ADVANCED PLANNING

Rising interest rates and their impact on collateralized lending:

HOW THE MIRRORED LOAN STRATEGY MAY HELP

When unexpected expenses arise, clients in need of liquidity have different options from which to choose. Historically, a line of credit had been an appealing source of funds, as they allowed access to loans at what were often favorable interest rates.

Lines of credit typically need to be secured by collateral, and life insurance policies could be leveraged for this purpose. Clients could often access these lines of credit at lower rates than other options, such as taking a loan out of their life insurance policy.

CREDIT LINES IN TODAY'S INTEREST RATE ENVIRONMENT

In a low interest rate environment, lines of credit could be even more attractive because they typically have minimal closing costs or fees beyond the interest rate. However, today's interest rate environment looks significantly different.

The ten-year Treasury has gone from 0.55% in mid-2020 to 4.72% in October 2023. Many clients have felt the negative impact in the rise in rates on loans, such as their mortgages or student debt.

But these changes also affect lines of credit, such as the ones where a life insurance policy may have been used as collateral, as they are generally subject to variable loan interest rates. What was once a situation where clients were realizing positive arbitrage, given the performance of their life insurance policies, has quickly flipped.

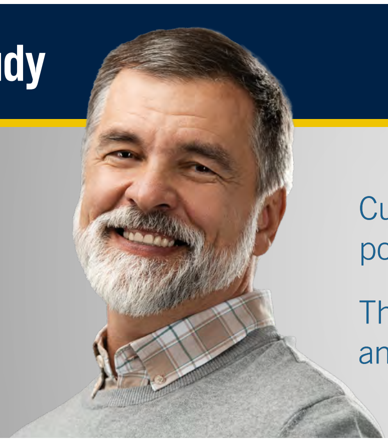
In light of a higher interest rate environment, review clients' current plans

Under current market conditions, review these types of arrangements with clients to determine if they still offer any benefit to their overall plans. As part of a review, clients should consider their various options, including:

- **Repaying the line of credit out-of-pocket** to avoid payments subject to higher interest rates.
- **Surrendering a life insurance policy used as collateral to repay the lender.** Clients need to understand that embedded gain in the policy would cause taxation upon surrender at ordinary income tax rates, as well as a loss of death benefit coverage.
- **Continuing to pay interest on the line of credit.** This could result in an ongoing outlay, increasing dramatically over time. In recent years, a common interest rate range was 3 – 4%; today, prevailing rates are more like 7 – 8%, representing an increase of two to three times cost. Interest payments are often due monthly.
    - Clients should also consider the ongoing performance and premium commitment to their life insurance policies, as that will have an impact that may be positive or negative.
- **Taking a loan from the life insurance policy to repay the lender.** An inforce illustration should be requested to determine the impact. A 1035 exchange to a new policy could also be explored through this route; this may not have been possible while the life insurance policy was collaterally assigned.

Prudential

Case Study



Currently, Steve, age 58, has a whole life insurance policy with a $3 million cash value.

The death benefit is now $4.25 million and the basis is $800,000.

Seven years ago

Steve made a large investment in real estate, utilizing a line of credit. His life insurance policy was used as collateral.

Today

The amount owed to the lender is $2.8 million, secured through a collateral assignment against Steve's life insurance policy. Steve's line of credit has a variable interest rate that has recently increased from 3% to 7%. This increase raised his annual interest owed from $84,000 to $196,000, with accrued interest payments due monthly.

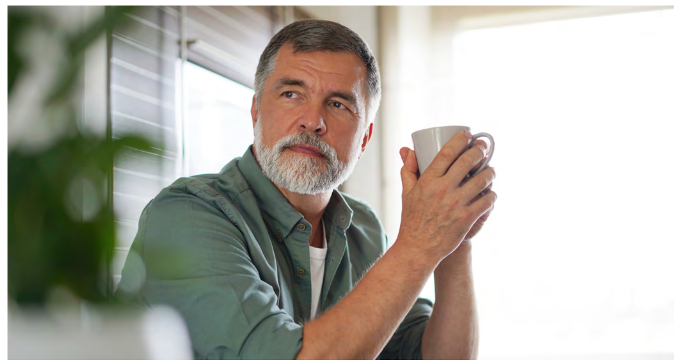
Steve does not wish to pay the higher interest payments; not increasing his outlay will cause the line of credit balance to exceed the value of his policy. Consider the options:

