

The Leveraged Index Arbitrage Strategy

How to Leverage a Bank's Money to Frontload
an Indexed Universal Life Insurance Policy

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THE CONCEPT OF LEVERAGED INDEX ARBITRAGE

The concept of *Leveraged Index Arbitrage*TM is relatively simple, however there are some essential components that need to be designed properly in order for this strategy to work properly.

For the sake of this discussion, we will use an *Indexed Universal Life Insurance (IUL)* policy as the policy being financed.

Before discussing the *Leveraged Index Arbitrage*TM program, it is paramount to understand the inner workings of how an IUL works.

As a prerequisite to this discussion, I highly encourage you to read my whitepaper entitled *What Is An Indexed Universal Life Insurance Policy? – A Deeper Look Into The Mechanics of Using an IUL as Part of a Tax-Free Cash Value Accumulation Strategy*. In the above referenced whitepaper, the 0% Floor and 5-Point Market Shadow index crediting method is discussed, as well as the options packages the carrier purchases to create this policy crediting method.

Once you understand the value of using an IUL as a tax-free accumulation strategy, the next step is exploring the most advantageous way to fund it.

Typically, clients will pay annual premiums up until a certain age. If used to generate future tax-free retirement income, these premiums are paid until age 65 or 70, then the client will begin taking withdrawals up to basis, then policy loans above basis. The death benefit is often used to pay off the policy loans, thus the beneficiaries receive the death benefit net of policy loans.

Another way to design premium payments is to *short pay* the policy. In other words, some clients will compress the premiums into the first 5, 7 or 10 years.

From a cash accumulation standpoint, the advantage of doing this is pretty obvious.

The more cash you frontload into the contract, the more years that larger dollar amount has to compound from the very beginning. When this is done, the client would obviously have a substantially larger annual cash outlay in years 1-5 (assuming a 5-pay design) than if they spread the premiums over the course of 20 years for example.

If the client does not want to tie up the amount of liquid capital required to do a 5-pay, they could utilize *Leveraged Index Arbitrage*TM.

How The *Leveraged Index Arbitrage*TM Program Works

Let's explore the two different ways to fund an Indexed Universal Life (IUL) Insurance policy.

The Standard Funding option is to just pay the annual premiums for an extended period of time (20, 30, 40+ years for example).

The second option is to use the *Leveraged Index Arbitrage* strategy.

Option One: Standard Funding.

In this scenario, the client pays the \$291,168 annual premium each year over the course of 20 years, equaling a total of \$5,823,360 in premium paid. At the end of 40 years, assuming the last 40-years of the S&P 500 performance, the projected cash surrender value is \$28,153,464. The policy has an face amount (initial death benefit) of \$13,000,000.

INDEXED UL		
YEAR	AGE	PREMIUM
1	55	\$291,168
2	56	\$291,168
3	57	\$291,168
4	58	\$291,168
5	59	\$291,168
6	60	\$291,168
7	61	\$291,168
8	62	\$291,168
9	63	\$291,168
10	64	\$291,168
11	65	\$291,168
12	66	\$291,168
13	67	\$291,168
14	68	\$291,168
15	69	\$291,168
16	70	\$291,168
17	71	\$291,168
18	72	\$291,168
19	73	\$291,168
20	74	\$291,168
TOTAL PAID:		\$5,823,360
40-YEAR CASH VALUE*:		\$28,153,464
NET IRR*:		5.16%
\$13,000,000		
DEATH BENEFIT		

Option Two: Leveraged Index Arbitrage™

Using the *Leveraged Index Arbitrage™* program, the client pays a first-year premium of \$1,000,000, then the bank frontloads the policy with \$1,384,446 annually in years 2-7.

The client then pays interest-only payments to the bank each year on the \$8,306,676 cumulative loan balance.

We see the interest payments stop in the 15th year because the client pays off the \$8.3 million loan in the 15th year using the policy cash surrender value.

