Robin & Peter on LIFE SETTLEMENTS

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STOLI on the Rocks?

The life insurance marketing scheme known as STOLI (Stranger Originated Life Insurance) appears to be taking its last breath. STOLI was usually sold under some sort of non-recourse or partial recourse financing arrangement in which elderly insureds were persuaded to obtain life insurance policies for investors, circumventing or violating insurable interest laws. A variety of factors have come together to eradicate this unsavory activity.

Regulatory Efforts

Life settlement legislation has now been passed in about 40 states. Although the legislation is intended to broadly regulate life settlements, these statutes usually include some anti-STOLI provisions. Most common is the type of provision contained in the NCOIL (National Conference of Insurance Legislators) Model which makes almost any sort of agreement to sell a life insurance policy within two years of issue a fraudulent act punishable by criminal and civil penalties.

Less common, and not as effective in combating STOLI, is the NAIC (National Association of Insurance Commissioners) Model which, subject to limited exceptions, bans all sales of life insurance for the first five years after issue. This model does not close a major loophole which is the sale of beneficial interests in a policy (that is, selling an interest in a trust that owns the policy rather than selling the policy itself).

Insurance Company Behavior

Until December 2005, when the New York Insurance Department issued an opinion stating that STOLI type arrangements violated insurable interest laws, insurance company practices regarding STOLI fell into four categories: 1) those that promoted it as a sales technique, 2) those that turned a blind eye towards the activity, 3) those that actively tried to prevent it, and 4) those that were unaware that STOLI activity was even going on. Once the NY Opinion was published, almost all companies "got religion" and began vigorously trying to prevent STOLI promoters from using their policies. This has been accomplished by monitoring sales of policies fitting the STOLI profile, large face amounts on insureds around age 75.

Litigation
Complementing the regulatory actions and increased vigilance of insurance companies, are numerous lawsuits that have been brought by insurers, regulators, and other parties involved in STOLI arrangements. These lawsuits typically involve the rescission of policies that were issued under suspected STOLI schemes: policies that were issued based on misrepresentations or fraudulent statements and policies for which there may have been no insurable interest. In addition to rescission, insurers frequently seek to keep all premiums received and recover all sales commissions that were paid.

Life Expectancies
One of the most compelling reasons for the demise of STOLI occurred in the fall of 2008 when the mortality tables used by some major life expectancy companies were increased by 20 to 30%. Until that change, the moment a policy was issued, there was usually a discrepancy between the insurer's life expectancy and that of life expectancy providers. That discrepancy increased the projected rate of return on death benefits to levels that were attractive to third party investors. With that arbitrage gone, newly issued life insurance policies are no longer an attractive investment.

Investment Markets
Investors have been burned by STOLI. Not only will the policies, that were previously originated, likely produce very disappointing results (due to apparently incorrect life expectancies projections), but investors have come to realize that they also bear substantial legal and headline risks. As a result, at a time where capital is already in short supply due to the recession, investors have lost their appetite for STOLI life insurance schemes.

STOLI IS NO LONGER A BIG PROBLEM
Some in the insurance industry want to perpetuate the myth that STOLI is still running rampant as a means to attack legitimate life settlements. This fear card is played to misinform the media and to negatively influence legislators into supporting draconian life settlement legislation that has even shut down legitimate settlement activity in a few states. This causes irreparable harm to consumers who have a valid need to sell their policies.

So Is That It?
Sadly, no. Unscrupulous schemes to sell life insurance have existed before and others will likely appear again. With the demise of STOLI, however, at least one of these undesirable activities, which hurt both the life insurance and life settlement industries, has been put to an end.

So the next time someone asks you about STOLI, let's hope it's wanting to know if you'd like it "straight up" or "on the rocks."

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