

STOLI ALERT

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Welcome to the first edition of *STOLI Alert*, a newsletter for state regulators and lawmakers, newsmakers and others who are concerned about the practice called stranger-originated life insurance (STOLI). Also known as speculator-initiated life insurance (SPIN-LIFE), these arrangements attempt to circumvent state insurable interest statutes—laws that are intended to assure that people who buy life insurance have a true and meaningful interest in the life of the insured.

State insurance regulators and lawmakers are looking closely at STOLI. The National Association of Insurance Commissioners Life Insurance and Annuities (A) Committee voted in December 2006 to restrict these arrangements by amending its Viatical Settlement Model Act (see page 3). The National Conference of Insurance Legislators is also considering a proposal. The life insurance community endorses efforts to regulate these contrived transactions.

STOLI involves investment firms inducing certain wealthy seniors to obtain life insurance. These come-ons often include promises of “free life insurance” and other incentives—sometimes including payments in the six figures. The investment firms fully finance the transaction and continue paying premiums throughout the life of the contract. Two years into the contract, the investment firms—speculators—purchase the policy and stand to profit from the death benefits from policies on lives of strangers.

Why two years? Because these arrangements are structured to avoid state “wet ink” laws, which bar life insurance policy settlements for two years after a policy takes effect unless certain conditions are met. In addition, under most life insurance policies, the validity of the contract can no longer be contested by the life insurance company two years after the policy takes effect.

STOLI arrangements turn the purpose of life insurance on its head. Instead of taking out policies to protect and benefit those with an insurable interest, it is initiated by strangers who attempt to circumvent the purpose of state insurable interest laws for their own investment purposes.

STOLI is bad for life insurance, and also represents a threat to consumers.

As life expectancies have increased, the life insurance community has taken major strides in making life insurance available to older people who, in years past, would have been

WHERE WE STAND

Life insurance serves many critical social functions. Most importantly, it protects and provides tremendous benefits to individuals, families, businesses and employees. The increasing use of life insurance by speculators—who attempt to circumvent insurable interest laws and profit from the death benefits from policies on lives of strangers—is a clear abuse of life insurance’s social purpose.

Insurable interest is a fundamental concept in a well-functioning life insurance marketplace. The concept preserves the social purpose of life insurance and helps to assure that the product will not be abused. Insurable interest statutes demonstrate the widespread belief among the nation’s lawmakers that society is diminished when life insurance is used as a vehicle for gambling on human life. Stranger-originated life insurance violates the concept of insurable interest. Changes to state viatical settlement laws, laws which deal with settlement issues, are necessary to prevent STOLI promoters from evading state insurable interest laws and violating the social purpose of life insurance.

The life insurance community recognizes that many circumstances may lead the owner of a life insurance policy to explore a life insurance settlement. We have always supported—and will continue to support—legitimate life settlements. The life insurance community also supports the NAIC Life Insurance and Annuities (A) Committee proposal that contains numerous exceptions to a five-year moratorium on policy settlements (see “*Moratorium Exceptions*” on page 3). However, we oppose transactions initiated and solely designed to enable speculators to initiate life insurance, circumvent the intent of insurable interest laws and profit from death benefits from policies on lives of strangers.

considered uninsurable. STOLI threatens to undermine this market, making life insurance more expensive for millions of people who need and want it.

The life insurance community is united in working for changes to state viatical settlement laws to address this abuse of life insurance and to protect legitimate uses of life insurance.

The American Council of Life Insurers (ACLI), the Association for Advanced Life Underwriting (AALU) and the National Association of Insurance and Financial Advisors (NAIFA) are pleased to present this newsletter as a resource on this critical issue. *STOLI Alert* will provide news on STOLI and insights about developments on issues relating to these transactions.



HOW STOLI WORKS

Stranger-originated life insurance –sometimes called speculator-initiated life insurance (SPINLIFE)—has many variations but a common purpose: to allow outside investors to initiate life insurance coverage on strangers and circumvent state insurable interest laws.

Investors will identify older, high-net-worth individuals, generally people 70 or older with a net worth of more than \$1 million. These individuals are targeted because of their relatively short life expectancy and their wealth qualifies them for substantial amounts of life insurance.

The investors offer these individuals the chance to obtain large amounts of life insurance for “free,” or in exchange for some cash compensation. Generally, the investors loan money to their targets to pay the premiums for a defined period, usually two years. This initial period is based on the life insurance policy’s contestability period and state “wet ink” laws. A common feature of the arrangement is that the insured is told that he or she can walk away from the debt without any cost or other liability.

STOLI is structured to allow an investor without an insurable interest to initiate and profit from a life insurance policy on a stranger.

If the insured survives the contestability period, he or she typically is given the option of repaying the loan or transferring ownership of the policy to the investors in complete satisfaction of the debt. As a practical matter, the STOLI arrangement often is designed so that the insured will transfer the policy to satisfy the debt because the cost to repay the loan plus other fees and charges is so high that repayment is economically unfeasible.

If the insured dies during the two-year period, the net death benefit will be paid to the insured’s beneficiaries. However, the beneficiaries will be obliged to repay the premium loan to the investor.

