Testimony of

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Life Settlements and the Need for Regulatory Transparency

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Good afternoon Chairman Kohl and Ranking Member Martinez. My name is Mary Beth Senkewicz, and I am the Deputy Insurance Commissioner of the Florida Office of Insurance Regulation responsible for the oversight of life and health products sold in our state. On behalf of Florida Insurance Commissioner Kevin M. McCarty and myself, I would like to thank you for inviting me here today to discuss the evolution of life settlements, and to give the Committee insight into Florida's regulatory experience with this industry.

Having one of the most elderly populations in the United States, Florida has been at the forefront of attempts to adequately regulate these products, first called "viatical settlements." Like other states, our state is struggling to understand the implications of developments in this market which include the emergence of life settlement contracts, and a related transaction – Stranger-Originated Life Insurance or STOLIs. The difficulties in regulating these complicated products have been compounded by the industry's lack of cooperation, administrative delays, and litigation.

I have four main points that I would like to make with my testimony today. Firstly, these arrangements are really investment or financial products that are only tangentially related to traditional life insurance. Secondly, we will not be able to make progress in protecting consumers from the negative aspects of these products without transparency to regulators and the public. My third point is the underlying reason investors can profit from life settlements is due to the exemption of life insurance proceeds from federal taxation.

My final point, which is the most important, is that we need to protect traditional life insurance products; this protection includes retaining the tax exempt status of life insurance proceeds to beneficiaries with an insurable interest in the deceased. I am concerned the emergence of life settlements and STOLIs may endanger this tax exempt status, which has historically been used by family members genuinely needing financial relief from the death of a loved one.

Overview of Life Settlements

Before we can commence a discussion of the implication of these products, and the regulatory oversight of these products, we must first begin with a history and definition of life settlement contracts. The basic structure of the transaction is simple: a consumer (often an elderly person) has an in-force life insurance policy. The elderly person “sells” his or her life insurance policy for cash to a third-party investor. The third-party investor becomes the owner (and beneficiary) of the policy and collects the face value of the death benefit (tax free) upon the demise of the insured.

This arrangement does have unseemly connotations, specifically, the third party has no insurable interest in the elderly person; to the contrary, investors have a financial interest in the death of this person. This has been referred to as “wagering” on a person’s life, which was initially against the law in most states. Like most states, Florida has an insurable interest law (Section 627.404, Florida Statutes), that requires the beneficiaries of a life insurance policy to have an “insurable interest” in the insured at the time the policy is purchased. This often includes a spouse, child, or other individual that is financially and emotionally dependent on the ongoing life of the insured.

History of Life Settlements

The first phase of the evolution of these products began in the 1980s. During this decade, the industry focused on obtaining life insurance proceeds for terminally ill insureds. Often marketed as “humane” products that provided terminally ill insureds with access to financial resources prior to their death – these products were often called viaticals. They were frequently marketed to AIDS patients as the mortality rates were very high for people with this disease, and death was relatively certain. Some ill patients sought to sell their life insurance policies to help defray medical expenses and gain access to life-prolonging drugs.

The first consumer oriented problems began during this period as viatical settlement companies acted as an intermediary for sick insureds and investors. Sometimes settlement companies misled investors about the health of the insured, and investors became frustrated when their “investments” did not die within specified periods of time. Ironically, it was the access to the life insurance proceeds that often allowed insureds to purchase life extending drugs which prolonged their life and made the viatical investments a poor financial investment for speculators.

The industry evolved into its second phase in the 1990s when terminally ill patients were more difficult to identify. The increased availability of the “AIDS cocktail” also altered the medical landscape as new drugs extended the lives of patients. To counter this new development, the viatical industry shifted its focus to purchasing policies for non-terminally ill patients, and repackaged this product as “life settlements.” These were marketed to seniors who wanted access to the value of their life insurance during their lifetimes, but who were not terminally ill. The providers typically offered seniors cash amounts well above the cash surrender amounts offered by life insurance companies.

