



**Premium Financing**  
**An *ab* Resources White Paper - 2010**

## **PREMIUM FINANCING FOR LIFE INSURANCE** **“A SWEET DEAL TURNS SOUR”**

In our practice we have recommended bank financing for life insurance premiums in instances where the death benefit desired for planning purposes was such that gifting of the premium was inadvisable due to the gift tax consequences required to exclude the death benefit from the taxable estate. With annual premiums of \$500,000 and more it is evident that gifting of premiums will quickly exhaust an individual's lifetime exemptions and gift taxes will be incurred. However, there is no gift made if the premiums are paid with loans from an unrelated third party, such as a bank, and the death benefit as well as the cash value of the policy is used to satisfy the debt. In the usual case, the life insurance acquired is structured to have a high initial cash value with future crediting of the policy tied to growth in a stock market index, such as the S&P 500. The cash value of the contract as well as the death benefit is assigned to the lender to secure the premium loans.

In addition to the cash value and death benefit, lenders today require that the insured personally guarantee the loan and deposit collateral acceptable to the lender adequate to cover any shortfall between the cash value of the policy and the amount required by the lender in the loan agreement. ( A number of “non-recourse financing” arrangements were made in prior years, but are generally no longer deemed acceptable by A rated carriers and for all intents and purposes have ceased to exist. We have never recommended these devices and will not be party to them)

Theoretically this design works well—premiums paid are not gifts, the loans are repaid either from the death benefit or the future cash value of the policy, and the proceeds of the insurance are excluded from the estate. So where is the problem? The problem lies in achieving in real life the assumptions that are used in the design of the premium financing structure. The recent turmoil in the financial markets has sharpened concerns about whether or not the illustrated results can be obtained. In assessing our clients' exposure in premium financing structures we have identified seven major areas of concern:

1. **Policy Performance Risk.**

The policy used to provide the death benefit required for the estate in these arrangements is typically an “indexed” universal life product that often has a high initial cash value. Although these policies are often guaranteed from loss, they are credited and increase in value based on positive results in the investment markets. If the stock indices do not increase over the policy crediting period, the contract value does not grow as intended and the arrangement will likely fail.

2. **Insurance Carrier Downgrade Risk.**

The financial meltdown of the last year has impaired the balance sheet of some carriers, reduced their ratings, and brought into question their future viability. If the carrier is deemed inadequate or its ratings are significantly reduced, the lender may call the loan on the grounds that its security in the cash value of the policy is at risk.

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3. Loan Structure Risk.

Although the arrangement may work well under current rates, an increase in rates will quickly unbalance the elements of the loan agreement and may cause the entire structure to collapse. In addition, there is the risk that the bank may be unable or unwilling to continue the loan arrangement in future years and a new lender may need to be found.

4. Bank Downgrade Risk.

In the past year numerous banks have failed and have been acquired by more financially sound institutions. The new owners may not be obligated to continue the loan agreement with the insured and may very well cancel or call the loan. This situation may leave the insured scrambling for a new lender at the worst possible time in the marketplace.

5. Policy Design Risk.

It is critical that the right design be used in choosing an insurance policy that will accommodate this type of transaction. Care must be taken to insure that the rising cost of an increasing death benefit is recognized and that the policy allows for this without increasing the premium required to sustain the contract. It is apparent that if any of the performance variables (i.e. interest rate and stock market indices) falter the entire policy design may fail.

6. Collateral Stability Risk.

Typically the insured will provide traditional investment assets as collateral for the loan. Negative performance in the investment and real estate markets may depreciate the value of the collateral posted and necessitate the addition of more assets, as lenders have become more particular about what they will accept as collateral in these structures. If collateral proves to be insufficient or unacceptable, the lender will call the loan and potentially destroy the transaction.

7. Change of Health Risk.

The ability to replace the existing insurance with a better policy, reduce death benefits, or vary the contract terms may be impossible or at best inadvisable if the insured's health has changed for the worse.

Our firm, having identified the risks associated with recourse premium financing and understanding the various moving parts of the transaction, has developed various strategies to monitor and manage the risks involved. We feel that it is imperative that a strong financial institution which is fully acquainted with this investment be used as the lender and that the appropriate guarantees be part of the loan agreement. The insurance carrier selected must be financially strong, have experience in these transactions and provide the type of policy needed to make the arrangement work. Perhaps, most importantly, we make certain that all parties to the transaction (the insured, the lender, and the insurance company) are communicating on a regular basis and that each is aware of the status of the arrangement on an on-going basis. The choice of which assets are to be utilized as collateral requires coordination between the insured/borrower and the lender. A complete understanding by both parties of which assets are acceptable and which are not is of critical importance if difficulties are to be avoided as the arrangement matures. It has been our experience that these elements of risk namely, Bank Risk, Carrier Risk, and Collateral Risk, can be managed and limited with frequent communication, due diligence in the selection of the carrier and lender and constant monitoring.

The most difficult risks to manage in these arrangements are interest rate risk and policy performance risk. If interest rates rise and stock market performance is poor the collateral requirement necessary to support the loan balloons and the design quickly implodes necessitating drastic measures by the insured such as reducing the death benefit or canceling the policy outright. These aspects of the structure, interest rate and policy performance, are affected by elements beyond the direct control of the parties to the agreement and therefore are not easily remedied.

In order to control the risk that interest rates may increase, many major lenders are suggesting the use of interest rate swaps which require the insured to enter into an ISDA agreement. Unfortunately, ISDA agreements are extremely complex and often do not provide the protection the borrower needs as the rate is fixed by a third party other than the lender and there is no assurance that the third party will perform. The solution for policy performance risk has been to choose the carrier with the best policy crediting method available and hoping for the best. We feel strongly that neither the ISDA contract nor hoping to pick the best policy crediting vehicle is adequate to protect our clients. Consulting with various financial engineers, we have developed two different strategies to address these risks. The first strategy, which controls interest rate risk, guarantees the interest rate cost for the loan period, is liquid at all times, and is directly controlled by the insured. The second strategy, which mitigates the stock market risk associated with indexed universal life contracts, involves an investor controlled account designed to perform positively whether the market goes up or down. In conjunction with the financial experts mentioned above, we have developed a program which profits from “distance” moved in an index rather than direction. This investment can increase in value whether the index increases or decreases and realizes profit from the amount of movement in the index thereby offsetting the “up” only assumption of the insurance contract.

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In summary, recourse premium financing is a useful estate planning tool allowing individuals to provide for their family's liquidity needs at death without incurring gift tax currently. However, the transaction is layered with risks which must be understood by all parties to the transaction. Certain of the risks involved can be managed with due diligence in selection of entities and through constant and effective communication between all parties involved.

Interest Rate Risk and Policy Performance Risk are a different matter. The uncertainty of the recent past in the financial markets has given rise to legitimate concerns about the future of premium financing. As in any investment, the use of leverage magnifies and accelerates the possibilities for disaster. Remedies for existing designs as well as planning of future financing structures requires implementation of new techniques and new financial strategies to cope with the unpredictability of the current financial world. As previously mentioned, our firm has developed strategies to manage and mitigate the final two elements of risk which we have identified: Interest Rate Risk and Policy Performance Risk. If you would like to learn more about how this is done, please contact us.

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