On August 9, 2011, SCOR SE, a global reinsurer with offices in more than 31 countries, acquired substantially all of the life reinsurance business, operations and staff of Transamerica Reinsurance, the life reinsurance division of the AEGON companies. The business of Transamerica Reinsurance will now be conducted through the SCOR Global Life companies, and Transamerica Reinsurance is no longer affiliated with the AEGON companies.

While articles, treaties and some historic materials may continue to bear the name Transamerica, AEGON is no longer producing new reinsurance business.

Archive Materials

Special Report: Return of Premium Products

Originally published in October 2007

by Christian Kendrick, Senior Analyst

Return of Premium (ROP) products are among the best selling items in the term life insurance market today. In less than five years, the number of ROP carriers has doubled, and more insurers are considering the move. Already a significant portion of the market, there is no indication that ROP is going away.

As with any new product, there are uncertainties about the pricing of ROP, because of there is so little actual experience to go on. Over the past several years, insurers have developed a stronger understanding of the main risks of ROP (lapse, interest rate sensitivity and mortality), and new policyholders are now paying higher premiums for the product than before.

Analysts expect rising prices and strong sales to continue, yet they remain concerned about the risks associated with ROP. There is limited experience on which to base lapse and mortality assumptions. Proposed changes to principles-based regulation (PBR) may cause discomfort for firms that are not yet pricing fully the risks of the ROP offering. Presently, most reinsurers are not accepting ROP policies, and those that do only enter into arrangements on a case-by-case basis.

In the meantime, carriers are casting about for answers to the many questions associated with fully understanding all the risks and opportunities presented by this product.

Rapid Growth for an Easy to Sell Product

ROP first appeared in the early 1980s as mortgage life insurance coverage, where a home loan would be bundled with an ROP term life policy of equal duration. Agents sold ROP as a means of keeping the home and repaying the loan, in the event of death of one or the other breadwinner.

Agents later noted the appeal of the return of premium for its own sake, and insurers gradually began to consider how to package the new product. ROP riders to term policies were the first step. Later, insurers also bundled the ROP with
the base coverage. The product was sold by variations on the theme: “You get insurance, and (if you live out the term) you get your money back.”

The ‘guaranteed return’ is the implied return on the amount of premium in excess of pure insurance. It works like this: you pay $355 a year for a $200,000 policy with a 30-year term. At the end of 30 years, you will get back the entire premium paid in - $10,650.

Let’s say that $250 a year covers the cost of protection ($7,500 overall) and the remaining $105 per annum ($3,150 overall) finances the ROP benefit. As a policyholder, you know that you will get back, dollar for dollar, exactly what you paid in premiums for insurance. And you know that your “return” – based on the ROP-related premium – will be about 6.5%.

If the guaranteed return is relatively high, then the ROP benefit is relatively inexpensive for the consumer. In January 2004, ROP policyholders were offered quotes in the 7%-11% range, and sales were robust. By May 2007, prospective buyers found guarantees in the 5-8% range, a higher price range, yet sales remain strong.

Rising prices coupled with rising demand, encouraged new entrants; the number of ROP carriers doubled from 10 in 2003 to at least 20 by 2007, with more carriers considering adding ROP to their offerings. Between 10-15% of new business in the market is ROP (LIMRA, 2004). ROP writers are reporting that about 30% of their new term business comes from ROP products, though there is a wide range (as high as 50%).

Also, the largest writers of term who also offer ROP saw their new business volume increase by an average 49% from 2003-2005, while the term life market at large grew 2.1% for the same period. While not all of the relative advantage in new business increase is attributable to ROP sales, LIMRA’s First Quarter 2007 review did note that “Return of premium and improved underwriting helped stimulate term sales.” There has also been reshuffling at the top of the term life insurer list with regards to new business writings; the current top two term writers (AIG and Genworth) owe their current standing in part to their being among the largest writers of ROP.

Historically, 30-year ROP offerings have run between 1.35 and 1.4 times more expensive than the comparable base level term product; a 20-year ROP is twice as expensive as a 20-year base term policy, and a 15-year issue is about 2.4 times more expensive. Since the ROP benefit is relatively cheaper for the longer-duration policies, most of the growth in ROP business is weighted there; as of September 2006, half of all ROP products sold were 30-year issues (48% of policies and 47% of premiums).