It is difficult to pin-point the third phase of this industry, but the current phase started sometime during the 21st century. This phase involves private investors or companies (even insurance agents or brokers) who solicit an elderly person *before* they purchase a life insurance product. These promoters entice seniors with inducements to buy life insurance they might not otherwise have purchased. The motivation for seniors was not access to funds, but to obtain “free insurance” and make a profit on their ability to purchase life insurance.

This is a very different scenario, as the purpose of the entire transaction was never intended to be insurance on the life of an insured, but instead, to initiate a life insurance policy for the sole purpose of selling it for cash to investors. To evade insurable interest laws, the insured and private investors often have a side-agreement or contract to “sell” the insurance policy after two years. One reason for the two-year timeframe is that many states have a two-year “contestability” period. After two years have expired, the insurance company is prohibited from rescinding a policy based on fraud.

These arrangements are marketed as "win-win" situations as the insurance company benefits by the sale of the product, the investor makes money upon the death of the insured, and the elderly person is compensated by the private investor. The only way this arrangement can benefit everyone is by taking advantage of a simple fact: life insurance proceeds are exempt from federal taxation. However, there are several hidden costs to seniors which will be discussed later in my testimony.

Regulatory Framework

Even from the beginning, the regulatory framework for this industry has been convoluted. Initially, these transactions were not regulated by any government entity as they were not traditional insurance products. In fact, Florida passed its comprehensive viatical law, Florida's Viatical Settlement Act, Part X Chapter 626, Florida Statutes, in 1996. Currently, roughly half of the states regulate life settlements. In Florida, our state laws do not directly differentiate between viatical settlements and life settlements, and do not acknowledge the existence of STOLIs associated with life insurance policies.

Florida's Viatical Settlement Act

The initial purpose of the act was designed to establish a regulatory scheme for the protection of "viators" (policy owners) by requiring the licensing of viatical settlement providers and viatical settlement brokers. The legislation required minimum disclosures affecting the rights of a viator and further provided a 15-day "free look" period that allowed a viator to rescind the transaction.

Due to increasing consumer complaints, in 1999 the Florida Legislature added additional consumer protections and additional disclosures to investors. Viatical/Life Settlement providers were required to inform investors the return on the investment was directly tied to the projected life expectancy of the insured and the investor could be responsible for premium payments should the insured outlive the projected life expectancy. The legislation also prohibited any person from misrepresenting the nature of the return on their investment or the life expectancy of a person with an insurance policy. Furthermore, it strengthened laws governing unfair trade practices.

The pace of regulatory change has also been influenced by developments in the court system. In February 2000, a Statewide Grand Jury was impaneled to investigate the viatical industry. The Grand Jury issued its first report on the viatical industry in Florida and as importantly, issued three indictments charging seven individuals and one corporation with 155 felonies relating to the viatication of life insurance policies. These policies had a face amount of approximately $12.7 million. The Grand Jury also recommended a number of legislative changes to curtail fraudulent activity.

The Florida Legislature responded in 2001 by enacting most of the Statewide Grand Jury's recommendations. The most important change was to expand regulation explicitly to life settlement arrangements. The legislation also added consumer protections including a rescission period and additional criminal penalties for fraud. The legislation also clarified the state's jurisdiction over viatical settlement purchases with residents of states other than Florida if the company operated from Florida.

The legislative changes in Florida since 2001 have been modest. In 2002, additional requirements were passed for sales agents. In 2003, the current division of regulatory authority among state agencies was established, and in 2005, the Florida Legislature enacted legislation that definitively identified viatical settlement investments as securities subject to the Florida Securities and Investor Protection Act regulated by the Office of Financial Regulation. The new law required persons selling these investments to become licensed securities brokers. In addition, viatical settlement providers were now required to file with the Office audited financial statements on a calendar year basis. In 2007 there was a technical change involving the submission of audited financial statements by viatical settlement providers.

