Chapter 6
Implications of Secondary Market Trading in Life Insurance Products

6.0 Introduction

This chapter aims at analysing the effects of trading in life insurance products from the viewpoint of each of the market participants, namely, policyholders, insurers, and investors. It also examines the implications of the secondary market for the life insurance sector. This discussion is based on the literature from the already existing markets in other countries, the interviews with the experts, and case study of the third party firm in India.

6.1 Case Study of the Third Party Firm in India

This section aims at an overview of a pioneering third party trading firm in India. This case study may help to provide a glimpse of what would be policyholders’ response; insurer’s reaction and provider’s strategy, if a secondary trading market evolves in India. The literature available in public domain in this regard is with respect to the western developed countries. Hence, the present case study gives a rare account of a pioneering though short-lived endeavour of formal sector secondary market trading in India.
6.1.1. Establishment and structure:

As mentioned earlier, the incidence of assigning life insurance in the name of a third party in exchange for certain amount of money has been a regular practice in India almost since the origin of the life insurance. Some finance companies, tried to give this business a more formal look. However, the trading in life insurance formed a part of their bigger and diversified business. A partnership firm established in the year 2000 has attempted the most explicit institutionalisation of this business. The directors registered the firm under the Companies Act. The structure of the business has been broadly similar to the endowment trading firms in UK.

**Figure 6.1**

Composition of Trading in life Insurance in India
The flowchart in Figure 6.1 provides a broad idea of the actual composition of secondary market trading in life insurance in India.

### 6.1.2 Composition of the firm:

The Head Office consists of the director, the chairman, legal advisors, technical staff, and the administrative staff. The functions of the Head Office are:

1. To form the business strategy, confirm legal procedures.
2. To mobilize capital from investors.
3. To tap new investors.
4. To supervise the branch offices.
5. To fund the branches for administration and purchase of policies.
6. To process the assigned policies for further assignment in the investors’ names.
7. To allocate the policies blocks to investors.
8. To pay premiums on purchased policies.
9. To keep track of policy benefits and complete legal procedure to claim.

The Branch Offices perform following functions:

1. To establish a network of agents.
2. To verify the viability of the potential policies for trading.
3. To complete legal and administrative procedure of transfer of policy rights.
4. To act as a link between policyholder and the Head office.
5. To keep abreast of changes in administrative procedures if any.
6. To achieve maximum efficiency in the procedure of exchange of the policy.
7. To maintain records for further processing of the policy and intimate the premium due or benefit due dates to the head office.

6.1.3 Functioning of the firm:

The firm established the branch offices in Pune, Nasik, Vapi and Thane. It has its Head Office at Mumbai. The branch offices established a network of agents.

To tap the policyholders in need of exchanging their policy rights for urgent money. The branch offices did the valuation of the policy, prepared the assignment papers, submitted the assignment notice with the insurer and got the policy assigned. Once the notice of assignment was registered, the Head Office immediately paid the policyholder the amount, through the branch office.

The assigned policy was sent to the Head Office for further processing. The policy was then engineered by modifying certain factors according to the policy terms and conditions for enhancing the profitability and then allocated into policy blocks to be purchased by the investors.
6.1.4 The experience of the third party firm:

As proved by the experience of the Insure Policy Plus Services Ltd., the life for a third party firm in India, as compared to the firms in the other countries, is at a time easy in certain aspects as well as difficult in some other aspects.

The working is easy because,

- The primary insurance market in India is well-regulated and transparent, thanks to the regulatory mechanism existing in Indian life insurance industry.

- The primary insurance that matters for trading consists of only those policies, which have the surrender value. Most of these policies are at present the policies sold by the public sector life insurance giant Life insurance Corporation of India. Hence, the costs and wastages because of the multiplicity of policies/plans/products are minimal.

