

R/P America Life Services

Premium Financing – Common Questions

What is premium financing?

By financing the premiums through a major lending institution, affluent clients can achieve the advantage of life insurance without the disadvantage of paying premiums with after-tax dollars. As a result, the client's cash flow and/or investments need not be liquidated to fund the policy and the client's portfolio can continue to grow without interruption.

Who qualifies for premium financing?

An individual or lawful entity with a minimum net worth of \$5 million who:
is willing to have a medical exam for underwriting

- will incorporate with the lender for financing and is willing to pledge personal assets as collateral
- has a significant insurable need for wealth creation, estate planning, for business succession planning, or charitable giving
- has an annual income of at least \$250,000
- have ample liquidity (or protected liquidity)

How does premium financing work?

The lender will finance the premiums for the insurance policy, taking an assignment on the death benefit to cover the loan plus interest. The policy is owned by an irrevocable trust or ILIT that designates the beneficiaries of the death benefit over and above the assignment to the lender. The lender pays the premiums directly to the insurance company. The insured will post collateral to any extent there is a difference between the policy cash value and the loan balance. In most cases, the principle of the loan is repaid to the lender at the death of the insured although there are generally no prepayment penalties should the client wish to retire the loan either with funds from the cash value in the policy or from estate transfer techniques. Alternatively, the owner may consider (a) refinancing the loan, (b) creating a lifetime income stream from the cash value during the life of the client, (c) using the cash value to purchase a single premium immediate annuity, or (d) converting the policy to a paid-up policy for a lesser face amount.

What type of insurance is used in a premium financing transaction?

The purchase of life insurance to meet long-term death protection needs generally entails the use of permanent Index Universal Life or Whole Life.

Which insurance carriers do you use for the financing?

In order to be approved by the lenders involved in the program, the carriers must be rated A+ or higher and have proven financial track records of over 100 years.

How is the projected growth of the cash value calculated?

Premium financing structures mainly incorporate a Whole Life or IUL policy because of the cash value component, which is the equity that will eventually pay back the financing lender. Although most clients are familiar with Whole Life policies, they tend to be very expensive to finance and can cause an increase in their collateral by 30-40% compared to most IUL policies.

The cash value performance of an IUL is linked to a monetary trading index, one of the most popular of which is the S&P 500. Carriers don't directly invest in the S&P 500. Rather they use it as a baseline to credit the cash value. These products have both a cap that ranges around 10-13.5% and a "floor" of 0-2% (depending on the insurance carrier). It works on a "point-to-point" system. For example, if an IUL was issued and funded on January 1st, if the S&P 500 performed at 15% growth the following January, the client's cash value would be credited with the full cap of around 10-13.5%. However, if the market experienced a steep decline with no growth, the cash value would not be affected by being credited 0% or even 2% (again, depending on the insurance carrier).

Based on historical returns of the S&P 500 going back to the 1930s, every ten, fifteen, and twenty years have shown an average return of 7.50% or greater. Clients who are best fit for premium financing believe, based on the historical returns of the market and given the potential for higher returns from the IUL cap and protection of the 0-2% "floor," that we will see on average a 6-7% return every seven to ten years in growth.

Who are the lenders?

The lenders are major global institutional money managers and highly rated banks that have been providing this type of financing for decades.

Which banks provide premium financing?

A substantial number of the country's leading banks that are global tier-one institutions and highly rated (A+ or higher) participate in the finance program.

Who manages the loan?

The lenders' committee manages the loan. The premiums are paid, the collateral is determined, and all managed internally at the lender.

What is the origination fee or other fees and when are they required?

The origination fee is the lender's transaction fee for the loan and varies from lender to lender. Typically, the fee ranges from 0.25%-1.00%. This one-time fee can either be rolled up into the loan transaction or paid directly by the client. If the client elects to capitalize the fee in the loan, the collateral number will increase commensurately. Any other fees from the client's CPA, attorney, and other advisors will be reimbursed to them at the closing.

Who determines the loan term?

Our lenders will go 5 years, 10 years, and even 20 years. Because the cross-point is generally within the first few years, these loan terms are simple. There are generally no prepayment penalties so the program can take advantage of improvements in the industry as they develop.

What is the interest rate charged in a typical financed transaction?