The Emergence of STOLI Arrangements

During the last few years, Florida has witnessed a new development, Stranger-Originated Life Insurance. Unlike life settlements, STOLI promoters actively solicit seniors before they have purchased an insurance policy, and convince them to purchase a policy with the intent to “sell” their life insurance to an investor. Sometimes STOLI promoters are not officially regulated entities or individuals (agents, brokers, insurance companies), and often arrange to pay the premiums on behalf of the senior. (Premium financing is one indicator of these transactions.)

Some STOLI promoters encourage seniors to overstate their net worth on the life insurance applications to obtain higher-value life insurance. They also coach seniors how to “correctly” answer specific questions on the application to avoid detection by the insurance companies of their intent to re-sell the policy after two years.

To understand recent developments in the marketplace, the Office of Insurance Regulation (the Office) conducted a public hearing on August 28, 2008 and invited testimony from the life insurance industry, life settlement industry, and other professionals knowledgeable in this subject area. The Office issued its report which summarized the issues discussed in the hearing and issued its report in January 2009. A copy of the report including the complete transcript and video of the hearing is available on the Office’s web site at www.floir.com.

During the 2009 legislative session, the Office proposed legislation to address stranger originated life insurance (“STOLI”), which attempted to address several concerns uncovered during the public hearing. The proposed legislation mirrored elements of the NAIC Viatical Settlement Model Act and the NCOIL Life Settlement Model Act. The Office encountered considerable opposition to its regulatory efforts in promulgating new administrative code, as well as in the legislative arena. The proposed legislation will not progress during the current legislative session, and the Office’s bill did not even receive a committee hearing.

Non-Cooperation from the Life Settlement Industry

Currently, there are 14 licensed viatical settlement providers in the State of Florida. Since Florida began its regulation of viatical settlement providers 24 viatical settlement providers licenses have been issued, four licenses have been revoked and six licenses have been surrendered. Furthermore, five applications for licensure were denied.

Since 1996, the Office has expended a tremendous amount of resources attempting to regulate these viatical settlement providers. The Office has finalized 18 separate orders (includes Orders to Show Cause, Orders to Cease and Desist, Consent Orders and other legal orders), filed two Administrative Complaints, and concluded an 11 investigations or examinations of additional entities which involved assessed fines and costs of $1.95 million. Even from its inception this “industry” which includes all three phases of viaticals, life settlements, and now STOLI arrangements have not acted as “good corporate citizens.” The industry has consistently attempted to circumvent statutes, and has been vigorous in its opposition of the adoption of new administrative code, and in changing Florida law.

The Office has attempted to use rule making authority to adopt additional regulations to make the industry more transparent. Unfortunately, most regulatory attempts by the Office have been met with litigation. As an example, in 2007 the Office initiated promulgation of Rule 69O-204.101 Disclosure to Viator of Disbursement. The proposed rule required disclosure of payments connected to the transaction, thus making the fees and compensation more transparent to the policy owner. The Life Insurance Settlement Association (LISA) successfully challenged the rule through the administrative process.

The Office attempted again in 2008 by proposing Rule 69O-204.040 – Prohibited Practices and Conflicts of Interest. The rule was designed to ensure the broker maintained its fiduciary responsibility to the viator and prohibit double dealing of affiliated entities in the same transaction. The proposed rule was challenged successfully by Institutional Life Services (Florida), LLC and David Matthew Janecek.

Despite repeated attempts, the Office has also been unable to formally adopt an Annual Report form. Once again, the industry has challenged the rule through the Florida Division of Administrative Hearings. As of this date, the Division of Administrative

Hearings has not issued a ruling on this challenge. The Office attempted a bill in the Florida Legislature in 2009 to expand the Office's statutory authority, but the industry prevailed in defeating any changes to the statute that would increase transparency to the industry.

