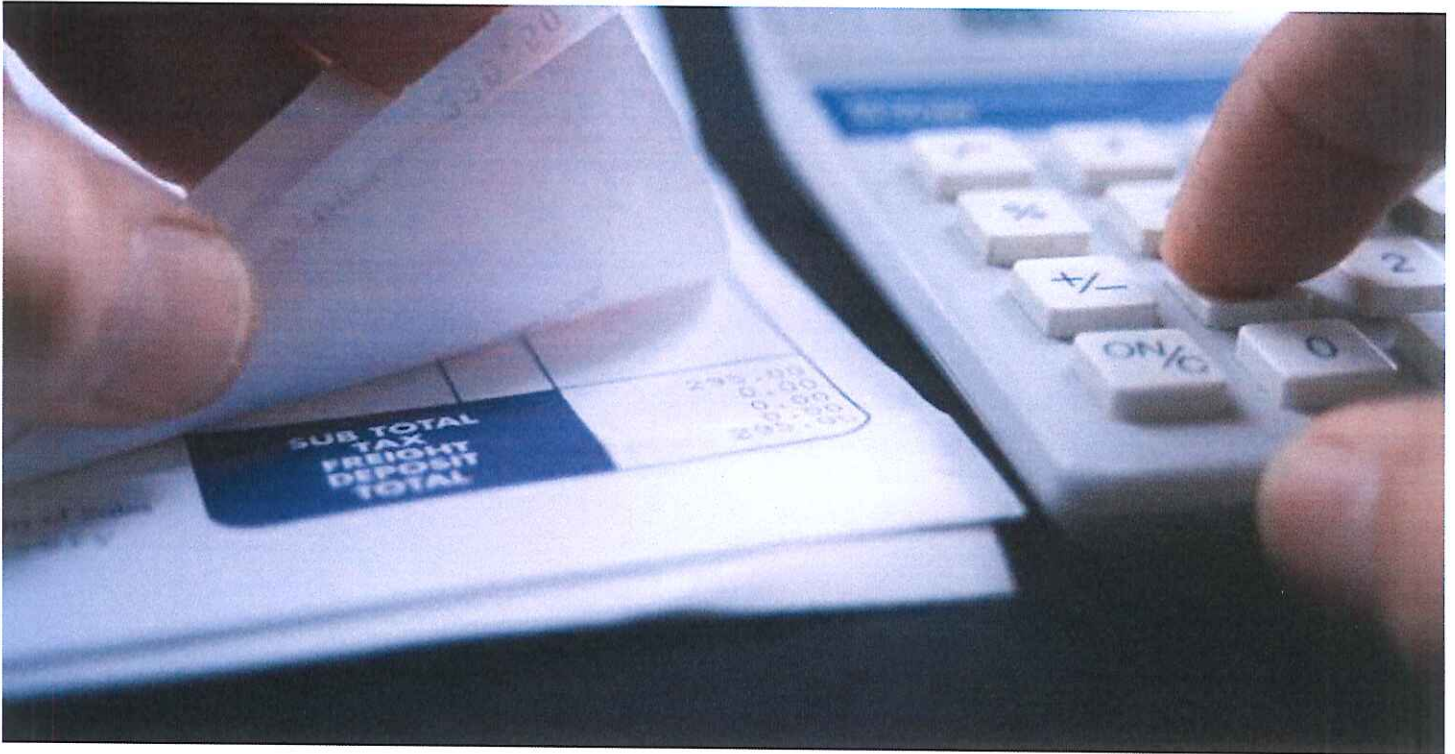


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Premium Financing With Indexed Universal Life: Part II

Balance risks and rewards.

[Robert W. Finnegan](#) | Jan 29, 2018

Premium financing can be an attractive strategy to fund indexed universal life (IUL) policies. Let's examine the rewards of a premium financing plan, use a model to analyze IUL returns in relation to the underlying index fund returns, stress test an aggressive plan and the risks it poses and outline a prudent approach to designing, monitoring and managing a successful premium financing plan. I'll close with a word of caution with issues from actual disputes involving premium financing plans based on attorney Richard L. Harris' experience as a consultant and expert witness.

