SOCIETY OF ACTUARIES

Article from:

Product Development News

July 2004 – Issue 59

Return of Premium Term

by Keith Dall

Return of premium term riders have been around for a long time. Generally, they have been used in the mortgage term marketplace, but now they are starting to hit the mainstream term market. More and more insurance companies are taking another look at the market appeal of the return of premium concept, but it is not without its risks.

Most companies use a rider to add the return of premium provision, but some companies file it as part of the base policy. This article will refer to the benefit as a rider.

Marketing

The marketing of return of premium term products offers great sales pitches. There are a number of catchy phrases that I have recently seen on Web sites.

"Wouldn't you like to get your money back when you don't die?"
"No-Cost (ROP) Term"
"Coverage when you need it, money back when you don't"
"Win-Win-Win"

The last marketing quote refers to a "win" for the policyowner whether it is a death benefit to the beneficiary, a conversion to a permanent level premium plan in case the insured becomes uninsurable and finally the return of premium to the policyowner if the policy persists to the end of the level premium term period.

Premiums

While the catchy sales pitches assist the producer in making the sale, the relatively high premium for term insurance makes the sale more difficult. For a typical male, preferred at issue age 35, the return of premium term policy for a 20-year level term period is about two-thirds higher than the same policy without the rider. Likewise, a 30-year term policy with a return of premium rider is 25 percent higher than the base policy.

As Figure 1 shows, even though the return of premium rider drastically increases the premium on the policy, the premiums are still lower than a universal life policy with the 20th year cash value equal to the sum of premiums.

While the universal life policy offers permanent insurance with flexible premium, the return of premium term policy may fill a void in the marketplace between term and universal life insurance.

Rate of Return

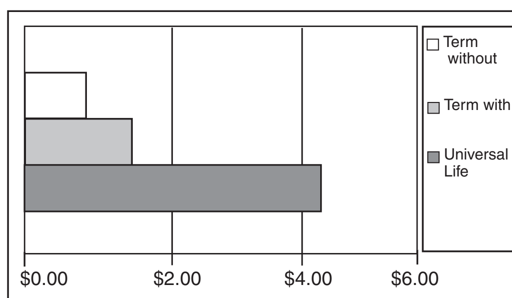
In addition to the sales pitches, producers are able to quote a very high rate of return for the policyowner. After-tax guaranteed rates of return of 14 percent are quoted on one insurance Web site. These rates of returns are calculated by using the rider premium as the investment and the total premium for surrender returned after 20 years as the return.

The rate of return stated above is from the maximum time period of 20 years. Typically, the return of premium rider does not return any premium through the first five years and then grades up to 100 percent of the paid premium in the 20th year. Therefore, the rate of return is zero in the early years and grades up from there.

Pricing

While there are advantages to the producers in higher commission amounts and great sales pitches and advantages to the

Figure 1: Premium Rate Per $1,000 for a 35-Year-Old



continued on page 26

In addition to the sales pitches, producers are able to quote a very high rate of return for the policyowner.

policyowner in high rates of return, the insurance companies should be careful in pricing the return of premium rider. The rider increases the uncertainty of earnings due to uncertain persistency effects and the increased sensitivity of profitability to the net investment earned rate. Also, the higher reserves create a greater surplus strain and the relative premium levels by term period change the mix of business by term period.

Everyone seems to have a different opinion about the ultimate lapse rate on return of premium riders. The range is generally from about 6 percent, which is similar to a base policy, to 3-4 percent, which is similar to a permanent plan, to 1-2 percent, which assumes the policyowner will take advantage of the higher returns. The lapse rate is the most important pricing assumption. Reducing the ultimate lapse rate by 50 percent can reduce pretax profit margins by a significant amount, for example, from 10 percent to 6 percent.

Keith Dall, FSA, MAAA is a consulting actuary at Milliman Incorporated in Indianapolis, Ind. He can be reached at keith.dall@milliman.com.

The variability of earnings due to investment rates increases when the rider is added to the policy. This is because of the higher reserves that have to be held. If interest rates keep increasing and the premium levels remain the same, the profits on the return of premium riders will increase.

Reserves

The reserves are much higher for policies with the rider than without. Typically, the reserve is the higher of the XXX Model Regulation reserve and the present value of the endowment.

Within the XXX Model Regulation there is a provision for an unusual pattern of guaranteed cash surrender values. An unusual pattern is considered when the change in cash surrender values is greater than 110 percent of the premium paid in the period plus 110 percent of the valuation interest rate on the prior cash value plus premium. The reserve floor is then equal to a term reserve to the next unusual cash surrender value period plus an endowment equal to the cash surrender value at that same period.

The reserve for the endowment may create deficiency reserves, as the gross premium for the endowment would assume lapse rates in the calculation, while the statutory reserve is calculated without lapses.

Miscellaneous Items

The regulators recently completed an NAIC survey on return of premium riders and most of the respondents indicated that their state does require a demonstration of compliance with the Standard Nonforfeiture Law.

The reinsurers have not been very active in the return of premium market mainly because the rider premium is based on persistency risk rather than a mortality risk. This may change as more insurance carriers enter the market.

Similar to universal life insurance, the total premium paid is the basis in the contract and therefore there is no taxable gain in returning the premiums. However, companies do have to be careful in complying with the definition of life insurance according to I.R.C. Section 7702. Some of the older ages for the longer-term periods may require increasing death benefits due to the corridor.

Summary

In summary, the return of premium rider can be beneficial to the policyowner, producer and insurance company, but it is not without its risks. Look for more companies to jump on the bandwagon and add a return of premium rider to their product portfolio. □