Even those entities complying with the law have made attempts to frustrate government regulation. In 2008, six of the viatical settlement providers filing an Annual Report have designated such information as "trade secret," whether that is appropriate or not.

Coventry First LLC

To illustrate the challenges in the marketplace, one should look no further than Coventry First LLC (Coventry), a principal player in the market. On October 27, 2006, the state of New York's Attorney General, Eliot Spitzer, sued Coventry accusing the company of bid-rigging and other types of fraud in acquiring more than $3.6 billion worth of life insurance policies. Spitzer alleged that Coventry made secret payments to life-settlement brokers in exchange for convincing the elderly and ill to sell their policies at lower prices to Coventry and to entice other buyers to withdraw rival bids.

As a result of these allegations, and subsequent investigation by the Office, on May 10, 2007, a Notice and Order to Show Cause was issued to Coventry alleging violations of the Florida Insurance Code by engaging in fraudulent or dishonest practices, dealing in bad faith with viators and employing individuals who have shown to be untrustworthy or dishonest. The legal documents detailed Coventry's transactions with eight (8) Florida viators. One transaction involved an individual with two (2) life insurance policies with a face value of $19.4 million who received only $968,832 of his policy while the brokers involved allegedly were paid over $1 million. Coventry collected a $247,707 bonus from the investor for keeping the total cost of the transaction under $2.5 million.

The matter was resolved on September 28, 2007, by Consent Order, in which Coventry denied violating any provision of Florida law, but agreed to adopt a Business Practice

Enhancement Plan. Coventry agreed to pay the Office $1.5 million in connection with the Office's investigation and examination, and agreed to a future examination.

As part of the follow-up from this settlement, during 2008 the Office notified Coventry of its intent to conduct an on-site examination of the company. To conduct the examination, the Office asked Coventry to produce specific information pertaining to its settlement business in Florida and nationwide. Unlike other regulated entities in Florida that welcome Office oversight as part of doing business in our state, Coventry responded by filing a Motion for Preliminary Injunction in the United States District Court for the Northern District of Florida, Tallahassee Division.

Coventry argued the Office does not have authority to review, regulate, examine or oversee its policies that relate to policy viators or policyholders who reside outside of Florida.

On March 31, 2009, the Office prevailed on this issue as the Federal Court issued an Order Denying Motion for Preliminary Injunction and Granting Motion to Dismiss. The Court explicitly recognized the state of Florida's rights to examine and investigate Coventry's out-of-state records. The Court concluded that being licensed in Florida is a privilege and "with that privilege comes the responsibility to adhere to the provisions of that act and any evaluations made by the Office regarding the 'personal fitness' of the licensee…This determination of the character of the settlement provider may be ascertained by evaluating the complete picture of Plaintiff and its business practices as a whole, both inside and outside the state of Florida." Coventry is currently appealing the decision in the U.S. Court of Appeals, 11th Circuit.

Although this issue has been resolved (pending an appeal) Coventry also challenged the Office on another issue. Coventry refused to file an Annual Report for the period ending December 31, 2008, as required by Section 626.9913(2), Florida Statutes. Coventry acknowledged the statute required an Annual Report, but argued it should not submit a statement because the form had not been adopted by rule. Coventry filed a Petition

Challenging Agency Statement As Rule with the Florida Division of Administrative Hearings on February 24, 2009, in which it argued the Annual Report form currently utilized by the Office was not currently required by statute or existing rule.

Ironically, one of the reasons the current proposed form for the Annual Report has not been approved, is because it has been challenged by the industry causing delays in the administrative process. Both LISA (the Life Insurance Settlement Association) and Coventry have objected to the submission of information pertaining to non-Florida regulated transactions. While the Office has prevailed on legal issues in conjunction with the viatical/life settlement industry generally and Coventry specifically, the sheer amount of lawsuits and other legal tactics have placed a tremendous strain on Office resources.