ROP has become a permanent feature of the term insurance market. Even as prices have risen (and guaranteed returns scaled back to less aggressive levels), sales continue to look strong for ROP offerings. It is now a question of identifying for whom ROP is a most suitable and therefore most sellable product.

**Changes in the Target Market**

ROP is significantly more expensive than regular term life. When first introducing the product, insurers focused on demographics where the absolute dollar amount of the ROP was the least – young, healthy persons with higher-than-average incomes seeking small-face, long-term policies. While it is possible to obtain significantly larger-face policies, most of the market for ROP has remained toward the lower end of the spectrum.

In the 2004 LIMRA survey, the mode demographic was males, aged 35-45 years, with an annual income range of $50,000-74,000, though for one writer, the average age was 35 (as of 2007). Figures in and just outside this range have been cited as well. More recent data suggests that the average face amount for mass customers is gradually migrating upward.

A scan of cell data for Males, Preferred, Age 35 years, shows relatively few offerings for ROP under $100,000 face, often for cost-ineffective rates. Many writers prefer that policyholders consider $100,000+ ROP instead, and three of the top five ROP carriers do not issue sub-$100K face policies. One possible explanation is overall market conditions. Base term coverage is cheap and pricing is highly competitive, such that fixed underwriting costs are now a higher percentage of premiums.
The first market for ROP is composed of persons buying smaller-sized ROP policies. These policyholders are attracted to the return of premium and treat the ROP benefit as forced savings. It is a simple sell: “You get your insurance, and if you live, you get your money back.” However, such customers tend to be conscious of the additional dollars paid in premium. While they appreciate the financial value of staying with the policy, they are more prone than wealthier policyholders to replace coverage with a less expensive alternative (such as basic term) or simply lapse the policy.

A second market for ROP includes more informed buyers who are already purchasing larger-face ROP policies, up to the $1,000,000 mark and beyond. Such policyholders focus on the guaranteed return and treat the ROP benefit as an investment. They also have a higher awareness of the financial value of persistency (staying with the same policy rather than allowing coverage to lapse). One analyst remarked that it would be prudent to apply different lapse assumptions for such policies, suggesting that larger-face policyholders are half as likely to lapse as mass customers (1% versus 2% ultimate lapse).

Another development is the emergence of the worksite market for ROP: Insurance companies selling to worksites have indicated interest in ROP with its lower lapse rates to balance out a set of products that have relatively higher lapse experience. ROP is also interesting to worksite insurers for its high commissions, which help support the enrollment-based distributions that are common in this market.

Dominique Lebel of Towers-Perrin has followed the worksite market closely for some time. He offers this insight:

“We’re seeing more interest…This is a good product for the worksite market because it may lower the lapse rate. [Much] depends on characteristics of the employer and employee (age, salary, etc.). The employees may not be interested in term because they don’t like fact that you only get a benefit if you die. But they’re not ready for a universal or whole life product, either. ROP is a good fit between the two. It’s seen as offering a better value.”

ROP’s reduced cost compared to traditional whole life may also explain why companies heavily weighted toward whole or universal policies may be concerned about ROP cutting into their existing business.

**Accumulation of Cash Values and ROP**

ROP writers offer a schedule of partial refunds for cash values after a minimum number of years (5-6 being typical), in compliance with standard non-forfeiture laws. The starting point for cash values is less important than the attainment of the crossover point – the policy year in which the annual increase in cash values exceeds the amount of annual premium paid.

The crossover point is where insurers assume that the lapse behavior of ROP policyholders will drop significantly. Based on a sampling of several large writers, the crossover point is around Year 7 for 15-year policies, Year 8 for 20-year and Year 11 for 30-year products.

Actual experience of this crossover effect is only now becoming available for the earliest ROP offerings, and then only for the shorter durations.

**Main Risks to Pricing ROP**

Many ROP writers offer guaranteed returns superior to what could be obtained in similarly-rated investments elsewhere. This is sustainable, so long as the insurer has the lapse and mortality risk in hand. The catch is that there are five years of experience for ROP at most and considerable variance in the assumptions and methodologies used in pricing. Some writers are taking advantage of this uncertainty and pricing for short-term competitiveness; others are looking to price with prudence. Over the past four years, rational pricing of the underlying risks has taken the lead, and few if any insurers are still offering double-digit guaranteed returns.

