# The Vast Difference Between Life Settlements and STOLI

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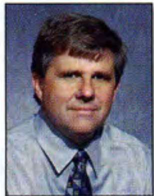

***"The secondary market is still very new and rapidly evolving. Accordingly, the market is immature and inefficient ..."***

As life settlements (or viatical settlements) have grown enormously in popularity and use over the past few years, regulation of this secondary market has become a headline issue for many states, garnering a great deal of attention (and controversy) among national organizations such as the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL). Consumers, institutional investors, financial advisors, and the "primary market" insurers, as well as regulators and public policy makers, are all very interested in the handling of life settlements.

The secondary market is still very new and rapidly evolving. Accordingly, the market is immature and inefficient; transactions are convoluted and complex, highly intermediated, and relatively opaque, even to market participants. These elements, as well as the fact that the underlying product (life insurance policies) is regulated, suggest that a robust regulatory regime is appropriate and necessary. Many states have adopted regulation, generally modeled on the NAIC "viatical" model promulgated in 2000, but there is a general consensus that this model is outdated and inadequate, given the state of the current market.

The formulation of good public policy in such a complex environment requires a deep understanding of both the primary and secondary markets (not to mention the "tertiary market"), as well as underlying principles such as insurable interest. The political process, however, tends to seek simple answers to complex problems, and in the rush to solve a

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perceived problem, a real dialogue on the fundamental public policy issues has, for the most part, been absent.

The current sense of urgency to address regulation of the secondary market is largely driven by two factors. In fall 2006, the then-Attorney General of New York, Eliot Spitzer, filed a civil action against the largest life settlement company, Coventry First of Valley Forge, Penn.. Spitzer alleged widespread abuses, including deceptive practices, bid-rigging, and fraud, with the collusion of several of the larger life settlement brokers. This action drew national headlines, and although this complaint has not been adjudicated and there have been no convictions or indictments, it unfortunately created the perception that the industry is rife with predatory practices that are detrimental to consumers.

The other major area of concern from a public policy perspective is the "manufacture" of new life insurance policies destined for sale into the secondary (or tertiary) market. This practice, labeled (perhaps inappropriately) as Stranger-Originated Life Insurance (STOLI), has caused deep concern among primary market insurers, and that concern has been forcefully communicated to the media, regulators, and public policymakers, primarily by the American Council of Life Insurers (ACLI).

It should be noted that although the supposed practices as described in the "Spitzer allegations" are indeed egregious, they are already clearly prohibited by regulation in those states

that do regulate the secondary market. In the states that do not currently have regulation (including New York), such practices would also be illegal under common law statutes regarding unfair trade practices, bid-rigging, and/or fraud. As previously noted, to date no individual or entity has been found guilty, and thus the presumption of innocence must, at least for the moment, prevail. Nevertheless, regulators appropriately take a position of "smoke means fire until proven otherwise," and in the interest of protecting consumers in their jurisdictions, they have made adopting (or revising) life settlement regulation a high priority.

It is somewhat ironic that regulatory issues related to the secondary market have become so high profile and contentious. Life settlements are generally regarded as beneficial to consumers and viewed favorably by consumer advocates. Furthermore, complaints from consumers to state regulators about life settlements are relatively rare; most sellers are delighted to have received a cash settlement for an asset they didn't even know they had — most people think of life insurance purely as an expense.

### *The Problem of STOLI*

Aside from consumer protection, the biggest area of concern for both regulators and legislators is the perceived problem of policies "manufactured" for the purpose of being sold as life settlements. The STOLI problem is widely seen as the primary reason for urgency in proposing new regulatory models.

The acronym itself is somewhat problematic. STOLI was coined and popularized (and to a large extent, demonized) by the ACLI. Intentionally or not, the acronym is often mistaken to mean Stranger-Owned Life Insurance, instead of Stranger-Originated Life Insurance. Since any secondary market transaction ultimately results in the ownership of a policy by a third party otherwise unrelated to the insured (a stranger), the potential for confusion between "owned" and "originated" tends to at least subliminally call into question the legitimacy of all life settlements.