To put this into perspective, Florida has issued licenses to 24 entities to offer these products (which is now 14 regulated entities due to revocations and surrendered licenses). Despite the fact this is such a small industry relative to other lines of insurance, the industry has incurred 18 different legal orders, two administrative complaints, and 11 examinations or investigations with additional accompanying consent orders that included assessed fines and costs of $1.95 million. The expenditure of government resources is especially egregious when considering this industry represents only 14 of the 3,900 regulated entities (or roughly 0.4%) of all entities regulated by the Office in 2008.

The number of viatical or life settlement contracts has expanded substantially as indicated by the following table based on data reported to the Office:

Florida Only			
Year	Number of Purchased Policies	Amount Paid for Purchased Policies (in millions)	Face Value of Purchased Policies (in millions)
1997	595	$28	$53
1998	926	$43	$113
1999	457	$15	$46
2000	226	$9	$25
2001	159	$11	$51
2002	149	$30	$169
2003	177	$40	$217
2004*	213	$64	$398
2005	263	$101	$612
2006	416	$181	$933
2007	580	$289	$1,423
2008*	529	$257	$1,326

** NOTE: The 2004 figures do not include the viatical transactions of Mutual Benefits Corporation. The 2008 figures do not include the viatical transactions of Coventry First LLC.*

Currently, viatical/life settlement transactions in Florida account for roughly one-fourth of the nation's total in terms of purchased policies, and face amount. The table above also shows that the mean face value of viaticated policies in Florida has increased from $89,000 in 1997 to $2.5 million in 2008.

These Arrangements Make Seniors the Victims

Florida is a unique state with over 17.6% of its population over the age of 65. From 1990 to 2000 the number of seniors residing in the state increased by 438,000, or 18.5%. While terminally ill patients were initially targeted by viaticals/life settlement providers, this has changed to targeting another group that may soon die – seniors. Although the industry has been fraught with fraud to encourage seniors to obtain life insurance policies for the purpose of selling them to investors, the outward appearance can be seen as victimless transactions. It is characterized as a "win-win" scenario.

However, there is potential harm to seniors for being induced to participate in these transactions. Seniors may exhaust their life insurance purchasing capability should they later want to purchase life insurance for traditional reasons. The incentives in the form of cash payments for selling their policy may subject seniors to an unexpected tax liability. Seniors may also have to give the investor, and subsequent investors, access to their confidential medical records when they sell their life insurance policy in the secondary market. This new strategy to use life insurance as an investment vehicle may also have unintended consequences for the industry including an increase in the cost of life insurance for those over 65.

Potentially the greatest harm to seniors is if the insurance company discovers a STOLI arrangement prior to the two-year contestability period. If insurance companies discover that misrepresentations were made by seniors to obtain a life insurance policy, the insurance companies have the right to rescind the policy, and file a lawsuit against the senior for incurred expenses. In addition, the investor or STOLI provider can also demand the seniors refund life insurance premiums paid on their behalf by investors to keep the insurance policy in force.

Conclusion

The life settlement industry has a checkered history on the whole. It lacks a basic transparency that should be available to consumers who legitimately obtained life insurance policies and want to access the value of their property in their lifetimes. Basic information, such as how much money the agent, broker, and life settlement provider are making on the transaction is not routinely provided. There is no vehicle for a consumer to “shop and compare” and see with what company he or she might get the best deal.

And now we have STOLI arrangements. These arrangements in particular provide little public benefit or satisfy any financial need in the marketplace. Instead these products exist solely for profiting on the tax exempt status of life insurance proceeds. Whatever meager benefits are achieved through this arrangement do not override public policy concerns of wagering on human life, and exposing seniors to potential tax liabilities and litigation. They should be banned at the federal level, since the industry has been active, and successful, at the state level where states have been trying to clarify that these arrangements are illegal. And further, the federal government has an overriding interest in this issue because it affects national tax policy.