Rewards

The rewards of premium financing are simple: It provides the opportunity to use other people's money to fund an established need for life insurance. An established need may include estate planning (trust owned life insurance (TOLI) is the focus of this article), wealth creation, buy-sell and other business planning or to fund a personal planning need. The client may not have sufficient current cash flow to pay premiums or may expect a liquidity event in the near future and therefore may prefer to borrow to fund the life insurance. In addition, premium financing allows the client to retain high return assets that would otherwise have been used to pay premiums.

Premium financing is attractive due to current low commercial loan rates coupled with an IUL policy's potential to generate reasonable market based returns. Both the policy performance and borrowing rates will vary over the duration of the program, so it's important to understand their variability, the risks they introduce and how to design and manage the plan to minimize those risks.

Understanding IUL Returns

As discussed in Part I of this article,¹ IUL policies reflect the returns of an index fund,² for example, the S&P 500. IUL premiums net of expenses and charges aren't invested directly in the index fund, but rather rely on hedging strategies that reflect the index fund's performance. The actual IUL return can vary substantially from the index fund's return due to the fact that the IUL return excludes dividends earned on the stocks comprising the index fund and that adjusted return is subject to a cap (for example, 10.5 percent), a floor (for example, 0 percent) and a participation rate (most commonly, 100 percent).³

Based on these policy limitations, it's important to understand how IUL returns relate to the returns of the index fund. It's a simple matter to exclude dividends and then apply the cap, floor and participation rate parameters to a specific annual index return. However, how do you put illustrated IUL returns in perspective, taking into account the long-term performance of the index fund's underlying stocks with their many and substantial ups and downs? All carriers calculate the maximum illustrative rate under AG494 based on historical S&P 500 index 1-year point-to-point returns (excluding dividends on the underlying stocks), a 0 percent floor, a 100 percent participation rate and the carrier's current cap. Most carriers'

policy illustrations include a table showing how their product parameters would affect the year-by-year historical index fund returns over the past 20 years. A few carriers offer tools for evaluating IUL rates of return in relation to historical equity returns.⁵ Historical returns are of limited use, however, because no IUL product has been in force over the historical time frame; the non-guaranteed cap, floor and participation rates may have varied from those in the current product; and the historical rates can't be used as the basis for predicting future performance.

The John Hancock Life Insurance Company has developed a "rate translator model"⁶ (RTM) that's based on the capital asset pricing model⁷ rather than on historical returns.⁸ The RTM "translates" a given or assumed equity index fund return into an assumed IUL return. For example, a 6.75 percent index fund return may translate to a 5.50 percent IUL return. Although the model is certainly not the final word on the subject, it's a useful tool for understanding IUL returns in relation to index fund returns, as well as for comparing IUL returns among various products, each with different cap, floor and participation rates. For a given equity return, the RTM takes into account the long-term performance of the equities market with its expected ups and downs (excluding dividends on the underlying stocks) and then subjects those returns to the specified participation, cap and floor rates of the IUL product indexed account to provide an approximation of the corresponding IUL return.

"John Hancock Rate Translator Examples" and "Index Fund Returns v. IUL Returns," this page, show how a given index fund return "translates" to a corresponding assumed "IUL return" based on a 1-year point-to-point IUL strategy with a 0 percent floor, 10.5 percent cap, 100 percent participation rate and excluding dividends.