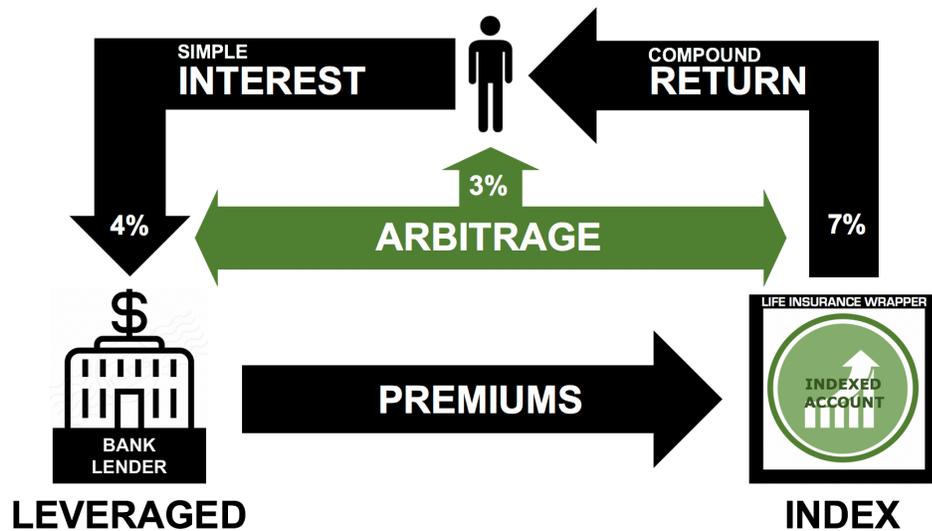
LEVERAGED INDEX ARBITRAGE				
PREMIUM PAID	PREMIUM BORROWED	CUMULATIVE LOAN AMOUNT	INTEREST RATE	INTEREST PAID
\$1,000,000				
	\$1,384,446	\$1,384,446	5%	\$69,222
	\$1,384,446	\$2,768,892	5%	\$138,445
	\$1,384,446	\$4,153,338	5%	\$207,667
	\$1,384,446	\$5,537,784	5%	\$276,889
	\$1,384,446	\$6,922,230	5%	\$346,112
	\$1,384,446	\$8,306,676	5%	\$415,334
			5%	\$415,334
			5%	\$415,334
			5%	\$415,334
			5%	\$415,334
			5%	\$415,334
			5%	\$415,334
			5%	\$415,334
			5%	\$415,334
				\$0
				\$0
				\$0
				\$0
				\$0
TOTAL PAID:				\$5,776,339
40-YEAR CASH VALUE*:				\$44,432,359
NET IRR*:				6.28%
\$20,000,000				
DEATH BENEFIT				

In addition, the interest-only payments are similar to the cash premiums the client would have paid over 20 years for example, yet both the cash accumulation and the death benefit are substantially larger for the client, all made possible by leveraging the bank's money.

2. **Indexed Account.** The value of the 0% protective floor of the Indexed Universal Life (IUL) Insurance policy ensures that the creates a zero-loss environment for the cash value to grow.

Again, to fully understand how this 0% protective floor is created, refer to my whitepaper entitled *What Is An Indexed Universal Life Insurance Policy? – A Deeper Look Into The Mechanics of Using an IUL as Part of a Tax-Free Cash Value Accumulation Strategy*.

Arbitrage. *Positive Interest Arbitrage* occurs when the client's annual interest payment is less than the IUL's annual gain. In other words, if the client borrowed at a rate of 4.00%, and the policy credited 7.00%, there would be a positive interest arbitrage of 3.00% (7.00%-4.00%=3.00%).



But in addition to the *Positive Interest Arbitrage*, another key component to understand is the difference between *Simple Interest* and *Compound Interest*.

