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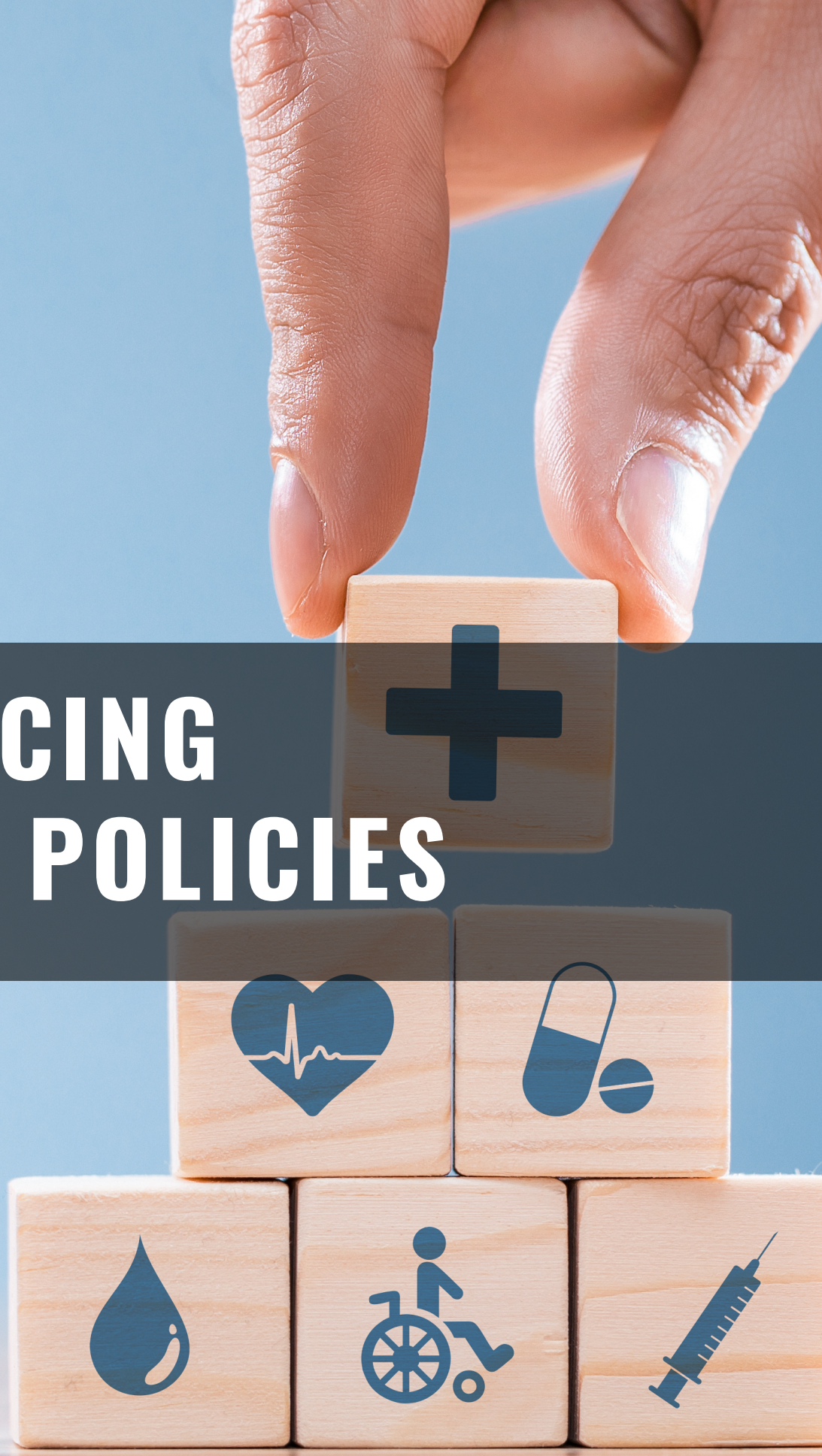
INSURANCE AND FINANCIAL PRACTITIONERS ASSOCIATION OF SINGAPORE