- Most importantly, since the most of these tradable policies are at present the policies sold by the public sector life insurance giant Life insurance Corporation of India, fetching investors is an easy task. The LIC of India is a default free insurer with the sovereign guarantee, the benefits are guaranteed, even the bonus rates are guaranteed for many conventional plans. This makes the tradable life insurance policy a risk free asset at par with the Government bond in terms of risk, however, with a much higher return. Hence the
high net worth investors are readily agreeing to invest in this asset.

The life of the secondary market firm became difficult because:

- There is no awareness about this novel concept in India. This required a considerable marketing effort.
- Prior to the firm started trading and went to the insurer’s offices for transfer procedures, most of the officials even in the life insurance firms had no idea about the business. This created tremendous problems at each stage of policy transfer.
- The fact that all policies to be traded were of the public sector giant also worked against the trading firm. The life insurance sector had been newly privatized and the private sector life insurance firms entered the market at about the same time when the trading firm started its business this changing environment led to the general animosity and suspicion with respect to anything ‘private’ even though the trading firms are not the competitors of the insurer firms\(^{31}\).
- At the administrative as well as managerial level, the paternalistic attitude toward life insurance strongly prevailed. This lead to the strong opposition to the private firm as it was looked upon as a greedy profit

\(^{31}\) These observations are from the interviews with the IPPS officials as well as the LIC of India officials.
monger, which was trying to speculate on the policyholders’ death and snatching ‘benefits of the widows’!\(^{32}\)

6.1.5 The Response of the Policy Holders:

The interviews with the trading firm officials reveals that, given the novelty of the concept, the policyholders’ response was tremendous. The data with the firm and the interviews with the officials show that most of the policyholders coming to the firm had already experienced of dealing with the moneylenders. The policyholders were mostly from lower middle-income backgrounds. They constituted the industrial laborers, small-scale vendors, and even employees of various government departments.

The total sum assured of policies, which entered the Pune branch office for trading, was approximately Rs.1,00,30,000 in the year 2002. In the year 2003, total of the actual cash value paid was approximately Rs.8,98,022 and the turnover in terms of sum assured of policies actually purchased during that year was approximately Rs.43,72,000. The response of the policyholders was overwhelming but the business in 2003 was dampened by the problems created in the processing of the transfer of policies. fig. 6.2(a) &(b)

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\(^{32}\) These are the reactions expressed by the senior level officials of LIC of India during the interviews. Please refer to Annexure 6.1 for the interview schedule.
The most important factor generating the policyholders’ response was the aura of formality and official atmosphere at the firm. Generally, the policyholders discontinuing the policy are either economically weaker sections or those facing a severe liquidity crunch. The studies on surrender and lapsation show that the policyholders treat the life insurance as a long-term asset and they are ready to sell it only as a last resort. (Balachandran and D’Mello 1985). These policyholders felt assured of a legitimate return and a respectable treatment along with transparent dealing. Equally important for the policyholders was the psychological effect of formal professional environment rendering an air of normality to the situation, which was lacking at the individual moneylenders and unincorporated third party purchasers. The business showed exponential growth as the mouth publicity by the policyholders helped. The urban, white collared policyholder finds it degrading to deal with the moneylenders in addition to the risk of being cheated; this policyholder also formed the clientele of the firm.

Following charts are based on a short period of time to show any deterministic trend about the market these figures show a glimpse of the business of the third party firm struggling to establish itself in the new market.
Figure 6.2(a)
A Glimpse of IPPS Business Turnover

Figure 6.2(b)
6.1.6 What went wrong?

The reaction of the incumbent firms has created problems for the trade in life insurance in USA and other Western countries. (Doherty, 2002)

In India, the response was extremely strong for the reason that the trade had to be in the products of the single most dominant life insurance firm, which happened to be a public sector firm. The interviews with the third party firm officials reveal that, the public sector giant was already perturbed due to the entry of private life insurance firms in the year 2000. Hence, the attitude toward anything in private sector was strongly cautious (if not vindictive).