John Hancock Rate Translator Examples

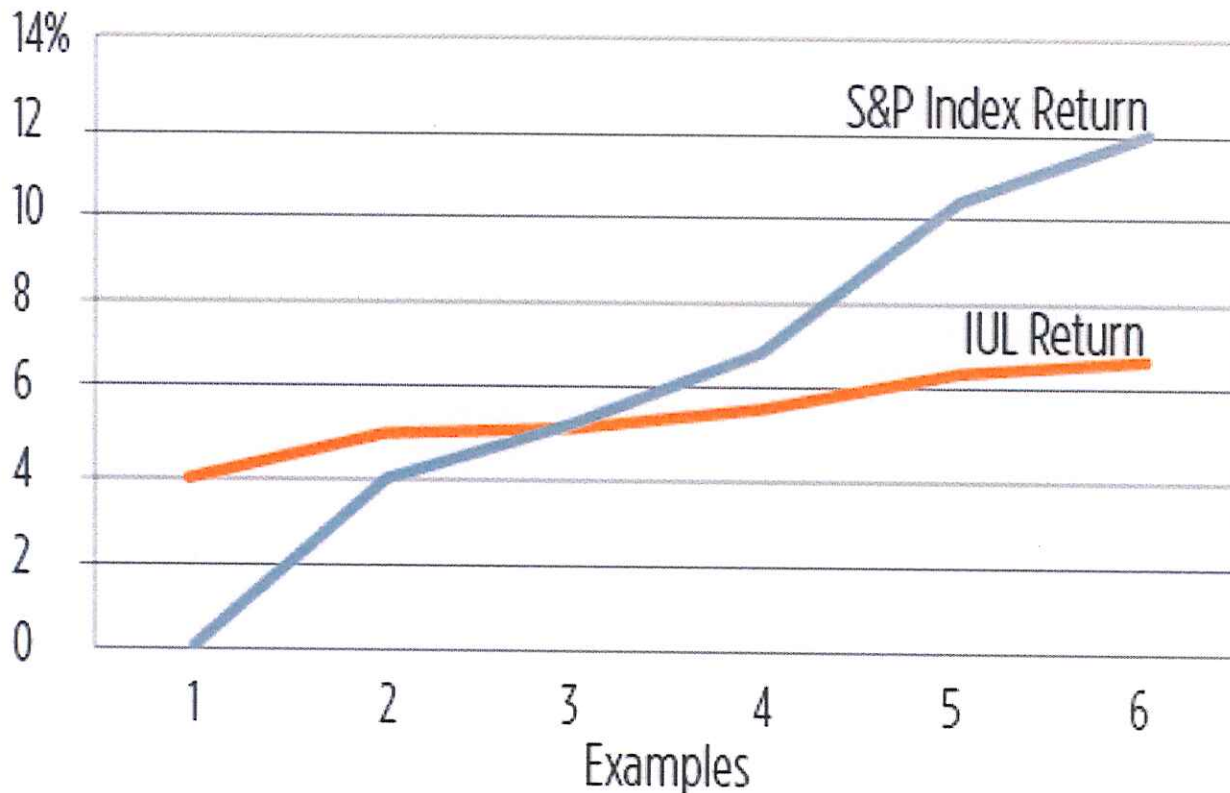
Index fund returns and assumed indexed universal life returns

Example	If the assumed index fund return is:	Then the assumed IUL return is:
1	0.00%	4.01%
2	4.00%	4.90%
3	5.15%	5.15%
4	6.75%	5.50%
5	10.25%	6.30%
6	12.00%	6.70%

— Robert W. Finnegan

Index Fund Returns v. IUL Returns

A 12 percent swing versus a 2.69 percent swing



— Robert W. Finnegan

The IUL return limitations significantly compress the assumed index fund returns. While the index fund return ranges from 0 percent to 12 percent (a 12 percent swing), the corresponding translated IUL return ranges from 4.01 percent to 6.70 percent (a 2.69 percent swing).

- In Example 3 of “John Hancock Rate Translator Examples,” 5.15 percent represents the “crossover return,” where the index fund and the corresponding translated IUL return (based on the given IUL limitations) are equivalent.
- In Examples 1 and 2 of “John Hancock Rate Translator Examples,” we can see that over time, as the index fund performs below the crossover return, the IUL return will be greater because, for the underlying index to return 0 percent or 4 percent over a long term, it would experience many years with returns less than zero, and the IUL 0 percent floor would eliminate those negative returns.

- Examples 4 to 6 of “John Hancock Rate Translator Examples” show that if over time, the index fund performance exceeds the crossover return, the IUL return will be smaller because it would experience more years with returns in excess of 10.5 percent, and the IUL cap would limit those higher returns to 10.5 percent. Examples 4 and 5 form the basis for Scenarios I and II in the example below.

Finally, for a given index fund return, the IUL crediting rate will vary depending on the floor, cap and participation rates. For example, given a 7 percent index fund return, a 0 percent floor and 100 percent participation rate, based on the RTM, an IUL product with a 10.5 percent cap will produce a 5.8 percent IUL return, while an IUL product with a 12.5 percent cap will produce a 6.5 percent IUL return.

