Should I Capitalize Interest Or Not?

Most traditional Premium Finance programs require the client to pay full interest on the loan whereas many (but not all) of NIW's designs capitalize interest. Why does NIW use a different approach? Could it be that the prevailing approach is wrong?

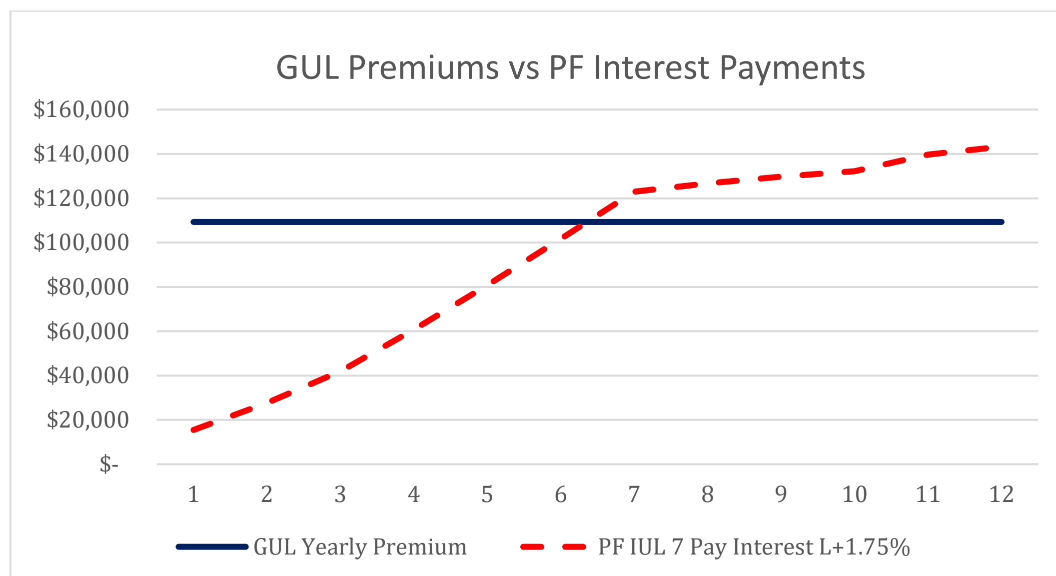
Capitalizing interest ultimately means rolling the interest into the loan, which has advantages and disadvantages over paying for the interest out-of-pocket. When designed correctly, NIW finds that most of the time clients prefer the interest on financed insurance cases to be capitalized. However, the right conditions must be met because there are multiple situations when this is not possible or recommended.

Paying the interest into the trust has historically been the norm for premium finance cases. However, this method comes with the price of gift taxes, opportunity costs, and fees associated with liquidating assets.

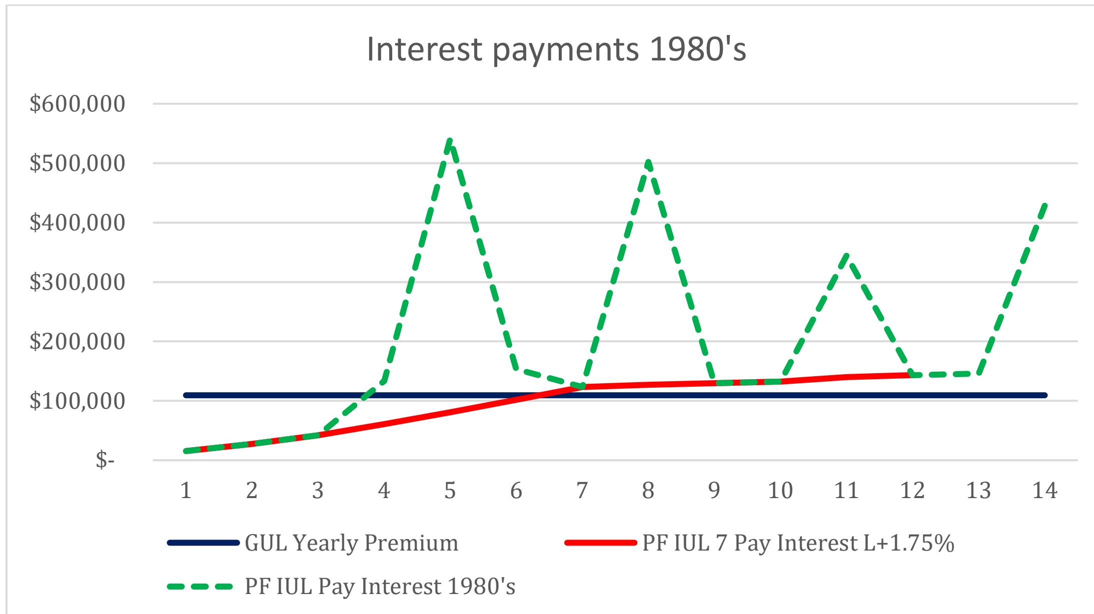
The problem of paying interest out-of-pocket is circular. Many programs rely on the cash accumulation of the life insurance policy to pay off the loan, and in order to get surplus cash accumulation the design must be over-funded. The result of over-funding is that the borrower (typically a trust) needs to continue borrowing larger sums of money to achieve the optimum level of funding. Over-funding results in a very large loan, and consequently more interest. As a result, the client ends up paying as much (or more) in interest as purchasing a conventional life insurance product. Clearly, paying interest payments out of pocket defeats one of the primary reasons clients use financing in the first place. On the other hand, if you don't over-fund the policy you can't create the surplus cash value to pay off the loan. Damned if you do; damned if you don't.

