LIFE INSURANCE PREMIUM FINANCE
A BORROWER'S GUIDE

Overview

YOU CAN FINANCE YOUR CAR, HOME OR BUSINESS, WHY NOT YOUR LIFE INSURANCE?

Life insurance premium financing is commonly defined as any arrangement whereby some or all required life insurance premiums are borrowed from a specialty lender, commercial lender, regional or money center bank. These loans are specialized and incorporate features that are unique and industry specific. The number of federally and state regulated entities providing such loans number less than fifty institutions.

Premium financing has been used for well over thirty years although is much more prevalent as various marketing participants, including life insurance carriers, have embraced its application and possible benefits. Primarily utilized by high net worth individuals the financing of premiums can enhance standard life insurance planning via three principals: (1) use of leverage; (2) the possibility of positive arbitrage; (3) retaining capital.

LEVERAGE is the concept of using debt to amplify or increase the long-term benefits of a given life insurance-based transaction. The out of pocket cost, to the borrower, is usually significantly less than the scheduled annual life insurance premiums.

POSITIVE ARBITRAGE with regards to premium finance, is possible when borrowing monies at an interest rate that remains consistently lower than the crediting rate of the financed life insurance policy. It is important to note that such a result takes time to evolve and the borrower must be prepared for a variation in results.

RETAINED CAPITAL is the concept that borrowers may have superior uses for the monies they would use to pay, out of pocket, for a life insurance policy. These "retained" assets may provide a rate of return superior to other alternatives including a self-funded policy.

The combination of these three principals with other aspects of financing offer a compelling solution to individuals that can qualify for such an arrangement and manage the risks associated with financing.

COMMON LOAN FEATURES

- Term loans although some maybe setup as lines of credit

- Loans are secured, fully collateralized through a combination of lender acceptable policy cash surrender value and other lender acceptable collateral
- Wide age applicability
- Numerous product options
- Specifications can be customized based on the planning scenario and borrower characteristics
- The out of pocket to support the loan can be considerably less than the annual premium obligation in a non-financed situation
- A personal guarantee may be required by the lender

Even though financing often minimizes the out of pocket costs there is no such thing as "Free Insurance". Premium finance is a method to fund premiums to support genuine insurance needs for individuals that can effectively use leverage while capitalizing on the possible advantage and accounting for the inherent risks.

CLIENT PROFILES

Premium finance is certainly not for everyone. Clients must meet certain requirements, have clear planning objectives and understand the risks associated with the transaction.

As life insurance premium finance has evolved so has the type of qualifying borrower. Traditional or large-case financing is typically reserved for higher net worth individuals that are pre-vetted by the issuing life insurance company and lending institution. Typical characteristics and requirements:

- Insurable individuals up to age 70
- Net worth in excess of $5 million
- Adjusted Gross Income (AGI) sufficient to cover standard expenses and debt – including the out of pocket obligations
- Individual or corporate borrower willing to provide required financial and other personal details for review
- Insured/Borrower with demonstrated capability to collateralize the loan at all times

PREVALENT CLIENTS INCLUDE

- Privately held business owners
- High income professionals
- Financial professionals
- Corporate executives
- Public corporations
- Non-profits
- Government entities
- Academic institutions
- Family offices
- Retired, high net worth
- Real estate developers
- Professional athletes

Recent innovations include loans that can be structured for individuals that do not qualify for traditional guidelines – as specified above. This "Emerging Affluent" segment offers financing options to a broader range of borrowers including those with a net worth below $1MM. Adjusted Gross Income and other metrics should allow the borrower to service the loan without financial stress.

PLANNING OBJECTIVES

Financing can be used a variety of common and more advanced planning scenarios. The potential benefits are varied and compelling:

- Investment portfolios may be maintained providing ongoing asset accumulation or capital growth
- Preservation of current cash flow and liquidity – limiting the reduction in income or savings to pay life insurance premiums
- In most cases (and depending on the timing of the death benefit) financing may generate superior yields when contrasted with full out of pocket premium situations
- Combined with other estate planning techniques, may reduce potential tax liabilities
- Can be used in a variety of business applications (i.e. buy-sell, key person, deferred compensation, "Golden Handcuffs")
- Increases life insurance purchasing power – insureds may be able to acquire more death benefit with less out of pocket costs than traditional payment methods

LOAN TYPES

The majority of premium finance loans are not made to individual borrowers but to an entity. There are numerous reasons for this with the primary being added security for the lender (which helps reduce borrowing costs) and keeping the transaction "at arm's length" for the borrower. The type of entity used will be determined by the planning objective and particular circumstances of the client:

- Irrevocable trusts
- Revocable Trusts
- Forms of business
  - LLC
  - C-Corp
  - S-Corp
  - LLP
- Non-profits
- Special Purpose Vehicles (SPVs) or Special Purpose Entities (SPEs)

In many cases a professional fiduciary (e.g. trustee) will be involved and hold a degree of responsibility for the origination and management of the transaction.

