FEATURE:
INSURANCE

By **Robert W. Finnegan**

Premium Financing With Indexed Universal Life: Part I

First understand the opportunity, the product and the loan

In the last 15 years, premium financing has become a popular strategy for funding large trust-owned life insurance (TOLI) policies. The rise of premium financing plans can be attributed to a number of factors, including high-net-worth clients being comfortable borrowing funds to finance transactions, ongoing favorable borrowing rates and the development of indexed universal life (IUL) policies that reflect the returns of an equity index fund (index fund), typically, the S&P 500.[1] Lenders are willing to make these loans because they're fully secured at all times and are therefore never at risk.

Premium financing provides many opportunities to fund life insurance using other people's money. Appropriate uses of premium financing begin with an established need for life insurance, typically for estate or business planning, and include scenarios in which:

- The client doesn't currently have the cash flow to pay for the insurance. For example, the client's closely held business may be in growth mode, and the owner is reinvesting profits back into the business.
- Short-term financing may make sense, including the accrual of loan interest. For example, a client may expect a liquidity event in the next three to five years that will generate cash flow to pay interest, repay the loan and pay future premiums.
- The client's business, real estate or other investments have a proven track record of generating substantially greater after-tax returns when compared to the projected loan rates so that he prefers to borrow to fund the life insurance rather than reposition high performing assets.

With the potential for strong cash value returns based on the associated index fund, IUL policies are frequently used for premium financing plans.[2] Depending on performance, policy values may be available to pay a portion of interest costs and loan principal. However, just as direct investment in an index fund bears the risk and reward of the performance of the fund, IUL bears that same risk with significant differences and limitations. In addition, most policy components aren't guaranteed. Unfortunately, designs that purport to create no cost or very low cost TOLI have been and are being aggressively marketed. And, who wouldn't want free insurance? Although it's possible that these aggressive plans might live up to their promise, they expose clients and their families to tremendous financial and tax risks.

I've divided this article into two parts. Part I provides an overview of premium financing plans and IUL policies. Part II will evaluate IUL returns; stress test an aggressive plan design; and illustrate the financial and compounding tax risks it poses. It will then outline a prudent approach to designing, funding and monitoring premium financing plans.

Premium Financing Overview

In a typical premium financing plan, an irrevocable life insurance trust (ILIT) borrows from a commercial or third-party lender, typically a bank, to pay the premiums on a policy owned by and payable to the trust. The trust either: (1) accrues the interest, or (2) pays the loan interest with cash flow from trust assets or with gifts from the client/insured. Sufficient collateral acceptable to the lender is posted so that the lender is fully secured at all times.

At inception, the lender agrees to a total loan for a

Robert W. Finnegan is senior VP, advanced planning attorney at Highland Capital Brokerage in Farmington, Conn.

term of years based on expected premium payments and subject to the guarantors continuing to meet financial qualifications. For example, assume a client desires to establish an ILIT and finance purchase a policy with five annual premiums of $500,000. The lender agrees to a $500,000 loan in Year 1 and total additional loans of $2 million to cover the remaining four premiums. The client guarantees the loan and posts collateral as needed. The lender pays the first premium and, on each anniversary during the 5-year period, provides an invoice for interest due, trues up collateral (to ensure that the lender remains fully secured) and, provided the loan isn't in default and the client as guarantor continues to meet financial qualifications, offers the borrower the option to finance all or a portion of the next premium. As part of the annual review, the client certifies to the lender that his financial net worth hasn't decreased, and the lender reserves the right to request a current financial statement. At the end of the 5-year period, the borrower will be given the opportunity to repay the loan or re-apply. The loan will be re-underwritten, and if approved, the borrower may re-up for another 5-year period, but subject to the lender's terms in effect at that time and based on the new underwriting. If the lender doesn't renew the loan, it will be due and payable in full, and the borrower may be scrambling to find an alternate financing source.