The public sector insurer was dominated by the benevolent culture of protecting the policyholders and conservative office bearers having a paternalistic approach. Although legally permissible, the trade is difficult to be practically conducted without the coordination of the life insurer in procedure of transfer of the policy. The procedures regarding the transfer cannot be realized without cooperation of the insurer33.

The Life Insurance Corporation of India banned the transfer of policies in the name of the third party trading firms. The third party trading firm lacked the experience and maturity to deal with this situation and went into the litigation to prove

33 Annexure 6.2 Interim order of the Supreme Court of India, Dated, 4th April, 2008.
its legal rights to trade. Though the litigation result is favorable for trade, the firm has lost the business due to the obvious reasons.

6.2 Implications for the market participants:

The world of finance has undergone major changes over the last three decades and many further changes can be expected in near future in emerging economies like India. Present day financial institutions and the way of doing business are likely to look very outdated in thirty years time. Nonetheless, there are some fundamental principles of finance that do not change; one is that higher return is usually associated with higher risk and another is that financial institutions and instruments will only survive if they meet clients’ needs at a competitive market place.

In the secondary market for life insurance, the financial intermediaries enter the market to perform the basic function of recycling of funds from surplus agents to the deficit agents. While performing this function, they provide services resulting into improved welfare and higher utility for the market participants. The effects of the secondary market trading on various elements are discussed below.
6.2.1. Effects on Policyholders:

The effects of trading in life insurance on policyholders is the most controversial issue in literature on secondary market in life insurance.

The opinions about the effect of secondary market trading on policyholders vary. Some reports depict the trading firms as the benevolent angels showering cash on needy policyholders while some others visualize the business of trading life insurance as the most horrid, only- next to- death- itself - thing happening to the policyholder.

In the following points, this study tries to summarise the implications of trading in life insurance for the policyholders.

- The Report of the Connecticut Actuarial Society popularly known as carrier’s report compares the value of the life insurance policy (called as intrinsic economic value) with the cash value received by the policyholders from the third party firms. The obvious result of this comparison is that the policyholder receives much less than the intrinsic economic value and hence, is proved to be exploited by the third party firms.

For evaluating the effects of secondary market trading in life insurance on the policyholder, one should compare the surrender value paid by the insurer with the cash value paid by the third party firm. The comparison of the paid up or maturity value with cash value is seriously flawed. The
comparison between a continuing policyholder’s utility function and a withdrawing policyholder’s utility function is totally unwarranted for.

- It should be noted that the preference function of the policyholder might change with the change in circumstances over time. Life insurance being a long-term financial instrument is not designed to cater to these changing needs. The raison d’être of life insurance is to protect the policyholder through a long period due to the uncertainty of life. The policyholder who purchases life insurance has a preference for this long term risk cover (and other policy benefits) at the time of purchasing life insurance policy. However, there is a possibility that his needs and preferences may change and at some point along the term of the policy, he may prefer immediate cash receipt than a promise to pay higher return in the future. In the event of this change in preference what are the choices for him?

In the absence of secondary market trading he has only one option that is to surrender the policy to the issuing insurance company.

In the event of secondary market trading, the policyholder has a number of companies to transact his policy and he can bargain for a higher cash value depending upon the condition of the policy.

As stated by Singer & Stallard (2005), “It may be true that holding a policy till death maximizes the value of the policy at the time of the death, it does not necessarily follow that such
a strategy is the utility–maximizing strategy for all policy holders at any point in time before death”. This statement brings out the raison d’etre of the third party firms.

- The withdrawing policyholder makes the decision to withdraw from the life insurance contract based on various grounds discussed in section

Once the decision to withdraw is made, he has following choices:
- To stop paying premiums.
- To claim surrender value
- To exchange the policy rights in official or unofficial secondary market.

The selection of the choice would depend on the transactions costs, the time required to get the receipt of the cash value and the amount of cash value.