COLLATERAL

One of the most important aspects of any life insurance premium finance transaction is collateral – which is necessary to initiate and manage the loan over time. It is essential to understand that all loans are always 100% secured and collateralized. Typical forms of collateral:

- Lender acceptable cash surrender value of the financed life insurance policy – this often represents the primary form of collateral
- Cash, cash equivalents, certificates of deposit, other banking products
- Money markets and mutual funds
- Individual equities, fixed income securities, exchange-traded funds, other registered investment products – must be non-qualified
- Asset Backed Standby Letter of Credit
- Cash surrender value of other (non-financed) life insurance policies
- Non-qualified annuities (subject to pre-approval and other requirements)
- Other assets such a real estate typically have to be "transformed" or used to support an acceptable security instrument – such as a standby letter of credit

OTHER CONSIDERATIONS

- Collateral obligations will change over time. The insured/borrower should be prepared for these fluctuations
- The hopeful outcome is that positive arbitrage will provide a situation in which the cash surrender value of the funded life insurance policy is the only form of collateral – although this is never a guaranteed outcome
- Each lender has different requirements as to acceptable forms of collateral and related procedures

EXIT STRATEGIES – LOAN PAYOFF

Premium finance loans are typically not intended to be in-place over the lifetime of the insured – there are defined terms and other conditions that outline repayment or the possibility to refinance the loan:

- Use of a side fund or retained capital
- Expected, planned liquidity event (e.g. asset sales)
- Inheritance
- Policy loans or cash surrender withdrawals
- Death of the insured

It is highly recommended that individuals have multiple exit strategies and clearly defined plans on how to manage the loan over time.

THE PROCESS

Applying for a life insurance policy and making the decision to finance the premiums is an involved process although there are specialists that facilitate the transaction and guide insureds each step of the way. What to expect:

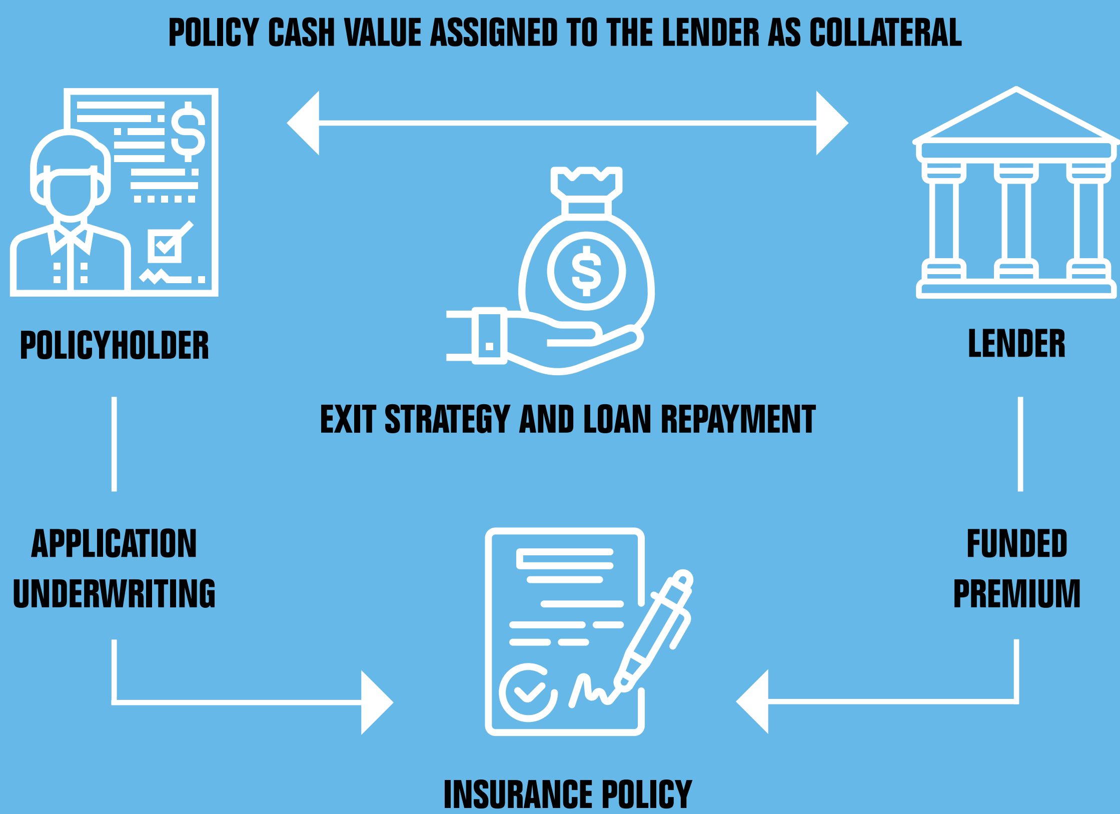
- Review of the planning objective, isolating a specific life insurance policy and deciding on financing as the funding method
- Life insurance policy design
- Loan modeling which provides a prospective/hypothetical analysis of policy performance and loan costs
- Review of collateral and "stressing" the transaction given varying economic and financial conditions
- Deciding on the borrowing entity (i.e. trust, etc.) as it relates to the planning and other objectives
- Life insurance application and financial/medical underwriting
- Loan application and financial/credit underwriting
- Approval of life insurance policy and loan
- Loan documentation, execution and placement of collateral
- Initial funding of first year premium due for the life insurance policy
- Ongoing management and loan administration