TUESDAY TIMES ISSUE #93

PREMIUM FINANCING FOR INSURANCE POLICIES



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INSURANCE AND FINANCIAL PRACTITIONERS ASSOCIATION OF SINGAPORE

EXECUTIVE SUMMARY

Premium financing for insurance policies is one of the financial planning strategies which can be utilised by both high net worth individuals (HNWI) and mass affluent clients for legacy or retirement planning.

There are generally two types of insurance policies that can be funded by premium financing:

- **Universal Life (UL) / Single Premium Whole Life Policy; and**
- **Single Premium Whole Life Income Plan or Annuity/Retirement Plan.**

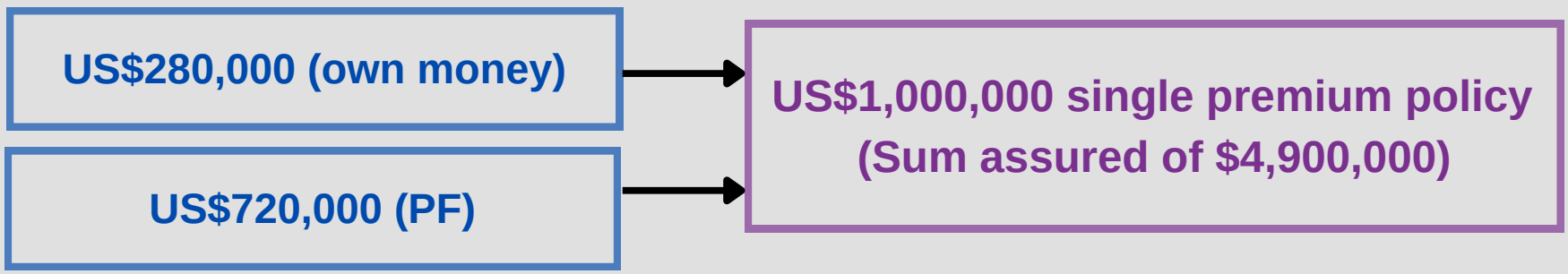
With the rise of lending interest rates, there may be concerns for clients who have funded their insurance policies with premium financing.

This article examines the premium financing for both type of insurance policies, including the pros & cons of such strategy.

CASE STUDY 1:
UL OR SINGLE PREMIUM WHOLE OF LIFE

Let's look at an example of a premium financing of a UL or single premium whole life policy for a 40-year old male client who is a non-smoker:

- US$1,000,000 single premium can grant him a coverage of US$4,900,000 (estimated);
- Day 1 cash value of the policy is valued at 80% of the single premium (US$800,000);
- For PF, assuming bank lends an amount which is based on 90% of day 1 cash value which is US$800,000 x 90% = US$720,000; and
- The money which client needs to fork out is US$1,000,000 - US$720,000= US$280,000.



- The loan is collateralised by the day 1 cash values of the UL/ single premium whole life policy;
- Client pays interests every month until he passes on (or gets a total and permanent disability for some insurers);
- Bank will receive the death/total permanent disability (TPD) benefits of US$4,900,000 to net off the PF loan of US$720,000; and
- Remaining amount (Sum assured - PF loan) will be paid to client's estate (for distribution to beneficiaries).

