



AMERICAN ACADEMY *of* ACTUARIES

To: Thomas R. Sullivan, Chair, Life Insurance and Annuities (A) Committee

From: American Academy of Actuaries' Life Products Committee

Re: May 20 Public Hearing

Date: May 14, 2010

The following Testimony of Cande Olsen is being submitted to you on behalf of the American Academy of Actuaries' Life Products Committee for your May 20 hearing: "Is the STOLI Market Moving to Annuities, and How Should We Protect Consumers?"

Please let us know if you have any questions regarding these remarks.



AMERICAN ACADEMY *of* ACTUARIES

Testimony of Cande Olsen, FSA, MAAA Chair, American Academy of Actuaries - Life Products Committee

Before the National Association of Insurance Commissioners Life Insurance and Annuities (A) Committee's Public Hearing: "Is the STOLI Market Moving to Annuities, and How Should We Protect Consumers?"

Commissioner Sullivan and distinguished committee members:

On behalf of the American Academy of Actuaries¹ Life Products Committee, I appreciate the opportunity to contribute to the Life Insurance & Annuities Committee hearing on issues arising from Stranger Originated Life Annuities, which I will refer to through out the rest of my testimony as "STOLA"s. Our purpose in presenting these comments to you today is to provide regulators with additional information to understand how STOLAs impact the annuity market and individual customer and to urge the adoption of regulations to protect the "end consumer."

Much of the public debate surrounding STOLAs and similar life and annuity transactions has centered on the issue of consumer rights and we agree that the impact on annuity consumers is the proper focus. However, much of the current discussion does not properly distinguish the end consumer from the individual who merely functions as a conduit in a transaction that benefits an investor. As I will describe in more detail, a STOLA typically begins with an investor approaching a terminally ill individual. This individual becomes an unknowing participant in a plan that uses a feature in the standard annuity contract in a manner unintended by the design of the annuity contract. This individual is not the end consumer in an annuity transaction for which the annuity contract had been designed.

In a STOLA transaction, the investor is the designated beneficiary and will profit from the annuitant's death, despite having no familial or insurable interest in the terminally ill annuitant. The investor's profits arise from using the knowledge that the life expectancy of the terminally ill annuitant is much shorter than the "typical" annuitant who purchases an annuity contract to save for retirement and protect against longevity risk. The STOLA investor profits from the annuitant's death in a manner not anticipated in today's annuity

¹ The American Academy of Actuaries is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

contracts and ultimately, these profits will become costs to the end consumers. **STOLAs convert retirement preparation products into investment arbitrage vehicles. In our opinion, STOLAs do not serve the public's interest and, in fact, undermine the annuity marketplace in a way that is harmful to consumers.**

The remainder of my remarks addresses the issues raised by your specific questions in the hearing notice, as well as provides some background information.

Our perspective on STOLAs is founded on the following:

1. **The Effect of STOLAs on Consumer Charges:** If the practice of selling variable annuity contracts with GMDB's to terminally ill people becomes more prevalent, companies will need to increase charges or institute underwriting (which increases charges) for all variable annuity customers with Guaranteed Minimum Death Benefits (GMDBs), because of the additional risks and their costs. The cost differential to issue a STOLA contract compared to the more typically purchased annuity is significant. These costs will be passed on to all variable annuity contract holders with GMDBs.

We have not provided any specific numerical analysis as our perspective is founded primarily from the conceptual view that STOLAs are not a proper use of annuities. We draw parallels between STOLAs and the suicide exclusion clause in life insurance. While the cost of paying benefits for suicide claims in the first two years of a life insurance policy could be quantified, the argument in favor of the suicide exclusion provision is not cost-based. Purchasing a life insurance policy with the intent of an early claim due to suicide is not the proper and intended use of life insurance.

2. **Consumer Protections:** The end consumers of annuity contracts need greater protection in STOLA transactions. Similar to Stranger Originated Life Insurance (STOLI), the ultimate owner of the contract is an investor, whose interests and behaviors are different than the individuals for whom the product was designed. Regulations reflecting this difference are already in place for STOLI transactions and comparable regulation is needed for STOLA transactions.

What is a Stranger Originated Life Annuity?

