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Voices What CPAs should understand about premium financing

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Premium financing has been around for many years but it became more popular when LIBOR rates plummeted after the recession and perceived crediting rates on indexed universal life (IUL) insurance and whole life policies were relatively high.

Originally, the concept of premium financing was not much different than why one might not pay off a home mortgage, even when the money is available. If one thought that money deployed elsewhere would be more productive than paying down a mortgage, then why not do so? If I'm confident I can make more in the market or my business, financially it would be silly to pay down my mortgage any faster than necessary.

Traditionally, policy owners used premium financing to take advantage of the spread between opportunity cost of money and borrowing rates. Theoretically, if you were making 20 percent on a real estate development or in your business, and you had to pay even 10 percent to borrow money for premiums, it might still be a good deal if you thoroughly understood the risks and realized you'd have to have a liquidity event at some point down the road to pay back the loan. Hopefully you'd be making money on the spread the entire time and would end up ahead in the game.

At some point, the concept of premium financing changed from focusing on the spread between the opportunity cost of capital and borrowing rates to the spread between policy crediting rates and borrowing rates. This is where things start to go awry for many people.

When LIBOR was down at a fraction of 1 percent and money for premiums could be borrowed for maybe 150 basis points over LIBOR and policy crediting rates seemed to be 6 to 8 percent or greater, why not take advantage of it?

Originally it was often marketed as free insurance, and even today it's pitched as steeply discounted insurance. The goal is that the cash value growth in the policy would result in a balance high enough to pay off the loan at some point, leaving enough cash value to power the policy indefinitely. Even if loan interest needed to be paid out of pocket, it would be a lot less than the full premiums.

This strategy has been marketed strongly to wealthy clients throughout the country. It's postured as a high-level strategy for sophisticated individuals to use other people's money to purchase their life insurance. What could possibly go wrong?

The fastest-growing aspect of our practices is litigation support and expert witness service. We're brought in by CPAs, attorneys and family offices who are contemplating or have implemented premium financing programs. They're calling because the programs aren't panning out as planned because the originally perceived spread isn't real and market dynamics have changed.

Even though a small minority of premium-financed deals are built around traditional whole life policies, financed whole life policies seem to be responsible for many of the current problems and resulting litigation. Let's examine the perception versus reality: many of the plans were built around whole life that had stated dividend rates around 6 to 7 percent. With borrowing at about 2 percent, the spread looked good and the story sounded attractive, and spreadsheets showing it working could be produced.

However, cash value for the first decade or so is lower than cumulative premiums, and though the cash value growth in whole life policies is back-end weighted, even many years down the road, the actual return in these policies is significantly less than policy owners believed it to be. This means the spread or arbitrage that policy owners understood to be real and was the basis for their decisionmaking never existed. In the meantime, dividends on whole-life policies have been steadily falling and borrowing rates have increased. The supposed arbitrage has been completely wiped out and many of these deals are causing major problems as the numbers are not working.

The reason there is a spike in complaints and litigation is because the numbers can't be fudged. The dividend rates are what they are and so are the borrowing rates. Current spreadsheets show the numbers going red. As more and more interest is required and collateral calls are being issued, clients are under water and unwilling to move forward with deals that have been misrepresented. Many IUL policies are facing (or will face) the same fate, but the numbers can still be fudged, so the problem is not yet apparent. With IUL contracts, it also helps that we've experienced a historic stock market run, but when things inevitably turn, the deals will look different and a similar panic will set in if the plans are not well understood, have been misrepresented or are in place for the wrong reasons.

Premium financing can still be a very powerful tool, but it must be thoughtfully designed, well underwritten and thoroughly understood. The multitude of risks must be clear and accepted, extensive stress testing must be performed, and the difference between a good loan and a cheap loan is apparent. Bailout options must be quantified, and there has to be a reasonable definition of what success really is. Third-party, independent consulting is of paramount importance, in part because these deals are ripe for obfuscation and generate significant commissions that can tempt some to push programs and go light on properly explaining details and risks.

Typical policy owners, even very wealthy and sophisticated consumers with excellent counsel, often fail to properly understand even straightforward insurance. They have almost no hope of understanding a complicated and opaque product wrapped inside financing and collateral requirements more susceptible to market factors and behaviors than they realize.

Some of these deals are outright, intentional misrepresentations and lies. Some of these deals are introduced from otherwise well-intentioned agents who are far out of their depth and who got sucked in by the sales and marketing of promoters.

All this being said, a well-built premium financed plan may be a good idea if your client is considering it for the right reasons and understands the downsides. If so, a good team can introduce an appropriate product, communicate reasonable assumptions, and provide leadership through the underwriting, testing and financing processes to implement and manage a program for your client's benefit.

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