The loan interest rate typically varies annually and is based on the current 12-month LIBOR[3] at the time of implementation, plus a spread ranging from approximately 100 to 350 basis points (bps). The spread will depend on the lender, the size of the loan and the creditworthiness of the borrower, and it isn't guaranteed over the term of the loan. On each annual renewal date, the loan rate is adjusted based on the then-current 12-month LIBOR plus the spread and applied to the entire outstanding loan balance. It's important to put the 12-month LIBOR in perspective by reviewing historical rates:

- In June 2014, the 12-month LIBOR reached an all-time low of 53 bps, and over the last nine years,[4] it reached a high of 2.1 percent with an average of 1 percent.
- For the calendar years 2006 and 2007, the 12-month LIBOR averaged over 5 percent.
- Over the last 20 years, the 12-month LIBOR reached a high of 7.5 percent and averaged 2.74 percent.
- Since 1990 (28 years), the 12-month LIBOR reached a high of 9.25 percent with an average of 3.6 percent.

Assuming a current 12-month LIBOR of 1.71 percent[5] and a 175 bps spread, 3.5 percent would be a reasonable current loan rate. If the 12-month LIBOR increased from 1.75 percent to the 28-year average of 3.6 percent, the loan rate would increase to 5.35 percent (3.6 percent LIBOR + 175 bps spread). As the historical LIBOR rates indicate, the loan rate could in fact go far higher, and the premium financing plan is likely to experience substantial swings over its lifetime.

Most lenders will provide the option to lock in a level multi-year loan rate at inception with an "interest rate swap," for example for five years. A 5-year lock would add approximately 100 to 125 bps to the annually renewable loan rate, so that, assuming a 3.5 percent annually variable rate, a current level 5-year loan rate would be approximately 4.5 percent to 4.75 percent. The additional cost of the locked-in rate is based on the expected premium loans so that once a level rate is locked in, the borrower is committed to borrow the specified amounts on the pre-designated dates. For example, the trust will be committed to borrow five annual premiums. If the client doesn't adhere to the premium borrowing schedule, including if the loan is repaid during the period, there will be a breakage fee, plus a possible pre-payment penalty.

Regarding collateral, the trust posts the policy cash surrender value (CSV) as collateral with any shortfall, the amount by which the loan exceeds the policy CSV being secured by assets acceptable to the lender. Typically, lenders will credit 90 percent to 95 percent of the policy CSV and will require that the insurance

IUL is a cash value general account product that's based on the returns of an index fund, typically the S&P 500.

carrier meet financial strength guidelines. To the extent that the trust doesn't hold sufficient assets to meet the shortfall, the grantor/insured pledges assets. Although there's no authority on point, most advisors believe that the posting of collateral isn't considered a gift to the trust.[6]

Most lenders will accept cash, certificates of deposit, money market funds, a letter of credit from a highly rated bank, a portfolio of quality marketable securities, life insurance cash values and some annuities as collateral. For collateral other than cash and letters of credit from a highly rated bank, the lender will require a greater amount than the outstanding loan balance (a margin) to reflect the risk that the value of the collateral will fluctuate during the loan period, thus ensuring that the lender is fully secured at all times. The riskier or less liquid the collateral, the greater the margin. Lenders monitor collateral closely to ensure that the loan isn't in default. Although the collateral posted is tied up, frequently, the client may trade the marketable securities held as collateral as well as receive income and dividends provided that such actions don't jeopardize the lender's security. Some specialty lenders will accept art or real estate, but with a substantially larger margin and/or higher borrowing rates.

Illustrations aren't a guarantee or a projection of future performance.

When comparing lenders, it's important not just to compare rates, but also to carefully assess and compare each lender's experience in the market, long-term commitment to the market, the number and amount of premium financing loans in place and whether the loan has pre-payment penalties (the better programs don't). Also, carefully review the conditions under which the loan may be called. The better lenders will only call the loan if it's in default, that is, when the loan balance exceeds combined collateral, and that shortfall hasn't been remedied following notification.