The interest rate varies from lender to lender but there are certain aspects each has in common. First, most use the LIBOR rate index. Second, each adds an individual "spread," usually between 100-150 basis points. However, we do offer fixed rate financing as well.

How do interest rate fluctuations effect financing transactions?

In a rising interest rate environment, bank loan rates will likely rise more quickly than life insurance crediting rates. If the loan rate rises significantly above the crediting rate, a negative arbitrage is created resulting in increased exposure to the insured that must be covered by an increased collateral amount. The client can choose to lower the death benefit thereby allowing the client to maintain their original collateral instead of increasing it. The "actual exposure" is limited to the difference between the loan balance and cash value in the policy. This figure is called the "client's collateral."

Why is collateral needed at all?

The lenders pay the insurance premium each year, but the cash value in life insurance policies takes time to grow. In the earlier years, there is a shortfall of what the lenders paid out in premiums and interest against the cash value equity in the policy. This gap needs to be covered by the clients' collateral. For example, if a lender paid \$500,000 into a client's policy for premiums and interest, but there is only cash value of \$200,000, that is a difference of \$300,000 that the client needs to post in the form of collateral.

What type of collateral is needed? What is the "skin in the game" that is needed to be provided by the client?

Clients must have "skin in the game," or post short-term collateral during the earlier years while the cash value in the policy grows. This collateral can be a control agreement against their existing brokerage account, letter of credit, the cash value in existing insurance policies, and/or any other "liquid" asset(s) approved by the lenders involved in the transaction. The most important factor is that clients do not have to move assets away from their current brokerage firms. Clients can still have investments work and grow exactly where they are. The amount of collateral posted equates to approximately 5-10% of the financed amount.

For the last several years, control agreements have been the most popular form of collateral. Control agreements are available at all the major banks and broker-dealers. Control agreements come at zero cost to the client and their assets stay at their respective brokerage firms where advisors can continue to trade and grow the account but allow clients to leverage the existing account as collateral thereby making it do "double duty" for them.

What if there is a call on the collateral?

The collateral is only at risk if the lender goes bankrupt, the insurance carrier goes under, and/or the client he or herself goes bankrupt. These three "defaults" could cause a call on the collateral. The chances of this happening are very remote—possible, but remote.

Am I personally responsible for the premium financing loan?

No. Clients are only responsible to maintain the needed collateral in the financing structure.

What are the risks associated with premium financing?

This is not “free insurance.” There are risks associated with the concept including loan interest fluctuations, the performance of the insurance cash value and the financial stability of the client, the bank, and/or insurance carrier. The client at any point in the program is only liable for the collateral that they have posted for the program.

Are there any tax issues in financing?

The structure has no tax ramifications, but the program will coordinate all legal and tax-related issues with the client’s advisors. The program also works with some of the largest law and accounting firms in the US that provide all needed advice related to questions concerning tax and legal issues.

How are the fees for the policy affect the financing?

Most consumers when paying for life insurance pay into the policy the absolute minimum amount needed to keep it in force. Therefore, the cost of insurance or COI substantially eats into the policy cash value. Therefore, it will take significantly longer to see any growth within the policy. However, in premium financing lenders **overfund** the policy beyond the minimum premium payments. In other words, it's funded right below the MEC levels. By doing so substantial cash value is accumulated from the beginning of the financing greatly offsetting the effect COI has on the policy.

What do Wall Street hedge funds and private equity firms think of premium financing?

Wall Street has embraced this premium financing for themselves and clients. By financing large amounts of life insurance with a control agreement or letter of credit, the clients can create millions of dollars in additional wealth for their families and/or increase charitable donations due to the following benefits:

- Lenders put up all the money to fund the premiums and interest.
- Money does not need to be moved out of existing accounts and/or investments to participate in premium financing.
- The only "skin in the game" is the client's collateral, which is a minimal amount of risk compared to the upside of this program.

"Too good to be true. Why haven't I heard about this financing option before? Why hasn't my insurance agent recommended it?"

Premium financing in the life insurance field is very specialized with a limited market, namely limited to those with high net worth clients. As such, the vast amount of life insurance agents focus their attention on selling single term and whole life policies and are not versed in premium financing mechanics in that they have not been introduced to this program and most are not even aware such a program exists. The complicated structure requires an in-depth understanding of both macro and microeconomics and markets to be able to discuss its benefits with clients.