Forbes.com

Money & Investing

Die or Your Money Back

Carrie Coolidge 04.24.06

New term life policies give back the premiums you paid--if you live long enough.

Brandon Cook, a Houston technology consultant, father of two and husband of one, was in the market for $1 million of life insurance. Obvious choice: a 30-year level payment term policy, one with a premium that is guaranteed not to rise but which builds no cash value whatever. For a male nonsmoker of Cook's age (31), such coverage is available for $1,090 a year (from Transamerica, for example). But there was something about term insurance that bothered Cook. You put in all this money and at the end of 30 years have nothing to show for it.

The traditional answer to this dilemma is an entirely different kind of policy called whole life. A $1 million policy would build a very significant cash value after 30 years, but whole life is immensely more expensive. The answer, for Cook, was a baby step toward whole life called return-of-premium term insurance. At the end of 30 years the buyer, if he's still alive, gets all his premiums returned, without interest. If he dies before then, his beneficiary gets the $1 million but no return of premiums.

Cook likes the ROP insurance because it allows him, even while he protects his family, to bet on his own health. Odds are that Cook will win this bet: The chance that a man his age will die by age 61 is only 5%. The ROP policy that Cook bought, from Genworth Financial (formerly part of General Electric) is costing him $1,671 a year. In effect, with the Genworth policy Cook is buying straight term worth $1,090 and also contributing $581 a year toward a savings account. If he lives, he will have put $17,430 into this virtual savings account. The account will turn into a check for $50,130 in the year 2036. That's not a bad investment return. It comes to 6.3% a year, better than Cook could get on a Treasury bond.

How can Genworth be so generous? Two reasons: One is that it gets a modest benefit by dint of paying little or nothing on the $581 investments to those people who collect on the underlying term policy--that is, who die before age 61. For the unfortunate one who gets flattened by a bus, the return on the investment side of the Genworth policy is a negative number. Add this risk into the equation and Cook's expected return from the rop option is something shy of 6.3%.

The second reason Genworth can offer a good deal: It is counting on the fact that a lot of young buyers will sooner or later let their term policies lapse. When they do, they walk away from some or all of the virtual savings account. Genworth pockets a good chunk of whatever is in the account. People let policies lapse for a variety of reasons, including divorce, lack of financial discipline and a desire to switch to a different kind of life insurance. The lapse rate on conventional term policies is in the neighborhood of 5% a year--that is, in any given 12 months, 5% of term policyholders stop paying their premiums. It's too soon to know what ROP lapse rates will be, but presumably they will be something less than 5%. You'd have to be a damned fool to let a 30-year ROP policy lapse in year 25.

Lapses are the great, dirty secret of the life insurance industry. Lapses keep profits up and prices low for all kinds of life insurance.

Here's another example. A healthy, nonsmoking 40-year-old male would pay a flat $2,249 yearly for a $1 million 30-year ROP policy from Genworth. That compares with $1,350 for conventional 30-year level term. If the policyholder sticks around until maturity, the now 70-year-old will get back the entire $67,470 he paid into the policy. For him, the incremental $26,970 investment earns a 5.4% annual return.

Return-of-premium policies work best for people who are young, healthy and disciplined. An applicant who is older and not in perfect health is likely to discover that standard term insurance is a better bargain.

If you quit an ROP plan early, the insurer won't stiff you completely. With most ROP policies you can get back something, just not much. Surrender it after 10 years and you'll receive only 9% of the total premiums you have paid to the insurer. Get out after 15 years, it's 19%; after 20 years, 35%.

As though all these actuarial calculations and hypothetical returns weren't complex enough, the insurance industry has yet other variations to offer you. The standard ROP policy has no cash value other than the right to exit early with these modest percentages refunds. But if you are willing to pay more, there's an alternative that gives you some flexibility. Known as an "enhanced" version, this type of ROP policy has a surrender value, which takes about ten years to amass. At that point you are allowed to borrow cash while keeping the policy in force. You can choose either to pay it back to the policy with interest, or never pay it back, and whatever you owe will be deducted from the return of premiums at the end of the term. Offered by Genworth, the enhanced version costs between 6% and 12% more in premiums.

At this point the policy has veered off in the direction of traditional whole life, high in premium cost, rich in cash value. There is no end to the variations that can be invented on the life insurance theme.

Genworth's enhanced 30-year ROP policy would cost the same healthy, nonsmoking 40-year-old $2,422 a year in premiums for $1 million of coverage. It would return 38% of his premiums should the policy be canceled after the tenth year. If it is in force for 15 years, the surrender value increases to 60%, and if it is surrendered after 20 years, 70% of the accumulated premiums paid would be returned. If you are sure you'll keep the policy until maturity, don't pay more for the enhanced version.

In their present form ROP policies are a new gimmick in life insurance sales. But they have a forerunner in something called "deposit" term insurance. This life insurance product, briefly popular two decades ago, required a higher first-year premium, followed by lower fixed premiums starting in the second year. In return the policyholder was offered an attractive interest rate that only applied to the payment made in the first year. If the policy lapsed, the policyholder received nothing in return, unlike return-of-premium policies.

Okay, let's turn to the tax question. Favorable tax treatment is one of the big selling points of life insurance, and it is not absent for ROP buyers. Go back to the 31-year-old who gets a check for $50,130 when he turns 61. Is any of this money taxable? An economist would tell you that it should be. Of the $1,671 annual cost of the policy, $1,090 is buying a lottery ticket (with a $1 million cash prize) that doesn't pay off. The $581 a year in additional contributions is like an investment in a bank account paying 6.3%. At termination the whole investment gain ($50,130 minus $17,430 invested) should be taxable as interest income.

But life insurance has a privileged place in the tax code, and it appears that the ROP refund check will be scot-free. The insurance industry argues--and the Internal Revenue Service will probably agree--that the policy buyer is merely getting back the $50,130 he put into the policy. Supporting this view is one private-letter ruling from the IRS. The no-tax policy, however, is not enshrined in IRS regs. So Peter Katt, a fee-only life insurance expert in Mattawan, Mich., warns there's always a chance that the agency might change its mind.

Return-of-premium term insurance is available in all states. Paternalistic New York, however, forbids term policies lasting longer than 20 years.

As with all insurance that builds future value, you should buy an ROP policy only from an insurer with a rating of A+ or better from AM Best, which assesses insurers' claims-paying ability and solvency. Reason: If the insurer goes bust in year 29, you won't get your money back. The leading sellers of ROP term insurance are AIG American General, Genworth and Lincoln National, all of them highly rated.