Economics of competitive markets shows that a competitive secondary market with large number of firms would result into efficient settlement of transaction and high cash value, resulting into a beneficial arrangement for the withdrawing policyholder.

As already discussed in Chapter 4 the economic logic of the life insurance firm does not allow the insurer to provide the competitive surrender value, while a third party firm, being a ‘third party’ to life insurance liability, is in a position to offer a higher cash value. This generates higher liquidity, greater cash value, and wider choice for the withdrawing policyholder.
• In India, the withdrawing policyholder is generally in need of liquid cash. The informal sector moneylenders can exploit the exigency of the policyholder. In this scenario, the existence of a more formal institutional structure will definitely benefit the policyholder. This aspect is peculiar to the Indian situation and is not discussed in the literature on the subject.

6.2.2. Implications for the Life Insurer

The effects of secondary market trading on life insurer have been dealt with some unanimity in the literature. The trading would affect the insurer in various ways.

**Effect on the insurer’s costs:**

It is stated that the costs to the insurer would increase in two ways.

1. In the absence of trading, the insurer is the sole source of exchanging the policy for cash surrender values. The insurer is the monopsony firm quoting the cash surrender value for the policies issued by it.

   Doherty & Singer (2002) call insurer the ‘incumbent firm’ and claim that the monopsony power of the insurer allows him to quote low surrender values, as the policyholders do not have any other option. The existence and expansion of third party trading firms would create competition for the insurer by
offering higher cash values. This would force the insurer to pay higher surrender values and inflate its costs.

The argument is theoretically correct but practically inapplicable to the life insurance sector in India. Even today, Indian life insurance sector is predominated by the public sector giant, LIC of India. This is particularly, for the trading in life insurance, due to the large reservoir of LIC products issued over last fifty-two years. However, this public sector firm cannot be visualized as a monopsony insurer seeking profit out of low surrender values. Although a monopsony, it is a benevolent monopsony.

The reaction of the life insurer in India to the third party trading firm is of suspicion and non-cooperation, which is similar to the insurers’ response that is observed in all countries. Nevertheless, the stance of the life insurer in India is of protecting the policyholders, which is not found in other countries due to complete privatisation of the insurance sector. The arguments regarding the insurer opposing third party firms for protecting profits might be applicable in India in remote future.

**Effect on costs in case of lapse supported pricing:**

The pricing of life insurance that is determination of instalment premiums is based on certain assumptions regarding the future liabilities of the insurer. One of these assumptions is regarding the lapse rate of a particular policy block. Rested on past experience the insurer assumes that a certain percentage of
the policies in the given policy block would be withdrawn and the full policy benefits would not be claimed. Based on these assumptions the level premium is calculated. Higher the assumed lapse/withdrawal rate, lower would be the premium.

In the event of extension of the secondary market, the lapse rate assumption would go wrong as the policies transferred to the third party firms would be continued and benefits would be claimed. This reduction in the lapse rate results into the liabilities for the insurer, for which the provision is not made in the premiums. In some cases, those life insurance firms, which were operating at break-even levels, started incurring losses due to the entry of third party firms.

We interviewed the life insurance experts in India, on this issue. All the experts were of the opinion that Life Insurance Corporation of India does not resort to lapse-supported pricing. The surplus generated due to lapsation is distributed among the policyholders as the final additional bonus. Hence, in case of LIC of India, the profits should not be affected adversely as the effect of secondary market trading.

The premiums can always be adjusted with the changed assumption of lapse rate. Hence, the negative impact on profit would be only short-term

**Effects on the market demand for life insurance:**

Doherty & Singer (2002) state that the secondary market trading will benefit the life insurance firms because the demand for the life insurance products will increase due to the ‘resale’
market for life insurance. The policyholders prefer liquidity. The conventional life insurance having risk assurance component is a long-term instrument and the life insurer cannot offer higher surrender value for such products.\textsuperscript{34}

The experience of the other markets ranging from real estate to financial assets shows that a well organized secondary market leads to higher demand in the primary market. This effect would be a long-term permanent effect beneficial for the life insurance companies.

