



The Problems with Premium Financing No One's Talking About – and How to Resolve Them!

Your clients, like many clients, have probably heard about, and are interested in, premium financing. Premium financing has been much promoted in recent years, unfortunately, the client is often unaware that there are unnecessary risks inherent in these programs that could create significant problems for them later on. Therefore, it is important that *you* are aware of these problems, and of the ways to avoid them, so you can protect your clients.

Premium Financing Overview

Borrowing money to pay life insurance premiums is not new. While the life insurance purchase and the loan are two separate transactions, attempts have been made to combine them. In recent years, lenders have become more willing to provide the necessary capital for clients to fund their insurance programs and carriers have become more receptive to designing their products to work in the premium financing markets. Below is an overview of how the loan and insurance components work together:

Loan

The premium financing loan works similarly to other loans:

1. Interest Rate: The interest rate is usually a variable one year rate but can sometimes be fixed up to 10 years.
2. Loan Term: The loan term is usually for one year, but can sometimes be as high as 10 years. Each year during the loan term, the lender will review the loan to make sure everything is in order. If anything is out-of-whack, adjustments will have to be made to bring everything in line. At the end of the loan term, your clients must either repay the loan or reapply for a new loan which will be subject to new financial underwriting. There is no guarantee the lender will renew the loan either due to a change in your client's financial situation or a change in the lender's appetite for these types of loans.
3. Collateral: Your client has to post collateral for the loan. The policy's cash surrender value is usually acceptable as collateral and, to the extent it is not sufficient to cover the loan, your client will have to post additional collateral – usually in the form of marketable securities. Your client is subject to an indefinite number of collateral calls should the value of his collateral fall at any time.

Insurance

To tie the insurance and loan together, some carriers have recently developed death benefit riders which are intended to grow the death benefit by the amount of the loan and, in some cases, also the interest. Today's riders fall into one of three categories:

1. ***Return of Premium Rider***. This rider increases the death benefit each year by the premiums paid in that year. The death benefit is intended to keep pace with the loan's principal so the loan principal can be repaid at death while still providing your client with the insurance coverage they need. This rider would be used where your client pays the loan interest each year.
2. ***Return of Premium with Interest Rider***. This rider increases the death benefit each year by that year's premiums *and* interest. This death benefit is intended to keep pace with the loan's principal *plus* accrued interest so the entire loan can be repaid at death while providing your client with the insurance coverage they need. This rider would be used where your client accrues loan interest.
3. ***No Rider***. The carrier does not offer either of the above riders, therefore, your client can only choose from the Level Death Benefit Option or the Increasing Death Benefit Option - neither of which are designed to work in the premium financing sale. Your client would most likely choose the Increasing Death Benefit option to have some death benefit growth to at least keep pace with part of the growing loan balance.

The unique characteristics in these premium financing arrangements are that the loan is *assumed* to be renewed until death and the insurance proceeds are *relied upon* to be sufficient to repay the loan at death *and* to provide your client's family with the insurance coverage they need. Conceptually, this is a great idea: your client uses borrowed funds to pay for their insurance program which will ultimately pay off the loan *and* provide their family with the needed funds at their death.

Unfortunately, there are significant risks your client assumes which could derail the entire program.

Risks Your Clients Assume, Knowingly or Not, With Premium Financing

Since the insurance policy and the loan operate independently of each other, there are no built in mechanisms or guarantees that they will work in sync. In other words, should changes to one occur without a corresponding change in the other, the entire premium financing arrangement could fail to perform as projected - putting your clients in a precarious situation. Any combination of the following risk factors place significant burden on your clients and could cause the entire program to fail:

1. **Interest Rate Risk** If the loan interest rates increase more than projected, your clients could be required to pay more money into the program and/or provide more collateral than originally anticipated. If your clients do not have sufficient funds and/or collateral to make up this shortfall, the entire loan could be called – forcing them to repay the loan before they planned to do so. This could occur at an inopportune time.
2. **Collateral Risk** If the value of your client's collateral falls below the level required by the lender to satisfy the loan, your clients could be called upon to provide additional collateral. If your clients do not have sufficient collateral to make up this shortfall, the entire loan could be called – forcing them

to repay the loan before they planned to do so. This also could occur at an inopportune time and put their collateral at risk.