Alternatives for Repayment

Because most premium financing plans are between an unfunded ILIT and a bank, transfers to the trust, whether to pay interest, to repay the loan or as a collateral call, are gifts. Such gifts could expose the estate to greater transfer taxes, whether as taxable gifts and/or smaller available exemptions. In addition, if it's a dynasty trust, there will be generation-skipping transfer tax implications. With all premium financing plans, it's therefore essential to carefully consider how the loan will be repaid. Consider these alternatives:

1. Some plans are designed to be maintained until death and repaid with the policy death benefit. That means that loans must be regularly renewed until death (subject to availability of credit, lender receptivity and ongoing commitment to the market and potentially different borrowing rates), and the policy must remain inforce.[7]
2. If CSV growth is sufficient, the loan may be repaid with a policy loan. This may, however, place tremendous strain on the policy, risking a reduced death benefit or a policy lapse and recognition of phantom income.
3. The premium financing plan may be implemented in a trust that's already funded and holds sufficient assets to repay the loan.
4. Other assets may be transferred to the trust using gifts, discounted gifts, grantor retained annuity trusts, intra-family loans and/or sales to a defective grantor trust. Such transfers may not only backstop the loan, but also, they may generate cash flow to pay loan interest and simply constitute sound estate planning.

It's essential that all premium financing plans, consisting of the policy, the loan and the collateral, be thoroughly stress tested, carefully administered and closely monitored at least annually, reviewing the performance of each component individually as well as collectively.

IUL

Universal life (UL) is a generic name for a non-fully guaranteed[8] flexible premium life insurance policy. With non-guaranteed UL policies, the carrier collects the annual premium, deducts charges and fees and invests the balance to generate the policy cash values. Each month, the cost of insurance (COI) (the 1-year term cost) is deducted from the cash values.[9] The COI is determined by multiplying the net amount at risk (the policy death benefit less the policy cash values)

times the carrier's rate per $1,000 of insurance based on the insured's age and rating (determined initially based on medical underwriting). As a 1-year term cost, the rate per thousand increases each year based on the insured's attained age. Neither the investment returns nor the current fees and charges including the COIs are guaranteed but rather can fluctuate based on the carrier's experience.[10] If overall carrier performance is worse than expected, initial projected premiums may not be sufficient to ensure that the policy stays in force and doesn't lapse or, if overall carrier performance is better than expected, lower premiums may result.

IUL[11] is a cash value general account product[12] that's based on the returns of an index fund, typically the S&P 500. IUL has a number of important and unique characteristics that advisors should understand that distinguish the IUL returns from the associated index fund. IUL premiums net of expenses and charges aren't invested directly in the underlying index fund. Rather, the carrier employs standard general account investment strategies combined with hedging strategies that are based on the underlying index fund. The actual IUL return can vary substantially from the index fund's return because: (1) the IUL return excludes dividends earned on the stocks comprising the index fund, (2) a participation rate or weighting (typically 100 percent) is then applied, and (3) the resulting return is then subject to a minimum (floor)[13] and maximum (cap).[14] These factors allow the carrier to employ hedging strategies to achieve the IUL policy's investment returns and develop policy cash values:

> AG49 was implemented to curb the use of unrealistic illustration rates by imposing limits on the maximum rate a carrier may use in product illustrations.

- On receipt of a premium, the carrier deducts policy expenses, charges (including the COI) and loads and invests excess premiums along with the policy's cash values as part of its general account portfolio, generally consisting of high grade bonds and mortgages.
- The bonds and mortgages ultimately return principal, providing principal protection. The carrier applies the associated portfolio income, referred to as the "options budget," to purchase options to meet the specific product's cap and floor based on the index fund and the current participation rate.
- One or more of the cap, floor or participation rate isn't guaranteed and can therefore be adjusted up or down as the carrier's experience dictates. As a result, the carrier has little investment risk in the IUL product, whereas the policyowner bears that risk.

Typically, a number of index fund and other options are available, the most common being the S&P 500 1-year point-to-point, but international indices and index fund with different terms[15] may also be available. A 1-year point-to-point term is most common, but the policies may also offer 2-year or 5-year point-to-point durations. Policies also include a fixed rate option based on the carrier's general account investments. For example, the carrier might offer a 3.75 percent guaranteed rate for one year, after which the fixed rate will change based on the carrier's expected general account investment performance for the coming year. Policy values may be allocated among the various investment options offered within the policy.

