

## Will Premium Financing continue to be a viable strategy?

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What a rollercoaster ride the premium financing marketplace has experienced. Depending on your view point, for several years premium financing has been either the victim or the benefactor of change. Some circles may view premium financing as a strategy of the past, while others may view it as a strategy from the past. One thing is for certain, the rules and playing field have changed. Those who wish to continue using the strategy in regard to financing life insurance premiums need to understand its evolution, recognize when it should be used, and learn from past selling practices that became more of a liability than an advantage.

### Traditional, SOLI, Hybrid, back to Traditional

The evolution of premium financing began with the advent of the Automatic Premium Loan (APL) feature in whole life policies. This automatic ability to borrow premiums using the cash value and death benefit as collateral has been used successfully for decades. Additionally, the loan interest could be either paid in cash or accrued. This type of premium financing is considered traditional, in that the loan and accrued interest is always fully secured. There were significant advantages to both the carrier and the insured to utilize this type of premium financing strategy; business stayed on the books and the insured enjoyed some cash flow relief when it was needed.

It wasn't until the mid 90's when the premium loan was obtained from an outside source. Utilizing a third party lender was the first step of an evolutionary process. Although using a third party lender to finance the annual premiums of a whole life policy was and still is a consideration, the transparency of a Universal Life policy

allowed lenders to feel more comfortable with the transaction as long as it adhered to their lending practices. In the beginning banks were considered a natural source of lending. Later, third party lenders that were not governed by banking laws and charters entered the business of lending to pay large property & casualty premiums, and eventually large life insurance premiums. Although these lenders offered short term financing, they grew to recognize the benefits of lending to pay life insurance policy premiums over a longer term. And, because these types of loans were fully secured, lending risks were mitigated and manageable.

Simultaneous to this evolution was another evolution taking place in the viatical marketplace. Carriers had just adapted to new ideas such as using policy riders that allow limited access to policy death values for those insureds who were terminally ill and with a very short life expectancy. This paved the way to recognizing that a life insurance policy possesses an intrinsic equity value that can now be monetized. Although this has been viewed as a potential insurable interest concern, this viewpoint evolved into the current Secondary Settlement Market. The pump was now primed and the inevitable union of premium financing and the Secondary Settlement Market unfolded in the insurance and investment industry.

Taking full advantage of the leveraged qualities of a permanent life insurance policy, the use of life expectancy tables, and a financial calculator hedge funds were willing to provide financing to pay annual premiums and debt interest of new life insurance policies that met their target market; insureds with a limited life expectancy and a death benefit sufficient to indemnify the outstanding loan plus a significant return on investment. After the incontestability period had expired, these loans became

non-recourse in nature allowing the lender to take ownership of the financed policy as full repayment of the premiums advanced. In some cases these policies were settled in the secondary market to realize an immediate profit.

For the first time, a life insurance policy became a commodity that was bought and sold. The insurance industry refers to this type of lending practice as Stranger Owner Life Insurance, or SOLI. I am sure we have all heard the pitch “If I could show you a way to purchase a large life insurance policy with no financial cost or obligation and after 2 years walk away with \$300,000 in cash, would you be interested?” Similar to a zero coupon bond, the death benefit of the life insurance policy would represent the future return on equity based on its cost. The internal rate of return calculation, or IRR, is typically used in measuring costs vs. benefit. The IRR calculation is still a very important part in recognizing the benefits or premium financing, and we will address this in greater detail a bit later.

As you probably are aware, these programs are rapidly becoming unavailable. Even though they went through some window dressing to imply a different appearance, the insurance carriers were hard pressed to close the door completely. Congressional involvement, industry watchdogs, and taxation issues imply that even after the door is closed, the industry and the insured’s have not begun to feel the repercussion of this creative, but short-lived phenomenon.

Regard my previous reference to “window dressing”, the next evolution in premium financing represented a combination of non-recourse and recourse lending referred to as Hybrids. A hybrid premium financing strategy promoted a “wait and see” mindset. The client may need the life insurance protection now; however he or she may not need it in the future. This mindset reopened the door to carriers that initially closed their door on SOLI. A typical hybrid design required little collateral and in some cases allowed the debt interest to be accrued for an extended period of time. A new bar was set for the premium financing marketplace; one that illustrated no cost, minimal collateral, and no exposure. And with the settlement market waiting in the wings hybrid financing appeared to have no downside.