3. Asset Risk

- a. While Alive: Should the loan be called and the collateral posted by your client not be sufficient to repay the loan, your client's other assets, whether cash or otherwise, may be at risk of being forfeited to satisfy the outstanding loan balance.
- b. At Death. Should the total death benefit be less than expected:
 - i. The *net* death benefit available for your client's family, after repaying the loan, could be less than he needs to satisfy his estate liquidity need, thus, putting his other assets at risk of having to be sold to satisfy this need.
 - ii. If the *total* death benefit is less than the outstanding loan balance, not only would your client not have *any* death benefit available for his family, but his family would owe the remaining loan balance – without neither the funds to satisfy this loan obligation nor those to satisfy his estate liquidity need.

4. Earnings Risk

- a. If the policy's cash surrender value does not perform as projected, your clients may be required to provide more collateral than originally anticipated. If the policy's death benefit does not, or can not, grow sufficiently to keep pace with the outstanding loan, then your clients are at risk of either not getting as much coverage as expected, after the loan is paid off, or, worse yet, getting no insurance coverage at all *and* having to come up with additional funds to repay the balance of the loan. **There is no guarantee that the insurance policy will be able to repay the entire loan and provide your clients with the insurance protection they need!**
- b. If a Side Fund is used to accumulate assets to later offset the loan, the growth of this side fund could be lower than projected. This could require your clients to put up additional funds to pay off the loan as scheduled and/or require a longer time than expected to repay the loan from the Side Fund.

5. Policy Design Risk

- a. *Policy Pricing*: The cost of an increasing death benefit, especially in the later years, can have an enormous effect on the policy's premium requirements. With premium financing programs, higher premiums means larger loans since a larger loan is needed to pay the policy's higher premium. However, a larger loan means even higher death benefits are needed which in turn mean higher premiums. This circular dependency can require significantly more insurance just to satisfy the ultimate loan. While this may be nice for commission purposes, it poses a particular problem for your clients if the cost to maintain the entire program becomes either more expensive than just purchasing the insurance outright or becomes cost prohibitive.
- b. *Lack of Guarantees*: There is no guarantee the policy will keep pace with the outstanding loan balance. For example:
 - i. If your client is accruing interest and has chosen a *Return of Premium with Interest Rider*, if interest rates rise, there is no guarantee the death benefit will be able to grow by the increased rate. For example, some riders require your client to select a *fixed* growth rate for the death

benefit at the time of policy issue. Should interest rates rise, the death benefit would continue to grow at the pre-set rate while the loan grew at the higher rate causing the death benefit to fall short in keeping pace with the outstanding loan balance. Some riders allow for an increasing growth rate for the death benefit, but have an upper rate limit by which the death benefit can grow. If the loan interest rate increases beyond this limit, then the death benefit would not keep pace with the outstanding loan balance.

- ii. Most carriers which offer the *Return of Premium Plus Interest Rider* have a maximum the death benefit can grow to – for example, 5 times the original death benefit. So if the original death benefit is \$10 million, then the death benefit can not grow beyond \$50 million. However, if interest is being accrued, the loan balance would continue to grow without limit even though the death benefit has hit this ceiling and has stopped growing. This would also create a situation where the death benefit was insufficient to repay the loan and possibly to provide your client’s family with the coverage they need.

Since the loan is repaid from the insurance proceeds first, before your client gets his share, if the loan is larger than projected, the additional amount would be paid from the death benefit originally intended to be available for your client’s family. Therefore, your client would be left without sufficient coverage, or possibly no coverage, for his family.