For example, if the client borrowed a total of \$2,000,000 and the borrowing rate was 4.00%, the client's annual interest-only payment would be \$80,000.

$$\begin{array}{r}
 \$2,000,000 \text{ loan} \\
 \times \quad 4.00\% \text{ borrowing rate} \\
 \hline
 \mathbf{\$80,000 \text{ interest payment}}
 \end{array}$$

But let's assume the borrowing rate increased to 7.00%. The client's annual interest payment would now be \$140,000.

$$\begin{array}{r}
 \$2,000,000 \text{ loan} \\
 \times \quad 7.00\% \text{ borrowing rate} \\
 \hline
 \mathbf{\$140,000 \text{ interest payment}}
 \end{array}$$

Let's assume the net compounded annual growth rate of the policy's cash value was a paltry 4.00%. Over a 20-year period, the cash value would have grown to \$4,382,246.

Let's also assume that in the 21st year of the policy, the index credited 4.00% again. A net 4.00% gain on the \$4,382,246 is \$175,290 gain in that year.

$$\begin{array}{r}
 \$4,382,246 \text{ policy cash value} \\
 \times \quad 4.00\% \text{ index crediting rate} \\
 \hline
 \mathbf{\$175,290 \text{ interest payment}}
 \end{array}$$

In this one-year scenario, even without a *Positive Interest Rate Arbitrage* (where the 7.00% borrowing rate was greater than the policy's 4.00% crediting rate), the client would still experience a \$35,290 net gain in that year.

4.00% policy cash value gain	\$175,290 policy cash value gain
<u>-7.00% borrowing rate</u>	<u>-\$140,000 interest payment</u>
-3.00% negative interest arbitrage	\$35,290 positive dollar arbitrage

Bank Lending Parameters

Lionsmark Capital has five lenders that facilitate our lending program. All five lenders are publicly traded banks. Three are regional banks, one is national and one is international. None of our lenders have capacity issues and based on the size of the loan and location of the client, Lionsmark Capital will appropriately place the client with the appropriate lender.

Our loans are based on the 12-Month U.S. Treasury Daily Yield Curve (USTDYC) instead of Prime or LIBOR. Once the loan is in force, the USTDYC rate is locked in for 13-months. Our lenders then add a spread on top of that base rate, dropping their spread 25 basis points after the borrowed premiums have been seasoned for 12 months.

We will not be beat when it comes to lending rates.

No Collateral Calls, No Personal Guarantor Requirements and Loan Recourse Solely Limited To The Policy

The design of the policy creates a 95/5 LTV ratio that has been approved by our five lenders and allows the policy to serve as the sole collateral. We do not use any high-early cash value riders to accomplish this, nor do we spread agent commissions.

Many of our competitors use these gimmicks, which are all unnecessary in our design. Due to the policy sufficing as the sole collateral, there are no client personal guarantor requirements and no personal guarantor requirements, which by definition results in the financed premium loans being non-recourse to the borrower.

To discover how we accomplish this, you may request an apples-to-apples comparison with one of your clients (you may redact the names for privacy purposes if you prefer), or you may request a preview of some of our case studies.

Lastly, the design of our policies virtually guarantees that the client shall never receive any collateral calls even if the S&P 500 has negative returns in the first three years of the policy and the policy credits 0% in these first three years.

Every client is obviously different, however the vast majority of clients may qualify for the parameters articulated above.

Policy Funding Design

In the *Leveraged Index Arbitrage™* program, the client pays a significant first-year premium out of pocket. Traditionalists in the premium financing space will often times balk at this idea, arguing that doing so negates the power of leverage.

This is a very ignorant stance because based on the way Lionsmark Capital designs our policies, the first-year premium is almost always less than the amount of collateral the client is required to post in a traditionally premium financed policy.

The first-year premium paid out-of-pocket allows the policy's CSV to get a "head start" so that when we load in financed premiums starting in year 2, the CSV is scheduled to be a minimum of 105% of the principal loan balance, not only in this year, but on a move-forward basis, even if the S&P 500 has negative returns in the first three years of the policy and the policy index credits 0%.

Essentially, in our design, the "non-collateral collateral" is sitting inside the policy instead of a low-to-zero returning collateral account. Those that do not understand nor subscribe to our methodology clearly do not fully believe in the IUL chassis with the 0% floor.

Carriers like our methodology for several reasons.

