



THE INSURANCE DESIGN CENTER, LLC ADVISOR ALERT

JANUARY 2007

PREMIUM FINANCING: DANGERS AND OPPORTUNITIES

Recently, clients have been calling upon their attorneys for advice on selling their option to buy life insurance in transactions referred to as free insurance, stranger owned life insurance, non-recourse premium financing or investor owned life insurance.

Premium financing has been around for decades. It was only a matter of time before hedge funds and institutional investors perceived an opportunity to participate in the sale of the collateral.

However, the walls are now closing in on the practice often referred to as stranger owned life insurance. On December 11, 2006, the National Association of Insurance Commissioners (NAIC) amended the Viatical Settlements Model Regulation to impose a five year ban on policies financed with the intent to sell.

Insurable interest has become a hot topic within the advisor community, with heated debate surrounding the insurable interest of third parties, including ILIT's, as part of a recent lawsuit: *Chawla vs. Transamerica Occidental Life*. Questions of insurable interest have been tried in the courts for over two hundred years. Yet, this new wave of financed policies, many of which will end up in investment portfolios or securitized as debt instruments, has yet to be tested.

TRADITIONAL PREMIUM FINANCING

Traditional premium financing, designed to meet long term insurance needs, is not under attack. However, all premium financing transactions have risk (see the following chart for the corresponding risks). In this transaction, a third-party lender makes a long term loan of the life insurance premiums. The insured's goal is to realize an arbitrage between the interest cost paid and their expected return or gain on other investments that were not liquidated. The client has a gift tax advantage because he only pays interest, and does not gift the entire premium. However, there is some debate about whether the interest paid is even considered a gift. Since policy surrender values are generally less than the premiums paid, the client has to put up additional collateral. Should the insured die prior to the repayment of the loan, it is repaid from the policy proceeds. Loan interest can be paid annually or accrued, depending on the arrangement.

NON-RECOURSE PREMIUM FINANCING

In a non-recourse arrangement, the policy is the sole collateral against the premium loan. These arrangements are generally for people over the age of 70. The loan is made without recourse beyond values in the policy because it has a limited term (generally between two and five years). If it is not repaid by the end of that term, the policy becomes the property of the lender. The lender may then keep the policy as part of a portfolio or attempt to sell it in the life settlement

> Continued



THE INSURANCE DESIGN CENTER, LLC

market. Depending on the structure of the deal, the insured may not have any control over the ultimate disposition of the death benefit.

True non-recourse financing with full participation and knowledge of the insurance company is now very difficult to find, given the uncertainty in many states of whether these transactions violate either current or pending insurable interest laws.

HYBRID PREMIUM FINANCING

Many lenders are revisiting their premium finance offerings. Hybrid premium financing is not “free insurance” - collateral is required. Each hybrid arrangement is very unique. Theoretically, the insured or trustee should have more control of the insurance policy being financed. The primary collateral for the loan is still the life insurance policy cash values and death benefit. In some arrangements, if the cash surrender value of the underlying life insurance policy exceeds 75% of the cumulative loan balance (principal, fees and accrued interest), no external collateral is required. Interest rates are not as excessive as those charged for non-recourse arrangements and range between 8% and 13%, rather than the 13% to 19% rates generally quoted for non-recourse. Typically, there is a requirement that beneficiaries be spouses or lineal descendants. However, depending on the terms of the loan agreement, should the loan not be repaid the client may still end up with his policy reverting to the lender.

RISKS OF FINANCING LIFE INSURANCE

	Traditional	Non-Recourse	Hybrid
Long Life	Living beyond life expectancy with no exit strategy (insufficient capital or death benefit available to pay off the loan).	Living beyond life expectancy with no exit strategy is only a risk if the policy is acquired and retained with new financing.	Living beyond life expectancy with no exit strategy is only a risk if the policy is retained.
Reduced Capacity	Only an issue if the loan becomes large enough reduce the net death benefit.	Insurance requires financial justification based on net worth or need. If a large amount of coverage is in place, more may not be available.	Insurance requires financial justification based on net worth or need. If a large amount of coverage is in place, more may not be available.
Taxes	Capital gains on sale if assets need to be liquidated to meet collateral calls.	This is an unknown and could include gain on sale, inclusion of forgiven debt or imputed income from insurance benefit received.	This is an unknown and could include gain on sale, inclusion of forgiven debt or imputed income from insurance benefit received.
Insurable Interest	Not applicable unless ILIT's really become a target of the IRS or the state legislators.	The risk is to the lender if policy rescinded. If they can prove recourse, the insured may have exposure.	If the deal does not consider insurable interest laws and/or is not approved by the insurance company issuing the policy.
Policy Performance	Poor policy performance could result in a need for additional collateral to secure the loan.	An issue only if the policy is acquired and refinanced.	Poor policy performance could result in a need for additional collateral to secure the loan.
Loan Interest Rate	Increased rates could force a collateral call to retain the loan, or a decrease in the net proceeds to the heirs.	Higher financing rates increase the amount necessary to acquire the policy at the end of the loan term.	Higher financing rates increase the amount necessary to retain the policy after the loan term or could result in a collateral call.
Collateral Call	Insufficient collateral for the loan would require additional assets be assigned as collateral.	Only an issue if the policy is acquired and refinanced.	Insufficient collateral to back the loan would require additional assets be assigned as collateral.
Recourse	If, due to a long life, premiums and accrued interest exceed the total death benefit.	If the policy is rescinded or contested and the insured is found at fault, the loan would come due.	If the policy is rescinded or contested and the insured is found at fault, the loan would come due.

DISCLOSURE: THIS MATERIAL IS FOR INFORMATIONAL PURPOSES ONLY. ALTHOUGH MANY OF THE TOPICS PRESENTED MAY ALSO INVOLVE TAX, LEGAL, ACCOUNTING OR OTHER ISSUES, NEITHER THE INSURANCE DESIGN CENTER LLC, NOR ANY OF ITS CONSULTANTS, ADVISORS, EMPLOYEES OR INSURANCE AFFILIATES ARE IN THE BUSINESS OF OFFERING SUCH ADVICE. INDIVIDUALS INTERESTED IN THESE TOPICS SHOULD CONSULT WITH THEIR OWN PROFESSIONAL ADVISORS TO EXAMINE TAX, LEGAL, ACCOUNTING, OR FINANCIAL PLANNING ASPECTS OF THESE TOPICS.

THE INSURANCE DESIGN CENTER LLC IS LICENSED AND REGULATED BY THE STATE OF ILLINOIS DIVISION OF INSURANCE AND PROVIDES SERVICES IN THE CAPACITY OF AN INSURANCE CONSULTANT ONLY. THE INFORMATION IS NOT INTENDED TO CONSTITUTE AN OFFER TO SELL OR A SOLICITATION IN CONNECTION WITH ANY PRODUCT OR STRATEGY.

TRADEMARK AND COPYRIGHT © 2006 THE INSURANCE DESIGN CENTER, LLC. ALL RIGHTS RESERVED.

THE INSURANCE DESIGN CENTER, LLC



500 Lake Cook Rd.

Suite 270

Deerfield, IL 60015

Tel: 866 943 6900

www.insurancedesigncenter.com