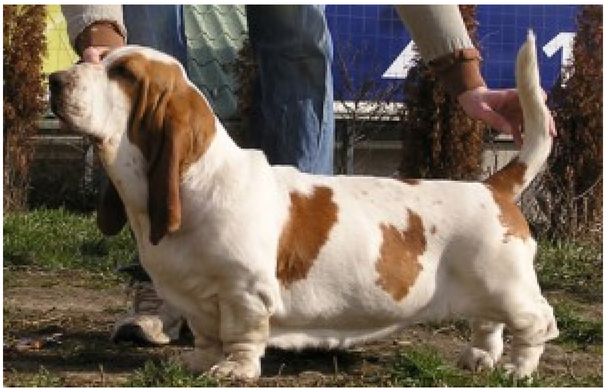
Return of Premium Term Life Insurance – Friday Q&A Series

Q.



What do you think about return on premium for a young doctor? I'm 30, we have a 1-year-old, and the difference is about $700/yr for 30-yr term vs. 30-yr term w/ROP. I'm in great health and no family history of chronic illness, so I think my odds of making it to 60 are excellent.

With regular term, I'm losing my entire premium at 60, so active investment of that $700/yr saved will have to generate a decent ROI to cover the premium, principal, and tax liability. To me, ROP makes sense if you can afford it, but I've seen other opinions that it's just a waste of money. What do you think?

A.

I've written before that [you shouldn't mix insurance and investing, and return of premium term life insurance (ROP) is a good example of why. It sounds great. You pay your premiums, and if you die, great! Your poor wife gets a million bucks to console herself. If you don't die, also great! You get all your money back. It's like free insurance, right? Not quite. There are several reasons why you almost surely don't want this.

Opportunity Cost

It's important that you don't forget about the opportunity cost of that extra money you're paying. In fact, it's quite easy to calculate out the actual return you're getting on that extra money you're paying. Although it's a 30 second task to get term life insurance quotes from term4sale.com, getting a quote on a return of premium policy is a little more complicated. I asked Larry Keller if he could get them for me and he provided me with quotes for a $1 Million policy on a healthy 35 year old non-smoking male in my state, both for their regular old term policies as well as their fancy ROP policies. I then calculated out the difference in cost between the two, the total premiums paid in on the ROP policy, and the guaranteed return you're getting on that extra money. This chart breaks it down:

Years	Term Cost	ROP Cost	Difference	Total Premium	Return
15	585	2666	2081	39990	3.04%
20	665	1926	1261	38520	3.88%
30	885	1748	863	52440	4.23%

As you can see, the guaranteed return isn't exactly spectacular, barely besting the historical rate of inflation. (Remember this is a nominal return.) If I can't beat that over 30 years with my portfolio, even after-tax, then my retirement isn't going to be very lavish.

It's also important that you remember who's providing the guarantee. If the insurance company goes out of business, you’re probably unlikely to get all of those premiums back, and perhaps not any of them. Some states will guarantee the cash value of permanent life insurance policies up to a certain amount in case the insurance company goes out of business, but I’ve never seen anything suggesting they’ll give you anything for a ROP policy from a failed insurer.

Expensive Apples

If I haven’t convinced you yet, consider the second reason why ROP isn’t a very good idea. Remember that the regular old term market has a lot more participants (both insurance companies and clients) and thus is more competitive and efficient with pricing. You’re just buying a plain old widget. Once you start adding bells and whistles like ROP, there are fewer companies and more variations between them, making it harder to compare apples to apples and know when you’re actually getting a good deal. When he sent me the quotes, Larry mentioned to me that (as I expected) very few companies offer ROP insurance. They are offered by AAA Life Insurance, Cincinnati Life Insurance, Prudential, Transamerica, Assurity Life Insurance, Reliastar Life Insurance, and American General. So you only get 7 options to choose from, instead of the hundreds available for plain-Jane term insurance. To make matters worse, not all of these companies offer ROP policies over even common guarantee periods such as 15, 20, and 30 years. Prudential happens to, and that’s why I used them in the chart above. What are the odds that one of these companies offers the cheapest term insurance AND the best ROP policy? Not very good it turns out. In fact, I went to term4sale.com and found the cheapest insurance (rated at least A-) for each guarantee period and compared that to the Prudential ROP quotes above. It makes the returns on these policies look even more abysmal. Incidentally, the only one of those 7 companies that made the top ten cheapest insurance policies was Cincinnati Life Insurance Company.

Years	Term Cost	ROP Cost	Difference	Total Premium	Return
15	300	2666	2366	39990	1.48%
20	435	1926	1491	38520	2.38%
30	790	1748	958	52440	3.64%

Lost Flexibility

There are two other issues with these policies that cause you to lose flexibility. The first is the inability to "refinance" your insurance. Sometimes you can replace your insurance with cheaper insurance. It doesn't happen a lot because life insurance generally gets more expensive as you age, but it can happen if rates drop, if your health improves, or if you give up a dangerous hobby. If you have a ROP policy you may not want to do that (since you forfeit all those premiums you've already paid.)

I advocate an approach where your portfolio gradually grows to replace your need for life insurance over time. You should try to match your terms to your predicted financial independence date, erring a bit on the conservative side in case of inadequate savings or poor portfolio performance. Once you hit your "retirement number", you can just cancel your term insurance and save the premiums. Not so with ROP insurance. If you want those premiums back, you're stuck with the policy until the bitter end.

So keep your insurance and investing separate. Buying life insurance is easy. Don't complicate it.