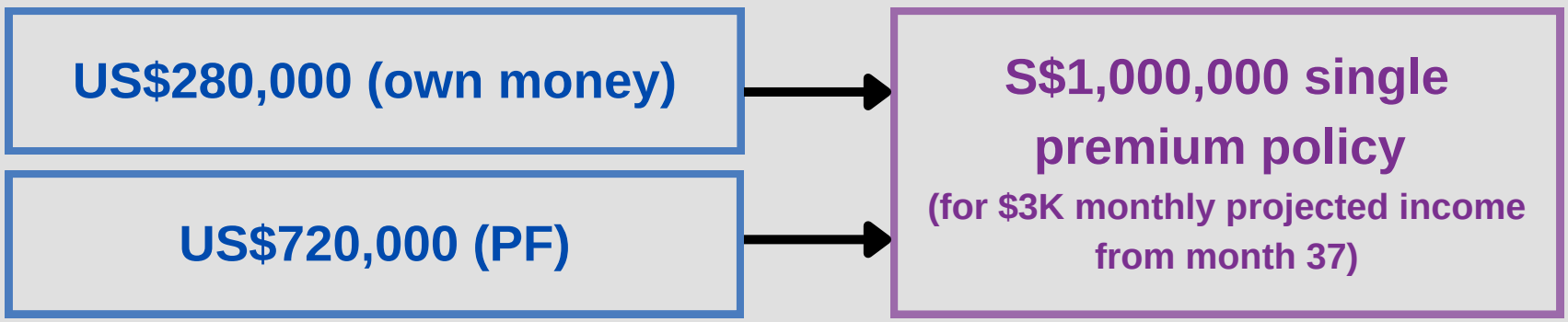
Pros and limitations/implications of PF for UL / single premium whole life policies:

PROS	LIMITATIONS / IMPLICATIONS
Interest payable only. This is an interest only loan and you can pay off the loan in a flexible manner.	Change in interest rates
Reduction in upfront payment of premiums (pays US$280,000 instead of US$1,000,000)	Total debt servicing ratio (TDSR) (55% of a person's gross monthly income) will affect individual TDSR to buy property, car or application of other personal loans.
Optimal coverage	Unlimited clause in the PF loan agreement (if any). For example, the same bank grants a US$5mil business loan to the same client based on his personal assets. Client suddenly passed on due to COVID. Other than the PF loan (which will be called back), bank can also call back US$5mil business loan from the sum assured (after netting off PF loan). This clause allows the bank to use the death benefits or cash values to clear the PF loan, as well as, other client's liabilities held under the same bank. • Sum assured US$4.9mil - PF US$720K = $4.18mil • US$4.18mil being called back to pay US$5mil business loan • Left o/s of US$820K • Bank can sue against client's estate to call back US$820K
Choices of interest rates packages to choose from (1-month, 3-month, 6-month, etc)	Uncommitted clause in the PF loan agreement (if any). For example, the loan is reviewed yearly. If the client's business is affected and the business is facing liquidation due to COVID, the client's credit-worthiness will be in doubt. The bank could call back the loan based on the above.
UL policies have cash values	Policy is pledged/assigned to the bank. Client cannot do life insurance nomination. Recommended to do a will to distribute the insurance proceeds.

CASE STUDY 2: WHOLE LIFE INCOME OR ANNUITY PLAN

Let's look at another example of a premium financing of whole life income plan or annuity plan for a 40-year old male client who is a non-smoker:

- S$1,000,000 single premium can grant him an estimated projected monthly income of $3,000 (guaranteed + non-guaranteed; based on 4.25% on the policy illustration);
- Income payment to client starts from month 37 (varies across insurers);
- Day 1 cash value of the policy is valued at 80% of the single premium (S$800,000);
- For PF, assuming bank lends out an amount that is based on 90% of day 1 cash value which is (S$800,000 x 90% = S$720,000); and
- The money which client needs to fork out is US$1,000,000 - US$720,000= US$280,000.



- The loan is collateralised by the day 1 cash values of the life policy;
- Client pays interests every month until he passes on or until he surrenders the policy;
- Bank will receive the death benefits to net off the PF loan of S$720,000; if he were to pass on; and
- Remaining amount (Sum assured - PF loan) will be paid to client's estate (for distribution to beneficiaries).

