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Premium Financing: Understanding the Risks Before Recommending the Strategy

Premium-financed life insurance is one of the most aggressively marketed strategies in the high-net-worth market — and one of the least scrutinized. This resource examines the structural risks that make it unsuitable for most clients and provides the analytical framework advisors need to evaluate it objectively.

Premium financing for life insurance has a surface logic that can be compelling: rather than liquidating assets or redirecting cash flow to fund large insurance premiums, a high-net-worth individual borrows from a third-party lender, pledges the policy's cash value as collateral, and waits for the policy's credited returns to outpace the loan interest — the so-called *arbitrage*. On paper, particularly at the low interest rates that persisted from 2008 through 2021, the numbers were attractive.

In practice, the strategy is far more fragile than its illustrations suggest. A growing body of litigation, academic research, and actuarial analysis reveals that premium-financed IUL arrangements fail to perform as projected in a significant majority of stress-tested scenarios — not because of bad luck, but because of structural design problems that are present from the start. For advisors operating under a fiduciary or best-interest standard, the risks are not only financial. They are professional.

This article provides a candid, research-grounded examination of how premium financing works, where the risks concentrate, what the independent data shows about outcomes, and why AdvisorServe does not recommend it as a primary planning strategy for estate planning clients.

How Premium Financing Works

In a premium financing arrangement, a third-party lender — typically a bank or specialty finance company — advances funds to pay premiums on a large life insurance policy, most commonly an indexed universal life (IUL) policy. The policy's cash surrender value serves as the primary loan collateral, with the borrower required to post "gap" collateral from other assets when the loan balance exceeds the cash value. The borrower pays loan interest — either currently or by capitalizing (rolling up) interest onto the outstanding balance — and the arrangement is designed to be unwound at some future date, typically 10 to 20 years out, when the policy's cash value is projected to exceed the loan balance.

The appeal is straightforward: rather than paying $1 million or more annually in premiums from personal resources, the borrower pays only loan interest — often projected far lower than the premium itself — while preserving capital for other uses. The unstated assumption underlying every premium financing proposal is that the policy will credit at a rate consistently above the loan interest rate, producing a positive spread (the arbitrage) that makes the whole structure self-sustaining. Industry practitioners estimate that a significant and growing share of IUL premiums are currently being financed, with some estimates ranging from 20 to 40 percent of IUL sales in the high-net-worth segment.[1]

QUESTIONS ON A SPECIFIC CASE?
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The Arbitrage Assumption

Premium financing illustrations project that policy crediting rates will exceed loan interest rates, sustainably, for decades. That assumption is the foundation on which the entire strategy rests — and it is **not guaranteed, not historically reliable, and not independently stress-tested** in most proposals clients receive.

The Five Principal Risk Categories

A January 2025 peer-reviewed article in the *Journal of Financial Service Professionals* (JFSP) by Vanderzanden, Weber, and Lockitch — three CLU and CFA-credentialed practitioners with decades of combined experience in insurance underwriting, financial planning, and institutional finance — identified five primary risk categories that must be evaluated before any premium financing arrangement is recommended.[2] These are not theoretical concerns. They are documented sources of failure in live cases.

1

INTEREST RATE RISK

Premium financing loans carry variable interest rates tied to short-term credit market benchmarks. Between 2008 and 2021, LIBOR-based borrowing rates ranged from 0.73% to approximately 5.85%, before being replaced by SOFR.[3] During that window, the spread between projected policy credits and loan rates looked compelling in illustrations. When rates rose sharply after 2021 — with SOFR ending 2023 near 5.40%, and lenders adding their typical 2.0% margin — the arbitrage that had been modeled into proposals largely disappeared.[4]

The problem is structural: premium financing borrows short-term to fund a long-term asset. Loan rates reset annually or on short cycles. Policy illustrations assume a constant crediting rate for decades. When those two assumptions diverge — as they inevitably will over a 15- to 30-year arrangement — projected self-sufficiency evaporates, and the borrower faces collateral calls or out-of-pocket demands not part of the original projection.