6. Loan Underwriting Risk Loans can be made for a fixed term of years, but can not be made in perpetuity. Premium financing programs assume the loan continuously gets renewed at the end of each term until your client’s death when the insurance proceeds are intended to repay the loan. Since each loan renewal is subject to the lender’s underwriting guidelines, the lender’s appetite for continuing to fund insurance premiums and your client’s financial situation, there is no guarantee the lender will renew your client’s loan nor that any lender will offer a new loan to continue the program. In this event, your clients could be required to repay the loan at a time other than death and from funds other than the insurance policy.
7. Reinsurance Risk Depending on the design of the insurer’s policy, if an increasing death benefit is used to keep pace with the outstanding loan balance, the *ultimate* death benefit may have to be underwritten *up-front*. The following could be issues in these situations:
 - a. Your clients may not qualify, due to medical or other reasons, for the required amount of reinsurance, thereby, limiting the amount of coverage available to repay the loan.
 - b. Even if your clients can qualify, there may not be sufficient reinsurance available in the marketplace to satisfy the ultimate need – thereby limiting the amount of insurance that can be purchased up-front.
 - c. Since worldwide reinsurance capacity is limited, if your clients are able to secure all the reinsurance they need, these committed amounts would not be available to satisfy any of their other insurance needs, such as Key Person, increased Estate Liquidity needs, etc.

Recap

Premium financing programs rely on the insurance policy to keep pace with the outstanding loan balance so the remaining death benefit is sufficient to provide your client with the coverage he needs. If any of the original assumptions change, then your client is in jeopardy of having a program which does not perform as projected. If loan interest rates rise, collateral value falls, death benefit does not grow as needed, your client could have a significant problem: either a lower than expected death benefit for his family or no death benefit for his family *and* his family owing money to repay the loan without the funds to do so.

Examples

Let's assume you have a client who is a Male 75 Standard Non-Smoker who is worth \$20 million and is looking for \$10 million of insurance for estate liquidity purposes. If he were to purchase this \$10 million of coverage outright on a Full Pay to Endow at Age 100 basis, it would look something like this:

Year	Premium	Cash Surrender Value	Total Death Benefit
1	532,804	0	10,000,000
2	532,804	50,961	10,000,000
3	532,804	275,002	10,000,000
4	532,804	461,602	10,000,000
5	532,804	615,141	10,000,000
Age 100	532,804	10,000,000	10,000,000

Let's look at some typical premium financing scenarios:

1. **Return of Premium Rider.** Since your client is looking for \$10,000,000 of *net* coverage (after the loan is paid off) for his family, his illustration would look something like this if he were **borrowing** premiums and **paying** interest:

Year	Borrowed Premium	Annual Interest Paid by Client @ 4%	Cumulative Loan	Total Death Benefit	Family's Net Death Benefit
1	1,228,100	49,124	1,228,100	11,228,100	10,000,000
2	1,228,100	98,248	2,456,200	12,456,200	10,000,000
3	1,228,100	147,372	3,684,300	13,684,300	10,000,000
4	1,228,100	196,496	4,912,400	14,912,400	10,000,000
5	1,228,100	245,620	6,140,500	16,140,500	10,000,000
Age 100	1,228,100	1,228,100	30,702,500	40,702,500	10,000,000

As you have seen, had your client purchased the \$10 million directly without premium financing, his annual premium would have been \$532,804. Since in this program, he is only paying each year's interest, it seems he has a good deal since the loan interest payments are significantly below the premiums he would have had to pay had he purchased outright. However, how would you feel recommending your client take on \$30 million of debt, at age 100, in order to get his family \$10 million of protection? What if interest rates rise? How much will his costs be then? What if the value of his collateral fell? How much additional collateral, and for how many years, would he have to put up? How much would it cost him to get out of this program if the costs and/or risks become too onerous? Is it worth all these risks? You are beginning to see the risks your clients can be assuming with premium financing.