Pros and limitations/implications of PF for whole life income plan or annuity plan:

PROS	LIMITATIONS / IMPLICATIONS
Interest payable only. This is an interest only loan and you can pay off the loan in a flexible manner.	*Change in interest rates **(refer to calculations/scenarios on next page)**
Reduction in upfront payment of premiums (pays US$280,000 instead of US$1,000,000)	Deficit cashflow for the initial years (say 3 years; but varies across insurers). For the example above, the payout is from month 37. This means that the client has to pay the interest from his own pocket from month 1 to month 36.
Gearing for potential higher returns	Total debt servicing ratio (TDSR) (55% of a person's gross monthly income) will affect individual TDSR to buy property, car or application of other personal loans.
Choices of interest rates packages to choose from (1-month, 3-month, 6-month, etc)	Unlimited clause in the PF loan agreement (if any). For example: the same bank grants a S$5mil business loan to the same client based on his personal assets. Client passed on due to COVID suddenly. Other than the PF loan (which will be called back), bank can also call back S$5mil business loan from the sum assured (after netting off PF loan). This clause allows the bank to use the death benefits or cash values to clear the PF loan, as well as, other client's liabilities held under the same bank. • Sum assured (higher of 105% of single premium paid or cash value) minus PF S$720K = $XXX • S$XXX being called back to pay S$5mil business loan • Remaining outstanding business loan • Bank can sue against client's estate to call back the o/s business loan
Such plan has cash values; income can be paid out or accumulated into the policy	Uncommitted clause in the PF loan agreement (if any). For example, the loan is reviewed yearly. If the client's business is affected and the business is facing liquidation due to COVID, the client's credit-worthiness will be in doubt. The bank could call back the loan based on the above.
	Policy is pledged/assigned to the bank. Client cannot do life insurance nomination. Recommended to do a will to distribute the insurance proceeds.
	Lack of liquidity: The breakeven amount varies across policies from different insurers. Assuming that the breakeven point is at the tenth year, and client fell into critical financial situations/challenges in the early years of the policy. Early surrender of the policy may result in immediate loss.

Let's look at the scenarios of rising interest rates for such policies under premium financing:

Scenario 1:	Scenario 2:	Scenario 3:
Assuming that interest rate is 1.2% p.a.	When interest rate at 2.0% p.a.	When interest rate at 3.0% p.a.
Based on $720K, the monthly interest is **$720/month**	Based on $720K, the monthly interest is **$1,200/month**	Based on $720K, the monthly interest is **$1,800/month**

The projected monthly income of $3,000 (guaranteed + non-guaranteed) will be able to service the PF in the cases above. It is a matter of whether the client is receiving higher or lower income after paying off the monthly interest. However, do also take note of the non-guaranteed portion of the returns (varies based on the insurers' par funds' performances).

