PREMIUM FINANCE:

The Solution You Didn't Know You Were Looking For

"Premium finance" is not a familiar term to most people, both inside and outside the insurance industry. If people have heard of it, they tend to think of it as a tool for making payments on a single payment life insurance policy. However, it can be an important tool for individuals and businesses to maintain insurance coverage while keeping their finances balanced.

Written by Karrie Hyatt

At its most basic, premium financing is a loan to pay insurance premium. It taps into the underlying value of insurance premium as a financial resource and can help the insured (also known as the policyholder) improve cash flow and preserve working capital. Premium finance companies facilitate this transaction with terms that won't tie up the assets of the insured.

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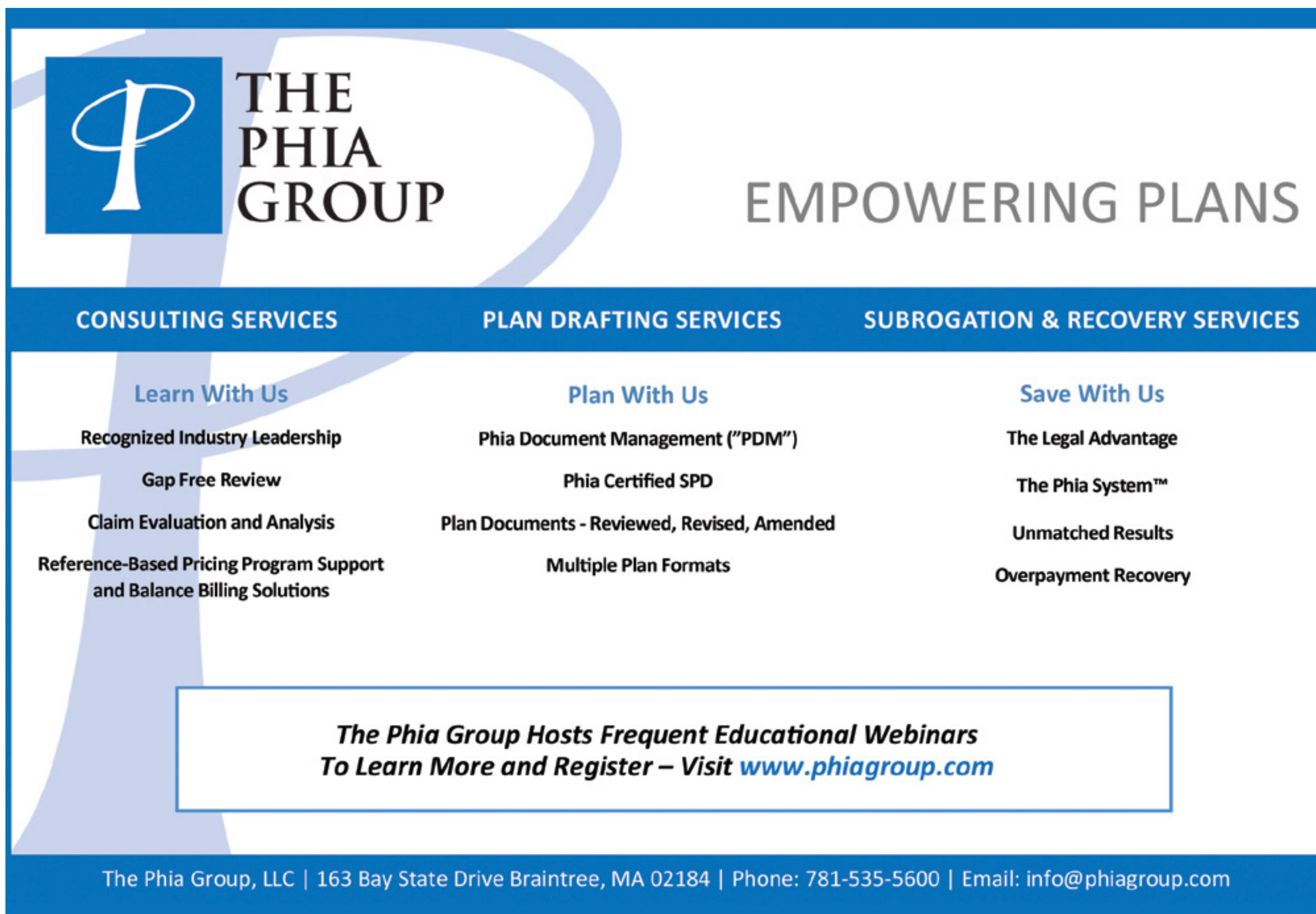


How does premium finance work?

