Center for Economic Justice

Statement on Speculator Initiated Life Insurance

Market Forces and Accurate Pricing, Not Regulatory Intervention, is the Proper Response to Speculator Initiated Life Insurance
Proposed Regulatory Solutions Take Away Consumer Rights

June 2006

Speculator initiated life insurance, what Professor Joe Belth calls SpinLife[1], is also known as stranger owned life insurance (SOLI) or investor owned life insurance (IOLI).

SpinLife refers to a situation where an investor approaches a consumer, asks the consumer to purchase a life insurance policy with the intention of the consumer selling the policy to the investor. The investor also offers to pay the insurance premiums for the consumer as a non-recourse loan to be repaid from the proceeds of the sale of the policy to the investor.

This type of speculative investment in life insurance policies has raised concerns about the legitimacy of the transaction, particularly in terms of whether an insurable interest exists or remains after the consumer sells the policy to the investor.

The life insurance industry has raised concern about these types of transactions, in large part because of a threat to their profitability from lower policy lapse rates. In response, life insurers have taken a number of actions that we consider anti-consumer, including:

- Refusal to issue policies if a consumer intends to sell the policy in the secondary market[2]

- Questions on applications about a consumer's intent to sell and refusal to issue policies if a consumer intends to sell the policy

- Refusal to sell a policy under a IOLI or SOLI scenario[3]

- Disclosure requirements for premium financing[4]

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[1] Statement of Joseph M. Belth Before the Life Insurance A Committee, May 3, 2006.
[2] Protective Family of Companies, Field Bulletin, "Life Insurance Secondary Markets and Premium Financing," March 13, 2006
[3] Protective Family of Companies, Field Bulletin, "Life Insurance Secondary Markets and Premium Financing," March 13, 2006; Lincoln Financial Group Memo from John Gotta and Wes Thompson to Strategic Partner Firms, February 21, 2006
[4] Protective Family of Companies, Field Bulletin, "Life Insurance Secondary Markets and Premium Financing," March 13, 2006

- Refusal to issue a policy whose premiums will be funded by a non-recourse loan, whether or not they involve IOLI/SOLI[5]

- Request for Congress to impose an excise tax on life insurance policies that are resold less than five years after purchase[6]

- Weakening or abolishing the incontestability clause[7]

We oppose these actions because they go far beyond SpinLife transactions and threaten important consumer protections or the legitimate secondary market. And while we certainly have concern about SpinLife transactions, we are not aware of a magnitude of consumer abuses that warrant these radical responses.

After reviewing the issue, we are convinced that there is a market solution to the problem of SpinLife and that no regulatory intervention in required. If insurers stopped underpricing their products, provided better nonforfeiture and surrender values to policyholders and stopped relying on high lapse rates for profitability, there would be no arbitrage potential in SpinLife and those types of transactions would cease.

The Role of Lapses in Insurer Profitability

SpinLife transactions are part of a broader set of transactions that fall under the heading of a secondary market for life insurance policies. The secondary market got started with viatical settlements in which a terminally ill consumer would sell his or her life insurance policy to an investor in order to obtain the proceeds from the life insurance policy prior to death to help pay for health care in the last months of life. The secondary market grew when other consumers who no longer wanted their life insurance policy or were no longer able to pay the premiums on the policy sold their policies to investors who paid significantly more for the policy than the consumer could get from surrendering the policy.

In general, we believe a secondary market in life insurance is a very positive development for consumers. The secondary market is a market response to a monopoly situation – and that monopoly is the control of the insurance company over the terms of surrender and lapse of an insurance policy. Insurance companies make a lot of money on policies that consumers hold for years, but then let lapse or surrender for any number of reasons. Historically, consumers, who were told that purchasing a whole life policy would enable them to build up an investment fund as well as have life insurance, found the extra monies paid over and above what a term life policy would have cost produced

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[5] Memo from Claude Accum, Vice President, Sun Life Financial to Distributors, March 27, 2006; Transamerica Memo to General Agents, March 3, 2006
[6] "ACLI Board Votes to Support SOLI Excise Tax," *National Underwriter*, May 16, 2006.
[7] Statement of Joseph M. Belth Before the Life Insurance A Committee, May 3, 2006.

little cash value or surrender value because of the terms of the whole life policy. Simply stated, millions of consumers got poor value from permanent life insurance because they did not hold the policies for a long enough period of time. Insurers relied upon this source of income and, in some cases, underpriced the policies with the knowledge that profit on lapses and surrenders would make up the difference.

