



Ohio Department of Insurance

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House Insurance Committee Tuesday, January 15, 2008 – 3:00 pm Testimony of Mary Jo Hudson, Director Ohio Department of Insurance

Introduction

Chairman Batchelder and members of the House Insurance Committee, good afternoon. I am Mary Jo Hudson, Director of the Ohio Department of Insurance, and I would like to thank you for inviting me here this afternoon to discuss Amended Substitute HB 404 and the proposed amendments to Chapter 3916 of the Ohio Revised Code, otherwise known as the Viatical Settlements Act.

A stranger-originated life insurance transaction, or a “STOLI,” is a transaction where an investor agrees with a consumer to purchase life insurance, from the first dollar of premium paid on the life insurance policy, in order to benefit the investor. The insured is often paid a fee, up front, in order to participate in the transaction. The insured may also be promised that his or her beneficiaries may receive a small portion of the policy proceeds. A STOLI transaction is, in effect, an arrangement where an investor - a stranger to the insured - owns the right to receive the death proceeds. The only way to recover the investor’s money is for the insured to die. As Justice Oliver Wendell Holmes noted in Grigsby v. Russell, 22 US 149 (1911), “*a contract of insurance upon life in which an insured has no interest is a pure wager that gives the insured a sinister counter interest having the life come to an end.*” The Ohio Department of Insurance agrees with Justice Holmes and is opposed to STOLI transactions because of their potential negative impact on the Ohio life insurance market and on the availability and affordability of life insurance for older Ohioans.

Negative Impact on Life Insurance Market

The viatical settlement industry was created in the early 1990s in response to a demand for settlements by individuals holding life insurance policies who were diagnosed with AIDS. In the early 1990s, a policyholder with an AIDS diagnosis knew that the disease was 100 percent fatal. Insurance policies were sold to investors for cents on the dollar, and the settlement transactions served their purpose. Fraud and corruption, along with improved treatments for AIDS, resulted in a virtual disappearance of this market by the end of the 1990s. However, we are beginning to see a curious resurgence in the viatical settlement, or life settlement market, given that it is not fueled by a crisis similar to that generated by AIDS.

In July 2007, *Business Week* reported that the life settlement industry reported virtually no investments in 2001. However, in 2005, the life settlement industry was reporting

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investments of more than \$10 billion and by 2006, \$15 billion. Experts are predicting that such investments could balloon to \$30 billion in 2007. Goldstein, Profiting from Mortality, *Business Week* (7/30/07). What was the source of this sudden growth, in the absence of a crisis such as AIDS? The *Business Week* article concluded that many of the transactions that drove these significant investment numbers include STOLI transactions. The Department agrees with the *Business Week* analysis.

In addition to this reported sales growth, the Ohio Department of Insurance has seen an increase in the number of applicants to become viatical sales providers and brokers (currently, viatical sales providers file limited information with insurance regulators, so sales numbers are limited). The Department is concerned that this alarming rate of growth in life settlements, especially in the absence of a significant health crisis, means that STOLI transactions are the foundation of the growth. Regulators across the country are seeing apparent STOLI transactions directed to seniors, usually near the age of 70, causing additional concern for questionable sales tactics being directed to sometimes vulnerable consumers.

With growth of the life settlement market driven by these STOLI transactions, the Department is also observing signs of an increasingly restrictive environment in the life insurance market for seniors. A major national carrier recently announced increased rates for universal life policies for policyholders over the age of 70. Also, the Department is receiving filings from life insurers, which are proposing significant restrictions on assignments. Thus far, the Department is not accepting these filings. These trends do not bode well for the Ohio life insurance market or Ohio consumers.

The Department is concerned that life insurance will become significantly more expensive, and less available, for older Ohioans. As a result, seniors and their families will need to turn to investments that are riskier and subject to additional tax liability. We have recommended changes to the viatical settlement law, as reflected in Amended Substitute House Bill 404, in order to assure we do not have an unnecessary disruption in our life insurance market.

The Department has proposed these amendments after considering comments from stakeholders in the life settlement and life insurance industries, the agent community, and upon review of the newly adopted National Conference of Insurance Legislators (NCOIL) model. We also appreciate the thorough dialogue and valuable input from comments that were made by this Subcommittee. Our suggestions are tailored to keep the impact of the amendments narrow and focused on STOLI transactions. Our priority is to protect Ohio seniors and to maintain the integrity of the life insurance sales market.

Transactional Definition on STOLIs Is More Effective Than Simple Definition

Transactional Definition Versus Simple Definition

The current version of the Ohio Viatical Settlement Act does not directly address or limit STOLI transactions. Likewise, the Ohio insurance code definition of “insurable interest” does not provide the Department with sufficient enforcement authority necessary to stem the significant tide of STOLI sales that are occurring. The proposed amendments address STOLI transactions, by (1) limiting STOLI through a transactional definition, and (2) by amending the definition of fraudulent viatical settlement to include sales attempted to circumvent to STOLI prohibitions.

