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CASE STUDY

PREMIUM FINANCING

A PLANNING TOOL TO CONSIDER

BENEFITS:

- Eliminate the need for large annual payments to the insurance company
- Multiple policies can be attached to a single premium finance contract, allowing one payment to cover all policies
- Clients may obtain coverage without liquidating other assets

By Michael S. Berry, ChFC

INTRODUCTION

Life insurance can provide very attractive financial protection and accumulation benefits, such as an income tax-free death benefit and tax-deferred cash value growth that can also be accessed income tax free, if structured and executed properly.

Before we go into the specifics of this case study, let's spend some time discussing cash value life insurance in general. Many people do not realize cash value life insurance, at its core, is property – an asset. There have been countless articles written regarding whole life, variable life, and indexed universal life. Each article seeks to compare and contrast policy benefits and accumulation features, yet often fails to discuss how these policies may fit into a well designed, comprehensive financial plan.

Another frequently quoted point is the cost of such policies. Often, the purchase of these policies require that assets be liquidated, or cash flow be redirected in order to fund the annual premiums. In practice, we have found that many of our clients, in particular our affluent clients, find this quite unattractive. They much prefer to not put forth the significant cash outlay that such policies require. Premium financing offers an alternative to this.

To begin, let us draw a simple analogy between cash value insurance and real estate. Most of our clients can wrap their minds around the characteristics and fundamentals of real estate. If you want to purchase a $5mm piece of real estate, how would you do it? Quite simply, you have only two options – you can write a check or you can borrow the money (or a combination of the two). Why would one choose to borrow money, or finance, real estate? The answers vary – for cash flow reasons or perhaps to leverage the upside growth potential of your real estate investment. There are lots of reasons.

Why not do the same with your life insurance plan, and finance the premium? In the case that follows, our client chose to finance the policy instead of using current cash flow to fund the premium.

CASE STUDY

THE FACTS:

The client is a successful physician in her early 40's, considering the purchase of a life insurance policy using the premium financing method. The client desires to put the death benefit in place, and to have significant cash accumulation, yet prefers to have additional cash flow for herself, to allow her greater flexibility in personal and business purchasing power.

PLANNING CONSIDERATIONS:

Planning points to consider for this client in looking at premium financing include the following: annual cash flow savings, IRR on the death benefit, and IRR on the cash accumulation.

Annual Cash Flow Comparison

Under the traditional model, the client would pay out of pocket (post tax) total premiums of $25K annually for a period of ten years ($250K total outlay), providing her with a $750K death benefit.

With the premium financing model, the premium is funded by a bank loan, with the client paying a combination of interest and principal on that loan - at an outlay of $25K per year for a period of 10 years. This $25K outlay supports a greater premium amount being put into the policy, thus garnering a death benefit of $5mm as opposed the $750K death benefit in the traditional model.

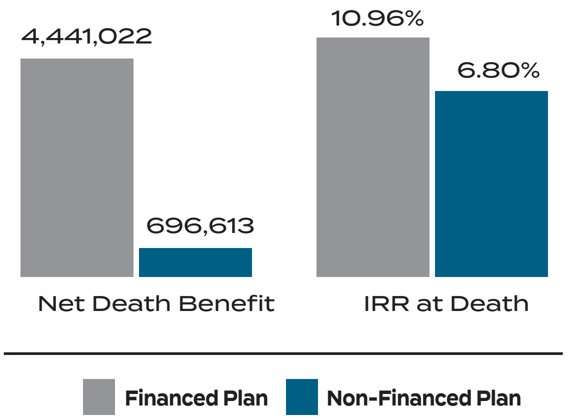
Internal Rate of Return (IRR) on the Death Benefit and Cash Value

Under the traditional model, at death (using her life expectancy of 86), the client is projected to have a net **death benefit** of approximately $700K - resulting in a Death Benefit IRR of 6.80%. Please note: with the traditional model, the death benefit IRR is inclusive of $660K of income the client enjoyed in the form of **tax-free withdrawals** from age 60 to age 79.

Using the premium financing model, the client's estimated net **death benefit** at her life expectancy is just over $4.4mm (a death benefit IRR of 10.96%). Please note: with the premium financing model, the death benefit IRR is inclusive of $1,112,000 of income the client enjoyed in the form of **tax-free withdrawals** from age 60 to age 79.