IUL investments are managed in segments. New net premiums along with policy cash values may be invested in different segments. For example, one segment may be based on the S&P 500 for a 12-month duration (1-year point-to-point). At any time, the policy may be invested in multiple segments representing different index funds, durations and start and end dates. Each segment is reinvested as it matures based on the floor, cap and participation rates in effect at that time.

Factors Affecting Performance

The following factors aren't guaranteed and can therefore affect IUL policy performance. It's important to understand that all of the non-guaranteed factors can either improve or weaken and that they can move independently and in opposite directions creating a complex

interplay. Again, this emphasizes the need for annual monitoring of policy performance.

First, the IUL policy investments will reflect the upward and downward movement of the associated index fund (in turn reflecting performance of the stocks comprising the index). That performance may be helped or hindered by the cap, floor and participation rates discussed above. The product cap will limit the upside earnings. For example, if the policy has a 10.5 percent cap and the index fund has a 35 percent return, the policy will only credit 10.5 percent on those funds.[16] The IUL product floor will mitigate market corrections. If the policy has a guaranteed 0 percent floor and cash values are invested in an index fund that has a -35 percent return, the policy will credit 0 percent on those cash values.[17] Market corrections tend to be followed by strongly positive return years. A good example is 2008, when the S&P 500 lost approximately 37 percent followed by positive returns of 27 percent and 15 percent in 2009 and 2010, respectively. One dollar invested in the S&P 500 on Jan. 1, 2008 would have been worth $.92 at the end of 2010. On the other hand, one dollar in an IUL policy with a 0 percent floor, 10.5 percent cap and assuming 2 percent policy fees and charges would have fared better, ending 2010 with $1.15.

Second, a number of non-guaranteed factors unrelated to the performance of the index fund can affect the IUL policy return including:

- The carrier could increase or decrease the product's costs and charges, including the COIs.[18]
- The options budget, which is a function of a carrier's general account investment performance, could increase or decrease. For example, if interest rates rise, a carrier's new investment in higher rate mortgages may generate a larger options budget. Conversely, continued downward pressure on carrier investment returns could shrink options budgets.
- The cost of options creating the cap and floor could increase or decrease.
- Depending on circumstances, the carrier may increase or decrease the non-guaranteed cap rate and/or participation rate.

Third, with most IUL policies, mid-segment withdrawals, whether due to policy fees, charges or policyowner withdrawals, are either not credited with interest during the partial segment period or are credited at a low fixed rate, for example 2 percent. This has the effect of depressing policy returns, and the larger the mid-segment withdrawals, the greater this downward pressure.

Policy Illustrations

Finally, a word on policy illustrations. Illustrations aren't a guarantee or a projection of future performance. They're based on non-guaranteed assumptions that reflect a combination of current carrier experience (expenses, COIs, investment returns and option prices), profit targets and pressure to remain competitive in the marketplace. One of the key factors driving aggressive premium financing designs is the ability to illustrate rates of return that generate strong cash values in the policy. Actuarial Guideline 49 (AG49)[19] was implemented to curb the use of unrealistic illustration rates by imposing limits on the maximum rate a carrier may use in product illustrations.[20] However, even within the AG49 constraints, the ability to illustrate high rates of return has led to many aggressive designs. The bottom line is that the policy contract, not the illustration, sets forth the legal rights and obligations of the parties, and the policyowner can be assured that actual policy performance will vary substantially from the illustration.

Many Components

As with all non-guaranteed UL policies, IUL has a number of non-guaranteed components that will affect policy performance upward or downward. Investment returns will vary significantly from the returns of the underlying index fund, which are themselves quite variable. One or more of the factors that define IUL returns can be adjusted downward if it suits the carrier's objectives. Likewise, commercial loan rates can and will vary substantially from current rates. Historical rates demonstrate the volatility of both the underlying index defining policy returns and the LIBOR rates that form the basis of most loan rates. Furthermore, these historical rates should never be viewed or relied on as predictive. The bottom line is that policy and loan illustrations shouldn't be taken as guarantees or predictions of future performance. Yet, that's exactly what the aggressive premium financing plans presume. The importance of prudent design, thorough initial and ongoing stress testing, careful administration and close monitoring of all

premium financing plans can't be overemphasized.