Variable annuities are generally marketed and sold as retirement vehicles. The owner, who is usually the annuitant, or "life being measured," specifies how the premium is to be invested, and receives a guaranteed income for life beginning on the maturity date. A death benefit is paid to the beneficiary if the owner/annuitant dies before income payments begin.

STOLA transactions which have been recently brought to light in the press occur when an investor purchases the variable annuity with a GMDB on the life of a terminally ill

person, with whom the investor has no financial or familial relationship. The terminally ill person is designated as the annuitant, and the investor, as the contract owner, is named as beneficiary. When the annuitant dies, the owner/beneficiary receives the greater of the account value and the GMDB. The GMDB is at least the amount of the premium and most likely is a larger amount, such as the premium accumulated at some specified interest rate.

The performance of the account value will depend on the investments chosen. Since there is no downside for the investor, the funds may be invested in the riskiest investments available. Upon the death of the annuitant, the investor has the opportunity for significant gain and no risk of loss.

While the terminally ill person generally is paid a fee for agreeing to be the annuitant, he may or may not realize or understand that he has agreed to be part of an annuity transaction.

How STOLA Transactions Compare to Similar Life and Annuity Transactions

STOLA transactions are similar to STOLI, and to life and annuity ownership change transactions where the life and annuity contracts are purchased by strangers (investors) after the contracts have been held for some time by the original purchaser. A summary of the similarities and differences are shown in **Appendix A** to this testimony, but the transactions all have one thing in common: the ultimate owner of the contract is an investor whose interests and behaviors are different than the individuals for whom the product was designed, and who have no insurable interest in the insured/annuitant. Some regulation reflecting this difference is already in place for similar transactions, and now comparable regulation is needed for STOLA transactions as well.

The Effect of STOLAs on Consumer Charges

Insurers price contracts with the expectation that the charges over the life of a product will allow the company to recoup the expected cost of all of the product benefits and expenses. Health and financial underwriting is often performed for life and health insurance to determine if charges for some applicants need to be increased or to decide whether to accept the applicant at all. While life and disability insurance applicants are generally underwritten for health conditions, annuity applicants are generally not underwritten for health conditions.

Until recently, the GMDB was not considered to provide a significant enough death benefit to necessitate health underwriting to determine the insurer's risk of paying the GMDB on an individual applicant. If the practice of selling variable annuity contracts with GMDB's to terminally ill people becomes more prevalent, companies will need to increase charges or institute underwriting (which increases charges) for all variable annuity customers with GMDBs, because of the additional risks and their costs.

Charges for all purchasers of variable annuity contracts with GMDBs would have to be increased for the following reasons:

- If charges were not increased for all variable annuity customers with GMDBs, and persons with much greater GMDB risks than the other members of the group were included in a group, all others in the group with a lower risk would subsidize the cost of those in a higher risk class. This would result in inequitable charges for individual members in the group who do not have the costlier risk.
- If the number of purchasers with the higher GMDB risk increases, resulting in a higher charge for the entire group, then persons with lower risk would likely be dissuaded from purchasing the product, thus resulting in a spiraling effect on rates and charges.
- Health underwriting costs will be borne by the entire group, also resulting in higher charges.

Another perspective to consider is the cost of providing guaranteed death benefits. For non-STOLA annuities with GMDBs, the initial mortality rate is roughly 1%, but the rate in STOLA cases approaches 100%. Additionally, a STOLA contract on a terminally ill annuitant may generate only one year of charges whereas the non-STOLA contract may generate charges ten times that amount over the annuitant's expected lifetime. The result is one thousand times the average benefit-to-cost relationship. In short, the cost of providing STOLA coverage is significant as compared to the typical annuitant.

A STOLA contract will be of short duration. Due to the more likely early death of the annuitant shortly after contract origination, the few annual charges for these contracts cannot cover all the expenses of the underlying annuity. If STOLA contracts become a larger proportion of all variable annuity contracts, all purchasers of variable annuities, not just those with GMDBs, would see increased charges.

Consumer Protections

The necessary consumer protections are not provided under most current laws. Consumers face several risks with STOLA.