Northwestern Mutual actuaries William Koenig and Stephen Frankel write in the June 2000 issue of *Best Review* in an article "Don't Eliminate Non-Forfeiture:"

> The major consumer beef about permanent life insurance involves early surrenders. Since the mid-1990s, the Consumer Federation of America and others have decried the "billions of dollars" that consumers waste on cash-value life insurance when they terminate early. The consumerists' point is that someone who surrenders a cash-value policy in the early years receives a cash value (or nonforfeiture benefit) far less than premiums paid.
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> What is the main attraction of these plans (with no nonforfeiture provisions)? It's simple: lower premiums, at least compared with plans offering the same death benefit guarantees with "regular" cash values. These policies, however, have an Achilles' heel. In order to work at such low premium levels, the policies depend on lapse-supported pricing, a pricing method facilitated by the absence of nonforfeiture requirements. This pricing method is unfair to consumers. And for insurers, it could lead to financial loss and/or unexpected increases in reserves.
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> Lapse-Supported Pricing
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> The main problem with lapse-supported pricing is that it depends on forfeiture. Simply put, companies count on policies to lapse in order to support those that don't. Without nonforfeiture requirements, a company does not have to pay a surrender value that bears a reasonable relationship to the assets it has accumulated for each policy.
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> Therefore, each time a policy lapses, the company's gain is much larger than would reasonably be expected. The company takes these gains to provide benefits for policyholders who don't allow their policies to lapse and who hold their policies until death. These gains are the basis of lower premiums in lapse-supported policies.
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> In other words, companies price such policies with the expectation that there will be a lot of "losers." If the company's original assumption for lapse rates materializes, it only must pay a few persisters, or "winners." The vast majority of policyholders who lapse their policies before death are the "losers." They receive much less at surrender than what any reasonable person would perceive as acceptable value.

> Some permanent policies are being sold with grossly inadequate cash values. In these cases, companies typically circumvent the standard nonforfeiture law by adding so-called "no-lapse, secondary guarantees" to universal life products.
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> The current environment suggests that **if an issuing company does not provide fair value, policyholders will proceed directly to a secondary market-presumably**, a viatical company-to get a better deal. There will be a secondary market for these contracts, and this will not be good for the life insurance industry.
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> Interestingly, this procession would lead to a final irony. Any mass rush to viatical companies would cause the lapse-supported pricing method to crumble altogether, because the policies just won't lapse. The viatical companies will see to that; they will continue to pay premiums to maintain the "no-lapse" guaranteed death benefit. This could result in financial problems for the issuing companies.
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> In short, lapse-supported pricing is not only unfair, but in the long run, it's unworkable.

The role of lapses in insurer profitability is discussed by Johnny Johns, Chairman of Protective Life Corporation, in meetings with investment analysts:

> But there is he another thing here which, again, we want to talk about some at our Investor's Conference but I'll go ahead and put it out right now, and that is, we're very concerned that there is this growing phenomenon in our industry which is the external financing of universal life premiums and it takes various forms. The old form of it is the viatical settlement. The newest form of it non-recourse premium financing. But we think that a significant amount of the sales that are going on in the industry right now, particularly for people that are 70 years of age or older, who have some kind of health impairment, that there's outside money coming in to finance those transactions. And the problem that presents for the industry is that most companies, I assume, are assuming some level of lapses in their products. But, if it is a hedge fund, that's buying your products, and they're buying it through some kind of financing arrangement, lapses are not going to be what you see in a traditional block of universal life products.
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> I think we may be suffering a little bit competitively for two reasons: One is we're pricing more rationally with respect to the reserves required under AG38, but the other is we're, I think, realistic in terms of the lapse assumptions one should make on older-age products, and particularly single-premium products, where I think some companies you reverse engineer their products. They've got to be assuming some lapses on single premium sales to elderly people, and we think that's just not appropriate. I'm concerned, personally, that there will be some profit margin deterioration for companies that write universal life if they're really aggressive right now with those lapse assumptions. Now I want to be clear, I'm not

> suggesting that the reserves are not redundant because they are. We think the AG38 cause reserves to go to levels that are really indefensible. But there's a different issue here which is are you going to make any money on your products if you are too aggressive with your lapse assumptions?[8]

The Importance of a Secondary Market for Life Insurance

The secondary market has been a major benefit to many consumers who have been able to get value out of their policies from investors that they could never have gotten out of insurers. The secondary market has forced insurers to improve the policy terms regarding surrender, which has benefited many more consumers.

