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The three potential Implications of a premium financing strategy

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During a recent interview over the radio with Money 98 FM, I was asked by the radio DJ on whether the complexity of financial products which triggered off the infamous mini bond saga in the 2008 global financial crisis has reduced, I replied in a blink of an eye that not only do the complexity remain, but it has gotten worse. One example is the use of the leverage strategy to acquire jumbo life insurance policies and high yield corporate bonds. The marketing term is commonly known as premium financing.

How this strategy works is that it is assumed that a client, typically of High Net Worth (HNW) status, has an estate planning need of creating a legacy. A jumbo life insurance, for example a universal life policy, is purchased with a single premium. Let's say the premium is US$1M for a US$3M sum assured. The client is first required to pay US$200,000, and the remaining US$800,000 premium is financed by a bank loan. The loan is collateralised by the first day cash value of the life policy. The client just has to pay off the interest on the loan every month to the bank until the client passes away or in some instances gets a TPD. The bank will than receive the death/ disability benefit from the insurer, net off the premium loan of $800,000 loan and pay the net sum assured of $2.2M to the client's estate. And the policy's beneficiaries live happily ever after. However, life is not always a fairly tale, and most of the time we are often caught by surprise. The purpose of this article is to highlight three negative implications that the premium financing strategy can cause.

1ST IMPLICATION:

INDIVIDUAL'S TOTAL DEBT SERVICING RATIO WILL BE WEAKENED

The Total Debt Servicing ratio is a statistic that compares your total debt commitment within your income. It is commonly computed in the monthly mode. In Singapore, the TDSR is a mandatory requirement by a bank before it disburses a loan to purchase a property.

The mandatory requirement is that TDSR should not be more than 60% of a person's income. If a client enters into a loan agreement to purchase a universal life policy, the monthly interest payment will add onto the TDSR calculations, hence there could be difficulties if the client wants to purchase a home or a second property in the future.

An even worse situation that could arise is that the client claims he/she did not fully understand how his earlier premium financing strategy had impacted his/her ability to fund the future property purchase and launches a negligence suit against the financial practitioner under the Financial Advisers Act.

2ND IMPLICATION: UNCOMMITTED & UNLIMITED CLAUSES IN THE PREMIUM LOAN AGREEMENT

These two clauses hide covertly in the loan agreement, but they have a serious impact on the client's finances if activated. The uncommitted clause means the lender (i.e. bank) is not committed to a specific tenure on the loan.

A typical premium financing loan agreement is yearly renewable and the bank can withdraw the loan back anytime it feels its interests are affected. For example, a famous restaurant appears in the news for the wrong reasons, and its business came to a standstill pending the authority's investigation. Assuming that the restaurant's owner had purchased the universal life policy with premium financing in its earlier years, the bank could then call back the loan on the grounds that the restaurant is facing liquidation, and that the credit-worthiness of the client is in doubt. It might be in the interest of the bank to be amongst the first to withdraw the loan before the other trade creditors do so.

The unlimited clause in the loan agreement is even more serious. This clause allows the bank to use the death benefit (or cash value) of the universal life policy to not only clear the premium loan amount but also the rest of the liabilities held under the bank by the client. A typical scenario is as follows: A HNW-business owner client enters into a premium financing universal life policy plan. He/she borrows US$800,000 premium loan secured by a US$3M universal life policy in 2018.

The bank subsequently markets to the client a business working capital loan (US$5M) in 2020 guaranteed by client's personal assets. Assuming the client's business is heavily impacted by an economic downturn, and passes away due to a cardiac arrest. As the policy's assigned owner, the bank will receive the death benefit of US$3M.

The unlimited clause allows the bank to use the death benefit not only to clear the premium loan of US$800K, but also the rest of the loan (total US$5M) liable by the client to the bank. Mathematically it is as follows:

Client's Debt with Bank

Items	US$	Remarks
Premium Loan on Universal Life Policy	(800,000)	
Working Capital Loan Guaranteed by client's personal assets	(5,000,000)	
Less cash inflow from universal life policy	3,000,000	Death Benefit
Net loan outstanding	**(2,800,000)**	**Bank will sue the client's estate to recover the outstanding amount.**
Other financial planning implications	The initial intent of using the universal life policy to create a legacy has also failed.	

3RD IMPLICATION:

TREATMENT OF THE POLICY DURING THE CLIENT'S FINANCIAL CHALLENGES

Premium financing works very well if the client holds it for life. However if the client finds themselves in a sudden financially challenging situation, this strategy could backfire. Most clients do not appreciate that in such a strategy, the universal life policy will not appear as an asset in his/her balance sheet because the policy's ownership has been assigned to the bank. On the other hand, the premium loan will appear in the client's balance sheet as a liability. Hence, if the client won't have access to the universal life policy's cash value when he/she needs it most.

Also if such a situation happens in the initial policy years and the loan is called back, the high back end surrender charges of the universal life policy can result in the policy value not being able to discharge the loan fully. In this situation, the bank will seize the client's other personal assets to recover the shortfall.

CONCLUSION

Premium financing of a universal life policy is complex and high-risk. It is not for every high net worth client. It's suitable for high net worth clients with substantial assets, and that have the financial muscle to flex under financially challenging situations. On the other hand, such a strategy is not appropriate for clients who have a high income but have few assets, because when the client enters into financial difficulties, this strategy will add onto his/her financial woes.

And bankruptcy could be the end result of that, most financial practitioners aspire to venture into the high net worth market, do exercise extra care and diligence before recommending premium financing for universal life policies to potential clients.

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