The premium on insurance policies are generally due annually. For many insureds this can pose a financial difficulty by having to make a large single payment for their insurance premium. Many large insurers offer a payment plan for the premium—especially for non-business consumer insurance such as private passenger auto, boats, or similar policies—but for many property and casualty products premium is due in a single payment. The options for the insured to avoid this drain on cash flow are a bank loan or premium finance.

Rather than taking a loan out from a bank, when the policyholder takes a loan from the premium finance company, they make payments on their premium finance loan over the course of the year. Premium finance companies offer interest rates that are competitive with banks without the large fees for taking out a bank loan or requiring the completion of long loan application forms. All this without tying up the insureds assets through UCC form filings.

According to Dick Crnkovich, vice president with Imperial PFS (IPFS), the largest originator of insurance premium finance loans in the U.S., "It's a very simple and short process. The insured's agent or broker prepares the premium finance agreement (PFA) electronically. The policyholder reviews the PFA, signs it, and pays the down payment amount to their agent or broker. That's it, very easy. The agent or broker submits the PFA to the premium finance company for review and acceptance. Upon acceptance, the premium finance company funds the loan amount to the agent or insurance company and the transaction is complete."

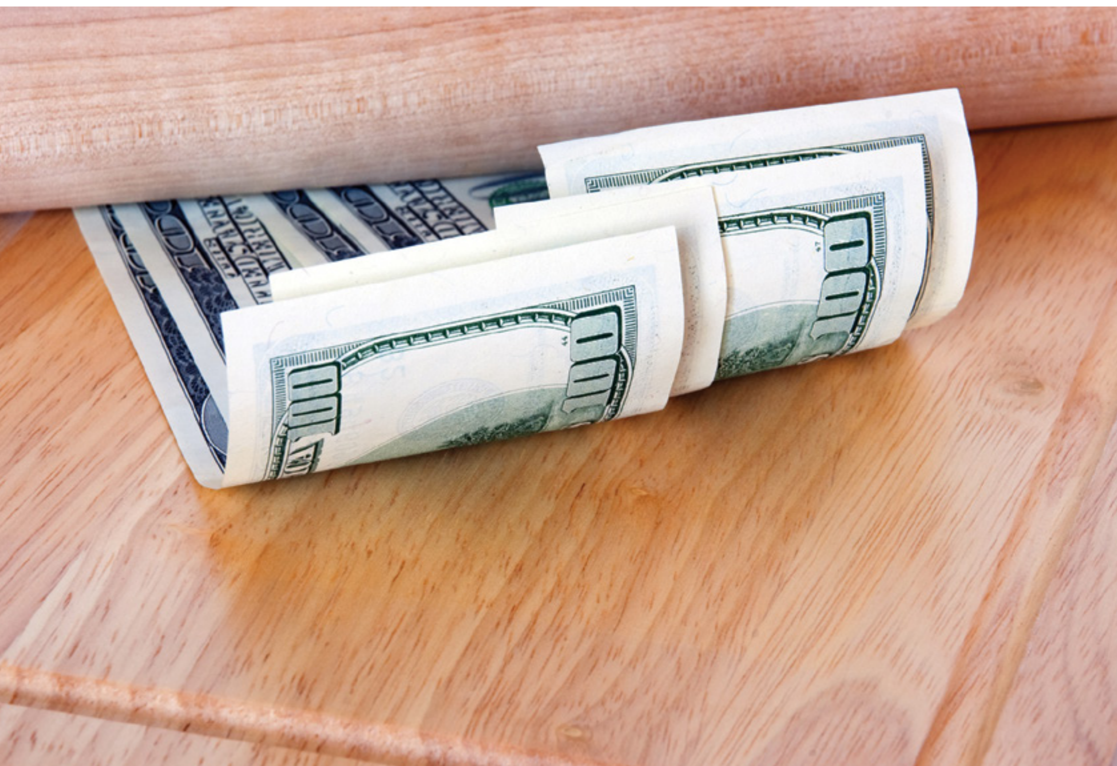
Many premium finance companies use propriety software that allows the agents and brokers they work with to generate the PFA in their office at the time the insured is obtaining or renewing their policies. It gives the insured the opportunity to choose between making a single payment for their policy or to take out a loan with a premium finance company.