One, the client has more "skin in the game" by paying a substantial first-year premium out-of-pocket.

Two, the fact that the financed premiums begin in the second year gets the policy closer to being outside the carrier's "two-year contestability period," which reduces both early policy lapses and negative PR issues in regards to premium financing that may fall on the carrier in the future. And three, paying the first-year premium out-of-pocket further

substantiates the client's credit-worthiness, solvency and suitability for premium financing.

Carrier Partners

Lionsmark Capital's *Leveraged Index Arbitrage™* program can be used with eight (8) different carriers. We only use A-rated carriers that are approved by our lenders in our program. To find out more about which carriers have products that work well with our program, contact us for a detailed conversation.

Loan Underwriting

We can typically secure a lending package for the client within five business days. In the *Leveraged Index Arbitrage™* program, the policy serves as the sole collateral and its CSV is required to be an amount greater or equal to 105% of principal loan balance at all times. Hence, the lender is really underwriting the strength of the carrier and the secured CSV of the policy more so than the borrower.

As a formality, our lenders require 2-years tax returns and a *Personal Financial Statement (PFS)* to be signed by the client (each lender has their own version of a PFS), however the profitability and balance sheet of the client is not taken into consideration for loan underwriting. The lenders are solely evaluating the carrier and the design of the policy, for they require to be 105% secured at all times, solely based on the policy's CSV.

At the annual loan renewal each year, the client will need to submit either their most recent tax return OR proof of filing an extension. Again, this is more of a formality and is not taken into consideration for loan renewal approval. It is the policy's CSV position that is being evaluated each year by the lender.

Quantifiable Superior Performance

Returns are more than double a 70/30 equity-to-bond ratio managed fund in any 40-year period in the history of the S&P 500, using an all-in investment fee of 1.35%.

Drop the fee to 27-basis points using a 100% S&P 500 correlated fund, and the *Leveraged Index Arbitrage™* program's 40-year outcome is about the same during a hypothetical 40-year period using 1980-1999 S&P 500 returns run back-to-back (creating a hypothetical 40-year period). During this period, the S&P 500 CAGR was 17.99% (not including dividends).

Other than this 40-year period of time, the net returns of the *Leveraged Index Arbitrage™* program are more than double compared to the hypothetical S&P 500 correlated fund.

Both of these examples above assume a 65-year old male client (not exactly a spring chicken) with a Preferred Non-Tobacco health rating.

Stress Testing & Historical Backtesting

Lionsmark Capital is the only firm in the premium financing sector that breaks down the annual *Total Policy Cost (TPC)* of life insurance policies and transparently shows the drag that such costs have on the cash value IRRs on a year-to-year basis.

We are also the only firm that illustrates actual/historical stress-tested time periods that include volatility, displaying several detrimental sequence-of-returns periods, using the years 2000, 2001 and 2002 as the first three years of the policy when the *TPCs* are the highest and create the most impactful negative drag on returns.

Most firms that stress test their designs use a static policy credit assumption (albeit a low assumption, say 3.85% for example), however this static policy credit does not take into account volatility nor negative sequence of returns, thus showing the client a stress-tested model that is not very stressful.

Lionsmark Capital uses a combination of historical periods that have actually happened to illustrate real scenarios. We also have the ability to model virtually any other alternative investment or life insurance policy (financed or non-financed) to show an apples-to-apples comparison of performance and cash value accumulation. Often times, our stress-testing modeling causes the majority of our premium financing competitors' designs to result in policy lapses.

Ultimate Transparency

Our software illustrates five different 40-year back-tested periods using S&P 500 performance (not including dividends), including:

1. The last 40 years (S&P 500 CAGR during this time was 11.86%)
2. The last 20 years x2 (S&P 500 CAGR during this time was 7.17%)
3. The best 20-year period (1980-1999) x2 (S&P 500 CAGR during this time was 17.99%)
4. The worst 10-year period (2000-2009) x2 (S&P 500 CAGR during this time was -0.99%)
5. 2000-2009, then the last 20 year period, then 2000-2009 (S&P 500 CAGR during this time was 3.01%)

These time periods illustrate volatility and various sequences of returns to showcase the value of the IUL chassis and crediting method. No other premium financing intermediary has software that is able to illustrate these models, applying the client's actual proposed policy to these back-tested periods. If you want your client to experience ultimate transparency

and you want to mathematically prove the financial outcome of the *Leveraged Index Arbitrage™* program compared to ANY other alternative investment or life insurance policy (financed or non-financed), Lionsmark Capital is the ONLY premium financing intermediary that has the ability to do so.

