

**Testimony of Michael T. McRaith
Director of Insurance
State of Illinois**

**Before the
Senate Special Committee on Aging
United States Senate**

**Regarding:
Life Settlements and the Need for Increased Transparency**

April 29, 2009

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Introduction

Chairman Kohl, Ranking Member Martinez, and distinguished Members of the Committee, thank you for the invitation to talk with you about the financial safety of our aging population. My name is Michael McRaith. I am the Director of Insurance for the State of Illinois, and in that capacity I testify today.

State insurance officials have a demonstrable record of successful consumer protection and industry oversight. Twenty-eight (28) of the fifty (50) largest insurance markets in the world are individual States within our nation, but we also respond to more than 3,000,000 consumer inquiries annually. The US insurance market surpasses the combined size of the second, third and fourth next largest markets.

In 2007, 387 life insurance companies reported \$4,635,396,241 in direct Illinois premiums for Individual Ordinary Life policies and 219 companies reported \$1,664,187,690 in direct Illinois premiums for Group Life Business. As of 2007, companies reported 6,941,391 individual policies in force in Illinois and 196,860 group policies in force, the latter accounting for 5,027,538 certificates. With a market of this magnitude, Illinois is fertile ground for those who would prey upon our aging population.

Each day state regulators focus our responsibilities on ensuring that the insurance safety net remains available when individuals, families and businesses are in need. With a

proud record of success, insurance regulation constantly evolves, innovates and improves to meet the needs of consumers and industry.

For this reason, we are grateful to the Special Committee for shining additional light on this still-murky marketplace known as "life settlements," a pernicious subset of which is known as "stranger-owned life insurance" (STOLI). With more seniors in need of supplemental income due to the economic crisis and the concurrent degradation of retirement assets, now is the time for this discussion. As insurance regulators, consumer protection has been, is and will remain priority one, and the information deficit with which we function relative to STOLI causes grave concern.

STOLI -- Dangerous for Seniors.

STOLI is a problem for Illinois' aging population because such arrangements often lead to unanticipated problems, including:

1. income taxes on cash payments that lured the consumer into the scheme;
2. income tax liability on proceeds from the sale of the insurance policy, which are often unexplained;
3. income tax liability if the premium payment is determined to be a gift in excess of the gift tax limitations;
4. loss of access to public health or other aid programs;
5. loss of access to other insurance products with legitimate insurance purposes;

6. phone calls from Wall Street, or elsewhere, from unknown third parties inquiring about health status;
7. widespread, unregulated dissemination of a senior's health records; and
8. potential liability for the senior's estate if the life insurer rescinds the policy due to fraud.

Life Settlements -- Regulation Must Protect Our Seniors.

This Committee's efforts, through this hearing and elsewhere, exemplify the national leadership that will greatly enhance our work at the State level. To this day, our nation remains largely uninformed about:

1. the mechanics of life settlement transactions;
2. the sources of capital for life settlement transactions;
3. the payment arrangements between the involved commercial participants;
4. the marketing and sales practices used to lure our aging population;
5. the identity and type of deal participants;
6. the identity of policyholders and beneficiaries;
7. the sources of profit within a transaction;
8. the regularity and substance of communications between investors and beneficiaries; and
9. the impact on tens of thousands of individual consumers.

In Illinois, our most significant challenges involve a life settlement marketplace about which little is known or can be determined based on reported information. As insurance

regulators, we aim to support legislators and to provide data and information on which rest critical consumer protection decisions and legislation. Our regulatory objectives can be stifled when we lack the factual foundation on which sound public policy can be based.

Since 1996, Illinois has regulated transactions commonly known as "viatical settlements," or transactions in which a life insurance policy is sold due to the terminal illness of the policyholder.¹ This law, based on the model developed by the National Association of Insurance Commissioners (NAIC), arose from the business model created during the mid- to late 1980's that afforded HIV/AIDS patients the ability to settle life insurance policies and receive funds for personal or medical expenses prior to death.

Fortunately, treatment and resources for those infected with HIV/AIDS improved. Regrettably, viatical settlements grew into the broader "life settlement" phenomenon, which then developed a strain of the predatory practices known as STOLI.

On September 11, 2007, the *Chicago Tribune* printed a full-page advertisement in which adults over the age of 55 were invited to meet former Chicago Bear Mike Ditka. Included in the "symposium" enticements was the opportunity to learn about "free insurance" and how not to "outlive your life insurance." A copy (8.5 x 11) of one-quarter of this advertisement is attached hereto as Exhibit A, and an actual-size version of the entire advertisement will be provided to Committee staff at the hearing on April 29, 2009.

¹ For purposes of this written testimony, the terms "viatical settlement" and "life settlements" shall have identical meaning.

Promotions such as this demonstrate that life settlements and STOLI are not marketed solely to wealthy, sophisticated consumers.

In this decade, the life settlement industry has reportedly exploded from an approximately \$2 billion enterprise to an approximately \$15 billion enterprise, although the exact size, volume and cumulative dollar value of transactions remains uncertain. Insurance regulators, media reports, and the former New York Attorney General, among others, raised public awareness about the explosive growth of STOLI, including abusive marketing and compensation practices. A frequent target of investigations, hearings and news stories has been Coventry First, L.L.C. ("Coventry").

Rather than rely upon allegations or findings by regulators or law enforcement from other states, we sought to scrutinize independently the size and scope of the life settlement industry in Illinois. We identified a need for Illinois to have state-specific information. Accordingly, in October 2007, we served Coventry -- reportedly the nation's largest participant in the life settlement market -- with a subpoena for Illinois-related records and information.

