

Loan Protection – A Case Study

Most businesses appreciate the value of using “someone else’s money” to fund their growth. It follows then that ambitious business ventures will often have “extensive” borrowings. On the other hand, the borrowings may appear “modest” against the assets or turnover of the business. The question arises; ... if the business assets more than outweigh the liabilities, is it worth diverting hard won cash flow into a risk management program?

To a certain extent, the answer can be found in the following account of two friends who died in a light plane crash – both were successful businessmen who had each acquired assets to supplement their incomes and to compliment their lifestyles. Both owed substantial sums of money. Their loans however were comfortably backed by a diversity of business assets, investment properties, farms, racehorses, and holiday houses.

Interestingly, only one had implemented a loan protection program. Mark took the view that he should own enough life insurance to cover all his debts. Considerable as his debts were, he felt that the premiums for his \$5 million program were not unreasonable. He had purchased four covers over the years and at the date of his death, was paying premiums at the rate of just under \$10,000 per year.

His friend Tom had quite a different philosophy. He too had debts in the vicinity of \$5 million, but his assets were perhaps worth \$10 - \$15 million.

He had thought about insurance but always argued that his business would do just fine if he died. The family home was debt free, and at the very worst his estate could sell up some business assets and have \$5 million in cash.

Following his death, Tom’s estate set about selling \$5 million of assets. It sold a couple of investment properties, and many of the shares in his portfolio. Obviously, the estate didn’t have the luxury of waiting until the markets were booming. From the sale proceeds, the executors had to pay estate agents’ and stockbrokers’ fees. In addition, the banks imposed various charges for early loan repayment. All up, the \$5 million of asset sales netted enough to reduce debts by only \$4.7 million. After due consideration the executors of the estate had to make additional asset sales to raise a further \$300,000. At the end of the day, the cost of raising \$5 million was \$5,320,000.

Mark’s estate on the other hand had the benefit of the proceeds from his loan protection program. No asset sales were necessary, and the business continued to thrive, thanks largely to this injection of cash. His family continued to look forward to their holidays at the beach, the snow, or the farm depending on their wishes. Mark was 48 when he died, and started establishing his covers at age 25.

He had progressively purchased a total of \$5 million of protection. He had spent about \$40,000 in premiums, and his estate received a \$5 million payout. You could say his estate got his \$40,000 back in full, plus a further \$4.96 million for free.

The premium for this loan protection program might seem quite high! Yet the size of the outlay is always quite small in relation to the size of the problem. Mark owed his bankers \$5 million and was paying, on average, about 8% interest on his money. The premiums amounted to around 0.2% of the total debt. If you could ask Tom today (the one without the cover) if he would have still borrowed all that money had his bank charged 8.2% instead of 8% he would probably say yes. It follows that while he was alive he might have considered a proposition wherein he paid the bank 8% and the other 0.2% for a loan protection program, for the comfort of knowing that his debts would die with him.

For further information please contact:

Melbourne Office

Paul Greenwood

Director – Private Clients

E-mail: pgreenwood@certainty.com.au

Sydney Office

Terry Dickens

Director

E-mail: tdickens@certainty.com.au