

THE IMPORTANCE OF STRESS TESTING COMMERCIAL PREMIUM FINANCING PROPOSALS

Commercial premium financing can be an effective way to pay for life insurance premiums. But without proper stress testing, illustrations can be misleading.

Commercial premium financing (CPF) provides a temporary way to pay insurance premiums: The policy owner or insured borrows money from a commercial lender to pay the premium on a life insurance contract. The policy is used as collateral for the loan, and the loan is either paid off using policy values, the policy death benefit, or other capital from the owner or insured.

Due in large part to historically low borrowing rates, the popularity and attractiveness of utilizing commercial premium financing to fund life insurance purchases has grown steadily over the last several years.

While not the only reason to consider the solution, the attractiveness of this arrangement increases when the policy's expected rate of return is greater than the borrowing rate. Simply put, if you can borrow money at 3.00% interest and that money can earn a potential rate of return of more than 3.00%, you are effectively arbitraging interest rates—and the larger the gap between those two rates, the better the potential outcome.

THE RISKS

There are, however, a number of risks involved with CPF. The primary risks are related to:

- loan interest rate,
- policy performance,
- loan renewal, and
- loan collateral.

Risks are introduced when the loan interest rate and policy rate of return are not guaranteed. Although this is typical of CPF, it is often illustrated based on assumptions made in the current environment and often not fully stress tested to demonstrate potential future outcomes.

Often, the most aggressive, non-stress-tested assumptions available today are used to make the proposition seem the most attractive to the client. The following are examples of aggressive assumptions that can be applied:

- volatility-controlled index account utilizing an AG49 rate of return equal to 5.90%
- CPF lending cost of 3.75% in all years
- CPF loan repaid using Alternate Loans inside the policy

As we enter an environment where interest rates are rising and the life insurance products involved become more complex, it is clear that properly stress testing potential outcomes will help set proper expectations of the long-term advantages and potential perils of the strategy for the client.

ANALYZING THE RISKS

For our analysis, we are going to focus on loan interest rate and policy performance risks. Policy performance has three risks that we will measure in this paper: the difference of assumed crediting rates using the S&P 500 index option, the difference of the S&P 500 index account option versus the volatility-controlled index account (VCIA) option, and the difference between the Standard and Alternate Loan options. The loan collateral and loan renewal risks are by-products of the loan interest and policy performance risks.

The point of this analysis is not to deter premium financing; it is a sound funding strategy with many benefits. Rather, the purpose is to provide the tools and perspectives to show the potential range of outcomes that are reasonably possible and then communicate those outcomes to clients.

INTEREST RATE RISK

For the last several years, many have benefitted from historically low borrowing rates. Borrowing rates are rarely consistent and may never reach the

Case Assumptions

Each scenario utilizes an equity-indexed universal life (EIUL) product, insuring a 50-year-old male with the second-best available underwriting, a \$10 million death benefit, and a CPF arrangement which provides seven max-funded premium payments. It also assumes the owner/insured pays the loan interest out of pocket and the CPF loan is repaid via policy values as early as possible, without lapsing the underlying policy.

attractiveness of recent history. Yet in many CPF proposals, the interest rate assumption is either static or only stress tested in a small way.

Increasing the stress testing helps shed light on the risk of potential rising interest rates, which we demonstrate in **Exhibit A**. For our baseline assumption, a static 3.75% was used for the borrowing rate, and the loan was able to be fully repaid in year 9 while paying \$1,058,005 in loan interest. Applying a stress test of a 4.5% borrowing rate after year 5 demonstrates how the policy owner or insured would have to pay an additional \$120,915 in interest due on the loan, an equivalent close to another 6 months of interest payments:

EXHIBIT A

SCENARIO	LOAN INTEREST RATE	LOAN PAYOFF YEAR	TOTAL LOAN INTEREST PAID	POLICY CASH VALUE @ 95	POLICY DEATH BENEFIT @ 95
Level Loan Interest	3.75% All Years	9	\$1,058,005	\$13,197,179	\$14,702,283
Increasing Loan Interest	3.75% 1–5 4.50% 6+	9	\$1,178,920	\$13,197,179	\$14,702,283