Endnotes

1. Whole life policies, occasionally used for premium financing plans, aren't the subject of this article.
2. Unlike variable universal life (UL), indexed UL (IUL) isn't a security. It's therefore not subject to the 50 percent margin rule of Regulation U allowing up to 100 percent of the policy cash value to secure the loan.
3. LIBOR is the London Interbank Offering Rate. Some loans are based on 1-month LIBOR or prime.
4. The calendar year average LIBOR cited herein treats the 9-month average LIBOR of 2017 as a full year.
5. The average 9-month LIBOR for January to September 2017 equals 1.71 percent.
6. Best practice is for the guarantor to charge a fee to the trust in exchange for the guarantee to reduce the possibility of the guarantee being treated as a gift.
7. Maintaining the loan for the insured's lifetime is generally unrealistic. Few clients want to borrow over that long a period, and experience shows that few loans remain on the books after seven to 10 years.
8. Fully guaranteed or no-lapse UL policies are excluded from this discussion. They're not considered suitable for premium financing because they have little or no cash value with which to secure the loan, requiring the posting of greater amounts of external collateral by the grantor. Such policies are fully guaranteed provided premiums are paid on a timely basis (neither too early nor too late) as required by the contract.
9. It's important to distinguish between the policy cash value and the cash surrender value. The difference represents a surrender charge that the insurer assesses if the policy is surrendered, typically grading to zero in the first 10 to 20 years, allowing the carrier to recover early acquisition costs of the policy.
10. Fees and charges including costs of insurance (COIs) do have guaranteed limits; however, they're well in excess of current charges.
11. *See* Richard L. Harris, "New Actuarial Guidelines Issued in 2015," *Trust & Estates* (January 2016), at p. 24, for a more complete discussion of the risks involved with an IUL policy.
12. Excess premiums from all general account products are pooled and invested in the insurer's general investment account. General account assets are subject to the claims of the insurer's creditors.
13. The existence of the floor, for example 0 percent, doesn't mean that the policy cash value won't experience negative returns because policy charges and expenses can reduce the return below zero.
14. The floor and the cap limit the downside and the upside of the underlying index. Assume the IUL product has a 0 percent floor, a 10.5 percent cap and a 100 percent participation rate. If the S&P 500 index fund (excluding dividends) has a negative 10 percent return over the segment, the product will credit 0 percent (the floor). If the S&P 500 index fund has a positive 27 percent return over the period, the product will credit 10.5 percent (the cap).
15. International indices may include the Hang Seng, the EURO STOXX 50 or the MSCI Merging Markets index. Index funds with other terms may include a high cap, high par or a fund based on a 2-year average of the S&P 500.
16. As with all UL policies, COIs have a compound effect on the expected earnings of policy investments. If policy cash values earn less than expected, the net amount at risk increases and the resulting COIs will be greater, reducing relative cash value growth. Likewise, if the policy earns more than expected, the net amount at risk will decrease and COIs will be less than expected, further improving relative cash value growth.
17. Again, after deducting fees and charges, the policy will have a negative return.
18. Many carriers have strong histories of improving inforce policy performance reflecting improved mortality and expense experience.
19. The National Association of Insurance Commissioners approved adoption of Actuarial Guideline 49 governing the maximum illustrative rate for IUL illustrations effective for policies sold after Sept. 1, 2015.
20. Many carriers have also added persistency and other bonuses to enhance illustrations and possibly performance.

SPOT LIGHT

Hangin' Out

Silent Seasons—Summer by Will Barnet sold for $4,750 at Swann Auction Galleries' Old Master Through Modern Prints sale in New York City on Nov. 2, 2017. In a *New York Times* obituary, Barnet is quoted as once saying that at the young age of 10 or 12, he discovered that being an artist would give him an ability to create something that would live on after death.