We are not just considered *Best Of Class* in this regard. We are literally the ONLY one in this regard.

Superior Point-Of-Sale Services

Not only does Lionsmark Capital secure the lending resources, design the policy illustration, import it into our software which generates the back-tested modeling and stress-tested proposal, we also assist in the point-of-sale process.

The agents/advisors that we do joint work with may either bring the client to our office in Irvine, California or we can screen share to present the proposal to the client. The ability for our software to change variables on-the-fly (ie: loan interest rates, early loan payoff, income drawdowns, etc.) exponentially increase efficiencies and compress the sales cycle dramatically.

If the client wants to see adjustments made to the overall plan, our software allow us to make those adjustments right there on the spot, rather than having to redesign and reschedule consecutive meetings booked a week out, which can prolong the sales process, often times resulting in a non-sale.

Our process is nimble, efficient and most of all, fully transparent to the client. For executing this process, we take 33% of the agent commission as our “fee” with no additional hidden fees.

Loan Renewal Process

Our premium financing loans are on 13-month cycles which allows the policy to receive its index credit PRIOR to the loan renewal date.

Upon the annual renewal of the loan, this allows the lender to see the policy’s cash surrender value AFTER the index receives its annual credit (assuming an annual point-to-point crediting method). This is important (and unique) because the CSV of the policy is factored into the annual collateral requirement, which is often times none. There is no other premium financing intermediary that has this type of loan cycle.

Each year, the client submits last year’s tax return OR proof of filing an extension. Our lenders solely evaluate the structure and CSV of the policy to determine renewing the loan, and based on the initial design of the policy that has already accounted for 0% index credits for the first three years of the policy, the likelihood of the CSV not meeting the required 95/5 LTV is virtually impossible. However in the virtually impossible scenario

that the lender does not renew the loan, we have four other lenders in our stable that step in.

Do The Math

At Lionsmark Capital, our campaign slogan is #dothemath.

We have the ability to model various products and compare performance during various historical periods to mathematically prove which products perform better in different market conditions.

The best 20-year period for the S&P 500 was 1980-1999 where the average annual return was 18.59%.

We also created the worst hypothetical 20-year period, stacking the worst actual 10-year period back-to-back. During this period (2000-2009), the S&P 500 produced a 1.21% average annual return.

We have run comparative analyses during each of these periods showing the comparison between the Premium Financed IUL and:

1. Managed Investment Accounts
2. Non-Financed Policies
3. Whole Life Policies
4. Buy Term & Invest The Difference Strategies
5. 401(k) & IRA
6. Roth IRA
7. Various Annuity Types (Fixed, Variable, Indexed)

We highly encourage you to go through this process with us, comparing the real math.

FREQUENTLY ASKED QUESTIONS

Why does the bank NOT require the owner of the policy (or the owner of the company if a company-owned policy) to personally guarantee the loan?

105% of the cumulative loan balance is collateralized against the policy's cash value. We design the policy to have a cash value amount that meets the bank's 95/5 LTV in the second year of the policy, assuming a 0% return in the index's crediting method in that year. Hence, there is no bank requirement for the policy owner to be a personal guarantor on the loan.

How does the loan affect the borrower's credit?

Because the policy owner is not a personal guarantor on the loan, it does not affect their personal credit. The loan is not recognized when calculating their debt-to-income ratio (DTI) and does not impact their ability to qualify for any other personal loan (ie: mortgage loan, etc).

Why is the bank willing to issue a nonrecourse loan in this program?