### **Change in Lending Practice**

The premium financing marketplace flourished until the credit market hit the brakes in the Fall of 2008. There was a time when life insurance premium financing was an

easy process and non-invasive. Lenders were willing to take unaudited personal financial statements without question, income was not verified to demonstrate the borrower’s ability to service the loan, and the requirement to post additional collateral was almost unheard of. Sound familiar? Competition was fierce among premium finance lenders allowing some to focus on simply making loans, rather than making financially sound ones. When the credit crisis hit, it hit hard leaving some borrowers with nowhere to turn. Several lenders stopped providing financing, and those who continued were forced to take a good look at their lending practice.

Although financing is still obtainable, lenders are now asking more questions. Today, a “back to basics” approach is being implemented to ensure profitability and their capacity to properly price risk. Lenders’ ability to underwrite loan risk is key in determining its pricing, which in turn allows them to stay committed to providing financing to pay life insurance premiums. Additionally, producers and advisors are also becoming more aware of what lenders are requiring for loan underwriting, which promotes better communication to their clients about a premium financing strategy.

### **Re-emergence of Traditional Premium Financing**

Today after a decade, the re-emergence of traditional premium financing as a leveraged strategy is representing greater value in the banking community. Now that lenders are taking a closer look at the borrower and their ability to qualify for credit a fully secured premium loan demonstrates greater security to the lender increasing the likelihood that the ability to borrow future premiums will be available.

It is important to note that the purchase of life insurance should be based on need and the client’s ability to pay the annual premium. When this is understood a natural exit strategy exists when financing premiums. Example: Mr. Client would have paid an annual premium of \$500,000, but now his fractional cost is reduced to a loan interest payment (assume 7%, or \$35,000). The remaining \$465,000 is retained by the client. This retained capital continues to grow over time. The future value of this retained capital becomes the natural exit strategy. Other exit strategies may also be considered that include Grantor Retained Annuity Trusts (GRATs) or Installment Sales to a Defective Grantor Trust. However, always keep in mind that traditional premium financing is only an alternative to consider when leveraging the purchase of life insurance

represents an additional benefit. If not, have the client write the premium check.

Premium financing should not be promoted as a cheaper way, rather as a potentially more efficient way of purchasing life insurance protection. To determine whether to finance the purchase of a permanent life insurance policy or not the cumulative costs over time for both need to be compared. The internal rate of return (IRR) calculation is commonly used to illustrate and compare the cost efficiency of both alternatives. The IRR calculation is non-discriminate and takes into consideration the relationship between cost and benefit over time and should be used to determine if financing represents greater benefits than paying the premiums in cash. Again, if not have the client write the check.

### **New Game, new rules**

It is important to learn from prior mistakes and build upon prior successes. Now that non-recourse premium financing programs are not available and hybrid financing is becoming increasingly more difficult to obtain traditional premium financing is worth exploring. The days of “free insurance” that illustrated borrowing annual premiums and loan interest forever is no longer being considered by lenders. Illustrating it is easy, however obtaining such a loan is nearly impossible. What appeared “too good to be true” actually was. A change was inevitable and desperately needed.

Rebuilding after change has always been this country’s strength. The life insurance premium financing marketplace is no different. Rising from the shadows emerges traditional premium financing, which requires full loan collateralization and the payment of loan interest, a “back to basics” mindset if you will. Now that unrealistic lending programs have left the marketplace, traditional premium financing is as strong as ever. Its strength is in the foundation of the strategy itself

including design, due diligence, and the lender providing capital. It mirrors standard lending practices by combining a need-based purchase of life insurance with the borrower’s ability to service the debt.

The future of premium financing requires the understanding of all its moving pieces, and its suitability for the client and situation. As always, full disclosure needs to be practiced to ensure that decisions are made, and based, on the understanding of not only benefits, but pitfalls as well. Securing a premium finance loan in today’s credit environment requires more due diligence than in the past from both the lender and the producer. Producers and advisors are recognizing that there is more to recommending a premium finance strategy than just the discounted outlay. Among the myriad of lenders and the loan programs presented it has become more difficult to ensure that the best loan program is being recommended to the client without knowing the other programs available. Producers and advisors freely accept this liability without fully understanding that it exists.

I have come to recognize that there are only a few experts qualified to provide direction in the many facets of premium financing. An area of concern is one of liability when promoting a single lender’s program. With the limited numbers of lenders available, and the understanding that each lender has a slightly different loan program, such an expert needs to be well versed in choosing the appropriate loan program to meet the needs of the consumer. Additionally, such an expert needs to be aware of a multitude of loan programs when discussing financing with a client. This due diligence is paramount for it strengthens the client-advisor relationship and ensures that the client is well advised.

The tightening of credit within the industry has further strengthened traditional premium financing as a valid tool in purchasing life insurance. Know your client and choose your expert when it comes to premium financing to ensure that you have all your bases covered.

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