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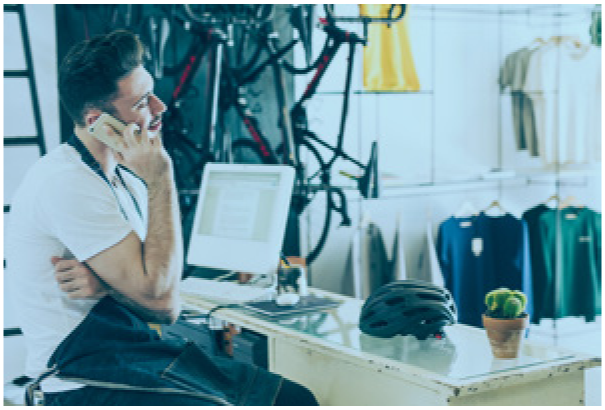
Guidelines for Collateral Assignments

Situation: Typically, this monthly publication focuses on technical life insurance concept information. However, this month we are taking a slightly different direction to describe how a collateral assignment of a life insurance policy can be used to help secure a loan from a bank or other lender.

Solution: Often, when trying to get a loan a lender will require life insurance. Many lenders require life insurance to secure a loan simply because it ensures they can collect if the person taking out the loan passes away. While this subject comes up with some frequency, I'm surprised at how many lenders and financial advisors are not familiar with the arrangement. So, we will start with an example of how adding a collateral assignment on a life insurance policy to secure a loan works.



Example. Mr. Business Owner went to his local bank to get a 10-year loan for $400,000 to fund the expansion of his successful business. As part of the loan arrangement the bank required that he make it the "beneficiary" of a $400,000 life insurance policy. The business was a second generation closely held operation that employed 10 people in addition to the owner. One employee was a long-time friend of the owner, who was "in charge" of the operation, and another was the owner's college age child who worked in the business during the summer. The owner netted $105,000 after expenses.

With the help of his financial advisor the owner applied for a $400,000 10-year term life insurance policy with the business as the owner and beneficiary. The financial advisor included a cover letter with the application that indicated that the stated purpose for the insurance was to liquidate the business debt and to leave funds in the business to provide a stay bonus to his close friend and operations manager to keep him working in the business in the event of the owner's death before the college age child was prepared to run the business. A collateral assignment form was executed at policy issue assigning an amount equal to the outstanding loan to the bank.

Eight years after the policy was issued Mr. Business Owner died in a car accident. At the time of his death he still owed $75,000 on the loan. The insurance carrier issued a check to the bank in the amount of $75,000 and the balance $325,000 was paid to the business.

Financial Underwriting Guidelines Limit Amount of Coverage.

The first point that a financial advisor must be aware of in acquiring a policy to cover debt is that carrier guidelines typically limit the face amount to between 60-80% of the outstanding loan. This is because carriers reasonably believe that the insured will not die, at least from a medical condition, for several years and they assume that during this time the loan will decrease.

* Not in the practice of law

Often financial advisors are surprised to learn that normally an insured cannot receive life insurance for the full amount of the loan solely based on covering a loan. However, it is possible to get coverage equal to the full loan by adding an additional need for the insurance. So, depending on whom the insured ultimately wants to benefit it might be possible to add a key person or survivor income insurance need on top of the desire to eliminate debt to qualify for the full coverage. In our example the insured had an additional need for insurance coverage, namely to provide a smooth transition by retaining a key person. By including a cover letter explaining the additional need for coverage it may be possible for a financial advisor's client to cover the full loan amount.

Lender or Investor It Makes a Difference. It's important to note that insurance carriers distinguish between lenders and investors. It's possible to get coverage to help liquidate business debts, but carriers will not insure an investor's risk of investment loss. So, carriers will want to know if there is an expectation of repayment verses acquiring an interest in a business.

Policy Structure: Who Should be the Insured, Owner and Beneficiary? The next point for an advisor to be aware of is that a carrier will demand an appropriate policy structure. Specifically, they will expect the insured to be the person whose death will either trigger the loan repayment or will materially impact the business's ability to repay the loan. Furthermore, carriers will typically reject an application where the lender is the owner or beneficiary. Carriers expect to see the business as the owner and beneficiary for a business loan and the insured as owner with the spouse/family the beneficiary for a personal loan. Instead of naming the lender as a beneficiary in either situation, carriers usually suggest use of a collateral assignment form because with a collateral assignment the amount of death benefit that a lender receives decreases as the loan amount decreases while a beneficiary designation may result in the lender receiving more death benefit than the amount of outstanding loan. The assignment form also prevents the policyholder from releasing the assignment without the consent of the lender. Thus, protecting the interest of the lender.

The Process of Obtaining a Collateral Assignment. The form can be provided by the insurance carrier, bank or drafted by client's legal advisor. When using a bank assignment form or one drafted by client's legal advisor the insurance carrier will want to approve the form before its use. Typically, the form is completed once the policy is active. The form is filed with the carrier and restricts the policy owner's rights until the assignment is released.

In Summary. A collateral assignment is a simple form that can be used in many situations. It is most often used when an insured wants to secure a loan, however, it may also come in handy when the objective is to restrict a policy owner's rights in a policy.