\textbf{6.2.3 Implications for the Investor:}

Like any other market for financial assets, the investors interested to invest support the secondary market for life insurance.

The literature on the subject shows that the investor in this market is individual investor as well as institutional investor. The tradable insurance product which is in the form of viatical and life settlement product in other countries, is well known to be delivering high returns.

Agents with surplus funds typically have a high preference for safety and require complete protection of their capital. Of course, they may be ready to accept some degree of risk if there are compensatory higher returns. This means this

\textsuperscript{34} Please refer to Annexure 5.1 on ULIPs.
less risky product would replace their more risky investments in certain other assets.

Chapter 5 provides empirical analysis of the returns, which can accrue to the Indian investors from the investment in tradable life insurance products under variety of conditions. The risk return composition of the tradable policies of LIC of India is unique as it provides a return, which is very high given the risk–free nature of the investment.

A peculiar characteristic of tradable insurance in India is the near risk less nature of the investment. In India, the investor has unique opportunity to invest in the totally zero risk instrument giving comparatively high rate of return. Even as the market interest rate rises, the bonus rate reflects this rise and the rate of return on the tradable life insurance remains higher than the market rate.

The unparalleled risk–return composition of this instrument is possible due to the sovereign guarantee to the Life Insurance Corporation of India. This makes the tradable life insurance policies of LIC of India an instrument at par with the Government securities in terms of risk but fetching very high return. The insolvency risk is zero as the principal invested is guaranteed .The only risk is the operating loss.

Tradable life insurance can be a new instrument for investment by the mutual fund, finance companies, and hedge funds, PF & pension funds.
6.2.4 Implications for the marketing personnel in life insurance:

The availability of competitive cash values for policies implies that those policyholders who are willing to withdraw from the contract will seek cash value for the policy, rather than letting it lapse. The third party firms generally continue the policies. This reduces the incidence of lapse/forfeited policies. Thus the marketing personnel, whose earnings are related to the continued or in-force policies sold by them, get benefited from this arrangement. From the experience of the third party trading firm in India as well as abroad, it is observed that the trading firms are supported by the network with the marketing personnel of the life insurance firms.

6.3. Implications for the market

1) Evolution of Life insurance derivatives:

Insurance markets world over are undergoing a transformation as new risk management strategies are formulated and new financial instruments are created to replace and/or supplement traditional insurance/reinsurance products. There is an entirely different gamut of actuarial literature devoted to the mortality bonds, longevity bonds and the securitization of life insurance through trading in life insurance products. This study refrains from going into the details of this issue as it is beyond the scope of the study. Nevertheless, the
recognition of the fact that the trading in life insurance opens up these interesting possibilities for the life insurance sector indicates the deeper implications of the trading over and above the direct effects on the policyholders.

The secondary market trading would result into the financial innovation in Indian life insurance sector. This macroeconomic effect is lost when the market is restricted to the informal sector as the informal sector exchange of life insurance for cash value is lending and not trading. In official secondary market, the trading in various multiple cycles takes place.

Financial innovation means design of a new financial instrument or packaging together of existing financial instruments. There are two views on why financial innovation occurs. One cynical view is that innovation is primarily designed to overcome the effects of regulations ad to exploit tax loopholes. While other view is that, they are designing of products to meet the wide variety of needs of investors to improve the efficiency with which they can achieve those objectives.

The rapid development and availability of new products implies that firms and investors are better able to achieve their risk-return investment objectives.

The process of converting the time to maturity of the financial liabilities is called maturity transformation. The commercial banks transform short-term liabilities into long-term liabilities. On the contrary, the third party firm in the
secondary market for life insurance would be transforming the long-term liability of the life insurance firm, repackaging it into the slots of policies having a specified risk–return feature and selling it to the investors. During this process, it would be offering the liquidity to the policyholders and risk transformation to the investors.