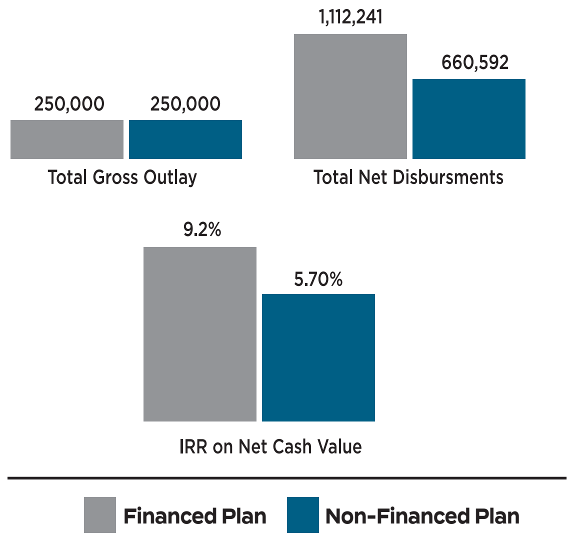
Summary of Life Expectancy Year 42 (Age 86)

	Financed Plan	Non-Financed Plan
Net Death Benefit	4,441,022	696,613
IRR at Death	10.96%	6.80%



Summary of Life Expectancy Year 42 (Age 86)

	Financed Plan	Non-Financed Plan
Total Gross Outlay	250,000	250,000
Total Net Disbursments	1,112,241	660,592
Net Cash Value	955,000	149,412
IRR on Net Cash Value	9.2%	5.70%



The **cash accumulation** feature is an aspect of the plan that was of great importance to this client. Under the traditional model, at her life expectancy, the client would have estimated cash values of just shy of $150K (please note, the client had already received the benefit of $660K in tax-free withdrawals prior to this date).

With the premium financing model, her cash values at life expectancy are estimated to be just under $955K (after receiving $1.1mm of tax-free withdrawals) – a significant difference in the cash value of the policy. This gives us a net Cash Value IRR of 9.22% on the premium-financed plan, compared to 5.70% on the traditional model.

It is clear to see that by utilizing the premium financing method, the client benefits from significantly higher death benefit amounts, while enjoying tax-free income.

OTHER PLANNING CONSIDERATIONS – "EXIT STRATEGY"

It is important to have a plan in place to repay the loan (i.e. an "exit strategy") The future loan can be repaid by taking a distribution from the policy's cash value, from other assets, from cash flow, from the proceeds of a liquidity event such as the sale of retained assets, or from some combination of the above.

In this case study, the bank loan is repaid using cash value from the policy.

OTHER KEY ASSUMPTIONS

Bank loan interest rates start at 2.19% in year one and increase by 40 bps per year, in anticipation of a rising interest rate environment, until year 8 where they level off at 5.04%.

The interest crediting rate of the policy is 6.45%, and the insurance underwriting class is preferred nonsmoker.

What risks should you consider?

- **Interest Rate Volatility Risk:** Rising interest rates could result in more out-of-pocket cost than originally projected.
- **Policy Performance Risk:** The policy's cash value performance is typically not guaranteed and could fluctuate from year to year, based on the underlying interest crediting and policy charge structure.
- **Collateral Risk:** Collateral requirements may vary with economic conditions and could force the client to liquidate other positions in order to post collateral. Furthermore, a decrease in the value of collateralized assets (such as real estate or securities) may require the insured or their estate to post additional collateral.

What are the benefits?

There are a number of benefits to financing insurance premiums. These include:

- Eliminates the need for large annual payments to the insurance company
- Multiple insurance policies can be attached to a single premium finance contract, allowing for a single payment plan to cover all policies.
- Allows for clients to obtain needed coverage without liquidating other assets, such as real estate or brokerage accounts.
- Clients avoid large out-of-pockets sums, thus allowing them to better leverage their capital (this avoiding unnecessary opportunity cost), clients can retain a significant amount of capital known as retained capital.

SUMMARY:

Premium financing is an alternative method for affluent clients to fund life insurance premiums. It involves borrowing the premium amounts from a commercial lender, as opposed to paying them out of pocket. The initial cost becomes loan interest and principal, which can be paid in cash or accrued, in some instances. The loan is collateralized primarily by the policy's cash value, with any shortfall covered by pledging personal assets. This saves the client money in terms of their annual outlay, which can they be utilized to meet other financial goals.

TYPICAL CLIENT PROFILE:

Traditionally, premium financing is a tool reserved for affluent individuals – those with significant wealth and highly appreciated assets. It can, however, be an excellent strategy for high income earners, who have a need for life insurance, yet wish to preserve their cash flow and avoid liquidating other assets. Premium financing may also be an option for clients who have trust-owned life insurance, and desire to reduce their annual gifting, or save on potential gift taxes.

Typically, the clients we work with, who would benefit from and have an interest in premium financing, are between the ages of 30 & 75, with net worths greater than $5mm. The majority are professionals or business owners, who desire to retain capital and not have to significantly reduce their cash flow.

CONTACT US

Thank you for taking the time to review this abbreviated case study.
For a complete analysis of this case, or to discuss your specific situation, contact us.

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