

Non-Forfeiture Options and Return of Premium

(Copyright May 2003 by Kraig Coleson PhD CallTheDoctor@Prodigy.net)

Including a non-forfeiture option in your policy means you don't lose everything if you cancel your policy or lapse the policy by failing to pay the premium when it is due.

All Tax Qualified policies offer you the option, for an additional premium, of including a "shortened benefit period", non-forfeiture option in your policy. This is essentially lapse protection. Typically with this option, if you pay the premium for 3 years or more and after that time cancel or lapse your policy, the insurance company still maintains a benefit for you (essentially a paid up policy with no more premiums due) which has an elimination period and benefit maximum equal to those you had in your policy at the time it was lapsed or canceled. The policy has a benefit period (pool of money) equal to the greater of 30 times your benefit maximum (a 30-day benefit period) or the cumulative premiums paid. If you meet the benefit triggers and receive covered services you can collect benefits until the pool of money is exhausted.

Let's consider an example. If you have a \$100 per day policy benefit and a \$1500 per year premium and you paid the premium for 4 years before you canceled your policy, you would have paid a total of \$6000 in premiums. Since 30 times your daily benefit is \$3000, the larger is the \$6000 cumulative premiums paid. This is the amount of money that remains available to pay benefits in the future if you need them. At a maximum rate of \$100 per day, benefits would last 60 days.

Since I only recommend purchasing a policy if there is a reasonable likelihood of being able to continue to pay the premium and since this option increases the premium without enhancing benefits in any way when you are receiving care (unless you lapsed or canceled the policy). I usually don't recommend this option.

One reason you might want to consider this option though is if you are concerned the insurance company might increase premiums in the future to a level where you can no longer afford the premium. In that case, at least you don't lose everything if you are forced to cancel your policy because it is no longer affordable.

Many states have addressed this concern about premiums increasing by requiring all policies issued in the state include a contingent non-forfeiture benefit. You can determine if this is required in your state by reading the outline of coverage for the policy you are considering purchasing or by reading the policy you already own. If it is available or included in the policy it will be clearly discussed in the policy or in the outline of coverage. The "contingency" of the contingent non-forfeiture benefit is if you are forced to lapse your policy due to a "substantial" rate increase. "Substantial" is defined as a percentage of your original premium and the percentage depends on your age at the time of purchase. For example, at age 40 it is 150%, at age 50 it is 110% and at age 60 it is 70%, at age 70 it is 40% and at age 80 it is 20%. If the

cumulative increases since the original purchase exceeds this amount and your policy lapses or is canceled because at this increase, you receive a paid up policy just like the one described in the "shortened benefit period" non-forfeiture. There is no additional premium for this contingent non-forfeiture. It is automatically included in the policy in those states that require it.

Other than this lapse protection, a few policies offer options which return all or part of the premiums you've paid. Most of the policies that offer this type of option refund all or part of your cumulative premiums paid at your death. Tax qualified policies are not allowed to provide any cash value or return of premium while the insured is still alive. A few non-tax-qualified policies have options that return all or part of the cumulative premiums you've paid at specific intervals, typically every ten years, and reduced by any benefits you've collected during the time period.

What is often called the "Full Nonforfeiture" benefit refunds all cumulative premiums paid, with no reduction for benefits collected, at the death of the insured (or second death in the case of a joint policy with two insureds). While this may sound very attractive, it is also very expensive. It should also be noted that this is a refund of cumulative premiums without any interest. It is not uncommon for this option to double the premium. If you can afford this option, a good way to evaluate whether it is a good value, is to compare the amount of money your beneficiary would receive upon your death to the amount of money you would have had in a savings account if you had simply put the additional money you are paying for this option into a savings account in which it was earning interest.

One other nonforfeiture option is often called a "Limited Nonforfeiture" option. It works the same as the "Full Nonforfeiture" option except that the cumulative premiums returned at death are reduced by any benefits collected from the policies.

Of course, to make this comparison we have to decide when you are going to die! Let's take a look at an example. A healthy individual age 60 could buy a very good policy with no nonforfeiture benefit for \$1296 per year. Including the shortened benefit period increases the premium by \$298 (23%) to \$1594 per year. Since this option provides no additional benefits except for people who lapse or cancel their policies, it is likely not to be very attractive to most people.

If you chose instead to include the "Limited Nonforfeiture" option it would increase the premiums from \$1296 per year to \$2100 per year, an increase of \$804 (62%) per year. If instead of buying the Limited Nonforfeiture option, you had invested the \$804 per year at 4% interest and if death occurred in 25 years, at age 85, you would have accumulated \$33,483. If you had no claims, the limited nonforfeiture benefit would refund \$52,500 to your heirs. To have accumulated \$52,500 in your investment, you would need a 7.22% rate of return every year. In today's investment climate a 7.22% return on your money sounds very attractive, but the amount of money refunded is reduced by any benefits you collect. If you collected benefits

for more than 155 days at age 85, you would have received the full \$52,500 in benefits and the "Limited Nonforfeiture" benefit would pay nothing at all.

Given the high probability you will collect benefits for 155 days or more, 62% extra seems to me too high a price to pay for something that could easily pay you nothing in return.

Finally, if you instead chose to include the "Full Nonforfeiture" benefit in the policy, it would increase the premium from \$1296 per year to \$2341 per year, an increase of \$1045 (81%). If we assume you die at age 85 after paying \$2341 per year for 25 years, your heirs will receive \$58,525, even if you did receive benefits from the policy.

If you had invested the additional \$1045 at 4% for the next 25 years, you would have accumulated \$43,520. To match the \$58,525 of the Full Nonforfeiture option, you would need to earn 6.15%. That number would be higher if death occurred prior to age 85 and lower if later.

This actually isn't all that bad of a return on investment. The reason I don't usually recommend the Full Nonforfeiture benefit is that most people seem to feel the premium without any nonforfeiture benefit is already too high. Since none of the nonforfeiture benefits add anything to the benefits collected when you need care, I would rather recommend options that increase benefits when you need care. If all you can afford is a 3 year benefit period with Full Nonforfeiture or a Lifetime Benefit period with no nonforfeiture benefits, I believe the lifetime benefit period is the better choice.

Since it seems like there is never enough money available to pay for all of the benefits it is desirable to include in a policy and because none of the nonforfeiture options enhances the benefits collected when care is needed, I rarely recommend nonforfeiture benefits.

Not intended to provide legal or accounting advice. Long Term Care is a complicated subject. It takes time to consider the implications of many of the options available. In addition to any necessary legal or accounting advice from the appropriate professional you should discuss your financial situation and objectives regarding long term care with a knowledgeable agent.