Aggressive Premium Financing Plans

IUL premium financing plans implemented within the last 15 years have experienced favorable IUL policy returns and progressively lower borrowing rates. But, is this what the future holds? Regardless of the need for life insurance, many clients have been induced to purchase plans that purport to offer no cost or very low cost life insurance. As previously discussed, policy and loan illustrations shouldn't be taken as guarantees or predictions, yet that's exactly what the aggressive premium financing plans presume. It's up to the client based on sound advice from his advisors to determine the acceptable level of risk and whether a premium financing plan is a suitable funding structure.

These aggressive plan designs are typically based on the following core assumptions:

- The IUL policy illustration is based on the highest illustrative rate allowed by the carrier (6.30 percent in our example below).
- The loan remains in effect for the insured's lifetime.⁹
- Loan interest is accrued and remains at today's low levels for all years of the plan.¹⁰

Although an aggressive premium financing program may look good based on historical index fund performance and might live up to its promise, there's a substantial chance that it won't and that it could fail spectacularly.

What Could Go Wrong?

Poorer than expected policy performance and higher loan rates can lead to several negative outcomes. Once performance starts to slip, the grantor would have to post and place at risk additional collateral to keep the loan fully secured. If the decreasing plan performance continues over time, tremendous costs can result. A collateral call by the lender or simply unwinding the loan could be a financial disaster:

- The policy would be surrendered for its cash value to repay a portion of the loan, thereby triggering income taxation of gain at ordinary income tax rates. The grantor would recognize taxable gain if the policy owner is a defective grantor trust, otherwise the trust would recognize it.

- If the commercial loan exceeds the policy cash surrender value (CSV), the collateral posted by the grantor/insured would be “called” by the lender to repay the shortfall, creating a taxable gift to the trust with generation-skipping transfer (GST) tax implications for a dynasty trust. If the trust isn’t defective, then the income tax paid by the trust on the policy gain will reduce the CSV available to repay the loan, thereby further increasing the amount of the collateral call and the resulting gift.
 - If the commercial loan has been repaid with a policy loan and the policy subsequently underperforms, there’s a significantly greater risk of the policy lapsing without value, creating a large taxable gain on the phantom income.¹¹
- These issues might not be uncovered until years into the plan. The costs of an aggressive no cost life insurance program could far exceed the cost of having simply purchased the insurance on a premium paying basis in the first place.

Premium Financing Example

“Policy and Loan Performance,” this page, compares Scenario I, an aggressive “no cost” design, with Scenario II, a more conservative design, each with accrued loan interest, otherwise representing two extremes on the design spectrum.¹²

Policy and Loan Performance

Comparing two scenarios

Scenario I - 6.3% IUL (10.25% S&P), 3.5% Loan				
Year	Cash Surrender Value (\$)	Loan Balance (\$)	Collateral at Risk (\$)	Death Benefit Net of Loan (\$)
5	2,400,000	3,000,000	600,000	9,300,000
10	4,300,000	4,900,000	600,000	9,300,000
20	8,100,000	6,800,000	0	11,000,000
35 (life expectancy)	15,100,000	11,500,000	0	13,200,000
Scenario II - 5.5% IUL (6.75% S&P), 3.5% - 5.25% Loan				
Year	Cash Surrender Value (\$)	Loan Balance (\$)	Collateral at Risk (\$)	Death Benefit Net of Loan (\$)
5	2,300,000	3,000,000	700,000	9,200,000
10	4,100,000	5,200,000	1,100,000	8,600,000
20	6,900,000	8,700,000	1,800,000	7,800,000
35 (life expectancy)	10,700,000	18,700,000	8,000,000	950,000
37	10,900,000	20,800,000	9,900,000	(950,000)

— Robert W. Finnegan

For both Scenarios, assume that the client, a male age 50, is in excellent health and has an established need for \$10 million of TOLI. The agent proposes funding an IUL policy with an increasing death benefit by borrowing seven annual premiums of \$562,270 from a

commercial lender (\$3,935,890 total)¹³ accruing loan interest. The policy is designed with an increasing death benefit, so the policy cash value and death benefit will keep pace with the loan. Scenario I represents a no cost design, in which the grantor has no out-of-pocket costs. Scenario II stress tests the design by reducing the IUL policy illustrative rate and increasing the assumed commercial loan rate.

