

Vetting a Premium Finance Deal

A family office called me in to review and analyze a proposed premium finance deal. After gathering the details of what the family was trying to accomplish and requesting presentation materials, insurance ledgers and financing term sheets, I dove into it.

The advisors let me know that one of the primary things they wanted to understand was what their “bail out” option would be in 10 years. In other words, they wanted to understand their options in a worst case scenario, which is an important thing to get one’s arms around.

This plan was built around a 10 pay whole life contract and the collateral for the policy was to be an existing whole life contract on the same individual, the matriarch of the family. A part of my analysis was a historic comparison of whole life dividend, and how they move in relation to the interest rate markets, to LIBOR rates. An important and revealing aspect of this for the advisors was how the policy dividends really work and how they are applied.



What I discovered through the process was that the advisors were significantly misinformed about the inherent workings of a traditional whole life contract in a couple of different ways. This is very important because the premise of the deal was to make hay on the spread between the crediting rate of the policy and the loan rate for funds to pay the premiums. The deal was postured to appear that there was a spread when, in fact, no such spread existed.

In the presentation materials the loan rate was assumed to be very low at less than 4% and the dividend of the policy was shown to be 6.4%, which was actually true. There are a couple things that make these numbers not real. First, the loan rate would assuredly increase over time and this was not accurately accounted for and the dividend rate of the policy is not the same as the effective growth rate of the policy cash value.

How can the growth rate for the policy and the declared dividend rate of the policy not be the same? The answer is: Expenses. While the dividend rate is actually credited to the cash value, after all of the expenses, including commissions, overhead costs, mortality charges, policy fees, state taxes, etc, are deducted, the actual internal rate (IRR) of return on the premiums to cash value are only about half the declared dividend rate at the proposed point of roll out. At the 10 year point the IRR on premium to cash value was only a fraction of one percent, this after eight figures of premiums was poured into the contract.

What we have is reverse arbitrage, which I am sure no-one entering the contract was looking for. When the loan rate is, in reality, greater than the growth rate of the cash value, clearly the cash value cannot grow in excess of the loan in order to pay it back some day.

The bottom line is that the deal was going to be underwater from day one and continue to sink every day moving forward. When I evaluated the bail out option in year 10, not only would the new \$20,000,000 policy be lost, if the collateralized cash value was used to pay back the loan, even the existing life insurance would be lost.

This was an absolute dumpster fire, a train wreck, an abomination of a financial shell game. But we caught it and moved on.