Many question the amendments supported by the Department because they do not include a simple definition of STOLI. Such questions are unfounded upon careful analysis of the proposed amendments. Since the market is growing so quickly, the Department believes the most prudent approach at this time is a transactional definition. The Department thinks that a simple definition would only create a “straw man” that will quickly become obsolete. Also, the Department is concerned with the impact of a simple definition. Defining STOLI in the simple definition requires determining the intent of the insurance applicant, rather than the seller. A simple definition would not require the life settlement brokers or providers to be less accountable for their sales, and thereby would create an untenable situation for consumers. The simple definition also requires review of the transaction after the fact. The transactional definition is an up-front review, thus requiring less regulatory involvement.

In order to address the shortcomings of a simple definition, the Department is recommending a transactional definition that is narrowly tailored to address STOLI transactions while allowing other life settlements, when appropriate. We recommend a transaction-based approach because of the simple impact of mortality on STOLI transactions. We know that STOLI transactions are directed to seniors near the age of 70. A STOLI transaction relies on the quick death of the policyholder so that limited premium is expended. A five-year waiting period would likely reduce the investment to interest only. Regulatory experts advise that the perpetrators of STOLI transactions would not benefit enough from a five-year delay before an opportunity to recover on their “investment,” and would turn to more legitimate life settlements instead.

Operation of the Transactional Definition

Our recommended transactional definition first defines every transaction as a viatical settlement contract, except for (1) all traditional insurance contracts and (2) all traditional premium financing, plus loan costs. Then, the amendments limit settlements for five years, but then (1) allow *any time* settlements for circumstances such as chronic or terminal illness, death of a spouse, divorce, retirement, disability or personal insolvency, and (2) allow for settlements after two years if (a) there was no agreement to settle the policy at least two years prior to issuance of the policy, (b) the insured was not evaluated for settlement at least two years prior to issuance of the policy, or (c) if the policy was originally financed with a non-recourse loan, that the insured posts cash or collateral for the loan against the policy, or limits the loan to the net cash surrender value of the policy. The result of this transactional definition is that only STOLI transactions are prohibited.

The five-year waiting period would not limit legitimate premium financing. Rather, it would only limit when the policy could be settled. Currently, older policyholders sometimes utilize premium financing and trust arrangements to maximize investment income on existing assets, and also to avoid gift and estate tax liability for their families. In a STOLI transaction, the policyholder creates immediate tax liability for himself, often unwittingly, and also potentially limits future insurance opportunities for himself and his family. The Department is troubled by this result.

Hardships and traditional use of life insurance as collateral are, likewise, exempted from the five-year limitation and may accelerate the timeline for settlements to occur. Hardship situations would allow for settlements within the two-year window because they do not involve STOLI. These are settlement situations that have been permitted in Ohio for over a decade, and the Department is not seeking to change this market. Rather, the amendments provide for additional accountability and transparency in these permitted transactions.

Finally, the Department supports the five-year transaction based limitation on STOLIs because life insurance regulations and mortality tables are well-established tools to encourage the sale of life insurance as a long-term financial planning product. STOLI transactions, which are designed to make quick dollars for brokers and investors, are not contemplated by the current regulatory or tax framework for life insurance, and they are not an element of a continued healthy market. Narrowly limiting the settlement process is intended to encourage continued stability and integrity in the Ohio life insurance market - through limiting only STOLI transactions. We encourage you and your colleagues to adopt these proposed amendments in order to address the concerns raised above.

The proposed amendments add extra protection for consumers by requiring full disclosures by viatical settlement providers and viatical settlement brokers, including any relationship between the provider and the broker, and the total compensation that the broker is making on the transaction.

The amendments also adjust the rescission period in a viatical sales transaction from 15 days to 30, after the insured receives the settlement proceeds, or 60 days after the insured signs

the agreements, so long as the insured repays any loan amounts and interest. If a rescission occurs, then the broker must refund his or her commission as well.

Finally, the amendments also require the broker to obtain regular continuing education on life settlement issues. They also allow for licensed insurance agents to be exempted from viatical settlement broker licensing in order to engage in incidental life settlement transactions.

Conclusion

HB 404 is an important amendment to Chapter 3916 of the Ohio Insurance Code. The amendments help to protect Ohio seniors against inappropriate insurance sales, and also preserve the venerable, long-standing principle of "insurable interest" in Ohio.

The Ohio Department of Insurance is in full support of these amendments, and encourages this Committee to adopt these amendments. Thank you for your time and attention. I would be happy to address any questions you might have at this time.