The creation of a secondary market has been a major benefit in many industries. For example, the creation of a secondary market for mortgages enabled many more entities to get into the business of selling mortgages and has made much more capital available for mortgage loans with the result of lower interest rates and many more mortgages. Now, if a secondary market for mortgage loans had been prohibited or stifled, the large banks, who could afford to issue and hold mortgage loans, would have made monopoly profits, but consumers would have experienced higher rates and fewer mortgage loans.

The secondary market for life insurance benefits consumers by attacking the monopoly position of insurers on lapse penalties and surrender charges. By providing consumers with an option to sell their policy if continued ownership of the policy is no longer possible or desirable, the secondary market encourages greater purchase of insurance.

Market Solution to SpinLife, Not Stifling of the Secondary Market and Removing Consumer Protections

While we are concerned about speculator initiated life insurance, we are also concerned that the various proposals to address the situation will stifle the secondary market and create a regulatory support for monopoly profits by insurers.

We oppose the following proposals, all of which will go way beyond the SpinLife issue and take away vital consumer rights and protections.

1. Limitations on sale of the policy, such as a prohibition on the sale of a policy for a given number of years from date of purchase. A consumer who faces a crisis in his or her life, say, 15 months after the purchase of a life insurance policy, should not be prohibited from selling that policy.

[8] Fair Disclosure Wire, 8 Feb 2006, Q4 2005 Protective Life Corporation Earnings Conference Call-Final.

2. Application questions about a consumer's intent to sell the policy. These types of questions are irrelevant to assessing the mortality risk posed by a consumer and will lead to post-claims underwriting.

3. An excise tax on proceeds from the sale of an insurance policy. This is a blatant effort to stifle the secondary market, limit consumer choice and recreate an insurer monopoly on policy surrender.

4. Weakening or eliminating the incontestability provision. The incontestability clause is the most important consumer protection in life insurance. Weakening this provision will lead to post-claims underwriting.

5. Allowing insurers to restrict change of ownership. If an insurer has issued a policy after appropriate underwriting and due diligence, then the consumer should be able to do with the policy as the consumer sees fits.

6. Limitations on premium financing. If insurers and regulators have had no problem with financed single premium credit insurance – a product and financing method that the United States Departments of Housing and Urban Development and Treasury found "abusive" to consumers – it seems hypocritical to single out premium financing of other life insurance products for restriction. Such proposed restrictions may prevent legitimate uses of premium finance by consumers.

All of these proposals will restrict legitimate sales of life insurance policies, take away critical consumer protections or stifle the beneficial secondary market.

We think there is a market solution to the SpinLife problem

Professor Belth suggests that an investor may be willing to pay more than the cash value of a life insurance policy for one or more of the following reasons:

1. the insured currently is in poor health
2. the insurance company underpriced the policy when issued
3. the investor is given false or incomplete information.

The key is number 2 – mispricing of the policy by the insurance company. How could an investor make money on an insurance policy that was correctly priced for the mortality risk of the consumer? SpinLife is essentially an investor exploiting an arbitrage possibility created by mispricing of the policy by the insurer. With a correctly priced policy, there is no arbitrage possibility and no incentive for SpinLife.

Consequently, we think there is a market solution to SpinLife – better pricing by insurers. We think it is an inappropriate regulatory intervention to restrict legitimate competitive challenges to existing life insurance industry practice. We were opposed to a limited license for term life insurance because the argument put forth by the proponents was predicated on existing industry agent commission practices which created disincentives for agents to sell term life. The proper response was not a regulatory action to lower consumer protections by cheapening the agent license but to tell the proponents to respond to market forces by changing the commission structure for term life.

As should be obvious from our comments on a variety of subjects here at the NAIC, we are not reticent to recommend government intervention in insurance markets when there is a market failure and normal competitive market forces cannot protect consumers. In the case of SpinLife, we believe that market forces can address the problem without regulatory intervention – insurers modifying their pricing to remedy initial underpricing and providing more favorable surrender values to consumers.

We don't like SpinLife and would like to see it go away. But we oppose regulatory solutions that dramatically restrict reasonable and legitimate secondary life insurance market transactions. And while we dislike SpinLife, we have not heard of widespread abuses of consumers because of it. SpinLife investors seem to target seniors, which suggests that enforcement of suitability requirements that protect seniors from other types of insurance and annuity sales abuses should also address the SpinLife problem.