POLICY PERFORMANCE RISKS

Risk 1 – Volatility Controlled Index Account (VCIA) vs. S&P 500 Index Accounts: After 2015, when the original AG49 guidelines were put into place, many carriers built “multiplier” account options that would illustrate better performances than the more standard S&P 500 index account options — even though they could actually perform worse. As a result, a second measure, known

as AG49-A, was implemented in 2020 to disallow illustrations that allowed “multiplier” accounts to illustrate any advantages over the non-multiplier S&P index account options.

After the enactment of and possibly in response to AG49-A, carriers began to create more VCIA options

that are based on more complex investment strategies, which are meant to curtail volatility inside the measured indices instead of just the S&P 500. The VCIA strategy currently reduces the cost of overall indexing and this cost savings can be passed on to the policyholder by a multiplier or through a fixed interest bonus. Many VCIA's have the multiplier, and some of the fixed bonuses are as high as 1.25%–1.50%.

The VCIA accounts have relatively short track records in comparison to the S&P 500 index, creating less confidence that the illustrated advantages available today are sustainable over the longer term. Either via

the fixed bonus feature or a less-proven investment strategy, the VCIA allows for higher illustrated rates of returns compared to the S&P 500 index option, effectively creating an extra value that *can only be illustrated when selecting the VCIA*.

Many CPF proposals and illustrations assume the premium dollars are allocated to those VCIA options, and their high illustrated rates of return. If we instead use the S&P 500 index option and accompanying AG49 rate of 5.21% (**Exhibit B**), the loan payoff moves from year 9 to 14, causing the owner to pay \$1,390,521 more in loan interest:

EXHIBIT B

SCENARIO	RATE OF RETURN	LOAN PAYOFF YEAR	TOTAL LOAN INTEREST PAID	POLICY CASH VALUE @ 95	POLICY DEATH BENEFIT @ 95
VCIA Account + Bonus	5.90% + 0.65% Bonus	9	\$1,058,005	\$13,197,179	\$14,702,283
S&P Index Account	5.21%	14	\$2,448,526	\$10,332,741	\$11,589,527

Risk 2 – Assumed Rate of Return:¹ The AG49 rate was adopted and put in place in 2015 as a measure to provide a unified methodology to the historical look-back assumptions used by carriers to establish a reasonable rate of return to illustrate future performance. It is the maximum allowed by the National Association of Insurance Commissioners (NAIC) and is the average of 25-year look back periods over the last 65 years.

Relying on an average rate of return to predict outcomes gives you about a 50% chance of each success and failure, yet it is a common assumption for

CPF proposals. Applying a stress test and an assumed rate of return that has between a 70%–80% chance of success (based on the S&P 500 account) will increase the chances that the illustrated outcome will come true. Stress testing the interest rate assumption by assuming a rate of return between the 70th and 80th confidence intervals, under the AG49 methodology, moves the repayment year to 16. As shown in **Exhibit C**, the owner would pay an additional \$1,898,363 of loan interest under that more probable outcome:

EXHIBIT C

SCENARIO	RATE OF RETURN	LOAN PAYOFF YEAR	TOTAL LOAN INTEREST PAID	POLICY CASH VALUE @ 95	POLICY DEATH BENEFIT @ 95
AG49 Rate VCIA Account + Bonus	5.90% + 0.65% Bonus	9	\$1,058,005	\$13,197,179	\$14,702,283
S&P Index Account Rate Between 70th–80th Confidence Interval	4.73%	16	\$2,956,368	\$ 9,133,922	\$10,291,458

Risk 3 – Standard Loan vs. Alternate Loan: When taking distributions from the cash value of life insurance policies, it is typical to withdraw your basis in the policy

(net premiums) and then distribute any gains inside the policy via loans to avoid creating taxable income upon these distributions.

