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Allianz Life Insurance Company of North America

PREMIUM FINANCE

In premium finance, strategy design matters

Premium finance is a strategy used by high net worth individuals and/or business owners to pay for (or finance) the premium for large life insurance policies through bank loans.

One important aspect of a premium finance strategy is the design. There are many factors that are taken into consideration when designing a premium finance strategy:

- Number of premium payments
- Term blend
- Type of policy used
- IRS 7702 rules
- Age and risk class
- Policyholder contribution
- Bank loan repayment
- Cash value accessed from life insurance policy

Three areas clients can control to help support a successful strategy

Our program research has identified three of the above design factors over which clients have control and that may help the policy work in their favor and help meet their strategy expectations and goals:

Policyholder contribution: In addition to borrowed money, clients are usually required to pay interest on the bank loan out of pocket, or a portion of the premium, or both.

Additional premium payments: Typical premium finance designs include premium payments for seven years. There are designs than can work with fewer payments, but the more years of payments, the higher the likelihood of a successful strategy. A policyholder also has the option of contributing additional premium to the policy above the required payments.

Including term blend in the strategy: A premium finance strategy that includes a fixed index universal life insurance (FIUL) policy and a term life insurance policy.

Let's now examine how changing these elements can make impacts on the policy.

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Product and feature availability may vary by state and broker/dealer.
This notice does not apply in the state of New York.

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Changing the policyholder contribution while holding other variables constant

First, we'll look at the implications using a 5.50% illustrated rate of return:

5.50% ILLUSTRATED RATE	**No interest paid**	**Interest/principal paydown (10% of premium)**	**Interest/principal paydown (20% of premium)**
Initial out-of-pocket premium	–	$639,239	$1,278,477
Average death benefit net of bank loan	$4.67MM	$5.42MM	$6.17MM
Cash value year 20 net of bank loan	$1.70MM	$2.90MM	$4.10MM

Assumptions: 7-Pay, $10 million death benefit, 15% Term, 55-year-old male, Standard nontobacco

Different levels of policyholder contribution are common in premium financing designs, but what does this mean for program performance?

- More contribution means more planned out-of-pocket payments for the client
- It also means less outstanding bank loan value, so the more contribution means the average death benefit and cash value after the bank loan is paid off would be higher

It's important to know that if a policy does not provide anticipated results – such as the index return not meeting projections – there is the possibility of a shortfall in the policy (not enough cash value to pay off the bank loan).

So let's lower the rate of return on the policy to 4.5% and see the effects (all other factors remain the same); however, the additional policyholder contribution helps protect the policyholder from additional financial loss:

4.5% ILLUSTRATED RATE	**No interest paid**	**Interest/principal paydown (10% of premium)**	**Interest/principal paydown (20% of premium)**
Initial out-of-pocket premium	–	$639,239	$1,278,477
Shortfall $	**$876,438**		
Average death benefit net of bank loan	$4.07MM	$4.56MM	$5.31MM
Cash value year 20 net of bank loan	$.69MM	$.77MM	$1.97MM

Assumptions: 7-Pay, $10 million death benefit, 15% Term, 55-year-old male, Standard nontobacco

- Without any contribution (no interest paid), the policy performance isn't enough to cover the bank loan and the policyholder will need to pay more than $875,000 out of pocket.
- With 20% contribution ($1,278,477), not only does the policyholder not need additional out of pocket, since there is no shortfall, but also would end up with almost $1.28MM more cash value.

The hypothetical examples in this piece are provided for illustrative purposes only and are not intended to represent a specific insurance product or premium financing program.

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Making additional premium payments while holding other variables constant

The more additional out-of-pocket premium payments, the higher the values. FIUL policies perform best when overfunded, so increasing the number of premium payments borrowed can help improve overall premium finance program design.

Using a 5.50% illustrated rate of return, as the number of premium payments increase:
- The amount of interest paid goes up
- But so do the death benefit and cash value

5.50% ILLUSTRATED RATE	5 payments	7 payments	10 payments
Initial out-of-pocket premium	$456,599	$639,239	$913,198
Average death benefit net of bank loan	$4.73MM	$5.42MM	$7.22MM
Cash value year 20 net of bank loan	$1.64MM	$2.90MM	$3.94MM

Assumptions: $10 million death benefit, 15% Term, 55-year-old male, Standard nontobacco, pay down principal/interest (10% of annual premium)

In a poor equity environment, using a 4.5% illustrated rate, even though there is still a shortfall, we see that the more premium payments, the better off the policyholder is:
- The average death benefit is higher
- The amount owed the bank to pay off the loan is lower
- There is more cash value

4.5% ILLUSTRATED RATE	No interest paid	Interest/principal paydown (10% of premium)	Interest/principal paydown (20% of premium)
Initial out-of-pocket premium	$456,599	$639,239	$913,198
Shortfall $	**$378,211**		
Average death benefit net of bank loan	$4.30MM	$4.56MM	$6.22MM
Cash value year 20 net of bank loan	$.47MM	$.77MM	$1.26MM

Assumptions: $10 million death benefit, 15% Term, 55-year-old male, Standard nontobacco, pay down principal/interest (10% of annual premium)

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Including a term blend while holding other variables constant

Here, we'll look at the effects of adding or not adding the Supplemental Term Rider[1] available with Allianz Life Pro+® Advantage Fixed Index Universal Life Insurance Policy. The amount of term blend will also help policy performance, as the more term blend, the lower the policy charges.

5.50% ILLUSTRATED RATE	Total out-of-pocket premium $639,239		
	No term blend	15% term blend	30% term blend
Average death benefit net of bank loan	$5.20MM	$5.42MM	$5.63MM
Cash value year 20 net of bank loan	$2.50MM	$2.90MM	$3.30MM

Assumptions: 7-Pay, $10 million death benefit, 55-year-old male, Standard nontobacco, pay down principal/interest (10% of annual premium)

More term blend will also help in the low market scenario, using a 4.5% illustrated rate. The more blend, the less of a shortfall while keeping consistent death benefit and cash values.

4.5% ILLUSTRATED RATE	Total out-of-pocket premium $639,239		
	No term blend	15% term blend	30% term blend
Shortfall	**$194,528**		
Average death benefit net of bank loan	$4.42MM	$4.56MM	$4.76MM
Cash value year 20 net of bank loan	$.67MM	$.77MM	$1.12MM

Assumptions: 7-Pay, $10 million death benefit, 55-year-old male, Standard nontobacco, pay down principal/interest (10% of annual premium)

A premium finance strategy is not appropriate for everyone. For additional information about premium financing, including benefits, potential prospects, and considerations, please review the Premium Financing agent guide (ASI-457). Clients should consult with their tax advisor and attorney before entering into this or any other arrangement involving tax, legal, and economic considerations.

DISCUSS ALL THESE DESIGN ASPECTS WITH YOUR clients and premium finance vendor. **For additional help, call your divisional vice president.**

[1] Rider is available at policy issue at an additional cost and is based on the amount of the additional term coverage.

The death benefit is generally paid to beneficiaries income-tax-free. FIUL requires qualification through health and financial underwriting.

Policy loans and withdrawals will reduce the available cash value and death benefit and may cause the policy to lapse, or affect guarantees against lapse. Withdrawals in excess of premiums paid will be subject to ordinary income tax. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. If a policy is a modified endowment contract (MEC), policy loans and withdrawals will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½ on a MEC, a 10% federal additional tax may be imposed. Tax laws are subject to change and you should consult a tax professional.

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