Financial Watch: There is no free lunch - Hidden costs in interest-free policy loans

Some insurance companies, headquartered in Trinidad and Tobago with operations in other Caribbean countries, offer their clients "interest-free loans" against life insurance policies that accumulate cash value. The policyholder is afforded the opportunity to borrow against the accumulated value of the policy at zero interest. By offering such loans, the insurance company presumably can attract a higher demand for its insurance products. Sounds like a win-win for both the policyholder and the company. The reality is very different. Interest-free policy loans are not free! There are hidden costs which have a significant impact on the financial wellbeing of the policyholder. It is important for policyholders to remember that "THERE IS NO FREE LUNCH"!! This maxim simply means that there is a cost to everything!!

Most life insurance policies, except term life policies, accumulate cash value overtime. Therefore, policyholders can access cash from these policies in the following ways, *viz*.:

- **A withdrawal from the client accumulation** (i.e. the cash value). The policyholder requests a withdrawal from the savings accumulated by the policy and does not become indebted to the insurance company! However, a withdrawal will immediately reduce the client accumulation, and the policyholder will therefore lose the opportunity to earn a return on the withdrawn funds. This will also reduce the final settlement on maturity or the occurrence of the insured risk.

- **A policy loan.** The insurance company lends its own funds to the policyholder and holds the policy as collateral. Hence, the client accumulation is not reduced and remains invested until maturity or the policy is surrendered. Such loans are usually interest bearing although the rates tend to be relatively low because the loan is fully secured. The repayment of a policy loan is not mandatory. However, if the loan is not repaid, the benefit and the final cash value will be reduced by the outstanding loan balance.

- **Surrender or cancellation.** The policyholder may opt to **surrender or cancel the entire policy** for the full accumulated cash value less any charges imposed by the insurer for surrendering the policy.

These options are mutually exclusive and carry different risks. The insurance company is legally obligated to disclose these risks to the policyholder. The pros and cons of the different options are summarized in the table below:

Ways to access cash from a Life Insurance Policy

Pros	Cons
Withdrawal from cash value	
• Available on short notice	• Will reduce the death benefit if not replenished
• Can usually withdraw as much as 90% of the cash value of the policy	• Not permitted by some policies in the first 2 years

Borrow (i.e. taking a loan)	
• Relatively low interest rates	• Interest charges will probably apply
• No loan application or credit check	• Any unpaid balances will reduce death benefit
Surrender/Cancel Policy	
• Will receive a lump sum payment	• The policy will no longer be active
• Can be a good option if coverage is no longer needed	• The cash value will be net of surrender fees

Source: Kinney, Jeff. US News When Is It OK To Draw Cash From a Life Insurance Policy? | U.S. News, Updated 30/6/2025

In Trinidad and Tobago insurance companies offer a fourth option – an interest-free policy loan. Designating this transaction as a loan is misleading because the insurance company does not lend its funds. In addition, the structure of these interest-free loans seems designed to increase the risks faced by the policyholder. In general, it does not appear that insurance companies in Trinidad and Tobago administer interest-free policy loans in a transparent or "fair" manner. The following are some of the practices observed in the administration of an interest free loan that arouse grave concern:

- The interest-free loan is funded by an immediate deduction from the client accumulation (i.e. the policy's cash value is reduced by the loan amount) and not by an extension of credit by the company. This makes the transaction a *de facto* withdrawal, albeit one that is initiated by the insurance company.

- It is not clear whether the insurance company advises policyholders that "the loan" will be funded from the client accumulation as this disclosure is not contained in either the policy contract or the loan agreement. This raises questions as to whether the policyholder is aware of the risks associated with this transaction and is able to make an informed decision.

- The insurance company takes a first charge on the policy which gives it the right to deduct the outstanding loan balance before a payout is made to the policyholder or the beneficiaries. The required assignment of the policy as collateral to the insurance company and the granting of a first charge are questionable actions given that the loan amount is immediately offset by a deduction from the policyholder's savings. Since the company has not extended a loan there seems to be no justification for the encumbrance placed on the policy.

- The loss of future earnings from the withdrawal from client accumulation can be substantial as the policyholder is deprived of future earnings that would have accrued on the loan amount. The situation is even more disadvantageous to individuals who purchase unit-linked insurance products as such policies at best receive only a minimum guaranteed payout at surrender or maturity. Instead, the cash value for unit-linked policies is based on the returns earned on their investment in an underlying pool of assets over a given period.

- Finally, the policyholder faces an undisclosed cost of borrowing. The reality is that the cost of the interest free loan for unit-linked policies is the loss of earnings on investments in the underlying fund, which is comprised of a pool of assets. Therefore, the cost of borrowing may be much higher than if the policyholder had taken a fixed rate loan from the credit union, the bank or other lenders.

What then is the true cost of interest-free policy loans? The real cost of the interest-free policy loan includes the forgone return that would have accrued on the loan amount that was deducted from the client accumulation (i.e. the client's savings) and the inability to use the policy as collateral in other financial transactions given the first charge on the policy. In addition, since insurance companies do not disclose all the risks and conditions associated with this transaction, policyholders who take out these loans are unable to make informed decisions, which in turn, adversely affect their financial well-being.

The concerns regarding the administration of interest-free policy loans add to the litany of complaints against insurance companies and in particular those that sell unit-linked insurance products. These include the charging of onerous fees that cannibalize premiums and cash value; the non-disclosure of risks to the policyholder before and over the life of the policy and the lack of information regarding the composition and performance of the underlying fund among other issues.

At minimum, insurance companies must be obligated to disclose the material facts and risks regarding their administration of interest-free policy loans to the policyholder before finalizing the contract. The situation confronting policyholders is exacerbated by a lack of effective oversight by the bodies mandated to monitor and regulate the market conduct of insurance companies. In addition, the relevant regulatory authorities should undertake a review of the administration of interest-free policy loans to ensure insurance companies adhere to international standards and market conduct guidelines. Further, the legal and regulatory framework governing insurance industry, especially unit-linked insurance products, should be strengthened to address consumer concerns.

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