THE MOVING PARTS OF PREMIUM FINANCING

The Risks Involved with Premium Financing

Your client must understand and be comfortable with the potential risks and all of the moving parts of premium financing. If your client is not aware of the risks and the premium financing structure does not go as planned, you could potentially be subject to litigation. It is crucial for your client to understand the ins and outs and all moving parts of premium financing.

Interest Rate Volatility Risk

When a client submits a credit application to the lender, the lender will set basis points for the term of the loan. The first year loan interest rate will be the basis points plus LIBOR or Prime Rate. The LIBOR or Prime Rates change with the market constantly. The basis points are fixed for the term for the loan but the LIBOR or Prime Rate will vary from year to year. For example, if the client gets approved for 200 basis points plus LIBOR, and the LIBOR Rate is currently at 2.5%, the first year loan interest rate is 4.5%. For the second year, if the LIBOR Rate increases to 5%, the loan interest due for the second year is 7% (5% LIBOR Rate plus 200 basis points).

Policy Performance Risk

Your client must understand that the policy also needs to perform well. If you show a client an Indexed Universal Life policy with a crediting rate of 8% for all years, the client needs to be aware that the policy may not credit 8% for all years. One of the most popular exit strategies is to pay back the lender by taking a withdrawal from the policy to repay the loan. If the policy did not credit 8% every year, the client is not going to have enough cash in the policy to repay the loan. There will be a shortfall and the client can either wait until the policy has enough cash to repay the loan, or the client could pay the shortfall from out-of-pocket funds.

Lending Programs Risk and Clients Credit Risk

Most premium financing lending programs have a lending term of five or ten years. If the client's exit strategy is not until year 15, he or she will have to requalify and reapply for another term loan. The client will have to submit another credit application to refinance the loan for another term. The terms of the note for the second term may be very different than the first term note.

Collateral Risk

The client will have to post collateral for the loan. The amount of collateral typically required is the difference between the outstanding loan and the cash surrender value of the life insurance policy. The type of collateral the client posts has to be adequate to satisfy the lender's terms. The lender could discount the client's collateral if he or she feels the collateral the client posted is volatile or lacks marketability. In a perfect scenario, the lender will approve the collateral as dollar for dollar. Depending on the collateral posted, it may only give the client fifty cents on the dollar, requiring the client to post two times the collateral required to secure the loan.

Other Considerations

There may be additional costs to setting up a premium financing transaction. Below is a list of potential additional costs that a producer and client should be aware of:

- Attorney fees—costs to set up the trust and any other legal documents
- Loan origination fees—typically 1% of the total amount to be financed
- Letter of credit fees
- Commision split—the lender may go on the application for a percentage of the life insurance
- commission
- One-time legal fees
- Annual maintenance fees
- Pre-payment penalties
- Refinancing fees

For more information on Premium Financing, please contact your Frontier Advanced Sales Specialist or your Frontier Sales Vice President.