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How the NAIC Model Act Could Change the Life Settlement Business

BY LARRY SIMON

The National Association of Insurance Commissioners (NAIC) recently adopted revisions to its Viatical Settlements Model Act as a way to align regulatory standards of the life settlement industry. These changes are important for financial professionals to know and understand because, if adopted by state legislatures, they may significantly affect one's involvement with life settlements.

History of the Model Act

In order to understand the changes and implications financial professionals may face as a result of the Model Act, one must know the background. The Viatical Settlements Model Act was adopted by most states in 1993, and since then has been amended twice — in 1998 and 2000. It was put in place to regulate the life settlement industry and has been the basis of many states' regulatory laws. There are 39 states that currently base their laws on some part of the original Model Act.

The NAIC Life Insurance and Annuities Committee first proposed the new Model Act amendments during a December 2006 meeting. These amendments were developed to help restrict stranger-oriented life insurance (STOLI) practices. STOLI transactions may challenge provisions in insurable interest laws while benefiting people unrelated to the insured individual.

Why revise?

The newly updated Model Act sets out to curb STOLI transactions by introducing a longer waiting period on the sale of insurance policies in the secondary market.

"Life insurance serves many critical social functions," said David F. Woods, former CEO of the National Association of Insurance and Financial Advisors. "Most importantly, it protects and provides tremendous benefits to individuals, families, businesses, and employees. STOLI perverts the social purpose of life insurance."

The previous act stated that a policy had to be issued at least two years prior to being sold as a life settlement. Under the new act, the waiting period increases to five years. The three-year increase was proposed to target policies that were funded by lending programs with certain characteristics, such as non-recourse programs.

"Our position on STOLI is strong, clear, and firm — we are seeking actions by the states to prohibit STOLI and simultaneously protect life insurance taken out to benefit individuals, families, businesses, and employees, as well as legitimate life settlements," said American Association of Life Underwriters president Dermot Healey. "Life insurance should not be taken out for the benefit of stranger investors who do not and should not have an insurable interest under the laws of the states."

The new Model Act applies the five-year ban to all insurance policies unless the insured person meets a number of exceptions. These include the death of the policy owner's spouse, divorce, retirement from full-time employment, or cases where the policy owner can no longer pay premiums due to an unexpected loss of income. The five-year ban can also be avoided if the insured becomes terminally ill or is adjudicated bankrupt or insolvent.

In addition to meeting these guidelines, a policy can be sold two years after issuance if the following provisions are met:

- The net cash surrender value is not surpassed by the premium finance loan
- The policy premium was not financed with a non-recourse loan or unencumbered assets
- The insured person and the policy have never been evaluated for a settlement option
- No agreement has been made guaranteeing purchase of the policy

The amendments in the Model Act were also created as an attempt to help identify premium finance loans disguised as life settlements. The new amendments also change the definition of a life settlement. In the past, a life settlement included any loan that used a life insurance policy as the main loan collateral. Under the new guidelines, life settlements are defined as premium finance loans made either before or after the issuance of a life insurance policy where:

- The policy owner or the insured receives a guarantee of the policy's future life settlement value
- Loan proceeds are used for other means besides paying policy premiums or the costs of the loan, or
- The policy owner or insured agrees to sell the policy or part of its death benefit after issuance

Not included in the life settlement definition are loans made by the carrier pursuant to policy terms and loans where the proceeds are used solely to pay the premiums on the policy and the cost of the loan.

Opposition exists

However, many in the industry oppose the changes to the Model Act. A number of industry associations have spoken out against the five-year regulation, stating the amendments are poorly drafted and will be ineffective against stopping STOLI transactions.

Groups who oppose the change, such as the Life Insurance Finance Association (LIFA) and the Life Insurance Settlement Association (LISA), believe the revisions did not take consumers' needs into consideration and may have negative effects on senior clients who rely on premium financing loans to pay policy premiums.

In an advisory letter to producers, LISA stated: "If adoption of the Model as a model means that all states should have settlement regulation, we agree. If it means that unscrupulous practices relating to the issuing of insurance should be curtailed, we agree. But if it means that the rights of consumers and producers to avail themselves of the option of a secondary market for their asset will be significantly damaged, we strongly disagree, and we will oppose the adoption of these provisions in the states."

The National Conference of Insurance Legislation (NCOIL), a regulatory body made up of state legislators who focus on life settlement legislation, also opposes the revisions and has requested that the Model Act be re-evaluated.

These organizations believe that placing a five-year ban on selling a life policy is not beneficial to clients, especially senior clients who need access to the funds these policies could create. Dissenters also say the ban impacts the consumers' ability to access the settlement industry and hinders clients from fully exploring all financial options.

What next?

Because NAIC is not a regulatory body, it only has the power to suggest new legislation. As a result, the amendments must be passed by each state's legislative body in order to be considered law.

Since the changes are likely to affect the way most professionals working within the life insurance industry approach settlements, it is especially important for financial professionals to educate themselves on all possible outcomes of the Model Act and make their voices heard. Since the provisions could potentially affect clients' ability to sell policies on the secondary market and place restrictions on clients who use certain lending plans, it is imperative to ensure that your agents are knowledgeable about the impact adoption of the Model Act may have on consumers.

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