposed; underwriting standards deteriorated to the point that outright fraud was actually encouraged; at the

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same time, documentation was so lax that in many cases it is not clear which—if any—mortgages actually underlay some of the securities; and most of the market was “over the counter”—unregulated and opaque. It is not necessary to recount all of the sorry details, except to note that the market for both MBSs and CDSs is moribund.

That is why the banking system is attempting to fuel yet another bubble, this one built on a new product very similar to CDS “insurance.” Instead of making bets on the “death” of securities, this one will allow “investors” to gamble on the death of human beings. As the *New York Times* recently highlighted, the banks “plan to market ‘life settlements,’ buying life insurance policies that ill and elderly people sell for cash—\$400,000 for a \$1 million policy, say, depending on the life expectancy of the insured person. Then they plan to ‘securitize’ these policies, packaging hundreds or thousands together into bonds. They will then resell those bonds to investors, like big pension funds, who will receive the payouts when people with the insurance die” (Anderson 2009). In effect, just as the sale of a CDS creates a vested interest in financial calamity, here the act of securitizing life insurance policies creates huge financial incentives in favor of personal calamity. In essence, the sooner you die, the bigger the payoff for the investor. And the corollary also applies, as the *Times* article notes: “If people live longer than expected, investors could get poor returns or even lose money.”

In this Policy Note we argue that this is a subversion—or an inversion—of insurance, similar to the role played by CDS “insurance.” CDSs were never really insurance; they simply allowed gamblers to bet on the survival of bonds, firms, and even nations. Indeed, as we explain, the existence of CDSs actually hastened the entity’s “death.” Similarly, owners of the new life settlement products actually have an interest in an early death, unlike the life insurance industry—which has an interest in seeing life prolonged. It is, of course, a huge jump to say that simply because it is in one’s financial interest to see underlying human “collateral” meet an untimely death, owners of these new securities would actually undertake actions to ensure that result. Still, it raises important public policy issues: Should we allow the marketing of an instrument in which holders have a financial stake in death? More generally, should we allow the “innovation” of products that condone speculation under the guise of providing insurance? Here, we first examine the nature of true insurance, show how the CDS products subvert this, and then analyze the new life settlement securities.

## Traditional Insurance versus Credit Default Swaps

Insurance is traditionally defined as a promise of compensation for specific potential future losses in exchange for a periodic payment. The underlying purpose, then, is to protect the financial well-being of an individual, company, or other entity in the case of unexpected loss. Implicit in this concept is that the individual, company, or other entity has an *insurable* interest to be protected in the event of unexpected loss.

That is, of course, until Wall Street’s financial engineers started tinkering with the concept through the creation of credit default swaps. Just as the mortgage industry gamed the regulatory system for lending, the CDS dealer banks—led by Goldman Sachs, Citigroup, and JPMorgan Chase—have gamed the political equation in Washington with great skill. In fact, aided in their efforts by Alan Greenspan, Robert Rubin, and then—SEC head Arthur Levitt, these banks got Congress to push through a moratorium on regulating all over-the-counter derivatives, of which credit default swaps were an important component. The moratorium specifically prohibited states from regulating CDSs as insurance, which effectively meant no regulation, since the states, not the federal government, were (and still are) charged with regulating the insurance business. Wall Street’s political objectives satisfied, the moratorium therefore precluded regulation of CDSs as either gambling or insurance—even as Wall Street institutions sold these securities as insurance.<sup>1</sup> Ironically, investors would have been better off taking their funds to gambling casinos, which are closely regulated, than investing them in the unregulated products sold on the Street (Kim 2009).

Credit default swaps are by far the worst of these “Frankenstein” products. Although commonly lumped together with other derivatives, CDSs are not “derivatives” in the classic sense, since their price is not based on, or “derived from,” something else. For true derivatives, such as oil futures or stock options, the price relates to that of something that has a current, “cash market” price; for example, there is a spot market price for oil and current trading prices for particular stocks and equity indices. By contrast, the CDS represents, in the words of risk analyst Christopher Whalen (2009b), “a deliberate evasion of established norms of transparency and safety and soundness, norms proven in practice by the great bilateral cash and futures exchanges over decades.” This customization, combined with market opacity, in effect creates a huge financial windfall for Wall Street—which explains why the banks have fought so tenaciously to retain the

status quo despite almost blowing up the entire financial system last year.