- Steve does not have the means to repay the line of credit out-of-pocket.
- Surrendering his policy to repay the lender will trigger $2.2 million of gain, taxed as ordinary income, leading to an expected $880,000 federal income tax payment and no life insurance coverage.
- Loan rate on his current life policy is 7.4%; utilizing a policy loan to repay the bank loan does not materially change his expected outcomes.
- A loan could be taken from his current life insurance policy to repay the lender and a 1035 could subsequently be executed to a new life insurance policy. The new policy may offer favorable loan interest rates and can be designed with Steve's specific scenario in mind.

Addressing Steve's concerns with a new policy

Steve's financial professional determines that he has the appropriate risk tolerance for variable investing, so a strategy using PruLife® Custom Premier II is proposed. In the scenario, the new contract can only support a loan of $2.75 million. To satisfy his obligations, Steve will need to repay the lender $50,000 out-of-pocket, on top of a $2.75 million loan from the existing life insurance policy, as agreed upon by the lender.

Once this is completed, Steve can then execute a 1035 exchange to his new life insurance policy, where the loan is mirrored on the new contract.



Going forward, Steve will pay the interest on his life insurance policy's loan out-of-pocket. In years 2 – 11, that will represent an annual $55,000 outlay; starting year 12, the annual outlay will would be $28,875.

This represents a significant decrease from $196,000 in annual interest Steve would be expected to pay if he were not to take any action. The mirrored loan strategy helps Steve achieve his primary goal of lowering his cash outlay. Steve's death benefit will be lower on the new life insurance policy than it had been in the old one. However, if this becomes a concern, Steve may consider purchasing an additional life insurance policy to increase his death benefit protection using the savings.

NET DEATH BENEFIT YEAR 1: **$1,939,635**

NET DEATH BENEFIT YEAR 20: **$1,357,675**

NET DEATH BENEFIT AGE 90: **$1,259,658**

Proposed policy assumptions: PruLife® Custom Premier II, male, age 58, Non-Smoker Plus, 100% Fixed Rate Option with non-guaranteed results based on Fixed Rate of 3.5% and current charges, Death Benefit option B for the first seven years, and then Death Benefit option A thereafter. This hypothetical example is for illustrative purposes only. Actual results will vary.

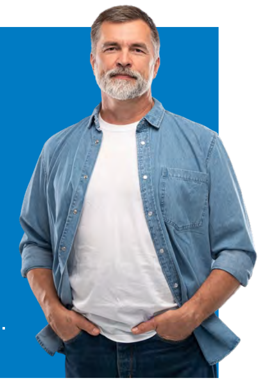
The above hypothetical example assumes nonguaranteed rates and current charges. It is necessary to assess how the policy performs under 0% return assumptions and maximum insurance charges; the policy lapses in the first year.

How the strategy worked for Steve

Before

The interest rate on Steve's $2.8 million loan secured by his life insurance policy recently increased from 3% to 7%. He was looking for strategies to help lower his annual outlay, as he does not want to pay the higher interest payments, so Steve reached out to his financial professional.

Step 1



After reviewing his options with his financial professional, Steve decided to take a $2.75 million loan from his existing life insurance policy, as agreed upon by the lender, to repay his loan obligation. In addition, he also paid $50,000 out-of-pocket toward the loan.

Step 2

With the help of his financial professional, Steve completed a 1035 exchange to a new Custom Premier II policy, mirroring the remaining loan on the new life insurance contract.

The Outcome

Steve maintained death benefit coverage of $1,939,635 and will pay annual loan interest payments of $55,000 (decreasing to $28,875 after year 11). This represents a decrease of over $140,000 in interest owed by Steve annually.