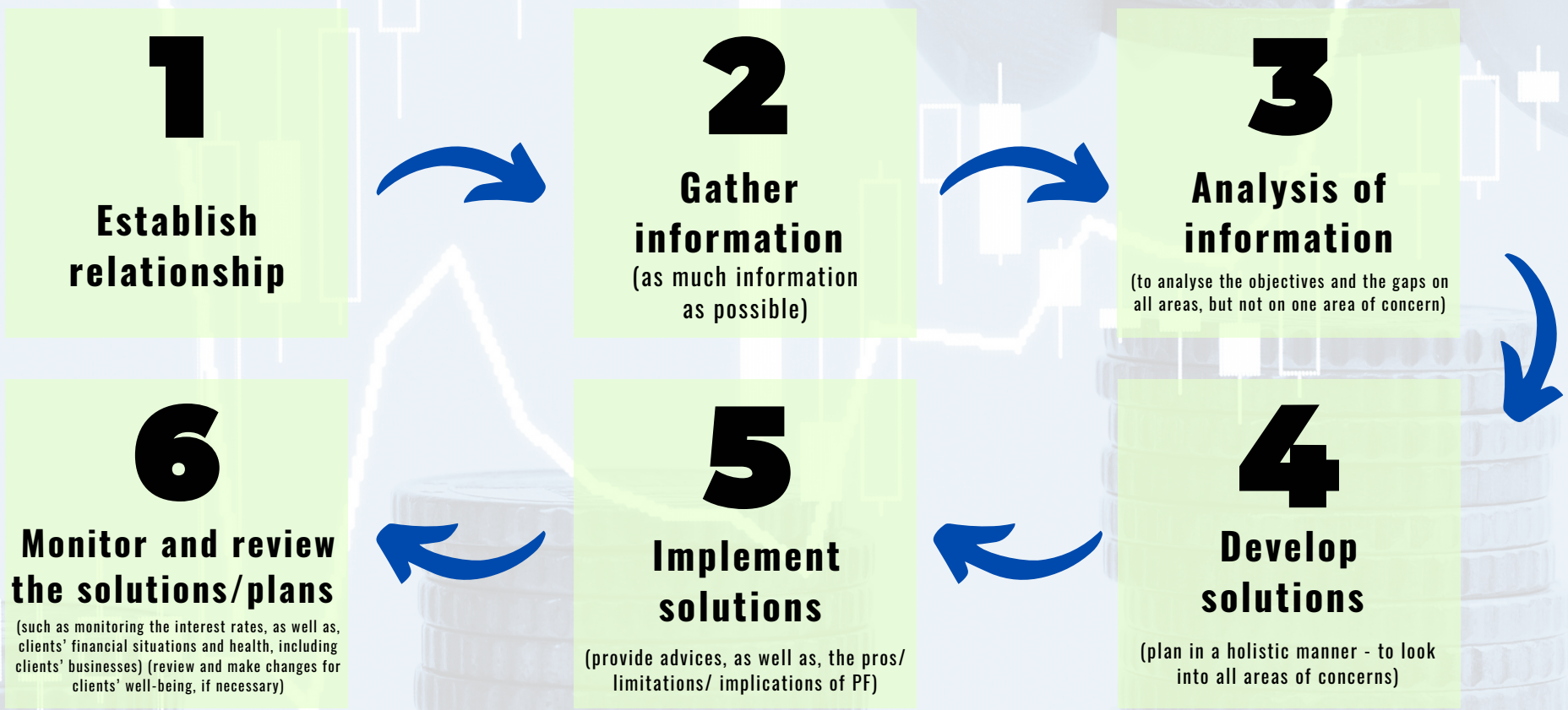
If the non-guaranteed portion of the investment return is below forecast, the client will need to contribute additional funds to meet the monthly interest payable.

Below are some general considerations for one to think through before taking up a premium financing for insurance policies:

- Suitable for HNWIs with substantial assets (for e,g.: interest rate goes up too high, the client can do the loan pay-up immediately)
- Suitable for HNWIs who have the financial muscle to flex during financially challenging situations / suitable for HNWIs who have set aside healthy amount of emergency funds
- Clients must understand that interest rates are subjected to changes and projected income may not be sufficient to cover interest payment (if interest rate rises too high)
- No plan for future loans (like buying second or third property; take note of TDSR issues)
- Ensure that clients have sufficient cashflow in the first few years (non-income payout period; for e.g: from month 1 to month 36)

Duty of care for financial practitioners:

- All solutions have its pros and limitations
- Exercise extra care and diligence before recommending PF to potential clients
- Plan according to clients' interests and benefits
- Follow the 6 steps in financial planning:



CONCLUSION

I hope the above provide valuable insights to premium financing for life insurance policies as all strategies come with pros and limitations/implications. It is important for us as financial practitioners to understand the technical aspects of premium financing including its benefits and all limitations/implications before we make recommendations to our clients, so as to better assist our clients in making informed decisions for their financial planning needs.

ABOUT THE AUTHOR

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