Borrowing to Finance Life Insurance Premiums

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BORROWING TO FINANCE LIFE INSURANCE PREMIUMS
What Professionals Need to Know

By: Richard L. Harris, CLU AEP TEP

SUMMARY

Many wealthy individuals are being approached to buy life insurance by borrowing the money to pay premiums (known as "Premium Finance".) While there are merits to the transaction, the concept is often over-sold. Illustrations for the program sometimes appear to offer "free" insurance. The mechanics and inner workings are intricate, especially when the insurance is going to be used in estate planning. If one of your clients approaches you about this, other than calling an expert in the area to vet it for you, here are some things to check out.

BASICS

Most of these loans are done in an estate planning context. An ILIT is set up to own the policy and the ILIT is the recipient of the loan. As in any loan, there are a number of basic terms:

- Amount of loan
- Renewability of loan
- Interest rate
- Interest payments or accruals
- Payment of principal
- Collateral
- Guarantees

As these refer to premium finance life insurance arrangements the terms have additional meaning:

Amount of Loan

In most cases premiums are going to be payable over a number of years, and a new loan is going to be made each year to pay that year's premium. Is the lender obligated to continue to make those loans?

Interest Rate

Unless interest rate SWAPs are used (and they add on to the interest rate that is guaranteed), the interest rate will fluctuate. Usually the interest rate is based on the London InterBank Offer Rate (LIBOR) or Prime Rate, plus some additional percent. The rate can be based on a rate for a specific term, such as three, six or 12-month rates. In the current environment, those rates are at or near all-time lows. They will not stay that way. Check the history of those rates at www.moneycafe.com to get a better idea of how they've behaved in the past so that your client is not betting on a low-ball rate lasting for a long time. Make sure that illustrations show realistic rates going forward. It is better to err on the high side.

Interest Payments

Interest may be paid or accrued. Since the money is being borrowed by an ILIT any interest due needs to be paid by the ILIT. If the ILIT is not already funded in some way, the grantor is going to have to make gifts to the ILIT to pay that interest. Make sure those gifts are taken into account when doing gift planning. If the reason the individual is considering premium financing is to minimize taxable gifts, there is a better way to do that using a split-dollar loan arrangement. (See Lawrence Brody & Richard Harris, "Private Split-dollar Arrangements: They're not dead; they're just different" Trusts & Estates May 2010.)

While in some cases interest may be accrued, unless the loan is for a short term, this should be avoided.

Payment of Principal

What are the note terms for repaying principal? While many illustrations show the loans being repaid a long time in the future or at death, the terms of the note may allow the lender to terminate sooner. One of the provisions that can create problems is that the guarantor must continue to be credit-worthy. Financial statements are required. (See Collateral below.)

Collateral

These loans are always collateralized. The first collateral is the cash surrender value of the life insurance policy. As in all life insurance policies, that cash value will vary according to economic conditions such as bond and mortgage rates. The guarantor (see below) is required to put up stand-by collateral in case the cash value of the insurance is insufficient to cover the loan. Additional collateral will have to be put up if the value of the policy and/or existing collateral deteriorates.

Guarantees

Someone has to guarantee the repayment of the loan. The guarantee is personal and unconditional. If the lender calls the loan or the borrower wants to repay it, repayment will have to be made in full, regardless of the cash value of the life insurance. If the guarantor has to make a repayment on behalf of the trust, the repayment is considered to be a gift.

LIFE INSURANCE SPECIFIC ISSUES

Life insurance is a unique financial instrument. In addition to understanding the loan, one needs to understand the insurance and how it is likely to perform.

Life Insurance Illustrations

Life insurance illustrations are just that. They use current economic and insurance company circumstances projected long into the future. In order for those illustrations to actually come true one has to assume that nothing will change in the future. Wanna bet?

There is a breed of life insurance policies that are often shown as ideal for premium financing - equity indexed universal life (EIUL). These products offer a very low guaranteed minimum rate of return, or the performance of the index after it is sliced and diced by the insurance carrier, if higher. While the index is straightforward, the amount that is credited will differ from policy to policy. The crediting formula is also changeable at the carrier's discretion. This is a much bigger topic than can be dealt with here but there are certain points to note.

The illustration shows a level arithmetic rate of return. Without getting into finance, actual returns will vary and the order of the returns greatly affects the outcome.
The rates illustrated are often high. If the success of the premium-financing program depends upon the success of the insurance policy, be certain you see illustrated rates in the 5% to 6.5% range.

Arbitrage

Often Premium Finance illustrations show arbitrage - what you can earn on your money versus what it will cost to use loans to pay premiums. Needless to say the assumptions are rosy. Unless your client is a VERY sophisticated investor, that part of the illustrations should be ignored.

Disclosure

Clients are asked to sign disclosures saying that they consulted with professional advisors and were aware of the risks of the transaction. If things go wrong the people that sold the program will use the disclosure to prove that the client was adequately warned and they are not responsible.

