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Premium financing: Is it worth the risks?

By Marilyn Bowden • Bankrate.com

Highlights

- Premium financing involves borrowing funds from a third party.
- Borrowing costs may be low initially, then escalate as rates rise.
- Policyholders could owe more for the premiums than the policy is worth.

For affluent people who don't want to liquidate other assets to pay for life insurance, borrowing funds from a third party to cover the cost of a policy and paying it back in installments -- a practice called premium financing -- can seem a practical solution.

But financial planners warn that such a strategy is vulnerable to abuse -- and the elderly in particular need to be wary of it.

How it works

A good prospect for premium financing might be someone who is still working and needs life insurance, but is not ready to liquidate his assets. For example, let's say Sam, age 67, wants to leave a legacy of $5 million to his wife and children. His business is worth a couple of million dollars, but he's not ready to sell it.

The premiums for a $5 million universal life insurance policy for a healthy 67-year-old would run about $100,000 per year, says Nicholas Gnad, managing partner of Beachwood Financial Group in Aventura, Fla. Rather than pay that in a lump sum, Sam might take out a premium finance loan, either from a premium financing company or, more rarely, from an insurance brokerage.

"It's no different from any other type of borrowing," Gnad says. "Premium financing allows very wealthy people whose assets are illiquid to borrow at a rate close to the Libor (London Interbank Offered Rate)."

However, though Libor rates are currently low and may stay low for awhile, they are subject to interest rate changes. From this level they would invariably rise.

Gnad says one advantage is that a universal life insurance policy accumulates value and will therefore become an income-producing asset.

"For example, the policy can be used as collateral for a bank loan," he says. "When you have a premium financing structure, if you die before that loan is repaid, the bank can attach the cash value or receive a portion of the death benefit, up to the loan balance."

Premium financing is a legitimate way for someone who needs a large amount of life insurance with a big premium to find ways to buy it, says Ellen Siegel, principal of Ellen R. Siegel & Associates, in Coral Gables, Fla.

"It's often a business deal, where a key person has to be insured for borrowing purposes," she says. "But it has risks."

Potential problems

For example, there's renewal risk. Because most premium financing contracts have terms less than the life of the policy, they have to be renewed periodically, requiring refinancing.

For someone like Sam, that opens up the potential for the loss of other assets. "It used to be the loans were nonrecourse, meaning they couldn't attach any of your other assets," says Mark Kennedy, president of Kennedy Wealth Management, in Woodland Hills, Calif. "That has pretty much gone away. If at the end of five years the loan lapses, the lender can come after personal assets. It can get nasty."

Many analysts are predicting interest rates will skyrocket in the next two to three years, and that should also be a very big concern for someone in Sam's shoes, says Certified Financial Planner James Holtzman, an adviser and shareholder with Legend Financial Advisors, in Pittsburgh.

"Most of the time a premium finance loan will have a variable interest rate," he says. "Right now that's a great thing. But when (interest rates) rise, it could really eat into the advantages you were trying to accomplish in the first place. What if the cash value is not increasing as fast as the interest rate?"

If the interest rate goes a lot higher, says Gnad, Sam could end up owing more for the premiums than the policy is worth.

Another concern, Holtzman says, is the credit quality of the company that writes the policy. If there's a downgrade, the lender may not pay additional premiums, or it may call for the loan's collateral.

Lucrative business

Large insurance policies mean large commissions, Kennedy says, and that opens the door to outright fraud. "Nowadays," he says, "with tight credit markets, unscrupulous agents are preying on the elderly. They tell them that in two years they can sell the policy and make money on the deal. Generally insurance companies have a two-year contestability period during which they can refuse to pay the claim if they suspect fraud."

Gnad says most insurance companies will not issue a policy to someone whose sole purpose is to resell it for profit. To get around this, unscrupulous agents advise applicants with this strategy in mind not to disclose it on the application or to indicate other intentions, such as estate tax planning. Insurance companies, he adds, are becoming more vigilant about cracking down on this type of abuse.

So while premium financing is a viable strategy in some cases, says Holtzman, "we try to keep it simple. If you want insurance, go to an insurance company; if you want to get financing, go to the bank."

A better option, he says, might be a home equity loan. "You should be able to write it off on your taxes, and you'd be dealing with a locked-in rate that is very attractive

"Or just get a personal loan from a bank."

Premium financing, says Kennedy, is "a way for a life insurance agent or premium finance company to make huge fees and commissions, but it could leave the client who signed for the loan holding the bag."

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