The three major risks in ROP pricing: lapse, interest rate sensitivity and mortality.

*Lapse Behavior.* There is a strong financial incentive for the ROP policyholder to persist; it is not a question of if but when the policyholder decides that lapse of the policy is not an attractive option. As noted earlier in the discussion
on cash values, the crossover model suggests that lapse rates drop significantly only on the back side of the policy’s duration.

While a fall to a lapse rate of zero is unlikely, very low lapse rates cannot be ruled out, based on policyholder behavior for other products. The 2004 LIMRA survey on long-term care insurance persistency found ultimate voluntary lapse rates approaching 1% for group coverage. In the 1990s, Canadian term-to-100 insurance was priced assuming a lapse rate of 6%, and an ultimate lapse rate of 3%. The actual experience was much different: 2% overall lapse, with lapse rates falling under 1%/year by year 14.

No one is currently pricing ROP with such optimistic lapse assumptions. A 2% lapse assumption on the back end seems prudent for purchasers of lower-face policies. For better-informed investors purchasing large-face policies, a 1% assumption appears more appropriate. In the event ultimate lapse were to approach zero, the losses would be light compared to the Canadian situation -- for ROP writers who are pricing with prudence in mind.

There is a possibility that the crossover model may not apply to ROP. The data is only now becoming available to answer if the model is indeed appropriate. If not, and if ROP lapse is significantly reduced right away, then lapse considerations are likely to become even more important than they are already.

**Interest Rate Sensitivity:** Long-term guarantees of any sort are highly sensitive to changes in interest rates. Not only is it prudent to reserve for this uncertainty but regulations require it. ROP products fall under XXX Section 6D “Unusual Pattern of Guaranteed Cash Surrender Values”. Reserves for ROP products have a longer, steeper ‘hump’ in reserves than for base term, peaking at roughly 1.5-2 times greater than non-ROP on a statutory basis, and 2.5-3 times higher levels using GAAP for 30-year products. The GAAP ratio is higher because of the cost of the endowment, the funds set aside to cover the guaranteed return of premium. And the concern is twofold, for not only is there uncertainty about forward rates but the interest risk exposure is also greater because of the larger reserve requirements.

One way ROP writers have accommodated this risk is to rationalize their guaranteed returns. As of May 2007, guarantees ranged between 5% and 8%. This may be optimistic given the rate on the 30-year bond at the same time (5.25%) but not aggressively so, so long as lapse and mortality assumptions hold. Firms that are pushing the top of the range need to take particular care with this type of risk; the expected ultimate lapse rates do not support much shortfall between market returns and the guarantee.

ROP writers should consider appropriate interest rate hedge strategies, perhaps via floating-versus-fixed rate swaps, or protection in the form of interest rate floors.

**Mortality Risk.** ROP may affect mortality experience in two ways. On the one hand, low lapse rates mean a greater number of lives in later years, raising claims expenses against expected premiums. A decrease of 1% in lapse rates could result in 4% or more lives after five years. On the other hand, there may be positive selection effects, as healthier lives opt for the ROP benefit based on greater optimism for surviving long enough to get back the premiums. This may work to reduce claims, but as a general rule, healthier lives are less profitable because healthier customers have more options for coverage. Margins are thinner due to greater competition for this business. Thus, expected premiums for the block would decrease.

Again, the lack of experience means we must wait for a decisive answer. Looking at another product’s experience may offer insight: Long-term care policies experienced a range of 20-40% lower morbidity than the overall demographic despite lower lapse behavior. It may be possible that similar (though likely lower-magnitude) mortality effects might show up in the later years of ROP policies.

**Other Concerns: Reinsurers, Resellers and Regulators**

**Reluctant Reinsurers.** Most reinsurers are reluctant to take on ROP, in part because of the limited actual experience. Some have accepted ROP blocks of business on a case-by-case basis, charging higher prices to cover the lapse risk.

For reinsurance companies, lapse risk causes less concern than investment risk, due to the high interest-rate sensitivity of the ROP policies. When the reinsurer is expected to cover the return of premium benefit as well as the death claim,
more attention must be paid to assessing current market conditions and forecasts of future economic events than is the case with base term policies.