Scenario I: Assume a 6.3 percent illustrative rate (a 10.25 percent index fund return), level 3.5 percent loan rate and accrued interest. After repaying the loan plus accrued interest, the program provides a net death benefit ranging from \$9.3 million to \$13.2+ million. Allowing 95 percent of the CSV as collateral, the collateral posted by the grantor maxes out at \$1 million in the sixth year, then grades to zero by the 17th year. That is, 95 percent of the CSV exceeds the loan balance by the 17th year. If the actual policy and loan rates meet or exceed these assumptions over time, the program could, in fact, provide no cost life insurance.

Scenario II: Assume a 5.5 percent illustrative rate (a 6.75 percent index fund return), 3.5 percent increasing to 5.25 percent loan rate and accrued interest. Based on these more conservative assumptions, the policy CSV is always less than the outstanding policy loan, and the client always has an increasing amount of collateral at risk. In the 20th year, the outside collateral at risk exceeds \$1.8 million; in the 35th year, it exceeds \$8 million. The plan has a steadily diminishing net death benefit, and by the 37th year, a few years beyond life expectancy, the death benefit net of the loan is underwater by \$950,000! Because life expectancy represents a 50 percent probability that the individual will live to age 85, there's nearly a 50 percent chance that the plan could fail.

Unwinding the loan in the 20th year would be costly based on Scenario II assumptions, and assuming that the trust is a defective grantor trust, the client doesn't have any lifetime gift or GST tax exemption available and the income, gift and estate tax rates each equals 40 percent. In the 20th year, the outstanding loan equals \$8.7 million. In addition to surrendering the policy and applying the \$6.9 million CSV to repay a portion of the loan, the grantor's out-of-pocket cost of unwinding the plan is \$3.7 million, itemized as follows:

- The policy is surrendered for its CSV of \$6.9 million. Based on the \$3.9 million cost basis, there's \$3 million of taxable gain creating \$1.2 million of income taxes (40 percent) payable by the grantor.
- Because the trust has no assets other than the policy, the \$1.8 million collateral shortfall is paid with the assets posted by the grantor.
- The \$1.8 million collateral call is a taxable gift from the grantor to the trust creating \$700,000 of gift tax.

In comparing Scenario II to Scenario I (the no cost insurance plan), the grantor's heirs would receive \$11.5 million less. In Scenario I, the trust will receive at least \$9.3 million of death benefit. Based on Scenario II, on termination during the grantor's lifetime, the heirs would lose the death benefit, and they would receive \$2.2 million (\$3.7 million x (1-40 percent)) less from the estate due to the costs to unwind the plan. Finally, if the trust is a dynasty trust,

there are potential GST tax implications not factored into the calculations above, for example an inclusion ratio for the trust that's greater than zero.

A few important observations are in order. First, this analysis compares one design with accrued loan interest in both scenarios. The comparison emphasizes the importance of a prudent design based on reasonable assumptions, including having the trust pay all or a portion of loan interest. Second, as loan rates increase, carrier general account performance may improve as well, creating a larger "options budget" and lead to better performance of the IUL policy. Third, the scenarios assume "tame" year-after-year IUL returns and loan rates. The reality is that the policy and loan performance will vary significantly from the assumed performance. Fourth and a corollary of the third point, annual monitoring and stress testing are essential and would have identified performance problems in time to address them.

Monitoring Existing Plans

Many clients may have implemented aggressive plans that are currently underperforming. These plans should be analyzed annually. If the plan is consistently underperforming the original projections, the following key questions should be asked and, when appropriate, remedial steps taken:

- Do in-force projections based on reasonable policy and loan assumptions indicate that the performance is likely to turn around?
- Should remedial action be taken such as the trust paying loan interest and/or a portion of loan principal?
- Is it a funded trust with other assets available to support the plan?
- Are gifts to the trust advisable?
- Are there steps that can be taken to enhance cash value performance, such as reducing the face amount?
- Are there GST tax as well as gift tax implications?

Prudent Premium Financing Design

Best practice suggests designing, implementing and managing a prudent premium financing plan from the outset.¹⁴ Prudent design begins with an established life insurance need and reasonable assumed IUL rates of return and loan rates. For example, advisors might determine that translating a 7 percent S&P 500 rate (including dividends) to an IUL illustrative rate and a 3.5 percent loan increasing to 4.5 percent is reasonable.¹⁵

Unlike Scenarios I and II based on accruing loan interest, most prudent plan designs are based on the trust paying part or all of the loan interest. Funds to pay interest may be from gifts of cash or from cash flow generated by other trust assets. If the trust is a dynasty trust, gifts will have to be sheltered from gift and GST taxes.

