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Answers to Difficult Questions on STOLI

The following Q & A is to assist ACLI staff, retained counsel, and member company representatives in responding to difficult questions from legislators and media regarding the industry's position on legislation to deter stranger-originated life insurance.

Q: Isn't ACLI pushing laws to regulate STOLI as a fig leaf to cover an underlying agenda to prevent all life settlements and thus deprive policy owners of the chance to receive fair market value for their policies?

A: To the contrary, STOLI promoters are using life settlements as a fig leaf to cover an underlying agenda to advance STOLI. The STOLI promoters continually try to confuse the issue by failing to distinguish between policies acquired in good faith—with a legitimate insurable interest and for the purpose of protection—and those acquired in bad faith—without a legitimate insurable interest and solely for settlement.

ACLI's position is clear: We support legislation targeted at STOLI. Several of our own members are now engaged in the life settlement business. Yet all these companies endorse our position on STOLI. In particular, we all support the NAIC's proposed five-year settlement moratorium on STOLI policies. The ACLI members who have made financial commitments to the life settlement business understand their interests will not be harmed by the NAIC's model because it only attacks STOLI.

As for consumers, United States District Court Judge Denny Chin reaffirmed the longstanding rule that there are no settlement rights involving policies that were acquired in bad faith. "Only one who obtains a life insurance policy on himself 'on his own initiative' and in good faith—that is, with a genuine intent to obtain insurance protection for a family member, loved one or business partner, rather than an intent to disguise what would otherwise be a gambling transaction by a stranger on his life—may freely assign the policy to one who does not have an insurable interest in him." *Life Product Clearing v. Angel, 2008, WL 170193, Jan. 22, 2008 (United States District Court for the Southern District of New York)*.

Q: Aren't life insurers simply trying to protect the excess profits they enjoy thanks to high lapse rates?

A: Wrong as to lapse rates and wrong as to profits. First, on lapse rates, a detailed study by Marianne Purushotham, a research actuary for LIMRA International, demonstrates that for the policies most likely to be settled in five years or less, the lapse rate is only 10 percent. Moreover, Purushotham noted that while the overall lapse rate for life insurance policies is 88 percent, that figure is skewed significantly by term insurance, a type of coverage which was never intended to be permanent. Lapse rates are not a significant issue in the debate over STOLI, except as a red herring raised by STOLI promoters to distract attention from their activities and the need for laws that protect consumers.

As for profits, life insurers must operate in a highly competitive environment. ACLI itself has more that 350 member companies who compete against each other in every market in the nation. In addition, other financial intermediaries, such as banks and investment firms, offer products and services that compete directly with products and services offered by life insurers. In a marketplace this competitive, the notion of "excess profits" is absurd.

Q: But wouldn't the problem with life settlements go away if life insurers priced their products adequately and paid higher surrender values?

A: Again, this is a red herring that confuses life settlements with STOLI. STOLI is a contrived transaction in which investors seek to profit by purchasing life insurance on a stranger. This has nothing to do with

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surrender values. Since the policy applicant in a STOLI transaction would not be purchasing life insurance at all but for the agreement to sell the policy to the investors, surrender values are meaningless because the true owners of the policy—the investors—have no interest in surrendering it. The only way they can profit is to wait for the applicant to die and collect the death benefit. Surrender values have no relationship to STOLI and are mentioned by STOLI promoters solely to distract attention from their activities and the need for good laws and regulations.

As for pricing, ACLI does not monitor insurance rates due to antitrust concerns. However, as noted above, the marketplace is highly competitive and under basic, free-market economic theory, prices in a competitive market reflect the fair market value for the product or service being offered. Are the STOLI advocates, who continually insist they represent the interests of consumers, demanding that life insurers artificially raise premiums to above the fair market value?

Q: Why should life insurance death benefits and inside buildup receive tax preferential treatment if life insurance is simply an investment like any other?

A: Life insurance is for protection of families and businesses, not an investment for hedge funds. That is the social purpose of life insurance and the industry is working hard to protect the integrity of the product by promoting laws that prevent STOLI. It should be noted, however, that death benefits paid to third party investors, whether under a legitimate life settlement or STOLI, are fully taxable as ordinary income. In addition, amounts paid to policy owners who settle their policies are fully taxable. The policy owners may also be liable for taxation on any premiums paid by investors before a policy is settled. And, as noted above, persons who engage in STOLI have no interest in the 'inside build-up' or surrender value of a life policy. So, while STOLI is an abusive transaction that must be addressed by the enactment of appropriate laws or rules, there is no reason to alter the tax treatment of life insurance. Good faith policyholders who have real need for protection should not suffer due to the misconduct of others. If insurance companies are given the proper tools to monitor and deter STOLI, by enactment of the NAIC or NCOIL models or a hybrid combining the best features of both, the problem of STOLI can be effectively addressed.

Q: Why are life insurers trying to interfere with the property rights of policy owners by imposing a five-year settlement moratorium?

A: This is not just a red herring, it's an out-and-out falsehood. Life insurers are not trying to deprive anyone's legitimate property rights. First, it is important to understand that property rights are not absolute. Just as lawmakers have enacted zoning laws prohibiting property in single family housing neighborhoods to be used for commercial development and have enacted laws making it illegal for patients to resell their prescriptions to advance certain public policy concerns, they can limit the right of policy owners to transfer life insurance for the sake of public policy considerations. There is already a two-year period in most jurisdictions during which ownership of policies cannot be transferred. Extending that to five years to advance the public interest in protecting the legitimate use of life insurance violates no one's rights.

But more important, the five-year moratorium in the NAIC's model only applies to STOLI policies. The STOLI advocates who say it is a blanket moratorium are flat out wrong. Read the bill. The moratorium does not apply to any policy purchased with the policy owner's own money. It does not apply to policy owners who need to settle their policies due to changes in life circumstances, such as the death of the intended beneficiary, divorce or medical expenses. The moratorium is targeted directly at STOLI. The fact that STOLI promoters are working so hard to mislead lawmakers on so basic a provision should raise red flags about their credibility.

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Q: If the life insurance industry is so concerned with the concept of insurable interest, why does it sell corporate-owned life insurance (COLI), a type of arrangement under which a company can maintain an insurable interest in people many years after they have left the employer that insured them?

A: COLI is a long-standing and well-recognized business-planning tool which serves many purposes, such as insuring "key" personnel, whose loss would devastate an employer. "Broad-based" COLI policies can help employers fund employee benefits. States have long recognized that employers have an insurable interest in the lives of their employees. As with any life insurance policy purchased in good faith, this insurable interest must be in place at the time of application. In contrast, hedge funds or other parties that stand to benefit from the death of an insured in a STOLI arrangement have no insurable interest in the life of the insured. While COLI is designed to serve a social benefit, STOLI is designed to provide a profit to speculators.

The life insurance industry has acknowledged problems with certain broad-based COLI policies written decades ago, particularly those that covered rank-and-file employees. When these problems emerged, the industry moved to the forefront of efforts to craft responses targeted to the concerns. For example, under the COLI Best Practices Act, federal legislation that was signed into law in 2006, employers must receive the informed consent of an employee before including that employee in a COLI policy. The life insurance industry worked closely with members of Congress and the regulatory community to assure that responses to concerns over COLI directly addressed the problems in ways that maintained the integrity of the concept of insurable interest.