Reinsurance companies can leave the investment risk component of the ROP with the direct writer by declining the ROP rider (in cases where the product feature is disaggregated) while accepting the base. However, ROP writers are beginning to ask reinsurers to take on the finance risk, as well. Reinsurance companies are studying ways to provide sustainable solutions for this emerging business need.

*Life Settlement Meets ROP.* Life settlement companies have historically focused on whole life policies, yet with 40% of all new policies sold being term coverage, there is growing interest in a secondary market for term policies. As ROP policies accumulate cash values, they may stand out as especially attractive because payment of some kind is guaranteed, whether the policyholder lives or dies. If an ROP policy is purchased at an attractive price, the life settlement company can guarantee itself an ROI on premiums paid (plus initial investment) and get an even higher return if the insured dies.

Historically, life settlement companies have focused on large-face policies for older lives experiencing a downturn in health. However ROP policies have a definite benefit – the ROP – at a guaranteed rate of return by a specific period of time. A life settlement company could pool many smaller-face policies and sell shares to investors or create the life settlement equivalent of mortgage-backed securities and sell the pools outright to large institutional investors.

*Regulatory Risk.* Some ROP products may be subject to disqualification under IRS Code Section 7702, which is intended to prevent the use of life insurance as a tax shelter, while not discouraging the purchase of life insurance altogether.

States are taking a closer look at ROP filings to ensure compliance with non-forfeiture laws. Several now require demonstrations of compliance with Section 8 of the SNFL (“Consistency of Progression of Cash Surrender Values with Increasing Policy Duration”, a.k.a. the Smoothness Test). The ROP benefit can be designed to pass muster, but many ROP products issued in the past would have a hard time receiving approval today.

Standardization of reserve modeling under PBR could mean trouble for insurers that calculate reserves by including just the cash benefit. Such firms are likely to see a significant increase in their reserves. Firms that calculate reserves with the endowment included are unlikely to see much change.

Most companies sell ROP as a rider and value it independently, the same as with other optional benefits. However, the ROP rider affects the mortality and lapse behavior of the base policy, so if the ROP rider is not assessed in combination with the term policy then reserves are likely to be understated. When the ROP feature is incorporated into the base product, under-reserving is less likely. Under PBR, the structure of the ROP product would not matter; and the risks would be transparent.

**Key Takeaways**

Policyholders have been willing to pay higher prices to purchase ROP, so far. Median guaranteed returns on the ROP portion of the premium are down by roughly one-quarter over the past four years, which, as with bonds, is another way of saying that prices for the ROP benefit have gone up. The ongoing market decline in the price for basic term coverage may mitigate consumer resistance to higher ROP prices as well.

Several major producers are moving away from small-face ROP policies. Relatively few providers are offering attractive bids for ROP for under $100,000 face, and several big-name carriers do not place bids for sub-$100K face at all. With margins so thin in today’s highly competitive term environment, it may be that offerings of less than six figures are or are becoming unattractive for many ROP writers.

Worksites distributors are now considering ROP. As Dominic LeBel of Towers-Perrin noted, insurers selling to worksites are looking at ROP not only for its low lapse rates but also for its high commissions, which help support enrollment-based distributions.
ROP lapse may very early become very low. Current expectations are that ROP lapse only falls away from near-normal levels for term after the annual accumulation of cash values becomes greater than the annual premiums paid. However, data is only now becoming available to test this hypothesis. If ROP lapse turns out to be significantly reduced sooner, then lapse considerations are likely to become even more important than they are already.

ROP assets lose value when rates go down. ROP depends on market returns supporting the long-term guaranteed return on premiums paid in excess of pure coverage. Thus, when rates go up, ROP blocks do well.

Life settlement companies are becoming interested in ROP. Some firms have already begun to make pure economic value plays on large-face term policies. However, since some payment is guaranteed with ROP, and policies could (as with mortgage-backed securities) be pooled together, there may be no lower limit to the size of policy that might be under consideration for life settlement.

At Transamerica Reinsurance we are committed to studying new products and working with clients to provide them with risk management solutions. We are taking close notice of ROP, examining a variety of risk management options, and working to provide the support ceding companies need in managing the risks associated with ROP.