- First, and most importantly, non-STOLA annuity purchasers will have to bear the additional cost created by STOLA purchases.
- In addition, because these transactions are not based on insurable interest, STOLA annuitants are exposed to the risk, admittedly small but still real, that the STOLA investor may want to hasten the death of the annuitant (often called moral hazard). Just because a person has been diagnosed as terminally ill doesn't always mean that death is imminent (consider treatments extending the life of some AIDS and cancer patients, for example).

While there are steps that insurers could (and, if possible, should) take, such as performing health underwriting or requiring that the owner and the insured be the same person, additional consumer protections are still needed. We offer the following observations and suggestions:

- There are apparent ambiguities in the insurable interest laws as to whether they apply to annuities. Since the historical basis of insurable interest laws is to prevent “wagering on a human life,” which should also apply to annuities, these laws should be clarified to ensure that they also apply to annuity purchases, for both lifetime income and supplementary death benefits.
- Even if there were clear insurable interest requirements for annuities, they could be circumvented by investors who might arrange for an annuitant to purchase the contract through a premium financing arrangement and then have annuitants sell the contract to them at a stated time. The NAIC Viatical Settlements Model Act was developed to control these types of arrangements for life insurance. The Academy’s Life Products Committee recommends that consideration be given to modifying the Viatical Settlements Model Act to ensure that the transactions the model seeks to regulate for life insurance are also regulated for annuities.
- The Interstate Insurance Product Regulation Commission (IIPRC) filing requirements permit insurers to terminate an existing GMDB upon sale to an investor because, per the IIPRC, “Eliminating restrictions on termination could potentially result in significant increases in cost for all consumers of these products”. Consumer protection would be stronger if the IIPRC filing requirements were supported by specific laws on the issue.
- Suitability and disclosure laws and/or regulations would be enhanced if both the purchaser and the agent were required to sign off on the suitability of the annuity purchase.

Thank you for the opportunity for the American Academy of Actuaries Life Product Committee to provide our views on this important issue. We do not think STOLAs serve the public interest. Further, we believe that allowing STOLA transactions undermines the annuity contract and the long-standing benefits annuities provide to consumers. I would now be happy to answer any questions you may have.

Appendix A

Following are very high level descriptions of how the four potential Stranger-Originated Transactions and Ownership Transfer Transactions work, including behavior of investors vs. contract holders, and the existing regulations (if any) to which these transactions are subject.

	<u>Stranger-Originated Transactions</u>	<u>Ownership Transfer Transactions</u>
Annuity	<ul style="list-style-type: none"> • Investor Purchase - A variable annuity with a GMDB on the life of a terminally ill stranger. • Insurable Interest - None • Investor Actions - Invests aggressively, knowing that there is a floor on the investment. • Compared to Normal Contractholder Behavior – Purchases as retirement product • Regulation - No specific regulation 	<ul style="list-style-type: none"> • Investor Purchase - Pays more than the cash surrender value, but a low enough amount to produce an attractive return, for a variable annuity with a guaranteed lifetime minimum withdrawal benefit that is owned by a healthy individual. • Insurable Interest – At issue, yes; at transfer, none. • Investor Actions - Invests aggressively, knowing there is a floor on the investment equal to the stream of guaranteed lifetime minimum withdrawal benefits. • Compared to Normal Contractholder Behavior – Manages as retirement product • Regulation - IIPRC and many states allow the company to terminate the benefit if the contract is sold to an investor.
Life Insurance	<ul style="list-style-type: none"> • Investor Purchase - Makes a loan to an elderly person (stranger) to buy a life policy that the person agrees to sell back to the investor after two years when the contestable period is over. • Insurable Interest - None • Investor Actions - Continues to pay the minimum amount of premium until he can collect the death benefit. • Compared to Normal Policyholder Behavior – Purchases a life policy to protect family or business • Regulation - Most states do not allow 	<ul style="list-style-type: none"> • Investor Purchase - Pays more than the cash surrender value, but a low enough amount to produce an attractive return, for a life policy of an elderly person • Insurable Interest – At issue, yes; at transfer, none. • Investor Actions - Continues to pay the minimum amount of premium until he can collect the death benefit. • Compared to Normal Policyholder Behavior – Pays planned annual premium until surrender or death • Regulation - Specifically permitted after the policy has been in force a specified number of years, which varies by state.