Testimony before the House Insurance Committee: *"House Bill 2188 - Viaticals"*

Presented by:
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On behalf of acting Insurance Commissioner Robert Pratter and the Pennsylvania Insurance Department, I would like to thank you for the opportunity to be here for discussion of this important piece of legislation, House Bill 2188. My name is Brad Harker, and I am Director of the Insurance Department's Life Insurance Bureau. I would like to thank you for inviting the Department to participate in today's discussion.

As you are aware, House Bill 2188 seeks to amend Pennsylvania's Viatical Settlement Act to include additional protections for insurance consumers and persons selling their life insurance policies on the secondary market, as well as prohibitions against stranger originated life insurance (or "STOLI") transactions. Viatical settlements, also known as life settlements, have been regulated in Pennsylvania since 2002. In its simplest form, a viatical settlement allows a consumer who owns a life insurance policy to sell the policy to a third party investor for an immediate lump sum of money, and the investor purchasing the policy then receives the policy's death benefit when the consumer dies. However, in the eight years since the Viatical Settlement Act was enacted, we have learned that viatical settlement transactions are rarely as simple as that and the viatical settlement industry has undergone significant changes and growth, some of which were never envisioned in the original legislation, giving rise to the need to amend our current law to address today's secondary market for life insurance.

The Department supports and encourages a healthy viatical settlement industry in the Commonwealth. Viatical settlements offer a valuable benefit to consumers who previously purchased life insurance, but no longer have a need for the product. Previously, the only options were to surrender the policy for its cash value (if any), take an accelerated death benefit if a need can be demonstrated, or simply allow the policy to lapse. Viatical settlement providers offer a legitimate and additional option to insurance consumers in the Commonwealth where they can sell the policy to investors in exchange for an immediate lump sum of money beyond the cash value of the policy.

Clearly, given the significant growth of the viatical settlement industry, viatical settlement transactions are filling a need that was previously vacant in the insurance industry. However, we have seen that "need" has, in some settings given rise to over-reaching ;" and out of a legitimate industry has grown illegitimate transactions that seek to harm Pennsylvania's consumers. These transactions go by a host of names: stranger initiated life insurance ("SILI"), speculator induced life insurance ("SPIN-LIFE"), stranger originated life insurance ("STOLI"). No matter the name, however, these transactions have a common thread - they seek to mask an illicit scheme for investors to profit on the life of another in the guise of what seems to be an ordinary life insurance transaction.

In a typical 'STOLI' transaction, an investor prompts a consumer (typically an elderly consumer near the age of 70) to apply for insurance on his or her own life, where there is no true need for the insurance coverage. Before the life insurance is even applied for, there is a side agreement from the investor to purchase that life insurance policy at the end of the policy's contestability period (2 years). Typically, the life insurance policy is purchased with a non-recourse premium financing arrangement where the consumer takes out a loan for the policy premiums, but no payment on that loan is due until the consumer

dies and a death benefit is collected, or the contestability period has lapsed. Therefore, there is no financial cost to the consumer.

The consumer is often attracted to the deal by the investor's promise to pay an up-front fee or inducement in order to participate in the transaction. These inducements can range from an up-front payment of a percentage of the death benefit to a new car. The consumer might also be promised that his or her beneficiaries "may" receive a small portion of the policy proceeds. However, the investor–who, again, is often a complete stranger to the insured–is in control of the transaction and is driving the life insurance purchase. The STOLI transaction is set up to hide this side agreement and pre-purchase dealings from the life insurance carrier.

As such, a STOLI transaction is nothing more than a wager on the life of another–a social ill that has long been 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."* This principle is precisely why all states have insurable interest requirements for the purchase of life insurance. The concept of "insurable interest" developed centuries ago, and is the cornerstone of American regulatory framework governing life insurance contracts. STOLI transactions stand in stark contradiction to the principles of life insurance and insurable interest requirements. STOLI investors seek to essentially "farm" life insurance by luring consumers into purchasing policies that they do not need solely for the purpose of later selling such policies in the secondary market. This is a scenario where the tail is truly wagging the dog.

STOLI transactions are inherently contrary to every public policy principle underlying life insurance. First, they tend to prey upon some of the most vulnerable populations in our Commonwealth seniors. STOLI transactions are generally directed to seniors over the age of 65, and are commonly promoted as "free" insurance. In the end, the deals are anything but free for the senior, and can lead to numerous adverse consequences, 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. Even if the consumer is offered "free insurance" during the contestability period, the value of that insurance could be considered a taxable event as well.

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, individuals have a maximum insurance capacity, and carriers will only issue a certain amount of life insurance to any one individual based upon need before a consumer will be considered a

poor insurance risk. STOLI transactions deplete that insurance capacity and the consumer could be faced with an inability to fulfill future life insurance needs for family, estate planning or business succession purposes.

What is most alarming is that consumers who are lured into STOLI transactions may become unwitting conspirators to insurance fraud, which could expose them to potential criminal penalties or other legal entanglements . Oftentimes, consumers are asked to inflate their net value to allow for higher amounts for insurance to be purchased, and consumers are often "coached" on how to fill out the applications to preserve the artifice that is created to hide the true purpose of the life insurance transaction from the life insurance carrier.

In addition, STOLI transactions are affecting the landscape of our state's life insurance marketplace. Some carriers are adopting increasingly restrictive underwriting guidelines in order to avoid potential STOLI transactions. Major carriers are announcing increased rates for life policies for policyholders over the age of 70, and many carriers are including significant restrictions on assignments in their life insurance contracts submitted to the Department for approval. The Department is concerned that such a restrictive environment will result in an artificial hardening of the life insurance market here in Pennsylvania, meaning that life insurance could become significantly more expensive, and less available, especially for our older Pennsylvanians.

Unfortunately, STOLI transactions are alive and well here in Pennsylvania. The Department has been involved in several investigations involving STOLI transactions, and several others are pending. STOLI presents a real threat to Pennsylvania's insurance consumers, and harms have already been perpetrated.

Accordingly, the current Viatical Settlement Act requires strengthening in order to prevent 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 will specifically define and prohibit STOLI transactions, as well as add further transparency and accountability to viatical settlement transactions. The Department supports these amendments, and encourages their adoption and enactment. Thank you for your consideration of this matter. I would be happy to address any questions you might have.