The essence of the arrangement is that the investor is betting that the insured will live longer than the two-year period and transfer ownership to the investor, which then results in nearly all death benefits being paid to the investor.

STOLI DEVELOPMENTS

National Association of Insurance Commissioners

The NAIC’s Life Insurance and Annuities (A) Committee on Dec. 11, 2006, unanimously approved amendments to the NAIC Viatical Settlements Model Act to place restrictions on stranger-originated life insurance arrangements. The entire life insurance community supports the NAIC model.

The model act effectively addresses STOLI while protecting life insurance taken out to benefit individuals, families, businesses and employees, as well as legitimate life settlements.

The NAIC panel voted to deter STOLI by prohibiting settlement of life insurance policies for five years from policy issuance when the policy is purchased for the purpose of selling it in the secondary market. However, the five-year prohibition would not apply if the insured, a family member or employer put up their own money or collateral to buy the policy. A wide array of other legitimate life insurance arrangements are also protected by the NAIC proposal (see *moratorium details on page 3*).

Far from being a blanket five-year ban, as some have charged, the NAIC model represents a carefully-drafted balancing of interests between allowing policy owners to settle for legitimate reasons and preserving the integrity of state insurable interest statutes.

The NAIC Executive Committee and Plenary will consider the model at its upcoming Spring National Meeting scheduled for March 9-12 in New York City.

National Conference of Insurance Legislators

NCOIL says it intends to devote considerable time and energy to reviewing life insurance settlement activities with an eye towards developing a new model act to address STOLI problems. NCOIL is likely to establish a work plan for its review at its Spring Meeting in Savannah, GA, scheduled for March 1-4.

States Where Action is Expected

Illinois: Legislation patterned after the amended NAIC model act has been drafted and is expected to be introduced soon in the Illinois General Assembly. The bill will be supported by the life insurance community and the Illinois Department of Insurance.

Indiana: Legislation designed to crack down on STOLI transactions (H. 1248) has been introduced in the Indiana Legislature. The bill, which would prohibit the sale of a life insurance policy that is financed with the intent to be sold to investors who have no insurable interest in the insured, passed the Insurance Committee unanimously on Feb. 20. ACLI testified in support of the concept of the bill, and suggested that the Committee consider amending the bill to reflect the approach taken by the proposed amendments to the NAIC model. Meanwhile, legislation (S. 144) supported by

the life settlement industry has been introduced in the Senate. This bill does not include the STOLI language and other consumer protection provisions contained in the amended NAIC model. The life insurance community is actively opposing the legislation.

New York: Both the State Assembly and the Senate are likely to consider legislation drafted by the New York State Department of Insurance that incorporates some of the NAIC model's language but takes a different approach to STOLI. Rather than attempting to prescribe which transactions are allowed and which are prohibited, the New York approach seeks broader regulatory oversight of life settlements. This approach includes new consumer protection provisions, disclosure requirements and anti-fraud protections. The legislation was considered last year as A.8785-C in the Assembly and S.8463 in the Senate.

North Dakota: Senate Bill 2268, which tracks the amended NAIC model act, was adopted unanimously by the Senate Industry, Banking and Labor Committee January 30, 2007, on the strength of testimony given by the Insurance Commissioner, the North Dakota Bankers Association, ACLI and NAIFA. The bill later passed the full Senate unanimously and is scheduled to be heard in the House Industry, Banking and Labor committee in early March.

Moratorium Exceptions

The NAIC Life Insurance and Annuity (A) Committee proposal provides numerous exceptions under which policyholders could settle their policies and not be subject to the settlement waiting period. For example, common uses of life insurance in estate planning, business continuation planning, and employee benefit planning would not be affected by the moratorium.

Specific "life circumstances" exempted from the five-year moratorium are:

- A** terminal or chronic illness;
- B** death of a spouse;
- C** divorce;
- D** retirement from full-time employment;
- E** physical or mental disability preventing full-time employment;
- F** bankruptcy or insolvency.

The (A) Committee proposal also would allow settlements after two years when:

- A** policy premiums have been funded exclusively by the insured;
- B** there is no agreement or understanding that a policy would be settled at the inception of the contract;
- C** neither the insured nor the policy has been evaluated for settlement.

While the NAIC model act was just amended in December, 2006, and is awaiting adoption by the full NAIC membership in March, 2007, legislation is expected to be introduced in five or more additional states this year.

Opinion Letters

New York: On Dec. 19, 2005, the New York Insurance Department's Office of General Counsel (OGC) issued an opinion stating a valid insurable interest does not exist in a certain STOLI transaction and thus the transaction is impermissible under New York law.

The OGC responded to an inquiry involving banks proposing to loan money to high net worth individuals to purchase life insurance policies and pay premiums due under an option agreement to sell the policies to third parties on a predetermined date, which would be at least two years from the date of the loan.

OGC said that as described, it appears the intent of the arrangement is to facilitate the procurement of life insurance policies solely for resale. "It is our view that a plan of this nature does not conform to the requirements of the New York Insurance Law," OGC said.