2. **Return of Premium with Interest Rider.** Your client's illustration would look something like this assuming he was *borrowing* premiums *and* interest:

Year	Borrowed Premium	Annual Interest Accrued by Client @ 4%	Cumulative Loan	Total Death Benefit	Family's Net Death Benefit
1	1,625,000	65,000	1,690,000	11,690,000	10,000,000
2	1,625,000	132,600	3,447,600	13,447,600	10,000,000
3	1,625,000	202,904	5,275,504	15,275,504	10,000,000
4	1,625,000	276,020	7,176,524	17,176,524	10,000,000
5	1,625,000	352,061	9,153,585	19,153,585	10,000,000
Age 100	1,625,000	2,706,984	70,381,585	50,000,000	(20,381,585)

In this scenario, you will notice that your client's premium is higher. This is because he has to purchase larger amounts of insurance because the loan is higher due to the accrued interest. In this case, you are asking your client to incur \$70 million of debt, at age 100, in order to leave his family with \$10 million - which seems an undue burden to assume for the benefit received - especially in light of all the risks your client is assuming.

There is also a flaw with this arrangement: the carrier limits the ultimate death benefit to five times the initial face amount (this ceiling is very common amongst carriers in premium financing scenarios). You will see that at age 100, although the death benefit has hit this \$50 million ceiling (the ceiling was actually hit at age 92), the loan continues to grow. So, not only does your client's family get *no* insurance protection at all at age 100, but they **owe** over \$20 million at his death - without the means to pay it! Also, the annual interest cost exceeds the \$532,804 non-premium financing premium early on. And, this assumes that interest rates remain at today's low rate of 4%. What if interest rates rise? How much will your client's family be in the hole then? At what age will he become in the hole? While he's still alive? How much collateral would your client have to put up in order to leave his family with \$10 million? As with the above example, he could have purchased the \$10 million outright, without the risks, for \$532,804 per year. How do you justify to your client's family (or, worse yet, their attorneys) that you recommended this premium financing program?

3. **No Rider.** Here's how your client's illustration would look if he used the Increasing Death Benefit Option and was *paying* interest each year:

Year	Borrowed Premium	Annual Interest Paid by Client @ 4%	Cumulative Loan	Total Death Benefit	Family's Net Death Benefit
1	686,913	27,477	686,913	10,200,007	9,513,094
2	686,913	54,953	1,373,826	10,569,310	9,195,484
3	686,913	82,430	2,060,739	10,920,186	8,859,447
4	686,913	109,906	2,747,652	11,230,816	8,483,164
5	686,913	137,383	3,434,565	11,505,384	8,070,819
Age 100	686,913	686,913	17,172,825	20,000,000	2,827,175

As you can see, even though the Total Death Benefit is growing, it is not growing as quickly as is the Cumulative Loan. Therefore, the Family's Net Death Benefit (the amount of death benefit

left over for your client's family) falls each year. Based on age 100 numbers, your client would have to purchase 3.5 times, or \$35,000,000, of initial death benefit just so his family would get their \$10 million at age 100. Of course, this is much more coverage than he needs initially - which is costly and inefficient.

Here is how his illustration would look with the Increasing Death Benefit Option if he were *accruing* interest each year:

Year	Borrowed Premium	Annual Interest Accrued by Client @ 4%	Cumulative Loan	Total Death Benefit	Family's Death Benefit
1	686,913	27,477	714,390	10,200,007	9,485,617
2	686,913	56,052	1,457,355	10,569,310	9,111,955
3	686,913	85,771	2,230,038	10,920,186	8,690,148
4	686,913	116,678	3,033,629	11,230,816	8,197,187
5	686,913	148,822	3,869,364	11,505,384	7,636,020
Age 100	686,913	1,144,285	29,751,400	20,000,000	(9,751,400)

With this scenario, there is no amount of coverage your client could have purchased up-front to insure his family would get the \$10 million they would need, because the Total Death Benefit would always end up less than the Cumulative Loan.

