

PREMIUM FINANCING

Frequently Asked Questions

Premium financing can be a complex process and sale, but Transamerica's Premium Financing Team is here to provide you with the resources you need to grow your business with this powerful strategy.

This reference guide addresses some of the most common questions that we get asked every day. If you have questions of your own, contact us at (866) 545-9058.

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1. What is premium financing?

Premium financing is an option available to high-net-worth individuals who prefer not to liquidate high-performing assets in order to buy a life insurance policy; rather, these people prefer to borrow money from a third-party lender at a lesser interest rate in order to pay premiums. There are several different types of premium financing including traditional, non-recourse, and hybrid financing. Some forms of premium financing are acceptable, while others are not.



2. What is traditional premium financing?

A traditional premium finance loan is generally designed to achieve long-term life insurance planning goals. It is a loan with a floating interest rate, which is composed of a benchmark—such as LIBOR or PRIME—plus a spread that varies according to lender. The loan is 100% collateralized and may have an extended loan term. Some loans offer extended loan commitments while others are annually renewable for the life of the insured, provided that the borrower's financial position has not deteriorated. Regardless of the extent of the loan commitment, it may become necessary to renew a traditional premium finance loan for an added term. A renewal may require the borrower to requalify and/or agree to a new set of loan terms. Moreover, a borrower runs the risk of the lender refusing to refinance the loan altogether.

3. What is non-recourse premium financing?

A non-recourse loan is one in which the borrower bears no economic risk outside of the financed policy. In the event of default, the lender's only option to collect on the outstanding loan balance is to foreclose on the policy. The lender may not pursue reimbursement from the borrower personally. Non-recourse loans are unacceptable since in the past they have been used to fund "Free Life Insurance."

Free Life Insurance is a term used to describe a transaction where a lender induces a person to finance a life insurance policy, not because he/she needs insurance coverage, but because other parties involved are interested in profiting from the ultimate sale of the policy or on a gamble on the early death of the insured. For example, a lender may offer an elderly person \$200,000 in cash if he/she will agree to finance a life insurance policy. The lender assures this person that no out-of-pocket money is required to consummate the deal—all expenses will be rolled into the loan and the only collateral required is the policy itself. At the end of two years, the policy owner has the option of (1) paying off the loan; (2) settling the policy in the secondary market; or (3) relinquishing the policy in satisfaction of the loan. Because the lenders build so many costs into these loans, option 3 is often the only viable option. The lender then becomes the new policy owner and is free to sell the policy in the secondary market for a significant profit.



While there are no standard age minimums, **ideal candidates** are generally between the ages of **60 and 80**, with a net worth (excluding their home) of \$5 million.

4. What is hybrid premium financing?

A hybrid premium finance loan is a loan designed to satisfy short-term liquidity needs. It is a loan with reduced collateral requirements, shorter terms and more lenient financial underwriting requirements.

5. Who is a candidate for premium financing?

High-net-worth clients who require a large amount of life insurance coverage and do not want to liquidate assets to fund their life insurance premiums are typical candidates for premium financing. While there are no standard age minimums, ideal candidates are generally between the ages of 60 and 80, with a net worth (excluding their home) of \$5 million.

6. How does the interest component work?

Generally, loan interest is made up of two elements, an index and a spread of 100 to 300 basis points. The 12-month LIBOR (London Interbank Offered Rate) and the Prime Rate are commonly used indices. While both fixed and variable interest loans are generally available, variable interest loans are more common. Fixed rate loans typically carry greater spreads and are not fixed for the life of the loan.

Caps and floors limit the risk of variation in the interest rate and are generally available on larger loan arrangements. Caps place a limit on how high a loan interest rate, including variable rates, can rise. On the other hand, a floor places a limit on how low an interest rate can sink. Many lenders require that interest be paid annually in advance or in arrears, while other lenders will allow the client to accrue the interest. Some lenders may impose time restrictions on how long interest can be accrued (e.g., five years) and may set additional financial requirements for the borrower (e.g., higher net worth or additional collateral requirements). Careful consideration should be taken when deciding whether or not to accrue interest (i.e., no out-of-pocket costs), since capitalizing interest will quickly increase the cumulative loan and may reduce the net death benefit if an exit strategy is not in place.

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7. How does the collateral work?

While the cash surrender value of a life insurance policy will always serve as primary collateral for a premium finance loan, guaranteed UL contracts are the most frequently financed policies and typically do not have much cash value in the early years. Thus, the borrower may need to make up for any shortfall between the loan balance and the policy cash value by pledging some other asset as collateral.



Acceptable forms of collateral typically include cash, cash equivalents, publicly traded stock, other life insurance cash values, letters of credit and personal guaranties. It should be noted that the lender may require the borrower to post additional collateral if a client's creditworthiness declines over time.

Many insurance carriers offer a high-cash-value rider which applies to the early years of a policy and is designed to mitigate, or eliminate, the need for additional collateral in a premium finance transaction. Some carriers even offer cash values equal to premiums paid. These provisions often result in reduced compensation to the producer selling the policy, or even a possible charge-back in commissions if the policy is surrendered in its early years.

8. What are the terms of a premium financing loan?

Premium financing loans are either annually renewable or fixed for a term of years. If the loan is for a fixed term of years, rather than for the life of the insured, the lender may require the balance to be repaid at maturity if the loan is not refinanced.

9. What are the minimum financing requirements?

All premium finance lenders have their own set of requirements based on minimum loan size, which are reflected as a minimum premium or minimum cumulative loan commitment. Generally, the minimum annual premium for a financed policy is \$75,000 to \$100,000. Some lenders will allow a borrower to aggregate their premiums on multiple policies to meet these minimum requirements. In addition, borrowers must meet a minimum net-worth requirement. Generally, a client's total net worth must exceed \$5 million.