¹ To request a copy of “M’s IUL Growth Cap Rate Model” paper (updated June 2022), contact your M Professional.

IUL products have traditionally had two options for taking policy loans:

- 1) the **Standard Loan**, where the loaned funds are moved from the index investment strategy into a loan collateral account where it earns nominal interest (2.00%–3.50%) and the loan interest that is charged is either equal to the interest credited or has a slight “spread” of 0.05%–0.50%, or
- 2) the **Alternate Loan**, where the cash value remains invested in the index investment strategy for potentially higher earnings in exchange for a higher interest rate charge, typically 4.00%–5.50%.

The attractiveness of the Alternate Loan is the potential for added leverage when a policy’s illustrated index strategy produces a higher rate of return than the Alternate Loan rate. For example, an assumed 5.90% crediting rate with an Alternate Loan rate of 4.50% would create 1.40% positive leverage each policy year.

However, given rising interest rates and volatile markets, there is no guarantee this outcome will occur and there certainly will be years where the loan interest charged is more than the return provided by the index strategy. As a result, AG49-A implemented a maximum amount of illustrated leverage between the Alternate Loan rate and the policy crediting rate of 0.50%. Most CPF proposals assume Alternate Loans with the full 0.50% leverage occurring every year.

Some proposals even replace the withdrawal portion of the income strategy with Alternate Loans, therefore maximizing this leverage to its utmost capability. Because the leverage is not guaranteed, it is important to stress test this dynamic. **Exhibit D** shows the impact of reducing the leverage to zero by utilizing the withdrawal and Standard Loan procedure instead of the Alternate Loans. The loan payoff goes from year 9 to 15, resulting in \$1,644,442 more interest being paid out of pocket:

EXHIBIT D

SCENARIO	LOAN INTEREST RATE LEVERAGE	LOAN PAYOFF YEAR	TOTAL LOAN INTEREST PAID	POLICY CASH VALUE @ 95	POLICY DEATH BENEFIT @ 95
All Alternate Loans	+0.50%	9	\$1,058,005	\$13,197,179	\$14,702,283
Withdrawal/ Standard Loan	0.00%	15	\$2,702,447	\$ 9,034,339	\$10,311,752

COMBINING STRESS TESTS

As displayed through these four moderate stress tests, each one can delay the payoff date by up to 7 years later than the most aggressive assumption, and possibly cause anywhere from \$120,915–\$1,898,313 more interest that would need to be paid out of pocket to service the loan.

Combining the four stress tests makes the impact even more severe, changing the payoff year from 9 to 18 and causing \$2,406,205 more interest that would need to be paid out of pocket, as seen in **Exhibit E**:

EXHIBIT E

SCENARIO	LOAN PAYOFF YEAR	TOTAL LOAN INTEREST PAID	POLICY CASH VALUE @ 95	POLICY DEATH BENEFIT @ 95
Level Loan Interest, VCIA Account, 5.90% + Bonus Return, and Alternate Loans	9	\$1,058,005	\$13,197,179	\$14,702,283
Increasing Loan Interest, S&P 500 Account, 4.73% Return, and Withdrawal/Standard Loan	18	\$3,464,210	\$ 9,172,322	\$10,391,270

The odds of all four risks occurring together are rare but not impossible. This potential scenario could turn a very attractively illustrated proposition into one that's not advisable.

CONCLUSION

While commercial premium financing can be a valuable tool to temporarily pay for life insurance premiums, failure to properly stress test potential outcomes can be misleading. A proper stress test should include potential rising loan interest rates, an assumed rate of return with a 70%–80% chance of success, the S&P 500 index option, and policy loan leverage marked at zero.

As this paper shows, including one or more of these risks can lead to longer payoff periods and increases the total loan interest paid. They can also decrease policy cash value and death benefit amounts. By using the tools described here, clients can see the gamut of reasonable results, and properly decide if CPF is a transaction they want to commit to for the long term.

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