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Testimony of Mary Jo Hudson, Director
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Introduction

Chairman Stivers and members of the Senate Insurance, Commerce, and Labor Committee, good afternoon. I am Mary Jo Hudson, Director of the Ohio Department of Insurance. 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.

Viatical settlements, also known as life settlements, have been regulated in Ohio since 2001. Ohio was one of the first states in the country to regulate viatical settlements. A viatical settlement allows a consumer who owns a life insurance policy to sell the policy to a third party investor, who would then receive the policy's death benefit when the consumer dies. The proposed amendments, as passed unanimously by the House, are intended to protect Ohio consumers, especially seniors, and also assure continued integrity and stability in the Ohio life insurance market, by (1) limiting Stranger Originated Life Insurance, or STOLI, transactions and (2) adding accountability and transparency to the viatical settlement, or life settlement, process.

The House held extensive hearings on Am. Sub. H.B. 404, and made numerous amendments, based on extensive stakeholder input. The bill is a strong combination of Model Acts developed by the NAIC and NCOIL. The proposed amendments to the Viatical Settlements Act protect Ohio seniors, preserves the integrity of the Ohio life insurance market and the Ohio life settlement market, and I am here today to support their adoption.

What is STOLI?

A "STOLI" is a transaction where an investor agrees to purchase life insurance on the life of the consumer, from the first dollar of premium paid on the life insurance policy, in order to benefit the investor. The insured consumer is often attracted to the deal by the investor's promise to pay an up-front fee in order to participate in the transaction. The insured consumer might also be promised that his or her beneficiaries may receive a small portion of the policy proceeds. But, the investor - a complete stranger to the insured - owns the right to receive all or nearly all of the death proceeds. The only way for the investor to recover the investor's initial investment (premiums it paid or financed for the consumer) and make money is for the insured to die within a short period of time, and for the investor to collect under the policy.

A STOLI transaction is nothing more than a wager on the life of another – a construct long rejected in American jurisprudence. In 1911, Justice Oliver Wendell Holmes noted in Grigsby v. Russell, 22 US 149 (1911), that "*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.” As recently as last month -- nearly 100 years after Grigsby -- an Ohio court applied this same principle in Wuliger v. Manufacturers Life Insurance Co., 2008 U.S. Lexis 9809, *22 (N. D. Ohio, February 11, 2008) to declare void contested insurance policies that were taken out by viators who arranged to purchase the policies solely to assign them to life settlement companies in return for a fee. These cases and Ohio’s insurable interest statutes, Ohio Revised Code Sections 3911.09 and 3911.091, make a strong statement of public policy against STOLI transactions. These laws are tools for the foundation of the concept of insurance. Ironically, no Ohio law specifically prohibits sales personnel from participating in or arranging STOLI transactions. The Department supports the proposed amendments to Chapter 3916 because they clarify Ohio’s long standing public policy regarding wagering on the life of another.

How Did We Get Here?

In order to understand why the Department is recommending an amendment to the Viatical Settlement Act, I would like to explain the concept of "insurable interest" as defined in Section 3911.09 of the Ohio Revised Code, and also how viatical settlements moved into the insurance market.

Insurance laws, and the concept of "insurable interest" developed centuries ago, when English lawmakers stopped the practice of investors pooling their funds and agreeing that the last surviving member of the investor group, or tontine, could keep the funds. Tontines were used to finance public works and made many investors rich. In 1774, England outlawed tontines because “investors” were killing each other to receive the investment pool. The Act of 1774 required that a person buying “life insurance” must have an insurable interest, i.e., a relationship with the insured that motivated the purchaser to want the insured to remain among the living. The concept of “insurable interest” is a basic principle of English law that became the basis for the regulation of life insurance sales.

Next, it is important to distinguish a tontine from a viatical settlement. In the early 1990’s, individuals who were diagnosed with AIDS received a virtual death sentence - there was no cure and death was almost guaranteed within a short time after diagnosis. Many of these individuals were young, and they were losing their jobs, housing and health insurance—reaching epidemic numbers in just a few years. For those AIDS victims who were fortunate enough to hold life insurance policies – policies purchased with a valid insurable interest - a market developed where the policyholder could, in effect, sell their policy to an investor for a fraction of the policy's value. Thus, a market for viatical sales, or life settlements, was born. However, just as the viatical settlement market began to develop, it also went into decline due to fraud, corruption and improved treatments for persons living with AIDS. These changes meant that investors had to keep paying premiums long after the time they expected to receive their profits. As a result, the viatical settlement market virtually disappeared by the late 1990s.

Recently, we have observed a significant increase in the viatical settlement, or life settlement market. Given the absence of any high fatality epidemic, experts believe that this increase is due to STOLI transactions in the life settlement market. 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 investments of more than \$10 billion and by 2006, \$15 billion, and a likely \$30 billion in 2007. Goldstein, Profiting from Mortality, *Business Week* (7/30/07). The *Business Week* article noted that “[m]any life settlement providers... are trying to lure people who don't even hold insurance. In this tail-wagging-the-dog scenario, speculators take out policies on the individuals' behalf, pay them something up front, cover the premiums, and then wait for the people to die so they can collect.” Id. The *Business Week* article concluded that many of the transactions that drove these significant investment numbers include STOLI transactions. The Department has observed a similar trend in Ohio and agrees with the *Business Week* analysis.