Just as describing credit default swaps as “derivatives” is problematic, so, too, is the notion that CDSs act as a form of “insurance.” In reality, a credit default swap gives the participant a vested interest in financial instability. True, they are described as “insurance instruments,” but with crucial differences that actually invert the true role of insurance: one party, the “protection buyer,” contracts with the insurer (“the protection seller”) to guarantee against the risk of default of a specified amount of exposure for a certain timeframe, but with a twist: the protection buyer can sell the CDS, with the new owner becoming the beneficiary of the insurance even if he has no insurable interest in the underlying asset that is the subject of the CDS (Mayer 2008). Likewise, the “protection seller” can offload his risk by selling it to a third party, thereby multiplying the number of counterparties involved in the transaction.

But more significant than the multiplication of the counterparty risk is the resultant financial instability, because CDSs create huge perverse incentives. They lead investors to be indifferent to a bankruptcy, and in many cases, to push for it. This is the so-called “empty creditor” concept described by law professor Henry Hu in testimony before the Senate banking committee earlier this year:

Credit default swaps and other credit derivatives now permit formal ownership of debt claims to be “decoupled” from economic exposure to the risk of default or credit deterioration. But formal ownership usually still conveys control rights under the debt agreement and legal rights under bankruptcy and other laws.

There could, for instance, be a situation involving what, in 2007, I termed an “empty creditor”: a creditor may have the control rights flowing from the debt contract but, by simultaneously holding credit default swaps, have little or no economic exposure to the debtor. The creditor would have weakened incentives to work with a troubled corporation for the latter to avoid bankruptcy. And if this empty creditor status is undisclosed, the troubled corporation will not know the true incentives of its creditor as the corporation attempts to seek relief in order to avoid bankruptcy. Indeed, if a creditor holds enough credit default swaps, it may simultaneously have control rights and a *negative* economic

exposure. With such an extreme version of the empty creditor situation, the creditor would actually have incentives to cause the firm’s value to fall. Debt decoupling could also cause substantive (empty creditor) and disclosure (“hidden non-interest” and “hidden interest”) complications for bankruptcy proceedings. (U.S. Congress 2009)

CDSs also create an incentive for lenders and investors to skip or do a cursory job on credit research. Further, since the CDS holder has little economic interest in the underlying asset, why bother spending the time in a lengthy and costly Chapter 11-style debt renegotiation if you can collect immediately via the proceeds of a credit default swap?

Despite their obvious drawbacks and nonexistent social utility, little has been done to rectify this obvious source of financial instability. In fact, one year after the demise of Lehman Brothers, the Federal Reserve still refuses to enforce any credit margin discipline over the principal CDS dealers. Similarly, the most recent set of reforms proposed by the Obama administration resists mandating that these instruments be traded solely on a regulated exchange, where transparency and standardization would be far more operative and systemic risk correspondingly reduced. Quite the contrary, in fact: we still have financial engineering run amok. In the next section, we examine life settlement securities—another bad idea whose time has apparently come.

### **Selling Death**

Under Wall Street’s new proposal, investment banks will package life insurance policies of individuals with an alphabet soup of diseases: AIDS, leukemia, lung cancer, heart disease, breast cancer, diabetes, and Alzheimer’s. The idea is to diversify across diseases to protect “investors” from the possibility that a cure might be found for one or more afflictions, thus prolonging life and reducing profits. These policies are the collateral behind securities graded by those same agencies that thought subprime mortgages should be rated as safe as U.S. Treasuries. Investors purchase the securities, paying fees to mortgage banking originators. The underlying collateralized humans receive a fraction of the death benefit up front as a single payout. Securities holders pay the life insurance premiums until the “collateral” dies, at which point they receive the death benefits. Naturally, managed money hopes death comes sooner rather than later.

Moral hazards abound. There is a fundamental reason why you are not permitted to take out fire insurance on your neighbor's house: you would have a strong interest in seeing that house burn. If you held a life insurance policy on your neighbor, you probably would not warn him about the loose lug nuts on his Volvo. (If you had lost your job and were sufficiently challenged ethically, you might even loosen them yourself.)

This product can be seen as the logical extension of the CDS. Once finance creates a vehicle that separates the insuring party from his insurable interest, these sorts of perverse incentives are built into the system. And they multiply the impact of a financial disaster, in addition to increasing counterparty risk:

The basic tension over CDS starts with the fact that these instruments actually increase overall systemic risk. Consider a real world example: When the auto parts maker for General Motors, Delphi, filed bankruptcy in October 2005, there were between \$20 and \$30 billion in CDS outstanding and deliverable against the \$2 billion in debt outstanding and another \$2 billion in bank loans that were also deliverable against the CDS. Whereas the maximum cash loss to investors in the Delphi default might have been limited to the \$4 billion of extant debt without CDS, the existence of CDS actually multiplied the potential opportunities for gain and loss on the Delphi default nearly 10 fold. (Whalen 2009b)

Those hedge funds holding CDS “insurance” fought to force the U.S. auto industry into bankruptcy for the simple reason that they would make more from its demise than from its resurrection. And the reason that most holders of troubled mortgages cannot obtain relief is because the firms that service these mortgages gain more from foreclosure than from a workout loan. When Warren Buffet described derivatives as “financial weapons of mass destruction,” he probably had this kind of scenario in mind. Separation of ownership from financial interest is the source of the problem.