The chart below shows a typical 7 pay funding pattern where the client is financing and paying full interest out of pocket. This is compared to the premium payments the client would have been making if they had purchased insurance out of pocket.

The following chart compares annual payments for a $10m Policy GUL vs. interest payments on a 7 Pay PF IUL 45-year-old Male Standard Non-Smoker. The loan was priced at the current forward 30 day LIBOR curve +1.75%.



If the client's concern was preserving liquidity, you can see that by year seven the client is paying higher interest payments than they would have paid in GUL premiums. And these numbers will inevitably become worse. Not only does the forecasted interest rate shown in the graph have interest rates near historic lows, but a 45 year old standard health male will live considerably more than 7 years. This problem becomes even more prominent if interest rates suddenly rise to values like those in the 1980's.



This chart is the same as the previous chart but with the dashed line representing a 1980's interest rate overlay. As a result of high interest rates, the positive impact on the client's liquidity quickly deteriorates. This is likely to be a significant shock to the client and any advantages associated with financing are likely to be lost.

The impact of this diagram and its systemic risk is that a large number of clients will suddenly find themselves having to pay substantially higher interest than initially expected. In this situation, it is highly likely that the client will panic and/or surrender the plan. This causes carriers to see a large number of lapses, and clients to lose both coverage and money. In this situation, paying interest out-of-pocket causes all parties to lose.

This can be partially resolved in two ways:

A) Showing clients a comparison between interest payments and a realistic out of pocket alternative, such as a GUL
B) Showing clients a high interest rate stress test that highlights what payments could potentially look like so clients can make informed decisions before they buy

Many life insurance carriers prefer that the client pays interest out-of-pocket because it reduces the overall risk for the carriers. From their perspective, if the client pays interest out of pocket the loan stays smaller, facilitating loan exits later. However, the downsides to this are on the client's side. When the client pays interest, they are liquidating working assets, losing future return (opportunity costs) and transferring that money to the trust (policy owner) which results in a gift or a loan. If it is a gift, there will typically be gift taxes; if it is a loan, interest payments are made back into the estate of the client.

To summarize, interest payments (like premium payments) incur the following costs:

- Interest payments
- Gift taxes
- Opportunity costs (The younger the client the more opportunity cost can be a significant factor)

Capitalizing interest has the following advantages and disadvantages:

Advantages

- Minimizes client's direct payments
- Does not trigger a gift tax unless the collateral is called (in a default situation)
- Does not trigger an opportunity cost

Disadvantages:

- The policy has to grow at a faster rate to outpace the loan. Only products that have higher risk, like an IUL, will grow at the rate required. This precludes using Whole Life or Universal Life products for fully capitalized designs.
- Underperformance of the policy has a greater impact on the collateral
- Requires the use of term blend (which excludes certain carrier's products and reduces agent commissions)
- Requires the client to post more collateral than a "paying out-of-pocket interest" design.