2

POLICY CREDITING RISK

IUL policies credit based on the performance of an external index, subject to carrier-set caps, participation rates, and floor rates that are non-guaranteed and subject to change at carrier discretion. Illustrations run these crediting assumptions as constants — the same rate every year for the life of the policy, often for 70 years or more. That assumption has no actuarial basis.

The JFSP authors applied Monte Carlo analysis to a representative premium-financed IUL case — a 55-year-old male, $12.75 million death benefit, $1.165 million in annual premiums financed over 10 years, illustrated at a constant 6.74% crediting rate. Running 1,000 statistically credible, volatile crediting scenarios based on the index's actual historical distribution, they found that the probability of the "as illustrated" policy sustaining to age 100 was **virtually zero: just 3 successful trials out of 1,000**.[5] Even when planned income distributions were removed, the probability improved only to 36% — a coin-flip weighted toward failure. The constant illustrated rate of 6.74% vs. a statistical mean of 5.53% — a 121-basis-point gap — compounded over decades within a leveraged structure, accounts for the catastrophic divergence.[6]

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In a peer-reviewed 2025 Monte Carlo analysis of a representative premium-financed IUL case illustrated at the maximum allowable crediting rate, just **3 of 1,000 statistically credible scenarios** sustained the policy to age 100 as proposed. Nearly 1 in 3 failures occurred at age 70 — immediately after the planned loan transfer to the policy. Illustrations create the illusion of precision. The underlying mathematics tell a very different story.

3

LOAN EXIT RISK

Most premium financing designs contemplate a "loan exit" event 10 to 20 years out: the external bank loan is repaid using the policy's accumulated cash value, which then continues under a policy loan structure. What this framing obscures is that the "exit" is not an exit at all — it is a refinancing. The external bank debt is exchanged for an internal policy loan, and the client's financial exposure continues under terms set by the insurance carrier rather than the bank.

In the JFSP case study, of 1,000 stochastically modeled trials, 671 were capable of repaying the third-party loan from cash values. Of those, 148 failed between ages 71 and 75, before any planned income distributions began. By the time the planned income phase started, **nearly half of all modeled paths had already experienced a policy failure**.[7]

4

REQUALIFICATION RISK

Premium financing loans typically require requalification every three to five years. At each renewal, the lender reassesses the borrower's creditworthiness, the policy's cash value as collateral, and current market rates. A borrower whose financial position has changed — due to business conditions, investment losses, divorce, or health changes — may face materially worse loan terms or be unable to requalify at all. **Current collateral requirements have tightened from the 100–110% ratios common before 2022 to 110–125% in the current environment**, reflecting lender recognition of increased risk.[8]

5

REFINANCE RISK

Lenders can and do exit the premium financing market. During the 2008 financial crisis, several institutions withdrew from this lending category entirely, leaving borrowers without renewal financing. A client who loses access to renewal capital faces an immediate forced choice: pay the full premium out of pocket, surrender the policy, or allow it to lapse — none of which was part of the original plan. This risk is particularly acute because it tends to materialize during precisely the conditions — financial stress, rising rates, credit tightening — when it is most difficult to manage.

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Additional Risks That Are Rarely Disclosed

Beyond the five primary categories, the JFSP authors identify a set of compounding risks that are infrequently quantified in proposals and almost never part of the client conversation at the point of sale.[8]

CAPITALIZED INTEREST

Designs that capitalize (roll up) loan interest onto the outstanding balance create a compounding debt obligation that grows rapidly. The JFSP authors specifically recommend that only arrangements in which the client pays at least all loan interest due each year should be considered. Minimum out-of-pocket designs — marketed as "free insurance" or "no out-of-pocket cost" — have the highest leverage and the lowest probability of success.

COLLATERAL VOLATILITY

Gap collateral is routinely presented as a smooth, declining curve that reaches zero as the policy grows. In the JFSP Monte Carlo analysis, collateral obligations were **"jagged rather than smooth."** In a sample of 20 randomly selected trials, 11 experienced recurring collateral calls after the gap had already closed, three experienced collateral recurring three times, and one saw it reach zero and re-open four times. Clients expecting collateral to be a brief, manageable early-year concern are repeatedly unprepared for its recurrence.