Worse, securitization of life insurance policies actually creates incentives to ensure that our system doesn't give us the healthiest outcomes. A powerful alliance of Big Pharma and Big Finance might well try to keep new miracle drugs off the market; or, if these drugs were capable of extending life and thereby reducing profits on the securities, make them prohibitively expensive, thus curbing access. As an example, consider the possibility raised by columnist Matt Taibbi in regard to the bill that

has emerged from the Senate's HELP Committee. Taibbi (2009) notes that manufacturers of complex drugs known as “biologics” would be able to keep their formulas from being copied by rivals for 12 years—twice as long as the protection for ordinary pharmaceuticals. Granting lucrative new protections against generic drugs not only substantially increases health care costs but also ensures that cutting-edge treatment will be denied to more people, which in turn will enhance the value of these securitized policies.

This perverse logic could be extended to health care more generally. Longevity is a big additional cost for the health care industry; ideally, you need to create incentives to ensure that people die younger. More people dead at age 55 and *Presto!*—there go the waiting lists for hip replacement surgery, and payouts to holders of life settlement products soar. Indeed, it is fairly easy to see some profitable synergies developing between financial firms marketing bets on death and health insurers opposed to universal, single-payer health care.<sup>2</sup>

It is also worth noting that most of the same problems that were created in the securitized mortgage business will be re-created in the market for securitized life insurance policies. In this case, healthy individuals are the equivalent of “sub-primes”: since they face a low probability of death, losses on the securities are likely. Unscrupulous brokers will buy their policies and overstate the likelihood of death. An “originate to distribute” business will be created, whereby life insurance policies will be sold indiscriminately without normal underwriting—which in this case would involve checking the medical history of the policyholder and consulting actuarial tables—since the policies will be immediately bought, packaged, and sold. The equivalent of “low doc” loans will be cases requiring little documentation of supposed terminal illness; “no docs” will simply require the policyholder to claim a life-threatening affliction. Ratings agencies will be called upon to certify risk, and competitive pressures will prevent them from doing due diligence. Securitizers will be tempted to sell securities without adequate records of ownership, or to market bundled policies they do not own—even selling credit default swaps on life insurance policies in order to allow investors to acquire the risk without actually owning the policies. Securities insurers will offer to take on the risk—another opening for CDSs, allowing more favorable bets on the possibility of death. Policyholders will be defrauded, since they will be paid far less than the actuarially based value of their policies, with minorities targeted for “special” treatment

by brokers. Leveraged money will flow in, creating an unsustainable bubble.

A collapse of this market can occur even without miracle drugs and higher-than-expected life spans simply due to the normal operation of unchecked market processes. Thus, it is likely that the bubble will be popped long before medical science generates losses for gamblers in life settlements—at which point Wall Street will look for the next investment opportunity.

## Conclusion

It should be amply evident that Wall Street hopes to re-create the conditions that existed in 2005. Virtually every element that contributed to the real estate, commodities, and CDS bubbles will be replicated in the securitization of life insurance policies. If this scheme succeeds, it will probably bankrupt the life insurance companies. (Premiums are set on the assumption that many policyholders will cancel long before death; but, once securitized, the premiums will be paid so that benefits can be collected.) If this new bubble actually materializes, another financial crisis will not be far behind. While we understand that there is a real need for some terminally ill patients to cash out their life insurance policies (to cover care expenses, for example), securitization is a path fraught with danger.

In a significant sense, the situation is worse today than it was in 2007 before the collapse. To date, the rescue of the financial sector has relied on a toxic package of policies that includes socialization of risk, continued reliance on self-regulation, and concentration of finance in the hands of 25 “megabanks” that are said to be both “too big to fail” and “systemically important.” The biggest of the behemoths, the deeply troubled Bank of America (BoA), now holds 12 percent of all U.S. deposits. The top four—BoA, JPMorgan Chase, Citigroup, and Wells Fargo—collectively hold 46 percent of the assets of all FDIC-insured banks, up from 37.7 percent a year ago. Goldman Sachs, the largest securities firm before it was handed a bank charter, has taken on more risk and increased its trading and investment profits by two thirds over the past year. According to Nomi Prins, formerly a managing director at Goldman, “Nothing has changed except that we have larger players who are more powerful, who are more dependent on government capital and who are harder to regulate than they were to begin with. We’re in a far less stable environment.”<sup>3</sup>