By capitalizing interest, the benefits of financed insurance are significantly more pronounced but with some risk. In order for the design to be successful, it must outpace the loan cost by an average of +1.5-2% depending on age, or +1.25% when partially financing (e.g. Kai-Zen or Tri-Zen). This has implications on the loan cost.

Because the internal design risks are greater, it is critical that stress tests are run to show the design survivability and the collateral implications on the client if underperformance occurs. At the end of the day, the client is not incurring the interest payment (direct cost) and transferring the cost of covering that portion of the loan to the policy. The internal risk is higher but the direct cost risk is lower, so the client has the risk either way and it is essentially a preference.

When to Capitalize

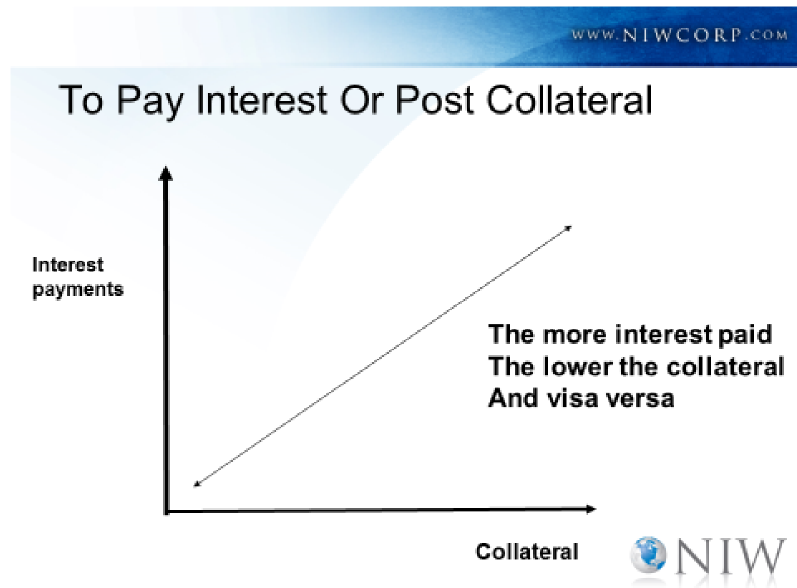
- Younger clients who are healthy, typically below the age of 60
- When appropriate IUL products are used (Not all IUL products work. IULs focused on protection instead of cash accumulation would be an example of an inappropriate IUL product)
- When clients have higher investment returns than the loan interest rate
- When clients would have to liquidate illiquid assets and incur taxes
- When a client's primary buying decision is based on minimizing cash out flows

When NOT to Capitalize

- Clients over the age of 70
- Clients who are substandard health
- When Whole life or Universal life products are being used
- When contracts are being minimum funded
- When a client's return on capital is very low
- When the client has low return assets already inside the trust that owns the policy
- When the life carrier's products will not pass stress testing without it
- When clients are more risk adverse and would prefer to pay interest
- When the life carrier policy requires this to happen

When to Partially Capitalize

- Clients between the age of 60-70 (costs of insurance are too high to get the net returns needed to outpace the loan with safety without some interest payment)
- Clients who don't like full interest payments but are more conservative
- When IUL products don't have term blend options
- Poor health clients
- When clients want to reduce collateral exposure



Is Capitalized Financing the same as free insurance?

No. Even though the client is posting collateral instead of making direct premium or interest payments, it bears pointing out that some or all of the collateral is forfeited in the event of a default. Also, when called, collateral is considered either a loan or gift to the trust/owner of the life insurance policy and so this may incur additional costs such as gift taxes. The result of a collateral call is expensive, especially in the early years when the cash values of the life insurance tend to be lower than the loan. THERE IS NO FREE INSURANCE!

Capitalized interest is merely transferring the risk to inside the life insurance design, resulting in higher collateral instead of out-of-pocket interest payments. When making the decision on whether to capitalize the client needs to consider:

Is the compounding of the loan offset by the reduced gift taxes and opportunity cost associated with an interest or premium payment? If not, then pay interest.

Please note that the above guidelines are not set in stone. Client preferences and situation have a lot of impact on design. Agents should ask the clients about their risk tolerance and ensure their understanding of the implications of the choices outlined above.

If you have any questions, feel free to contact NIW for further discussion.