Episode #235: The 5 Red Flags of Premium Finance Plans

Video Transcription

Hi, welcome to another episode of "Money Script Monday." My name is Brian Manderscheid. Today, I want to talk about the five red flags of premium finance programs.

Now, premium finance can be a very effective solution when done for the right person, for the right reasons, and when done the right way. What I want to do today is talk about the five red flags of premium finance, but also talk about five ways to minimize the risk of this transaction and help make it more successful.

So first, watch out: five red flags. Number one definitely has to be free insurance. We've all heard this phrase before, "there is no free lunch," that's perfectly true with premium finance.

What is free insurance? It's basically when you are borrowing 100% of the premiums to fund the policy with zero out-of-pocket cost, tends to have high amounts of outside gap collateral.

If things go perfectly right, you'll end up with a pot of gold at the end of the rainbow. The problem is if you even slightly stress test these programs, they blow up meaning that the liability, the bank loan ends up being greater than the asset, which is a life insurance policy.

So again, watch out for free insurance. And if you're being pitched this, definitely run for the hills and make sure you have your lawyer on speed dial.

Number two, minimal out-of-pocket. So these programs contain leverage and leverage is a tool that amplifies both the good and the bad. If you take too much risk too much leverage, that means that there's a very minimal margin of error in case things don't go perfectly right.

For example, let's say you're funding $200,000 in premiums into the program, total out-of-pocket. And your out-of-pocket is let's just say $10,000 or $20,000 per year. So, $200,000 going into the policy and only $10,000 or $20,000 for your contribution.

That represents a 10X or 20X leverage, which is just too much leverage. And if things, again, don't go perfectly right, the plan may not be successful.

Number three is a 70% loan-to-value on the bank exit. So, what you're going to do in a premium finance transaction is you're going to borrow from a bank to pay a portion of the premiums. Once your cash value builds, you're going to borrow from the insurance company with their cash value and death benefit as collateral to pay off the original bank.

Now, if you borrow more than 70% from the insurance company that tends to accentuate the risks of the policy or of the transaction. So, interesting statistic here, if you borrow more than 90% loan-to-value on the bank exit that actually reduces the success probability down to 28%.

Number four is inaccurate collateral calculations. Now, with the premium finance program, the life insurance cash value and the death benefit are going to be the primary source of collateral.

However, there oftentimes is an outside gap in collateral required to make the bank whole. If these collateral numbers aren't shown up front, done correctly, you may be in for surprises in policy as 2, 3, 4, and 5 with increases in what's required for the outside gap collateral even if the program actually outpaces the original expectations.

Number five, unrealistic income expectations. So, oftentimes these programs are done for estate planning or for business succession planning, but they're often also used for supplemental tax-free income.

Oftentimes, we've seen these programs with withdrawal rates after the bank loan is paid off at 13%, 14%, 15%, and even 16% against the remaining cash surrender value. These income expectations in a perfect scenario could happen, but keep in mind that the illustration assumes a constantly illustrated arbitrage between the borrowing cost and the earnings rate.

The reality is you're going to have ups and downs, or I would say ups and zeros where if you have zero years and which is going to be lower than your borrowing cost, this income may not be sustainable. So make sure, again, you're avoiding all these five things when looking at premium finance.

However, there is hope at the end of the rainbow. There are potential solutions which are the five ways to make premium finance more successful. Now, this is not the "better have your lawyer on speed dial" insurance, this is well-designed, this is well-structured, well-collateralized, and done with top-tier insurance companies.

So, number one is client out-of-pocket of 5 to 1 leverage or less. So, what I mean by that is you want to make sure that if you're funding hypothetically $100,000 a year, $500,000 is really the peak of what you want being funded into the policy. If you have more leverage than that greater than a 5x or 5 to 1 leverage, that opens you up to more risk with the transaction.

Number two is a term insurance blend. There are really three different variables of this policy. There's the bank loan that you're borrowing for the premiums. There are the index returns, the policy, and there are the life insurance policy expenses.

The higher the life insurance policy expenses mean the greater the spread needs to be between the bank loan and the returns on the policy.

What our most successful advisors do is do a term insurance blend, which is basically a way to purposefully reduce the advisor commission on the policy, which also, in turn, reduces the upfront policy expenses, reduces the drag on the cash value, and allows this policy to be more successful. Maybe you may only need a 1%, 1.5% spread between the borrowing rate and the returns to make this program successful.

Number three is less than a 70% loan to value borrowing on the bank loan exit. So again, an interesting statistic is if you borrow less than 70% against the insurance policy to pay off the bank and also do all these other five things, that actually increases the success probability based on our research to 98%. So again, don't borrow more than 70% when paying off the original bank.

Number four is 10 years of premium payments. The way we design the policy is 10 years of max premiums, the least amount of death benefit that the IRS will allow. We do it this way so to minimize the risk associated with the program, reduce any lapse potential, and essentially make this transaction much more beneficial.

And lastly, and I think most importantly, is to make sure that these are age, risk tolerance, and goal appropriate, meaning that they tend to be best for younger clients, 60 or under. They can work with clients between 60 and 70. Typically, survivorship policies tend to work better there, because it has a lower mortality cost when insuring two lives.

As far as goal or risk tolerance, this is a riskier transaction relative to other insurance programs out there. So, if you're not a risk-taker or a risky person, or maybe, let's say you're more conservative and can't stomach any risk, there may be more beneficial programs that don't implore any bank financing that potentially have more guarantees and are better suited for your needs.

Likewise, when making sure when you're working with the advisor, you can't look at the premium finance program in a vacuum. You have to look at it holistically based on your entire financial picture and make sure it fits.

So today we talked about the five red flags of premium finance plans. Also, talked about five ways to make the transaction more successful.

If you're interested in exploring premium finance to see if it makes sense for you, please contact the advisor who sent you this video to get started today.

Thank you very much. We'll see you next time.