Radical reform is needed. Ideally, instruments such as credit default swaps and life settlement securities ought to be banned, since they operate against the public interest. At a minimum, the sale of CDS “protection” should be limited to those with an economic interest in the default, such as the holders of bonds, mortgages, or other assets that might be “insured.” No one should be permitted to buy “insurance” to bet on another person’s calamity: “By requiring buyers of protection to deliver the underlying basis of the contracts, much of the systemic risk created by the bilateral OTC credit model will be extinguished” (Whalen 2009a). Further, all such contracts should be executed on exchanges—and declared to be unenforceable if they are not. Why should we extend the protection of enforcement by U.S. courts of law to contracts, made in secret, that increase systemic risk?

Here’s the problem: there is still, even after the massive losses incurred in this crisis, far too much managed money chasing far too few returns. And there are far too many “rocket scientists” looking for the next “newest and bestest” financial product. Each new product brings a rush of funds that narrows returns; this then spurs rising leverage ratios, with borrowed funds being used to make up for low spreads by increasing volume; this causes risk to rise far too high to be covered by the returns. And the risk-multiplication properties of CDSs allow more and more players to join the game, both long and short. Eventually, lenders and managed money try to get out, but delevering creates a liquidity crisis as asset prices plunge. The resulting losses are socialized as government bails out the banks. Repeat as needed.

Reform of the U.S. financial sector is not possible. Nor would it ever be sufficient. What’s called for is downsizing of the financial system, which can begin with the following set of actions:

- a) All bank assets and liabilities must be brought onto balance sheets and made subject to reserve and capital requirements—and, more importantly, to normal oversight by appropriate regulatory agencies. Any assets and liabilities that are left off balance sheet will be declared null and void, unenforceable by U.S. courts.
- b) All CDSs must be bought and sold on regulated exchanges; otherwise, they will be declared unenforceable by U.S. courts.
- c) Unless specifically approved by Congress, securitization of financial products such as life insurance policies will be prohibited and thus unenforceable by U.S. courts. In its deliberation, Congress will consider whether the proposed

financial products serve a legitimate public interest that cannot be better served through some other mechanism.

- d) The FDIC will be directed to examine the books of the 25 largest insured banks in order to uncover all CDS contracts held. These contracts will then be netted among the 25 banks, canceling any contracts the banks hold on one another. CDS contracts with foreign banks will be unwound. The FDIC will also examine derivative positions with a view to determining whether unwinding these would be in the public interest. The goal will be to downsize the balance sheets of the “megabanks” in order to reduce systemic risk.
- e) In its examination, the FDIC will determine which of these banks are insolvent based on current market values, after netting positions. Those that are insolvent will be resolved. Resolution will be accomplished with a goal of (1) minimizing costs to the FDIC and (2) minimizing impacts on the rest of the banking system. It will be necessary to cover some uninsured losses, to other financial institutions as well as to equity holders (such as pension funds), that arise in the course of the resolution.
- f) The Treasury and Fed will be directed to work to reduce concentration of the financial sector by avoiding resolution methods that favor large institutions. There will be a bias in favor of rescuing smaller institutions and using the resolution process to break up the larger ones.

These actions should substantially reduce the size of the financial sector and would eliminate some of the riskiest assets, including assets that serve no useful public purpose. The financial system would emerge with healthier institutions, and with much less market concentration.<sup>4</sup>

## Notes

1. In 1999, Greenspan famously testified before Congress that regulating derivatives was “superfluous,” thus helping pave the way for repeal of the Depression-era laws separating commercial and investment banking—and passage of the deregulatory Commodity Futures Modernization Act the following year. See Goodman 2008.
2. None of this is far-fetched. As AFL-CIO Secretary-Treasurer Richard Trumka recently remarked on NPR, we already have so-called “death panels” deciding when to cut off care: the private health insurers that deny coverage when proper

care would reduce company profits. It is not in the interest of either securities holders or health insurers to provide expensive care that prolongs the life of human collateral.

3. All data and quotes in this paragraph, Fitzgerald and Harper 2009.
4. As this Policy Note went to press, a press release on September 23 announced that Congressman Paul E. Kanjorski (D-PA), Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will hold a hearing “to examine innovations in securitization, especially those related to life insurance settlements” ([www.house.gov/apps/list/press/financialsvcs\\_dem/presskanjorski\\_092309.shtml](http://www.house.gov/apps/list/press/financialsvcs_dem/presskanjorski_092309.shtml)).

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