Prudential Requirements

Prudential has established the following guidelines governing 1035 exchanges with mirrored loans to ensure suitability:

- The new policy must have a minimum net cash value of $25,000.
- The gross cash value, after transfer, must create enough immediate net surrender value to mirror the loan and place the new policy in force.
- All 1035 exchanges with mirrored loans require underwriting approval.
- The client must call Prudential Customer Service (800-782-5356, Option 0) to request a withdrawal in a subsequent year (as early as year two) to repay the loan using the new policy's cash value. Initiating a withdrawal may trigger surrender charges and reduce the policy's death benefit. A withdrawal may generate taxable income.

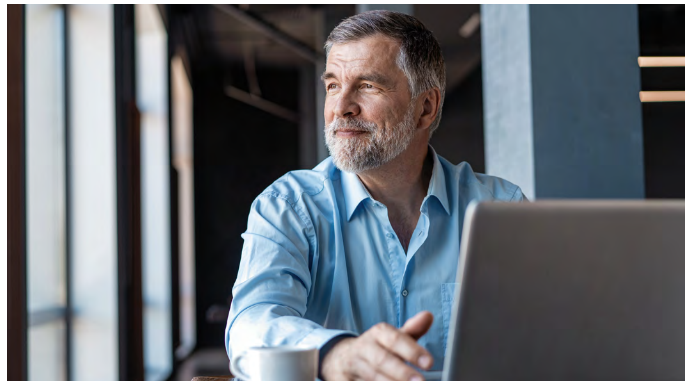
Considerations

- A 1035 exchange of an existing policy with a mirrored loan is not for everyone.
- If the loan is not mirrored on the new policy in the 1035 exchange, the client may incur taxes.
- The long-term impact of the loan that is mirrored on the new policy must be considered.
- It will be necessary, in most cases, for the policyowner to repay the loan in year two or later. The cash value, if sufficient, may be used to repay the loan, or funds outside of the policy can be used to repay the loan. If the loan is not repaid, the policy performance must be reviewed on an ongoing basis to consider options that can help ensure against lapse. If the policy is owned by a trust, transfer taxes must be considered when repaying the loan.
- Policy loan repayment is not automatic. Please work with clients to monitor repayment, as well as policy performance.
- In order for the loan to be repaid, the client must call Prudential Customer Service (800-782-5356, Option 0) to request a withdrawal to repay the loan using the new policy's cash value. Initiating a withdrawal is likely to trigger surrender charges and will reduce the policy's death benefit. A withdrawal may generate taxable income.
- 1035 exchanges may be subjected to policy surrender charges and may have tax consequences.

Where there is a reduction in benefits with an associated distribution on a non-MEC life insurance policy in the first 15 years, the recapture rules under Code Section 7702(f)(7) may be triggered. In those circumstances, the normal non-MEC tax rules do not apply and the cash distributed may be taxable to the extent of gain. Clients should consult an independent tax advisor prior to making changes to a policy.

RELY ON PRUDENTIAL TO HELP MEET CLIENTS' NEEDS

There are many clients with similar situations to Steve's. Consider reviewing their existing coverage and loan arrangements to determine the effects that the rising interest rate environment may have on their plans.



Prudential's Advanced Planning team has the experience to help you successfully address a client's unique needs, and design strategies that can help address their personal situations.

Call Advanced Planning at 800-800-2738, Option 4 for help with your next case.

PruLife Custom Premier II is issued by Pruco Life Insurance Company in all states except New York, where it is issued by Pruco Life Insurance Company of New Jersey and offered through Pruco Securities, LLC (member SIPC). All are Prudential Financial companies located in Newark, NJ.

Clients should consider the investment objectives, risks, and charges and expenses carefully before investing in the contract and/or underlying portfolios. The initial summary prospectus for the contract and the prospectus or summary prospectus for the underlying portfolios (collectively, the "prospectuses") contain this information as well as other important information and may be obtained by contacting your Prudential Life Wholesaler or from prudential.com. Clients should read the prospectuses carefully before investing.

All guarantees and benefits of the insurance policy are backed by the claims-paying ability of the issuing insurance company and do not apply to the underlying investment options. Policy guarantees and benefits are not backed by the broker-dealer and/or insurance agency selling the policy, nor by any of their affiliates, and none of them makes any representations or guarantees regarding the claims-paying ability of the issuing insurance company.

We do not provide tax, accounting, or legal advice. Clients should consult their own independent advisors as to any tax, accounting, or legal statements made herein.

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