PROM TECH LETTER #1705

OUTSTANDING-BALANCE CREDIT INSURANCE ON CLOSED-END LOANS

This Tech Letter discusses the calculation of monthly-outstanding balance (MOB) credit insurance premium(s), interest charges, and the calculation of the disclosures required by the U.S. Federal Reserve Board Truth-in-Lending Regulation Z. Many of the considerations and problems related to MOB insurance also apply to debt cancellation coverage products. One of the major problems associated with this type of insurance is the overcharging of premiums for disability insurance – the actual calculations are far more complicated that just adding a differential to the loan interest rate.

Two sample loans are compared: the first with no credit insurance and the second with MOB credit insurance. The calculation of the payment, finance charge, insurance premium, and A.P.R. are illustrated and discussed.

Background

There are two general methods of calculating credit insurance premiums on closed-end loans: 1) A single premium is charged at the start of the loan which covers the total cost of the insurance for the duration of the loan, and 2) a premium is charged each month during the term of the loan.

In the first method, the premium is nearly always added to the loan amount and financed as part of the loan[1]. Thus, a loan with proceeds to the borrower of $10,000 with a credit insurance premium of $200 becomes a loan of $10,200. The monthly payment and interest charge is based on the loan amount of $10,200. In this case, the lender has advanced the premium to the insurance company and has added it to the loan. The borrower pays interest on the premium at the same rate as charged on the proceeds of the loan. The monthly payment made each month to the lender has two components: 1) the interest charge, and 2) the principal payment.

In the second method (the subject of this Tech Letter), the borrower pays a portion of the premium each month. The amount paid each month is dependent upon the balance of the loan at that time. Thus the total payment the borrower makes to the lending institution has three components: 1) the credit insurance premium, 2) the interest charge, and 3) the principal payment. This method is widely used by credit unions and is also required for longer loans by some states (notably New York and California).

MOB credit insurance can be for life insurance, disability insurance, or other types of insurance (involuntary unemployment, property), or any combination of these. In the examples that follow, we will use a simple loan with only 6 payments and with life insurance to keep the examples and schedules of a reasonable size. MOB loans can be written of any length, and are commonly written to 15 years or more.

This complete Tech Letter is available to lenders upon request.
Contact us via email at info @ promsoft.com.

[1] Although it is rarely done, it is possible for the borrower to pay for the credit insurance premium separately.