Rather than comply with the subpoena, Coventry filed a lawsuit in February 2008, contending that Illinois laws regulating viatical settlements do not regulate the life settlement industry. *See Coventry First, L.L.C. v. McRaith, et al.*, No. 08 CH 5537 (Cook County Circuit Court). Represented by the Office of the Attorney General of the State of Illinois, we (the State) prevailed in the Circuit Court, a decision which Coventry

promptly appealed. *See Coventry First, L.L.C. v. McRaith, et al.*, No. 08-1917 (Ill. App. Ct. 1st Dist.). Among other arguments, Coventry asserts that legislative activity in Illinois, and elsewhere, constitutes an admission that our current laws do not subject the Coventry business model to regulatory oversight. The appeal remains pending.

In January 2008, Senator William Haine, chairman of the Illinois Senate's Insurance Committee, and Representative Frank Mautino, chairman of the Illinois House's Insurance Committee, introduced parallel legislation to the Illinois General Assembly consisting of a modified version of the model act proposed by the National Conference of Insurance Legislators (NCOIL) and the model developed by the NAIC, respectively. The draft legislation now pending constitutes a hybrid of the best provisions of each model, including clearly articulated consumer protections and regulatory tools. Through seventeen (17) months, the effective and balanced leadership of Senator Haine and Representative Mautino have brought Illinois to the brink of effective consumer protection legislation.

Regulation of Life Settlements -- An Effective Solution.

If passed, Illinois law will recognize the valuable rights that policyholders have in a life insurance policy. Recognizing legitimate estate-planning needs and the often unanticipated volatility of life, any prohibition on STOLI should permit lawful life settlements when:

1. the viator exercises conversion rights arising from a group or individual policy, provided that the time covered under the conversion policy plus the time covered under the prior policy exceed twenty-four (24) months;
2. the viator is terminally or chronically ill;
3. the viator's spouse dies;
4. the viator divorces;
5. the viator retires from full-time employment;
6. the viator becomes physically or mentally disabled and a physician determines the disability precludes full-time employment;
7. the sole beneficiary is a family member and the beneficiary dies; and,
8. in any other condition that the regulator determines to be an extraordinary circumstance, as determined by rule.

Illinois' draft legislation does not prohibit family members from supporting one another in the purchase of a life insurance policy, but does prohibit the financing of a premium by a hedge fund or other third party. The draft bill allows viatical settlement transactions that do not constitute STOLI, as explicitly described in items 1 - 8, but prohibits those transactions in which the policy is initiated for the benefit of a third-party investor.

As noted above, STOLI and the business practice of "life settlements" has grown explosively. In recent years, investors who purchased large blocks of life insurance policies on the secondary market encountered solvency and liquidity problems if the individuals did not die in a timely fashion. STOLI business models have evolved so that

complicated series of trusts generate a veneer of a genuine "insurable interest," even though the veneer shields the identity of a third party investor.

Many justifiably argue that our current economic crisis was caused by the failure of federal regulators and rating agencies to understand the bundles of assets and potential liabilities on which much of the Wall Street wealth was based. Despite rating agency and regulator concerns, few actually knew and understood the sophisticated financial products on which institutional profit was based. Indeed, our current economic crisis illustrates the need for STOLI regulation that does not remain static but provides regulators with the tools and data on which to base public policy recommendations to legislators. In other words, effective STOLI regulation requires:

1. licensing of viatical settlement brokers, including solicitors and promoters;
 2. licensing of viatical settlement providers;
 3. regulation of viatical settlement transactions;
 4. at least annual reporting by viatical settlement providers to the regulator;
- and,
5. regulator authority to examine and impose appropriate penalties on all participants in a viatical settlement transaction.

Licensing and reporting requirements, combined with examination authority, provide the regulator with tools needed to protect our aging population. STOLI emerged, and has grown, as a business model because investors, providers and brokers generate enormous profits -- an incentive to circumvent any regulation. For this reason, as illustrated by the

credit default swap fiasco, mandatory, thorough and annual reporting will aid regulators so that applicable law and oversight can evolve with the marketplace.

Given the lack of information publicly available to State and Federal legislators regarding the impact of STOLI and life settlements on our aging population, many states, like Illinois, have moved forward with legislation to regulate the viatical, or life settlement industry. Effective regulation, however, will not statutorily endorse a business model about which policymakers and regulators remain largely ignorant. With more seniors growing ever more vulnerable, and with more investors looking for certainty of a return, *i.e.* as certain as death, the time for effective regulation is now.

Conclusion

STOLI arrangements are predatory, abusive practices that convert the lives of our elderly parents, friends and neighbors into commodities. The State of Illinois, led by two great legislators, Senator Haine and Representative Mautino, has drafted balanced but effective legislation that, if passed, will protect consumers, and preserve our seniors' ability to enter into legitimate estate-planning arrangements.

We welcome the interest of Congress and this Special Committee in this important consumer protection initiative. As we move forward with regulation of STOLI and viatical settlement transactions, we pledge to share our experience, expertise and Congress and to work with the members and staff of this Special Committee.

Regulation of all financial sectors must allow for innovation and efficiency. Not under any circumstance, though, should consumer interest be sacrificed for the benefit of market goals. In this instance, as we work to protect our aging population from predators, we must remain vigilant to limit, if not eliminate, the potential abuses of life settlement practices.

Thank you for the opportunity to testify, and I look forward to your questions.

ANNUITIES AND LIFE INSURANCE

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- ▶ WHEN YOU DON'T NEED AN ANNUITY
- ▶ WHY VARIABLE ANNUITIES MAY BE A MISTAKE