EARLY TERMINATION LOSSES

The JFSP authors performed an early termination analysis: if the client exited at age 60 (year 5), the after-tax cash position was **negative $1.17 million**. If exiting at age 80 (year 25), when gross cash value appeared positive, an estimated $7.66 million in ordinary income tax on the policy's internal gain produced an **after-tax loss of $1.54 million**. The favorable income tax treatment of life insurance only applies when the policy is held to death. Voluntary or involuntary termination before death triggers ordinary income tax on the accumulated gain.

BEHAVIORAL RISKS

Three behavioral risks are structurally embedded in long-duration arrangements. **Recency bias** leads clients who entered during the low-rate period to assume favorable conditions will persist. **Loss aversion** causes clients to make suboptimal design choices, such as allocating early premiums to the fixed account rather than the intended index strategy, permanently undermining illustrated performance. **Borrower fatigue** — the accumulating burden of annual loan renewals, collateral calls, and volatile credits — frequently leads to early termination at a loss, often at the worst possible time.

THE "SOPHISTICATED BUYER" FALLACY

A persistent assumption is that high-net-worth individuals — hedge fund managers, business owners, investment bankers — are sophisticated enough to evaluate these arrangements independently. The JFSP authors explicitly reject this view. Even experienced financial professionals are not professional insurance buyers, and the combination of IUL policy mechanics with external financing involves a level of complexity that few clients or their non-insurance advisors are equipped to evaluate without independent, unconflicted expertise. In litigation, it has been repeatedly observed that clients asked *"Is it legal?"* rather than *"Does it make financial sense?"*

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The Litigation Environment

Premium financing lawsuits are not rare events. They are a documented and growing feature of this market. Industry practitioners and observers note that the volume of litigation has increased sharply since 2022 as rising rates exposed the fragility of arrangements designed during the low-rate era.

- **Pacific Life IUL Illustration Lawsuit (September 2025, Washington State):** Pacific Life settled a lawsuit brought by a Washington state couple alleging they were misled about the performance of an IUL policy. This case illustrates the broader litigation environment around IUL illustration practices and the gap between projected and actual policy performance.[9]
- **Gottlieb Premium-Financed IUL Lawsuit (January 2025):** Former advisor Joshua L. Gottlieb, barred by FINRA in 2017, faced a lawsuit for mishandling a premium-financed IUL program that caused significant financial harm to clients. The case exemplifies the professional and legal exposure that follows failed premium financing arrangements.[10]

These cases reflect a pattern: illustrations that created unrealistic expectations, inadequate risk disclosure, and clients left with compounding loan balances, reduced policy values, and no viable exit. From a legal standpoint, financial professionals who recommend premium financing carry material exposure if they have not performed — and documented — independent stress testing of both the policy and the financing overlay, disclosed the probability of early termination losses, and ensured the client understood that illustrations are not projections.

THE PROFESSIONAL RISK TO THE RECOMMENDING ADVISOR

In litigation arising from failed premium finance arrangements, the recommending advisor is typically a named party. Courts and regulators have found that advisors who relied solely on illustrations provided by the selling agent — without independent analysis — did not satisfy their duty of care. The burden of demonstrating that the recommendation was suitable and well-analyzed falls squarely on the advisor.

A Direct Comparison: Financed vs. Unfinanced

The most instructive element of the JFSP analysis is the comparison between the financed case and a direct-pay alternative using the same policy and the same premium capital. When the authors applied Monte Carlo methodology to an equivalent unfinanced design — redirecting the capital that would have funded loan interest toward direct premium payments — the probability of the policy sustaining to age 100 increased from virtually zero to **96 percent**. If the client accepted a lower success threshold of 80 percent, annual policy loan income from the unfinanced policy could actually exceed the projected income from the financed version.[11]