It's advisable to consider an exit strategy as part of the initial design combining premium financing with other non-insurance wealth transfer strategies, such as grantor retained

annuity trusts, gifts and/or sales to defective grantor trusts or intra-family loans. Financing insurance in an existing funded trust with sufficient cash flow may be attractive. Either way, a trust's non-insurance assets may generate cash flow that can pay interest costs and ongoing premiums as well as repay the loan in the future. In addition, those assets act as a backstop to ensure the successful completion of the plan.

Stress testing the initial plan design to evaluate how the plan will perform based on various loan rate and policy performance scenarios is strongly advised. The expected investment performance of the assets not used to pay premiums should be factored into the analysis. This investment performance offsets the cost of the plan and may be a key driver in the decision to finance the life insurance. It should also compare the economics of the premium financing plan to the baseline of simply paying the annual premium for equivalent net coverage. Prudent design also includes carefully selecting the lender, carrier, product and writing agent.

- When comparing lenders, it's important not just to compare rates but rather to carefully assess and compare each lender's experience in the market, long-term commitment to the market, the size of the premium finance portfolio and whether the loan has pre-payment penalties (the better programs don't), as well as to carefully review the conditions under which the loan may be called.
- Is the carrier highly rated by the major rating agencies? Has the carrier increased the cost-of-insurance (COI) charges on in-force policies? Has the carrier credited performance improvements to the in-force block as opposed to using them to support competitive pricing on new policies?¹⁶ Has the carrier unfairly increased COI charges? What's the carrier's record for reducing non-guaranteed elements of the IUL policy (typically the cap)?
- Is the product proposed designed to accumulate cash values rather than emphasize death benefit? If the product has performance bonuses, are they fully disclosed? Does the product offer uncapped index options so that the product has the potential to experience greater upside in the market? Is it a true uncapped option, or are there other limitations built in?
- Does the agent have experience designing and, most importantly, administering and monitoring premium financing plans? Does the agent represent a range of carriers and products and understand how to optimize the policy design for premium financing? As part of the sales process, has the agent introduced robust stress testing of the policy on his own? Finally, the importance of annual monitoring of plan performance can't be overemphasized. It uncovers issues in the early stages when it's easier to address them. Annual monitoring evaluates performance to date and includes re-stress testing the plan parameters, primarily policy performance and projected loan rates. Re-stress testing consists of projecting future policy performance with in-force ledgers in conjunction with projecting the current loan balance plus expected additional premium loans based on reasonable assumptions as to forward borrowing rates. If the policy performance and/or loan rates are better than expected, then it may be possible to skip premiums or use cash values to repay the loan without jeopardizing the policy.

What's Actually Gone Wrong?

As a consultant and expert witness, Richard L. Harris¹⁷ has been on the front line of litigation over aggressive premium financing designs. His resulting observations can be taken as a cautionary tale with respect to issues raised by the improper use of premium financing:

- In many cases, the death benefit bore no relationship to the need for insurance, and the insurance amount was greater than the need. The hook that led the prospect to buy that much insurance was the small or nonexistent outlay illustrated in the financing projections.
- The promoters sold the maximum amount of insurance that the insurance carriers would allow based on the insured's finances, generating maximum revenue. Suitability was never considered. In one case, an insurance company ignored its own financial underwriting guidelines to issue coverage well in excess of its guidelines.
- The assumed loan interest rate was low, for example, based on the current 12-month London Interbank Offered Rate and projected to stay the same well into the future.
- The illustration earning assumptions were the highest the carrier would allow.
- The promoter never explained all the details and what could go wrong. The focus was always on the history of the S&P index—without going into the policy limitations, costs and expenses.
- Even though they earned commission from the sale, the promoters often held themselves out as educators and consultants, not sales people.
- Promoters have literally pulled numbers out of thin air to make the transaction attractive without any supporting basis. In one case, the full amount of insurance was used without deducting the outstanding loan payable.
- Comparisons to the cost to purchase a similar policy outright were strongly biased in favor of the premium finance transaction, or the supporting illustrations were never provided.
- In some cases, term insurance would have satisfied the insurance need.
- The client was led to believe that the policy performance and loan rates were fully guaranteed.