Retained Capital Account

A valid reason for borrowing premiums is to allow your client to keep his money invested in higher return opportunities. After all, if he can make more money elsewhere than it costs him to borrow the premiums, then he is better off. While it is perfectly valid to show your client this benefit, it could be misleading if it deflects attention away from an insurance / loan combination that does not intrinsically work. Using the accrue interest scenario, it would look something like this:

Year	Borrowed Premium	Annual Interest Accrued by Client @ 4%	Cumulative Loan	Total Death Benefit	Family's Net Death Benefit	Retained Capital Account @ 6%	\$20 Million Estate with Insurance & Ret. Cap. Acct.
1	1,625,000	65,000	1,690,000	11,690,000	10,000,000	1,722,500	31,722,500
2	1,625,000	132,600	3,447,600	13,447,600	10,000,000	3,548,350	33,548,350
3	1,625,000	202,904	5,275,504	15,275,504	10,000,000	5,483,751	35,483,751
4	1,625,000	276,020	7,176,524	17,176,524	10,000,000	7,535,276	37,535,276
5	1,625,000	352,061	9,153,585	19,153,585	10,000,000	9,709,893	39,709,892
Age 100	1,625,000	2,706,984	70,381,585	50,000,000	-20,381,585	94,504,122	94,122,537

Your client would naturally look at the far right hand column and see that, with this premium financing program, his estate grows from \$20 million to \$94 million at age 100. What he does *not* readily see is:

1. The insurance / loan combination has produced no ultimate benefit to him and has created a significant debt (\$20 million) at age 100 for his family – without the means to repay it.
2. That he would have been better off investing his money elsewhere and *not* doing the insurance program.

3. The values of the Retained Capital Account, showing the effect of investing his money elsewhere, are inside his estate and do *not* reflect estate, capital gain nor income taxes.
4. The risks and consequences he will have to incur, as we have discussed, should this program not perform as projected.

The problem with premium financing is that everything hinges on the death benefit being sufficient to repay the loan *and* to provide your clients with the insurance they need. *There is simply no way to guarantee this will happen – and your client assumes all the risks and will suffer all the consequences if it does not happen!*

[A Well Designed Premium Financing Program Without the Risks](#)

We have a premium financing program where:

1. The insurance policy is *not* needed at all to repay the loan.
2. The loan is self-completing allowing your clients to purchase their insurance policy *without* concern for its ability to ultimately repay the loan.
3. Interest accrues for the entire loan term – your client does not make any payments during the loan term – nor do they have to have an insurance policy to keep pace with this loan.
4. There are no collateral calls – regardless of the value of your client’s collateral.
5. The loan is non-recourse so your client’s other assets are *never* at risk.

Our premium financing program allows your clients to:

1. **Borrow the necessary funds** to pay premiums.
2. **Eliminate Interest Rate Risk:**
 - a. Lock in fixed interest rates significantly longer than 10 years.
 - b. Have loan terms significantly longer than 10 years.
 - c. Premiums could easily be structured to end by the end of the loan term.
 - d. At the end of the loan term, the loan self-completes eliminating the risk of non-renewal or increased interest rates.
 - e. Since the loan self-completes, a Side Fund is not needed.
3. **Eliminate Collateral Risk:** Your client will *never* be subject to a collateral call should the value of his collateral fall.
4. **Eliminate Asset Risk:** Our loan is non-recourse so none of his other assets are ever at risk.
5. **Eliminate Earnings Risk:** Since the policy is not needed to repay the loan, the interest rate is fixed for the entire loan term and the loan self-completes at the end of the term, your client is not at risk should the policy not grow as originally projected.
6. **Eliminate Policy Design Risk:** Since the policy is not needed to repay the loan, your client can structure his policy so it solves his need *without* the burden of also having to repay the loan.
7. **Eliminate Loan Underwriting Risk:** Since the loan self-completes at the end of its term, there is no need to reapply and, therefore, no risk the loan will not get renewed.
8. **Eliminate Reinsurance Risk:** Since your client is purchasing just the amount of coverage he needs without regards for the loan, there is no need for a premium financing death benefit rider and, therefore, no corresponding reinsurance risk.

If you have a premium financing case and are interested in our program, call Michael Gallop at The Broker’s Network at (800) 811-4601 or e-mail him at michael@brokersnet.com.