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Marketplace

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This Finseca Report Marketplace was prepared exclusively for Finseca Influencer members by Jon Forster (Partner), John F. DeStefano (Counsel), and Alyssa L. Tiebout (Associate) at **BakerHostetler**.

Rising Rates and Falling Markets – A Focus on Life Insurance Third-Party Premium Financing and Loan Regime Split Dollar Arrangements

Market Trend: Rising interest rates and a volatile stock market may change the economics around loan regime split dollar life insurance arrangements and third-party premium financing.

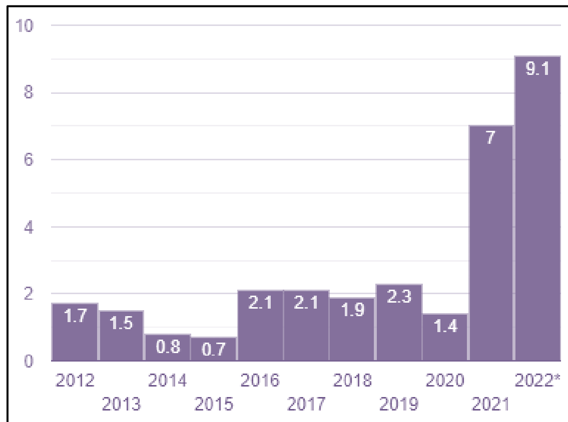
Synopsis: Financing techniques to fund large life insurance policies have become increasingly popular over the last decade or so of historically low interest rates. Rising interest rates may have the opposite effect on performance. With the Federal Reserve's benchmark rate up a rapid 2.25 percentage points so far this year – and expected to rise to 3.5% by the end of 2022 and 4% by the end of 2023 – the arbitrage opportunities of loan regime split dollar arrangements and third-party premium financing may face extended headwinds.

Take Aways: Life insurance continues to play a vital role in legacy planning because of its unique value proposition – a source of income tax efficient liquidity, efficient wealth transfer on a multi-generational basis, a mortality hedge, a non-correlated asset class, and strong internal rates of return relative to the current stock market. Nonetheless, advisors should evaluate how higher rates and a volatile market may impact the performance of both new and existing life insurance funding approaches.

Background

Nearly all of the world's developed economies are experiencing significant inflationary pressure. The United States is experiencing its highest inflation in decades with the annual inflation rate hitting a 40-year high of 9.1% in June 2022 and remaining alarmingly elevated at 8.5% in July.

United States Annual Inflation Rates



To cool demand and curb surging prices, the Federal Reserve has aggressively raised the federal funds rate from its floor range of 0% to 0.25% during the pandemic to its current range of 2.25% to 2.50% – the fastest monetary policy tightening since Paul Volckner fought double digit inflation in the 1980s – and more increases are coming. In his July press conference, Federal Reserve Chairman Jerome Powell said, as it relates to September, "another unusually large increase could be appropriate" and reiterated that the central bank will push its benchmark rate to 3.5% by year end.

Impact on life insurance planning

Background

Life insurance owned by an irrevocable life insurance trust ("**ILIT**") removes the policy proceeds from a client's taxable estate and provides a mortality and market-based hedge by securing a family legacy if other asset values fall or recover slowly. Typically, the client makes annual gifts to the ILIT to fund policy premiums, but larger policies with premium amounts greater than the client's annual gift tax exclusion capacity (currently $16,000 per donee) create a gift tax concern and, thus, a need to explore other funding methods.

Enter loan-regime split-dollar arrangements and third-party premium financing, which arbitrage borrowing costs (interest rates) against policy returns to fund premiums with more gift tax efficiency.

Loan Regime Private Split Dollar

Private split dollar arrangements ("**SDA**") come in two flavors: economic benefit and loan regime. This Report focuses on the latter, as its effectiveness is highly sensitive to interest rates.

A loan regime SDA allows the client (insured) to pay annual premiums directly on behalf of the owner (ILIT) by way of a loan secured by the policy proceeds. Instead of having to gift the whole premium amount to the ILIT each year, the client typically need only gift (or forgive) the interest due on the outstanding loans. Alternatively, interest may be capitalized. Because each premium advance is considered a loan (not a gift) to the ILIT, the client can fund a larger policy in a more gift tax efficient manner.

Loan regime SDAs are principally variable rate loans. The interest rate charged depends on the loan structure, i.e., demand loan, term loan, or hybrid, but all are tied to the applicable federal rate ("**AFR**"), which currently stands at 3.30% (August 2022 long-term AFR).

As the AFR continues to rise, so too will the cost of the loan regime SDA. Consequently, advisors should consider the total loan cost in the current interest rate environment compared to other financing methods (such as economic benefit SDA) to determine the most effective path forward.

Third-Party Premium Financing

Alternatively, the client or ILIT can borrow funds from an outside lender to pay insurance premiums. Third-party premium financing can facilitate clients with largely illiquid assets obtain sizable insurance policies or otherwise allow liquid clients to avoid selling assets to fund premiums. In either case, third-party financing may increase a client's overall portfolio return through the effective use of leverage.

The financial arbitrage is successful only if the policy's paid up additions cover the debt, i.e., the policy's internal rate of return must exceed the interest rate on the borrowed funds. Accordingly, the approach is more attractive when borrowing costs are low or declining. As interest rates rise, however, the costs associated with financing premiums can escalate quickly, especially if the program is based on a variable rate loan.

Observations

- Younger clients engaged in loan regime split dollar or third-party premium financing arrangements face greater interest rate risk as they will likely have variable interest rate loans outstanding for a longer period.

- Third-party financing arrangements, if they fail to meet economic demands, may even require additional capital.

- As interest rates rise, clients may find other arrangements, such as economic benefit SDAs, are more economically advantageous. If the client's age renders an economic benefit SDA untenable, the client may consider a lifetime gift or asset sale to the ILIT of sufficient size to produce enough income to cover annual premiums going forward.

Takeaways

Life insurance continues to play a vital role in legacy planning because of its unique value proposition – a source of income tax efficient liquidity, efficient wealth transfer on a multi-generational basis, a mortality hedge, a non-correlated asset class, and strong internal rates of return relative to the current stock market. Nonetheless, advisors should evaluate how higher rates and a volatile market may impact the performance of both new and existing life insurance funding approaches.

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