FACTOR	PREMIUM FINANCED	DIRECT PAY (UNFINANCED)
Probability sustaining to age 100	**0.3% (3 of 1,000 trials)**	**96%**
Interest rate exposure	**High — variable, resets annually**	**None**
Collateral requirements	**Recurring, jagged, unpredictable**	**None**
Early termination exposure	**Significant (up to -$1.54M after-tax)**	**Minimal**
Lapse/refinance risk	**Present throughout arrangement**	**None**
Income potential (80% threshold)	Lower or negative	**Equal or greater**

This comparison directly challenges the central marketing premise of premium financing: that leverage creates value. In a properly

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Why AdvisorServe Does Not Recommend Premium Financing

Our position is not that premium financing is always impermissible. The JFSP authors acknowledge that with rigorous independent analysis, fully disclosed risks, adequate collateral capacity well beyond initial projections, out-of-pocket interest payments at all times, and a credible alternative exit plan, there may be narrow circumstances where it is appropriate. The standards required to reach that conclusion are demanding and rarely met in practice.

ADVISORSERVE POSITION

Our concern is simpler and more direct: in the estate planning context, the goal is to provide a known, reliable death benefit to address a specific future obligation. Premium financing introduces multiple layers of uncertainty — interest rate volatility, crediting volatility, collateral exposure, refinance risk, and behavioral drag — that fundamentally undermine that objective. A strategy that has a near-zero probability of performing as illustrated, introduces significant early-termination tax exposure, and generates litigation at a rate that has attracted a dedicated national plaintiffs' bar is not a strategy that serves the client's planning interests.

Our approach is to recommend life insurance policies structured and funded to be self-sustaining: permanent policies, owned by an ILIT, funded directly from the grantor's resources, sized appropriately for the estate tax obligation being addressed. That approach is straightforward, well-supported, and consistent with the independent actuarial evidence. It is not glamorous. It does not promise arbitrage. It delivers what the client actually needs: a reliable, tax-efficient liquidity mechanism that will be there when the estate needs it.

IF A CLIENT OR COLLEAGUE RAISES PREMIUM FINANCING

- → Request an independent Monte Carlo analysis — not an illustration — of the proposed policy and financing overlay before any recommendation is made.
- → Stress-test loan interest rates at historical highs, apply realistic stochastic crediting based on the index's actual historical distribution, and model collateral requirements across the full range of possible outcomes — not the average.
- → Ensure the client understands the after-tax cost of early termination in every year of the arrangement before committing.
- → If the independent analysis does not produce a satisfactory probability of success at the client's required reliability level, the arrangement should not proceed.

REFERENCES

[1] Practitioner estimate. Vanderzanden, Gerard J., CLU, ChFC, CLTC; Weber, Richard M., MBA, CLU, AEP; and Lockitch, Michael J., CFA. "The Risks of Premium-Financed Life Insurance Arrangements and the Role of the Financial Professional." *Journal of Financial Service Professionals* 79, no. 1 (January 2025): 42–59.

[2] Ibid. The authors hold CLU, ChFC, CLTC (Vanderzanden), MBA, CLU, AEP (Weber), and CFA (Lockitch) designations, and draw on litigation consulting experience across numerous failed premium financing cases.

[3] London Interbank Offered Rate (LIBOR) historical data; Secured Overnight Financing Rate (SOFR). Federal Reserve Bank of New York. Vanderzanden et al. (2025), footnote 3.

[4] Ibid. SOFR ended 2023 at approximately 5.40%, with lenders' typical margin producing all-in borrowing rates approaching 7.40%.

[5] Vanderzanden et al. (2025). Monte Carlo analysis performed at www.lifeinsuranceanalytics.com. 1,000 trials applied to case parameters described in the article (pp. 48–52). Three trials sustained the policy to age 100 "as proposed."

[6] Ibid., p. 51. The tested statistical mean for the current index was 5.53% versus the maximum-allowed constant illustration rate of 6.74%.

[7] Ibid., pp. 46–47. Of 1,000 Monte Carlo trials, 671 were capable of repaying the third-party loan. Of those, 148 failed between ages 71 and 75 prior to planned income distributions.

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