An Attractive Alternative

For high-net-worth and ultra-high-net-worth clients purchasing large TOLI policies, premium financing may be an attractive alternative to simply paying the annual premium. Premium financing plans can be in effect for many years. Neither policy performance nor commercial loan rates are guaranteed. In a worse case, aggressive premium financing designs can lock clients into a progressively deteriorating program with escalating and substantial costs to unwind.

Best practice dictates designing the premium financing plan with prudent policy and loan assumptions, with a well thought out exit strategy and subjecting the plan to careful annual monitoring. Such monitoring should review and compare the actual policy and loan performance and re-stress test the design going forward. Prudent design allows flexibility, while careful monitoring allows issues to be uncovered and addressed before they become major problems.

With premium financing, it's essential to understand the risks as well as the rewards.

Endnotes

1. Robert W. Finnegan, "Premium Financing With Indexed Universal Life: Part I," *Trusts & Estates* (December 2017), at p. 42.
2. For purposes of this article, the underlying index fund such as the S&P 500 index is referred to as the "index fund." In all references to index fund, specific rates such as 7 percent include dividends of the stocks comprising the index.
3. The cap, floor and participation rates vary from product to product.
4. The National Association of Insurance Commissioners approved adoption of Actuarial Guideline 49 (AG49) governing the maximum illustrative rate for indexed universal life illustrations effective for policies sold after Sept. 1, 2015. The AG49 rate is calculated in a complex formula averaging 25-year rolling averages for the S&P 500 index over the last 66 years. See Timothy C. Pfeifer, "Actuarial Guideline 49—A Closer Look," *LifeTrends* (July 27, 2015).
5. VOYA offers a percentile model that calculates the probability of realizing a specific indexed universal life (IUL) return based on historical S&P 500 returns.
6. Used with permission of the John Hancock Life Insurance Company.
7. The capital asset pricing model (CAPM) is designed to account for systemic risks that can't be addressed through portfolio diversification. It reflects the premise that a higher return introduces a higher level of investment risk. Although there have been many criticisms of the CAPM, it's still widely used by investment managers as a tool for managing systematic risks.
8. Of note, John Hancock verified the results of the translator model with a separate stochastic model that's based on the historical S&P 500 index returns.
9. With some plans, the loan is repaid with a policy loan, for example in the 15th year of the plan, shifting the commercial loan to a policy loan. Policy loan parameters may be aggressive and should be reviewed.
10. Accrued loan interest is a substantial benefit. For example, it doesn't make sense to repay that loan accruing interest at 3.5 percent with cash values earning 5.5 percent net of expenses and charges.
11. Phantom income is created because the policy cash surrender value (including outstanding policy loans) in excess of basis was never taxed.
12. Based on the Rate Translator Model results: Example 5 is the basis for Scenario I, in which a 10.25 percent index fund return corresponds to a 6.3 percent IUL return. Example 4 is the basis for Scenario II, in which a 6.75 percent index fund return corresponds to a 5.5 percent IUL return. A 3.5 percent difference in the index fund return corresponding to a mere 80 basis points difference in the IUL policy crediting rates!
13. Does this already look questionable, borrowing \$4 million to fund a \$10 million policy?
14. It's worth noting that there are some interesting designs beyond the scope of this article in which the client borrows funds from a commercial lender and lends those funds to the trust pursuant to a loan regime split-dollar plan. These plans shift the borrowing risk to the client and take advantage of favorable split-dollar rules and current low applicable federal rates for significantly greater wealth transfer efficiency.

15. In fact, it's frequently advisable to evaluate a number of scenarios varying policy performance and loan assumptions.

16. For example, one prominent carrier has provided in-force improvements 125 times in the last 30 years.

17. Richard L. Harris is the managing member of Richard L. Harris LLC, a life insurance sales and consulting firm in Clifton, N.J., devoted to helping ultra-high-net-worth clients and their professional advisors deal with issues regarding life insurance. He works as a back-office life insurance expert for many accountants, attorneys and trust officers. With 40 years of experience, Richard is a nationally recognized expert in very advanced planning with life insurance. He's on the Insurance Committee for this magazine and has written extensively for various trade publications.