OGC based its opinion on New York's insurable interest law. The transaction presented involves the procurement of life insurance solely as a speculative investment for the ultimate benefit of a disinterested third party, OGC said. This arrangement is "contrary to the long-established public policy against 'gaming' through life insurance purchases," OGC said.

Utah: On July 10, 2006, the Utah Department of Insurance issued Bulletin 2006-3 reminding life insurance companies, agents and viatical settlement providers that transactions involving the purchase of a life insurance policy, premium financing through a non-recourse loan, the sale of the policy in the secondary market and a payment to the policy applicant are not compliant with the insurable interest requirements of Utah law.

The Bulletin says that to determine if an insurable interest exists, the department will look at the entire transaction and will not limit its review to only that part of the transaction that relates to applying for life insurance. The Bulletin describes transactions in which a third-party initiates and arranges the transaction, and ultimately expects to receive the proceeds of the insurance policy.

"The third party has no insurable interest in the person insured because a lawful and substantial interest does not exist in having the life of the insured continue; in fact, there is a substantial interest in *not* having the life of the person continue," the Bulletin says.

Louisiana: On Sept. 5, 2006, Louisiana Insurance Commissioner James J. Donelon issued Bulletin No. 06-05, which deals with whether an insurance company can question policy applicants about their intentions regarding ownership and transfer of the policy. Commissioner Donelon noted that it has come to his attention that some investors, seeking to own policies insuring the lives of those in which the investors lack an insurable interest, have begun to initiate the creation

of life insurance policies for the purpose of settlement in contravention of controlling Louisiana law.

These arrangements, Commissioner Donelon said, may violate some or all of several Louisiana Insurance Code provisions, including insurable interest, the prohibition against wager policies, the prohibition on “wet ink” life settlements, premium finance and usury.

The life insurance community supports Commissioner Donelon’s comments on STOLI and its possible violation of Louisiana law. However, we take issue with one aspect of

Bulletin No. 06-05, which prohibits insurance companies from asking questions on policy applications that could help identify whether the policies are for legitimate purposes or for STOLI. We will continue to work with Commissioner Donelon on ways that will help life insurance companies identify illegal transactions.

MYTHS & FACTS

1. Myth: The life insurance industry wants to restrict all life settlements. **Fact:** The life insurance community recognizes and supports the right of our policyholders to sell legitimate life insurance policies in the secondary market. Policyholders often have compelling reasons to sell their life insurance policies. Our concern is not with settlements involving life insurance policies that were purchased consistent with the intent of state insurable interest laws—laws designed to make sure that all policy owners have an insurable interest in the insured at the time the policy is taken out in order to protect their families and their businesses. Rather, we strongly oppose those who want to corrupt the legitimate settlement market with contrived arrangements that circumvent those laws.

2. Myth: The STOLI market would not have developed if life insurance policies had greater cash surrender values. **Fact:** This argument is a red herring. STOLI promoters have no interest in the policy’s cash value. Promoters are only interested in receiving the policy’s death benefit. A life insurance policy’s cash value is important when life insurance is purchased for appropriate reasons. Cash value provides liquidity to a policy owner. Some policy owners turn their cash value into annuities. Cash value also assures that premiums can remain level throughout the life of the contract. These benefits of cash value are inconsequential in the STOLI market.

3. Myth: Insurance company pricing and underwriting practices, such as lapse rates, are the real reason the industry opposes STOLI arrangements. **Fact:** This is also a red herring. The reason the life insurance industry strongly opposes STOLI is that it attempts to circumvent the intent of state insurable interest laws. On the other hand, do those who promote STOLI use underwriting, pricing and other factors to their advantage? Yes they do.

Insurance companies underwrite and price policies based on several factors such as age and health. Because of state solvency requirements, insurers must price their policies to assure they maintain adequate reserves to pay all valid claims promptly. It is true that some policyholders allow their contracts to lapse when they are no longer needed. Insurance companies account for this in their pricing, which helps lower the price of insurance for everyone..

4. Myth: No one is harmed by STOLI. **Fact:** STOLI is life insurance initiated by strangers for their own investment purposes. It attempts to circumvent the intent of state insurable interest laws that assure proper and responsible use of life insurance. A stranger with no insurable interest should not be allowed to initiate coverage and profit from policy death benefits. STOLI violates the public policy of prohibiting wagering on human life.

From an insurance standpoint, STOLI threatens to undermine the life insurance market for senior citizens. Life insurers have increasingly found ways to make life insurance both available and affordable to senior citizens who want to secure the financial future of a child, a grandchild or other family member. However, if millions of dollars in benefits are paid for contrived arrangements, who can predict what will happen to this market?

Should this growing market be impaired due to skyrocketing and inappropriate claims, the real victims of STOLI could well be those senior citizens who have legitimate needs for life insurance.

STOLI Alert is published by the Association for Advanced Life Underwriting, American Council of Life Insurers, the National Association of Insurance and Financial Advisors and the National Association of Independent Life Brokerage Agencies.

Readers are encouraged to copy and share the information contained in *STOLI Alert*.

For further information about *STOLI Alert* and the issue of stranger-originated life insurance, please contact us.

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