Regulators across the country are also 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. Indeed, Ohio is only one of 17 states currently moving to address STOLI. Last month, West Virginia passed STOLI legislation patterned after the proposed amendments in Ohio. Further, since my testimony in the House, the Department has investigated complaints regarding STOLI activity in Ohio.

Negative Impact on Life Insurance Market

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. Many carriers are adopting increasingly restrictive underwriting guidelines in order to avoid potential STOLI transactions. 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 that are proposing significant restrictions on assignments.

The Department is concerned that such a restrictive environment will result in an artificial hardening of the Ohio life insurance market. If the life insurance market hardens, 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. Also, business succession planning arrangement financed through life insurance may become more cost prohibitive for Ohio small business and family business owners. Amended Substitute House Bill 404 will help assure we do not have an unnecessary disruption in our life insurance market.

STOLI Transactions and Negative Impact on Ohio Seniors

The Department is also deeply concerned about the significant, adverse impact that STOLI transactions can have on Ohio seniors. STOLI transactions are generally directed to seniors over the age of 65. These transactions are commonly promoted as “free” insurance. However, these deals are anything but free for the senior.

STOLI transactions can have adverse consequences for seniors, including unexpected income tax liability, credit score issues, limited future insurability and higher life insurance rates. When a senior enters into a STOLI transaction, the senior often receives an up-front fee. This fee may be the only remuneration that the senior receives in the transaction. Unlike life insurance proceeds, which are exempt from income tax liability, STOLI transaction payments are fully taxable.

Also, when a STOLI transaction is structured as a first dollar, premium financed transaction, a loan is issued to the insured, or at least in the name of the policyholder. If the loan is in the insured’s name, the debt obligation is reported on the insured’s credit history. High debt loads can lower credit scores, and adversely impact future credit applications that the senior might undertake. Similar to credit history, an individual can only be issued a certain amount of life insurance before the individual would be considered a poor insurance risk. If an individual enters into a STOLI transaction, then needs to apply for life insurance for family or business succession purposes, the insured’s application may be denied due to excessive prior insurance coverage.

Finally, life insurance rates are established on actuarial principles, assuming the insurer has full knowledge of the risk it is assuming. The premium rates do not consider third parties investing in life insurance proceeds, or the other risks associated with such investments. If STOLI transactions are allowed to continue, unchecked, in Ohio, we can anticipate that life insurance for Ohioans will become more expensive, as insurers begin to try to protect themselves from these artificial transactions.

The Amendments Encourage Greater Transparency and Accountability in Life Settlement Transactions

The current Viatical Settlement Act requires strengthening in order to limit STOLI transactions. The proposed amendments, in their current form, are narrowly tailored to prohibit STOLI transactions, while continuing to permit legitimate life settlement transactions. The amendments (1) limit STOLI through a combined transactional and simple definition of STOLI that effectively limits all shapes and sizes of STOLI transactions, while also allowing other legitimate life settlements; and (2) add sales attempting to circumvent the STOLI prohibitions to the definition of fraudulent viatical settlement.

Many question the use of a “transactional definition” of STOLI. Since the STOLI market is growing so aggressively, the Department believes the most prudent approach to limit STOLI’s now and in the future is a transactional definition that includes a “five year moratorium”. The five year period was selected because the typical investment period in a STOLI settlement is four years. The transactional definition accounts for the dynamics of STOLI transactions in the viatical or life settlement market, without limiting legitimate life settlement transactions. Also, the transactional definition puts the burden on the investor or life settlement company to structure a legal transaction. Defining STOLI exclusively by the simple definition requires a regulator to determine the intent of the insurance applicant, rather than the seller or the settlement broker. A simple definition also requires review of the transaction at only one point in time and after the transaction has occurred. The transactional definition adds valuable accountability to all life settlement transactions, and requires life settlement brokers and providers to assure that they are not engaging in a STOLI transaction.

Am. Sub. H.B. 404 also includes other valuable amendments that add transparency and accountability to viatical or life settlement transactions. For example, 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. Further, the amendments require the viatical or life settlement broker to obtain regular continuing education on life settlement issues. These amendments will further protect consumers from unscrupulous sales practices and will assure the life insurance market that Ohio is no place to engage in STOLI transactions.

Conclusion

The amendments to the Viatical Sales Act, as set forth in Am. Sub. H.B. 404 protect Ohio seniors and support the continued integrity of the Ohio life insurance market. The Ohio Department of Insurance is in full support of these amendments, and encourages this Committee to adopt them in their entirety. Thank you for your consideration of this matter. I would be happy to address any questions you might have at this time.