

Combating STAT Abuse

Law360, New York (March 23, 2010) -- In October and November of 2009, three insurance companies — Western Reserve, Transamerica Life Insurance Co., and Nationwide Life Insurance — filed numerous lawsuits against a Rhode Island estate planner who allegedly claims to have identified a loophole that allows him to profit by selling variable annuity products to terminally ill annuitants.

The alleged misconduct varies by suit, but included fraud, breach of contract, breach of duty of good faith and fair dealing, civil conspiracy, unjust enrichment and negligence.



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Through newspaper advertisements and other sources, the estate planner began by recruiting terminally ill individuals to serve as annuitants in exchange for modest payments of around \$2,000.

The estate planner or his clients would then purchase a variable annuity and, along with the broker who sold it, realize a risk-free profit of at least 5 percent of the premium invested in the annuity. In one example, the annuity owner and broker earned \$106,000 in less than a year, profiting from both commissions and investment returns.

Variable annuities are insurance contracts generally marketed as long-term retirement products which, when sold, generate large commissions to brokers from the issuing insurance company. Commissions are often 5 or even 7.5 percent, which means that on a \$1 million investment the broker makes an immediate profit of \$50,000 to \$75,000.

In addition, the owner and broker not only realize any investment gains earned during the short time the annuity is open, but also are protected from any investment losses because of the guaranteed minimum death benefit feature common to variable annuities. In other words, if the market goes up, they win. If it goes down, the insurance company loses.

One of the recent cases filed by Transamerica illustrates how profitable these annuities can be for the broker and contract owner. On Feb. 19, 2008, Transamerica issued an annuity in which the initial premium was \$820,000, and it paid the broker a \$61,500 commission.

The annuitant died three days later, on Feb. 22, 2008, but the owner of the annuity did not inform Transamerica of the annuitant's death until September 2008, by which time the account balance had risen to \$864,000. The broker and contract owner earned \$106,000 in approximately seven months.

The courts have yet to rule on whether these transactions are legal or not, but, given the large profits that can be made, there is the potential for stranger owned annuity transactions to become a significant and costly problem for insurance companies.

Stranger-owned life insurance policies have been in the news for several years, but only recently have stranger-owned annuity transactions ("STATs") made headlines. Insurance companies are beginning to take note, however.

For example, in May 2009, ING USA Annuity and Life Insurance Company issued a policy on STATs to articulate a number of additional business guidelines that prohibited STATs, and threatened disciplinary action for violating the guidelines.

Insurance companies have two options for combating STAT abuse. First, they can make it more difficult for brokers to sell variable annuities to terminally ill patients.

For example, all applicants could be required to attest that they are not terminally ill as of the date the application is submitted. Insurance companies could also prohibit STATs and rely on the threat of sanctions if a broker participates in STATs to ensure compliance; this is the path ING selected.

The more difficult approach to preventing STAT abuse requires insurance companies to identify STATs that have already been issued, which will allow the insurance company to initiate litigation to recover commissions and, if the annuitant has died, investment losses or possibly investment gains paid on these annuities.

In addition, for annuities still in the accumulation phase, the insurance company may rescind the annuity to avoid future liability from the guaranteed minimum death benefit.

A number of unique characteristics can be used to identify STATs. Unfortunately, the most obvious — the fact that the annuitant is terminally ill and has no relationship with the contract owner — is not observable in the insurance company's data.

There are many characteristics that are observable, however. Using data from an insurance company's annuity administration, accounting and investment systems, it is possible to develop a series of checks to identify potential STATs.

The first step in identifying STATs should be a review the company's annuity administration system to identify annuities for which the annuitant passed away shortly after the policy was issued and for which the annuitant was not the contract owner. If an annuity does not satisfy both criteria, it is not a STAT.

Next, determine whether the contract owner selected riders that would increase the death benefit or guarantee a return of premium, whether the annuitant has other annuities with the insurance company, and whether the annuity is funded by rolling over another investment. If an annuity satisfies these checks, the likelihood that it is a STAT increases, although not all STATs will satisfy every check.

The next step is to analyze the accounting data for the annuities identified through the above process. To avoid raising suspicion, contract owners for STATs often make a relatively modest initial deposit when applying for the annuity. Once the contract issues, a second, much larger deposit is made. This pattern can be revealed through three separate checks.

First, STATs will likely have larger than average account balances. Second, STATs will likely have a limited number of deposits all within a short period of time after the policy issues and no withdrawals other than a death benefit. Third, STATs will likely have a modest initial deposit followed by much larger deposits after the policy issues.

The final step is to review the investment options selected by the contract owner. Often, the initial investment allocation requested on the application is relatively conservative, again to avoid raising suspicion. Once the policy issues, however, the investment allocation will switch to a much riskier allocation to maximize the expected return.

Completing these three steps will identify transactions with characteristics consistent with STATs. To assume that all such contracts are STATs, however, would be premature, as it is possible that some of the annuities exhibit characteristics of STATs, but are not stranger-owned.

Therefore, one additional analysis is needed: identify the broker for all of the annuities that appear to be STATs and assess whether any specific brokers have greater concentrations of suspicious transactions than other brokers.

A number of statistical tests, like the Fisher Exact Test, which is used to calculate probability, can determine whether one or more brokers has a statistically significant higher proportion of the transactions, which would imply that the transactions are indeed STATs.

Once a number of STATs have been identified, the characteristics of those transactions can be used to refine or extend earlier analyses and improve the results. For example, the administrative system should be queried to identify all annuities for contract owners of an annuity flagged as a STAT.

A review of an insurance company's computerized annuity data would be relatively inexpensive to undertake and would allow the insurance company to recover commissions, investment losses and possibly investment gains paid to brokers and contract owners who participate in STATs.

It would also send a message to brokers contemplating engaging in STATs that the insurance company will identify such

activities and discipline those involved.

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