The design of the policy is the key determining factor. The policy's cash value must show a 95/5 LTV (loan-to-value ratio) in the second year of the policy. The bank takes a collateral assignment against the cash value of the policy based on the outstanding cumulative loan amount. There is no additional collateral requirement because 105% of the cumulative loan is sitting inside the cash surrender value of the policy.

What is the loan rate based on?

Currently, our lenders use the 12-month U.S. Treasury Daily Yield Curve as the base rate. The bank adds a 2.50% spread on the first year of borrowed money, then reduces the spread to 2.25% after the first year.

What if loan interest rates rise?

We are clearly in a low-interest rate environment right now. If we track the U.S. Treasury Daily Yield Curve back 20 years from 2017, it decreased at a compounded annual rate of 5.31% between 1996-2017.

In our hypothetical modeling calculations, we always show an example of rates increasing 8% per year.

We show this 8% annual increase for the first 10 years, then a deescalating 10% per year for 10 years, then escalating 10% for 10 years, then deescalating 10% again for 10 years.

Comparing the out-of-pocket outlay in this unrealistically adverse circumstance to a traditional investment account with a 0% investment fee, 100/0 equity/bond ratio, and 100/0 LTCG/STCG tax ratio, the premium financed strategy utilizing our unique banking relationships beats the managed account in every single 20-year and 40-year historical run. This is not opinion or philosophy. This is a mathematical fact.

Why is the bank so confident in the insurance carrier's ability to perform in regards to the crediting method they use in their Indexed Universal Life product?

The carrier utilizes a bull-call spread strategy which the 0% protective floor is based upon. For a more comprehensive explanation of how the carriers construct this product in regards to how they buy options packages in the options market, I highly recommend you reference my whitepaper entitled *What Is An Indexed Universal Life Insurance Policy? – A Deeper Look Into The Mechanics of Using an IUL as Part of a Tax-Free Cash Value Accumulation Strategy.*

Are the interest-only payments to the bank tax-deductible?

Before I address this question, let me clarify that I am not a licensed CPA or tax planning professional, thus my answer is not intended to give any tax advice nor imply whether or not a client should deduct the interest payments to the bank.

That being said, the section of the IRS tax code that addresses this issue is *Title 26 – Internal Revenue Code § 264.*

This tax code states that the general rule is that no deduction is allowed for life insurance premiums or interest payments associated with financed premiums. However, the tax code spells out very specific exceptions to this general rule, one of which is if the policy is owned by a business.

If a client owns 20% or more of a business, our *Leveraged Index Arbitrage* program typically structures the bank loan between the bank and the insured person's business. Ultimately, it is still advised to consult your CPA or tax planning professional in regards to interpreting this tax code and the exceptions that allow the tax-deductibility of interest payments on such a loan. We offer our firm as a resource to discuss our program with your tax professional so they understand how the loan is structured and how to apply this tax code's parameters to this unique program.

That being said, it is common that many CPAs and tax planning professionals (due to their limited knowledge regarding Premium Financing) will misinterpret the tax code and its references to exceptions. Our goal when working with CPAs, estate planning attorneys and tax attorneys is to assist them in fully understanding this fundamental difference within life insurance nomenclature and how IRS tax code § 264 applies to Premium Financing and the tax deductibility.

For a full explanation of our interpretation of this tax code, reference the whitepaper entitled *Tax Deductibility of Premium Financed Interest Payments*.

What Makes Lionsmark Capital's Program So Unique?

There are several elements in our *Leveraged Index Arbitrage* program that are proprietary to Lionsmark Capital.

1. Client does not need to be a personal guarantor on the *Leveraged Index Arbitrage* loan.
2. The loan is not reported to the credit bureaus and has no effect on the client's personal credit score or DTI (Debt-To-Income ratio).
3. There is no additional/outside collateral posting requirement.
4. Underwriting the loan can be executed in one week.

Each of these proprietary items may be discussed with a Lionsmark Capital representative to find out if this *Leveraged Index Arbitrage* strategy is right for you.