RISK MANAGEMENT

Using borrowed monies for funding life insurance is an advanced technique and does involve a degree of risk. As highlighted the lender is always fully secured (via collateral) and the borrower is contractually bound to fulfill the terms and conditions of the loan agreement. The borrower should anticipate and plan for variations in the policy performance, interest rates, personal financial changes and macro-economic factors – all of which can influence the borrower's capability to manage the loan. The primary reason some loans are placed in jeopardy is the inability of the borrower/guarantor to provide the required level of additional or "gap" collateral – when the annual collateral test is completed. Two areas of particular focus should be interest rates and the relative performance of the financed life insurance policy. Key points of consideration:

- Monetary policy has been historically accommodative although planning for static or perhaps declining interest rates can distort expectations as to the growth of the loan balance and the impact on collateral and other long-term results

HOW ENHANCED FUNDING WORKS



IN THE EVENT OF THE INSURED'S DEATH, WHILE THE LOAN IS OUTSTANDING, THE LENDER WILL USE A PORTION OF THE DEATH BENEFIT PROCEEDS TO PAYOFF THE LOAN. ANY REMAINING DEATH BENEFIT PROCEEDS WILL BE DISTRIBUTED TO THE DESIGNATED BENEFICIARIES.

- Life insurance illustrations present hypothetical results. Insureds/borrowers should familiarize themselves with the differences between guaranteed and non-Guaranteed results. Most financing projections use these illustrations to create projections as to collateral, net death benefit and possible exit strategies. Furthermore, most financing projections use, to some extent, non-guaranteed values – which will absolutely fluctuate over time. Given this, the non-guaranteed values should not be considered absolute as actual results will differ.

GIVEN THE NUMBER OF VARIATIONS AND POSSIBILITIES ALL BORROWERS SHOULD:

- Use loan models and illustrations that simulate rising interest rates and discounted increases in the buildup of the funded life insurance policy's cash surrender value
- Budget for an annual out of pocket amount to reduce the amount of accrued interest, financed premium and/or reduce the principal balance of the loan
- Devise multiple exit strategies
- Use properly trained financial advisors who are working in concert with legal and tax counsel
- Take time during each policy year to analyze the arrangement and plan, in advance, for changes (known and unknown)

NEXT STEPS

Life insurance premium finance can be an involved process and it is essential to involve the expertise of your chosen insurance advisor and other counsel from the tax and legal fields. Northstar Funding Partners (NSPF) is the nation's preeminent facilitator of financed life insurance transactions. Working in concert with your advisory team NSFP applies its expertise and experience to address all the elements of the transaction and dramatically increase the probability of success.