10. What are the risks associated with premium financing?

There are always risks associated with any loan transaction. The risks in a premium finance loan include interest rate risk, collateral call risk, and crediting rate risk. Unfortunately, interest rate risk is unavoidable in any premium finance transaction, since there is no way to predict the future of the interest rate environment.

Collateral risk comes along with the lender's right to call the borrower's collateral if the policy is in jeopardy of lapsing or going into default. While this may keep the loan out of default status, the borrower may have to post additional collateral in order to keep the loan in good standing. Crediting risk occurs when the anticipated crediting rate of a policy diminishes and the policy is at risk of lapsing. In such a case, the policy owner will have to inject cash into the policy in order to keep the policy in force.

The source of these funds will either be the current premium finance lender or the policy owner's pocket. If the policy owner is short of cash and the lender is unwilling to make additional loans, the loan may go into default. And even if the lender is willing to make additional loans, the cumulative loan cost will increase beyond initial projections and further reduce the net death benefit.



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11. Is prepayment an option?

Some lenders impose a “breakage” fee for paying off the loan before the scheduled maturity date. Generally, a premature death will not trigger a prepayment or breakage fee. The borrower may use the following sources of funds for early repayment: (1) a liquidity event such as the sale of a business; (2) policy cash value; (3) a side fund containing the savings experienced due to financing the policy; (4) family trusts; or (5) a family limited partnership. It is important for the borrower to seek the advice of appropriate counsel prior to deciding on the method of prepayment since many of the aforementioned transfers may trigger gift, income or capital gains taxes.

12. What are the most common exit strategies?

The most common exit strategy employed in a premium finance transaction is to use the death benefit to repay the loan. However, it should be noted that this strategy reduces the net benefit ultimately distributed to beneficiaries. A borrower who wants to ensure that his or her beneficiaries receive a certain death benefit should elect a return of premium feature and pay loan interest as it comes due. Another possible exit strategy is to simply withdraw from the policy cash value to pay off the loan. The challenge with this approach is that most lenders require approval before any withdrawals from the policy are allowed. Moreover, the policy may not perform as initially projected, resulting in insufficient cash values and a potential lapse in coverage.

A more sophisticated exit strategy is a Grantor Retained Annuity Trust (GRAT). A GRAT is a wealth-transferring device. It is an irrevocable trust set up for a specified term of years. The grantor makes a one-time

transfer to this trust consisting of a highly appreciated asset that may also be income-producing. For the term of the GRAT, the grantor is entitled to receive an annuity payment from the trust determined by the fair market value of the asset at the time it is contributed. At the end of this term, whatever assets are left in the trust are paid out to trust beneficiaries. In this case, the beneficiary would be the trustee of the ILIT that is purchasing the premium-financed policy.

A GRAT removes an asset poised for significant appreciation from the client’s estate, ultimately reducing the client’s potential estate tax liability. The grantor can also use a GRAT to minimize gift tax exposure by maximizing his/her retained annuity payment, thereby shrinking the value of the remainder interest—the only value that is subject to gift tax. However, a GRAT does involve a degree of calculated risk. If the client dies before the end of the GRAT term, the assets left in the trust will be subject to estate taxes.

13. Can a premium financing loan ever be called?

Generally, lenders will only call a loan in the event of default, as defined by the loan documents. Some lenders do retain the right to call the loan at any time and may call the loan if the financial condition of the borrower or the collateral backing the loan has deteriorated. Additionally, the lender may require the posting of additional collateral should a client’s creditworthiness decline. If the client does not have additional collateral available to be posted, the lender may call the loan.

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A borrower who wants to ensure that his or her beneficiaries receive a certain death benefit should elect a **return of premium feature** and pay loan interest as it comes due.



14. How do I get started?

Lenders have their own set of documents and checklists outlining their program requirements and processes for premium financing. One of the first steps in educating yourself about premium financing is to become familiar with a few of these programs. In addition, insurance providers have their own definition of acceptable premium financing business and corresponding requirements. Finally, knowing the client and being able to identify his or her goals and circumstances is critical. Your knowledge of the concept of premium financing, as well as lender and carrier requirements, should enable you to identify clients for whom the strategy is appropriate.

15. What types of life insurance products are typically financed? Why?

Secondarily guaranteed UL contracts are the best fit for premium finance since these policies eliminate crediting rate risk. Typically, high-net-worth individuals purchase a life insurance policy to solve an estate liquidity problem. With a guaranteed product, high-net-worth individuals can eliminate variables and ensure that their estate will have sufficient cash to pay any estate tax liability.

Current assumption products are used from time to time to help increase cash values and thus reduce the collateral required to be posted. Most lenders will not finance a survivorship policy due to the potential difference between spouses in terms of age and/or health rating. Indexed UL policies are common among younger insureds because of the product's flexibility and higher cash value growth potential.

Modified Endowment Contracts (MECs), as defined by Internal Revenue Code § 7702A, should never be premium financed. This is because distributions from a MEC—which include withdrawals, loans and a pledge of the policy as collateral for a loan—will be taxed to the extent there is a gain in the policy. Also, a 10% penalty will be assessed on the taxable amount of any

distributions made prior to the policy owner attaining age 59½, unless the policy owner is disabled or receives the cash value under a life annuity settlement option. However, it should be noted that the 10% penalty tax will always apply if the policy owner is a “non-natural” person (e.g., a corporation or trust).

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