THE REAL WORLD

What you ultimately have when looking at illustrations for premium finance are assumptions on top of assumptions on top of assumptions. There are assumptions about the continuous availability of loans; interest rates; life insurance policy projections; earnings on other assets; performance of assets used as collateral; and gift tax consequences. What we do know is that none of those assumptions will actually occur as illustrated.

Life insurance is a confusing topic in and of itself. Start a conversation about life insurance at the next cocktail party you go to and see what happens. The subject is guaranteed to have eyes glaze over, even among many professionals. Many premium finance sales are made based on "Trust me because you don't understand it and I do."

ACTUAL CASES

In my experience what has been sold to the client is the idea that this will be "free" insurance and/or this is better than what they are currently doing. Many of the people I have come in contact with would not otherwise have bought the insurance.

I have been brought into situations in which the potential problems became realities. Two cases involved retired professional baseball pitchers: Todd Stottlemyre, Tom Candiotti and Jeff Fassero.

Stottlemyre had recently become securities licensed and a registered representative for Merrill Lynch. To grow his book of business he talked to Candiotti and Fassero, asking them to come in and learn what Merrill had to offer. In both cases, a detailed fact-finding and analysis of their assets, retirement, education and estate planning were performed. They were introduced to a team of Merrill experts including experts in estate planning and life insurance.

When the reports were presented, Candiotti was advised to get $2,000,000 of second-to-die life insurance for estate purposes. Fassero's report made no insurance recommendations, based on the fact that he already had enough insurance to cover any needs. However, because their assets qualified them for premium financing, they were shown illustrations for very large policies. Based on the loan interest assumptions and the life insurance projections, it appeared that they would only have to pay a very minimal amount, if any, to have those policies until they died. After being asked why wouldn't they want to provide this legacy for their families, they went ahead with the programs.

LESSONS

There were numerous things that were wrong with the transactions. Neither of them needed that insurance. In Candiotti's case, he wasn't even shown an illustration for the recommended second-to-die life insurance. Fassero was told that this was a better way to buy the insurance than how he was doing it.

- Lesson 1. Don't buy insurance unless it is needed.

In both instances, the loan interest rate was LIBOR plus. The maximum LIBOR rates shown in the proposal were 3.5% and 3.6%. In the history of LIBOR, actual interest rates were higher approximately 80% of the time. There was no chance that events would bear out the projections, and shortly thereafter, interest rates on the loans were higher than projected. No projections were shown at higher and more realistic interest rates. Had Candiotti and Fassero seen those illustrations, they would have seen the risks and not gone ahead with the transaction.

- Lesson 2. Ask for illustrations showing high interest rates.

Although crediting rates for the life insurance policies were going down, the policy illustrations showed crediting rates based on the rates at that time. The sales people should have known that the policies were not going to meet the projections.

- Lesson 3. Ask for premium finance illustrations based on low projected crediting rates.

In Fassero's case the total amount he was projected to spend under the rosy projection was more than what he was spending, and the ultimate amount of insurance was going to be only slightly greater than what he currently had.

- Lesson 4. Have the sales people give a side-by-side year-by-year comparison of the current program and the proposed program.

The "We are the experts. Trust us." sales pitch was compelling.

- Lesson 5. If someone can't explain it to you so that you or other professionals can understand it, don't do it

While one advisor attempted to get more information, he was assured that things would work out as planned. The information requested was never provided.

- Lesson 6. If you don't get what you ask for, don't do the deal.

Both Candiotti and Fassero had the disclosures described above signed by all parties involved.

- Lesson 7. If they are asking for signed disclosures, go over the disclosures. Find out what can go wrong, as they wouldn't ask for the disclosures to be signed if nothing could go wrong. Ask for them to specifically identify and illustrate the risks. And make sure that professional advisors who understand the transaction have been consulted.

Even after the cases were settled, it cost Candiotti and Fassero a good deal of money to end the transaction, not including legal fees.

- Lesson 8. Before going into a premium financed program make sure your client has an exit strategy. If they don't have a good plan to end the program (other than death), they should not go into it.

For more about these cases, Deborah Jacobs wrote a highly entertaining and informative article, "Wild Pitch," in the July 18, 2011 issue of Forbes.

RECOMMENDATIONS

Look at the client's current planning situation to get an idea of the amount of insurance that is appropriate. It is important in any planning that you understand the client's situation - what is the client hoping to accomplish and how will the transaction help the client accomplish those goals. Don't impose your opinions on the client. Just because a client has a lot of liquid assets but wants to buy insurance to pay estate taxes doesn't make the transaction bad. Many people want all of their assets to go to their heirs unencumbered.

If after that discussion and analysis, someone is contemplating entering into a premium finance transaction, find someone who is expert on life insurance, premium finance, estate planning, and a reputation for integrity. Since all three interact, a good knowledge in those areas is what is necessary to assess the proposals. If you do not have someone you can go to for that expertise, I recommend that you ask for illustrations that show the most unfavorable assumptions - high loan interest rates, poor policy performance, and poor collateral performance. At the very least those assumptions will show you the problems your client is likely to face. Also read all the documents related to the loan. Be particularly attentive to what can go wrong and how it would affect your client if and when it does.

Final lesson. There is no free lunch and there is no free life insurance.