Typically, a premium finance loan requires a down payment that is around 25 percent of the insured's annual premium, followed by a monthly payment plan to pay for the additional 75 percent. Different premium finance companies have different payment plans—some require quarterly payments and some allow for the loan to be paid monthly. Nine payments are the standard within the premium finance industry.

The premium finance agreement, while describing the terms and conditions of the loan, also, "Contains provisions wherein the policyholder grants the premium finance company a security interest in any return premiums on the policies financed and listed on the PFA, and a power of attorney to cancel the financed policies in the event of non-payment of an installment," said Crnkovich. This is basis of the premium finance business. By having the power of attorney to cancel a policy and retaining an interest in returned premiums, premium finance companies protect their interests. If a policyholder misses a payment on their premium finance loan, the premium finance company has the right to cancel the insured's policy. Upon cancellation, the insurance company sends any unused premium to the premium finance company in order to recoup their losses from the unpaid loan.

For many individuals and companies, premium finance can smooth out their cash flow and help them retain liquidity. Rather than having to make a one-time large payment that could negatively affect their liquidity, insureds can spread the payments over the year which can help to keep their cash flow balanced. This arrangement is especially good for companies or individuals whose business operates on month-to-month arrangement, such as physicians or trucking companies. These types of businesses don't get paid in large sums, but smaller sums every month as services are rendered. Premium finance can help to mitigate over-extension that a large single-payment may entail.

According to Crnkovich, *"The insured gets to smooth out the impact of the cost of insurance on their cash flow. It takes a lot of pressure off the policyholder to come up with a significant amount of money at the start of the policy."*



How does premium finance work for captives?

Like traditional insurance policies, premium finance can help the captive policyholder smooth out their cash flow and the PFA is issued in much the same way. "The primary difference in the captive insurance company market space versus the traditional insurance company market is the availability of financial information on the financial position of the captive insurance company," said Crnkovich. "Traditional insurance companies are required to report their financial information to the National Association of Insurance Companies (NAIC). The financial information reported to the NAIC is publicly available, whereas financial information on captives may not be available to the public." Premium finance companies review the creditworthiness of the insurance companies that issue the insurance policies they finance.

Premium finance can be especially useful for captive insurance companies as many of them won't have the resources to offer a premium payment plan to their policyholders. As Crnkovich stated, "Insurance companies are in the business of taking underwriting risk and settling claims while finance companies are in the business of making and servicing loans, including collecting installment payments. Insurance companies, captives, and RRGs can better serve their stakeholders by collecting premiums upfront and leaving the premium billing function to others."

Another reason it can be useful to captives is that the captive will get the entire premium amount at one time which allows the company to

use that money towards their operating expenses and investments. Most insurers, captive and traditional alike, prefer to have "the money in the bank" as it were than to have to anticipate collection of premium payments. For captives, especially, it means they aren't taking the credit risk, which can go a long way to enhancing their position as a legitimate insurer in the eyes of their regulator. Most captives utilize reinsurance to lower their net risk exposure and many reinsurance arrangements require upfront minimum and deposit premium payments to put the contract into effect. These large, upfront cash payments for reinsurance can be a huge burden on small- to medium-size captives.

Association captives and risk retention groups are key users of premium finance in the captive industry. Crnkovich is seeing pure captives and micro-captives making greater use the mechanism as well. For association captives and RRGs, and for that matter—all captives, credit risk can be a real concern, so it makes sense for captives to seek out premium finance and transfer the credit risk exposure to the premium finance company.

Why doesn't everyone use premium finance?

People need to know about premium finance, like any useful tool, before it can be used and it is still a relatively unknown sector. Crnkovich said, "Lack of knowledge about the availability of premium financing typically is the reason more captives are not using premium financing. As captives and their insureds learn more about the insurance premium financing option more are choosing this method to pay their annual premiums."

Many times captive owners just don't know that premium finance is even an option. Occasionally, captive managers aren't aware of it either. Many captive managers come from the accounting or legal side of insurance and may not be familiar with the front-end, hands-on side of the insurance business that is usually handled by agents and brokers. Premium finance companies, like IPFS, are working to change that through outreach and education. Premium finance can be an important tool for insureds, they just need to know about it first.

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years.
More information about her work can be found at: www.karriehyatt.com.

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