LIFE INSURANCE PREMIUM FINANCE

What is it, why do people do it, and what do you need to know?

What is life insurance premium finance?

As the name suggests, instead of choosing to pay life insurance premiums using cash on-hand, some clients choose to finance the premiums through a third-party lender. Why might a person choose to finance the premiums on their life insurance policy? There are several reasons.

- Many ultra-high net worth clients utilize and are very comfortable with debt, especially debt that is secured by assets, in other areas of their financial world. They might prefer to keep their cash invested in illiquid assets generating a high return (e.g., commercial property, privately held businesses, alternative investments, art, etc.) instead of liquidating holdings (and potentially incurring taxes) to pay insurance premiums.
- Financing insurance premiums might serve as a temporary bridge prior to an upcoming liquidity event. For example, consider a corporate executive with a large amount of restricted stock with a known vesting schedule. The executive may have a sizable estate tax exposure yet not have the liquidity needed today to purchase the life insurance needed to mitigate it. One strategy would be to finance the premiums with the intention of paying off the loan once the shares vest. Often these policies are structured with high-early-cash-value products so that the cash value of the policy can cover a large portion of the collateral requirement for the loan.

Who is life insurance premium finance appropriate for?

Everyone's situation is unique, and your specific circumstances and objectives should be taken into account when exploring life insurance premium finance. Here are a few guidelines on who this strategy is most appropriate for:

- Clients who have a need for a large amount of life insurance, e.g., for estate tax mitigation, business succession, charitable giving, estate equalization, etc.
- Although there are no formal income or asset restrictions to finance a policy, most clients who explore this financing approach are high-net-worth or ultra-high-net-worth and are familiar and comfortable with debt. This strategy works best for those who are supported by a team of advisors including an attorney and an accountant, in addition to their LPL financial advisor.
- Those choosing to finance their insurance premiums should have an exit strategy other than death and have the financial resources readily available if the performance of the policy and interest rates move in the wrong direction.
- Prospective buyers should be in good enough health to qualify for life insurance (this is true for all life insurance buyers, not just those financing the purchase). Your LPL financial advisor has access to world class insurance underwriting team who can help with this process.

How does life insurance premium finance work?

When selecting the insurance carrier and product to be used, a different mix of carriers and products is in play if it is known the purchase is intended to be financed. Variable products cannot be financed as they are registered products and non-marginable – a loan against them would be considered a margin loan. Typically, indexed-universal-life insurance or whole life insurance policies are most often used since both have high-early-cash value versions. As with any life insurance purchase, the client (insured) needs to go through an underwriting approval process. Simultaneous with the underwriting process, the legal work required to establish any trusts where the insurance will be held can be done. Most policies of this type are held in irrevocable trusts so that the death benefit is not included in the insured's taxable estate. Securing the funding source for the loan can also happen in parallel with the carrier underwriting and selection process. Several national banks are active in life insurance premium finance as well as more specialty financing companies.

Things to consider when it comes to financing life insurance premiums

- The loan rate assumptions and projected policy performance should be subjected to stress-test modeling prior to implementing this funding approach. Specifically, what would happen in a worst-case scenario (e.g., the policy performs poorer than expected, perhaps due to market volatility if an indexed product is used and at the same time, the interest rate on the loan rises due to market conditions). It is important to plan ahead for these possibilities and understand the implications for your overall financial situation (e.g., additional collateral requirements or loan repayment which may necessitate a sale of assets at an inopportune time potentially with unwanted tax consequences).
- Premium finance is often incorrectly marketed as "free" insurance, by suggesting, for example, that the loan can be collateralized fully by the cash value of the policy. Nothing in life is free, and we are seeing many situations where premium financed insurance was sold with overly optimistic assumptions and no clear exit strategy. Don't let this happen to you.
- The client should always have a loan exit strategy in mind, other than death. Life is uncertain and market conditions or one's own financial situation can change quickly, for unforeseeable reasons. Understanding up front how the loan would be retired early, if needed, can save many hard choices later.
- Some lenders (typically those who also have Wealth Management divisions) may require the borrower to place assets on deposit with the bank as a condition of the loan, if additional collateral outside the policy is required. Many lenders do not have this requirement, but it is something to be aware of when securing the loan.

Life insurance premium finance can be an effective planning tool for sophisticated, high-net-worth clients with a large need for insurance, but it is not suited for everyone. With the potential changes in the estate tax at the end of 2025, many clients will consider implementing wealth transfer and estate liquidity planning over the coming year, and premium finance will be a timely topic, especially if interest rates continue to trend down and the market performance stays strong. Your LPL financial advisor and the LPL Insurance Associates team have the experience and resources to assist you in exploring custom life insurance planning and premium funding options to fit your financial situation and goals.