Life insurance product may change its identity as a long-term product. The repetitive trading of tradable life insurance slots can give it a character of a financial derivative at a later more advanced stage of the secondary market trading.

2) Implications for Securitisation of ‘life insurers’ risk:

Securitisation is a financing tool, involving creating, combining, and recombining categories of assets and securities into new forms. Assets, loans, receivables, etc, from multiple obligors, and many times from more than one seller, are pooled and repackaged, underwritten and sold in the form of asset-backed or other securities. Securitizations provide financing for the sellers of the assets. These ‘asset-backed securities’ (‘ABS’) are collateralized or ‘backed’ by the pooled assets and are not considered general obligations of the asset sellers. While securitization structures can vary significantly, in general, the investor in an asset-backed security is entitled to receive a pass through of the timely payment of interest and principal on the pooled assets. The investor, therefore, looks to the cash flow from the purchased assets for repayment. A special purpose vehicle (SPV) issues slots of securities having different grades.
At a much later stage of secondary market expansion and institutionalisation, tradable life insurance securities can be treated as asset-backed securities. The establishment of secondary market trading in life insurance would be the initial stage for the securitization of life insurance.

These possibilities reveal the extent of long run impact on the life insurance market and product innovation promised by the secondary market trading in life insurance.
Annexure 6.1

Broad Sketch of the Issues Discussed with the Life Insurance Experts

The following points give a general idea of the issues covered in the interviews with the Life Insurance Experts and Professionals. The actual discussions were more detailed, revealing intricacies of the life insurance, legal and moral aspects, as well as ideological responses, which are mentioned in the study at various points.

1. What is your opinion about the current state of life insurance sector in India?
2. Can a policyholder sell the life insurance rights to a third party? Is this transaction legal?
3. To what extent this market is successful in other countries?
4. Do the policyholders sell their policies in India? How? Is it legal?
5. Do you think that it should be allowed in India? Why?
6. If this type of trading is established in India what would be the implications?
   for:
   Policyholders: -----
   Life Insurance Companies: -----
   Investors: ------
   Life Insurance Sector: -------
7. If the market exists what should be the stance of the regulator?
   What kind of arrangement should be established?
8. Any other comments/suggestions/information:
Annexure 6.2

Interim Order by the Supreme Court

SUPREME COURT OF INDIA   RECORD OF PROCEEDINGS
Petition(s) for Special Leave to Appeal (Civil) No(s).10783/2007
(From the judgment and order dated 23/04/2007 in WP No. 3282/2004 of
TheHIGH COURT OF BOMBAY)
LIC OF INDIA   Petitioner(s)   VERSUS
BACHRAJ FINANCE PVT. LTD. & ORS.   Respondent(s)
(With appln. for stay and with prayer for interim relief and office report)
(For final disposal)
Date: 04/04/2008 This Petition was called on for hearing today.
UPON hearing counsel the Court made the following ORDER

Matter to come up, as a short matter, for final hearing on a non-
miscellaneous day i.e. 5.11.2008. Pending the hearing and final disposal of
the special leave petition the following interim order is passed:

(a) The respondent-Company shall file an undertaking in this Court
within four weeks from today undertaking not to file any death claim with
the LIC in the event of death of policy holder during the pendency of the
special leave petition.

(b) The respondent-Company further undertakes not to raise
any funds or create a lien on the policies being assigned in favour of the
respondent-Company during the pendency of the special leave petition.

(c) The respondent-company further undertakes not to make any
claim that may arise by reason of maturity of term-policy/endowment
policy or surrender before its maturity or other benefits during the
pendency of the special leave petition.

(d) The above undertakings shall be without prejudice to
rights and contentions of the parties.

Subject to above terms and conditions LIC is directed to grant a
provisional registration of first assignment in favour of the respondent-
Company which will be subject to the rights of the parties in the special
leave petition.