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Premium financing

What underwriters should know

- Designed and used properly, premium financing is an acceptable way to pay for a policy.
- Look for personal financial and loan characteristics that make for acceptable premium financing design.
- Be aware of unique financial and legal risks.

Introduction

Many companies employ the power of leverage — borrowing from a bank or other financial institution — in managing their business operations. Used properly and responsibly, leverage allows for cash flow to be used more effectively, usually invested back in the business to grow and expand. Skilled executives understand the full benefits and potential risks of borrowing. Potential investors also look at debt ratios to see how much of a company's assets are being financed when analyzing whether or not to invest in them. But, when borrowing is done improperly, it can cause additional stress on a company's financial footing.

Financially savvy individuals may also employ leverage in managing their personal finances. Some choose to finance a major purchase, such as a car, given the low interest rates on a loan. They prefer the arbitrage, believing they can earn a higher rate of return on their money compared to the amount being charged to finance the purchase. Many financial advisors present the use of premium financing to their qualified clients as an option for funding their life insurance purchases. Used properly, it can be an effective and suitable tool. However, one must know the potential risks of using such a technique as well.

Early years: IOLI/STOLI

Premium financing has been around for decades. In earlier stages the programs typically involved designs where non-recourse loans were used to fund the policies. As a result, a policyholder did not have to post collateral besides the insurance policy itself. The lender couldn't go after any other assets of the insured if the policy lapsed or did not perform in a manner to cover the loan. This structure made selling policies into the secondary market to settlement companies an attractive option. Some unscrupulous agents also found it enticing to sell policies to individuals who would not otherwise qualify, often to older insureds who were induced by an offer of "free coverage" or even cash. Many times fraudulent or fabricated financial disclosures were involved and the policies were quickly sold to investors, or "strangers," (hence "STOLI") who had no insurable interest in the continued life of the insured. Fortunately for the insurance industry, non-recourse premium financing is no longer accepted as a financing option.

Current practice

Today, in light of the relatively low interest rate environment, premium financing may be a practical and appropriate way to assist individuals who have a legitimate need to purchase life insurance for estate planning or business needs. Structured properly, it provides a flexible alternative way to manage assets and cash flow. And, today many programs are constructed and designed in ways that are more acceptable to insurers and reinsurers alike. As an underwriter, there are several characteristics that indicate a more acceptable and favorable design. These qualities include:

- An insured that is financially savvy with a high net worth.
- Wealthy, but limited cash or liquid assets.

- Insured is generally under age 70.
- A clearly demonstrated insurable interest and financial need.
- An amount the insured would qualify for even if financing was not involved.
- Additional collateral being pledged besides the insurance contract alone.
- Involvement by outside legal or financial counsel.
- A demonstrated exit strategy besides death benefit payoff.
- Reasonable lending terms and fees that are fully disclosed.
- Internal review and approval by advanced sales design team.
- Loan interest to be paid at least annually and not accrued.

However, even if you are comfortable with the design of the lending arrangement, all parties involved should still be aware of the potential hazards of using premium financing. Many well-structured plan designs can still be at risk for many different reasons. For an underwriter, some of the risks involved with financing to be aware of include:

- Interest rate risk: rising interest rates can impact cash value growth, causing a policy to lapse or a need for additional collateral.
- Refinance risk: the insured may need to requalify for financing if the loan is not paid off at the end of the initial term. Requalifying could be an issue if their financial status has changed.
- Over-insurance risk: is there excessive exposure to unnecessary risk with the use of leverage?
- Legal risk: does the insured understand the risks of financing and could they take legal action against you if something is not disclosed or handled properly?

An underwriter should also ask...

- Is a majority of an insured's insurance portfolio in force by use of premium financing?
- Does a distribution source write a disproportionate amount of financed business?
- Is the source of the funds from a U.S. based lender?

Conclusion

Premium financing has been used in the insurance industry for decades and most experienced underwriters have come across a financed case. Understanding the risks inherent with the loan designs provides the underwriter the proper tools to uncover potential issues and make a sound underwriting decision. Structured properly, financing allows the qualified insured the flexibility to meet their insurance needs, while keeping their assets employed in other income or revenue generating ventures. Knowing what constitutes an acceptable lending design gives the underwriter confidence it meets both their company's approval and the insured's needs.

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