A more appropriate acronym would be IILI (Investor Initiated Life Insurance). IILI involves the creation of a new contract of life insurance where the true "owner" of the policy at inception does not have a valid insurable interest in the life of the insured. It is solely to create an asset for investment purposes. IILI is indeed a problem, and a multi-dimensional one at that. Insurable interest is fundamental to the public policy rationale for allowing the business of life insurance to operate at all, and the most basic underwriting responsibility for a carrier is to establish insurable interest before issuing a policy. Indeed, from a legal perspective, a strong case can be made that in the absence of insurable interest at inception, there is no contract of insurance; there may be a contract with consideration, but it is not a life insurance policy.

Since the issues surrounding IILI arise at the inception of the contract, it is a primary market problem and only peripherally related to what are now known as life settlements. That said, much of the (often questionable) economic rationale for engaging in IILI transactions involves the existence of an "exit strategy" for the investor.

IILI is not a new phenomenon. Many of the earliest public policy debates involving life insurance as a commercial enterprise revolved around establishing a distinction between "wagering" contracts versus legitimate insurable interest. Since a life insurance contract can literally make an individual worth more dead than alive, there is clearly the potential for moral hazard — a rather deadly one at that.

Everyone can agree that public policy has an overwhelming interest in prohibiting contracts that are effectively mere wagers on the life or death of a human being. Insurable interest addresses this concern by requiring that the owner of an insurance policy have "strong ties of blood or affection" and/or a direct financial interest in the continued well-being of the insured. Insurable interest is an ancient concept, and laws dealing with insurable interest exist in virtually every country, state, or jurisdiction that allows the sale or purchase of life insurance.

Among the more vexing public policy issues surrounding the IILI/STOLI problem is the difficulty of defining what it is. At one extreme, there are

life settlement transactions that are unquestionably legitimate. An example would be an insured who has owned a policy on his own life (and paid premiums with his own funds for many years), who no longer needs or wants the policy, and therefore offers it for sale on the secondary market via intermediaries (life settlement brokers and providers) licensed in his state of residence. No one, including the most vociferous critics of IILI, questions either the legality or appropriateness in this circumstance.

At the other extreme, consider an individual being contacted by an unrelated third party with a proposal whereby he or she will receive financial incentives in return for taking out a new life insurance policy, which will be owned (beneficially or otherwise) by someone else solely for investment purposes. This is clearly not a legitimate life insurance transaction. While those examples are clearly black and white, pretty much everything in between is various shades of gray; all public policy makers can do is try to draw bright lines in the midst of gray murk.

IILI transactions can have adverse consequences for seniors including unexpected income tax liabilities, credit score issues, limits on future insurability, and (potentially) higher life insurance rates in the future. Unlike life insurance proceeds, which are generally exempt from income tax, any monies received in an IILI transaction are fully taxable. The Life Insurance Settlement Association (LISA), is against IILI/STOLI as it violates the purpose of life insurance as well as insurable interest laws.

**"... insurable interest ... must be rigorously enforced."**

Further confusing the issue are stealth transactions. In today's environment, the real action is in unregulated tertiary market activity. Agents are encouraged to write new insurance on seniors with a trust (domiciled in an unregulated state) as the owner. Premium payments and financial incentives are advanced by the funder to the insured, and beneficial ownership of the trust (rather the policy itself) is then transferred to the funder — often within days of policy's issue.

Since no change of ownership or beneficiary occurs, neither insurance carriers nor regulators have any way of knowing the real circumstances. In these situations, funders operate as "accredited investors" or lenders, rather than as licensed providers, and the transaction does not require the participation of a life settlement broker. Indeed, this is not a secondary market transaction at all.

The regulation of life settlements or viaticals is almost entirely focused on the activities of licensed intermediaries — brokers and providers — who neither participate in, nor profit from, the transaction described above. From this standpoint, trying to address the STOLI problem through regulation of life settlements is doomed to failure.

Investor- or stranger- initiated life insurance transactions do represent a genuine issue. The principle of insurable interest is fundamental to the foundations of the life insurance industry and must be rigorously enforced. It is important, however, that the problem be addressed in a fashion that does not unduly restrict the rights of consumers or distort what has become a legitimate and thriving marketplace. As a former life company CEO, I strongly support regulation that prohibits IILI activities, while at the same time protects consumers' rights and privacy, and promotes a transparent and efficient secondary market. Life settlements can provide an excellent alternative to simply lapsing or surrendering a policy that is no longer needed and wanted, and the right of policy owners to avail themselves of that option must also be protected.

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