Premium Financing

Premium Financing is actually pretty simple: Instead of paying cash to fund a life insurance policy, a bank lends the money to pay the premium and the bank is later repaid from the death benefit. This allows the purchaser to acquire an insurance policy without having to actually put up cash. The bank's loan can either be collateralized by other assets of the purchaser or not, although obviously the arrangement costs more if it is not collateralized.

Although these arrangements are sometimes referred to as "free insurance", what is going on is an arbitrage. The purchaser is betting that the performance of the life insurance policy exceeds the lending rate of the bank. During times of low interest rates, this is usually an easy bet. It is likewise a poor bet during a time of high interest rates.

Obviously, the longer the bank is required to lend the more money will have to be paid in interest to the bank. Also, it is much more difficult to estimate what the investment returns will be over a long period as opposed to a short one. Thus, typically premium financing only makes sense where the policy is purchased on the life of somebody whose life expectancy is less than 20 years, i.e., a 65 year-old man with a life expectancy of 78 (meaning an estimated 13-year lending period). For this reason, premium financing is often used by middle-aged wealthy clients to buy life insurance on the lives of their elderly parents basically as an investment.

Where premium financing is most effective is where it utilizes the equity in hard assets that are otherwise not creating wealth. An example is equity in property: Equity in property does not create wealth because the property will appreciate at the same rate whether or not it is paid for. Thus, the equity in property is said to be "trapped" or "unused" for investment purposes. Equity in property is also, in most states, available to creditors. By using the equity in the property as collateral for the bank's loan to fund the premium payment, the equity of the property is effectively "stripped" out until the bank releases the property when the death benefit pays off. If a creditor appears, the creditor will be behind the bank's lien, and will have to wait for somebody to die to have a chance of getting at the equity (that the property is leveraged will facilitate settlement with the creditor, who will not want to wait for possibly years).

The other big advantage to premium financing is where it is used to fund life insurance outside the estate, thus avoiding federal estate and gift taxes while creating great wealth for the children.

Premium financing comes in too many variations to discuss, but a popular variation includes the use of a Single-Premium Immediate Annuity (SPIA) to fund the life insurance policy. The idea is that the SPIA gives a specific rate of return, and that the whole arrangement becomes more efficient. While this can be true, it is also unfortunately true that some life insurance agents will include the SPIA in instances were it is not needed only to increase the commissions that are involved. Other times it will be just as efficient to simply have the bank lend in series, or to escrow the money lent until the life insurance premiums are due.

A recent phenomena is for premium financing to be utilized to get around the Corporate Owned Life Insurance (COLI) rules, or as an income tax shelter when used in some structures. Great caution is advised in participating these arrangements, which are probably as likely to blow up as succeed.

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