Certified Financial Services, LLC
600 Parsippany Road Suite 200
Parsippany, NJ 07054

Richard Aronwald
Financial Specialist

Exploring Whole Life + Term Versus Universal Life

Part I: An Insurance Primer

Introduction

In this paper, we explore both participating[1] whole life and universal life[2] insurance policies — the predominant life insurance policies used in personal financial planning today. We provide an overview of both types of life insurance, as well as a detailed comparison between them, and finally, offer our conclusions so that consumers will be able to make more informed choices when it comes to purchasing the life insurance policy they feel is right for them.

The Roots of Modern Life Insurance

With most types of insurance, policyholders are seeking protection from possible losses — a home fire, a car accident, etc. However, only life insurance provides financial protection from a *guaranteed* event — death. As a result, individuals must look at life insurance very differently than they do other types of insurance.

Before we compare the two products, it's worth exploring the history of both whole life insurance, which has existed for *hundreds* of years, and universal life insurance, which emerged *less than 50 years ago*.

Whole Life

The first life insurance company was founded in London in 1706 by William Talbot and Sir Thomas Allen. Early life insurance policies bore a striking resemblance to what we know today as whole life insurance.[3]

With a whole life policy, the insurance company assumes the *total* risk, guaranteeing[4] a level, fixed premium and a final payout at death, or when the policy matures. At maturity, the cash value equals the death benefit ("endows") and the company may pay out the policy value to the policy owner. As we will discuss below, whole life offers guarantees that no other form of insurance or savings account provides.

Universal Life

After centuries as the mainstay of life insurance, whole life became somewhat "boring" during the " high interest" rate period of the 1970's. Policyholders wanted flexibility and higher returns. It was at that time that universal life insurance was created by the iconic brokerage firm E.F. Hutton and its insurance arm, E.F. Hutton Life Insurance.

Universal life wraps an annual renewable term life insurance policy around either a savings or an investment-based cash product with flexible premiums, death benefits and payment schedules. These policies tie the cash value portion of the policy to a savings or investment vehicle with the minimum costs[5] set by the insurance company.

Universal life policies offer flexibility for the policyholder, allowing for changes to premium payments, death benefits and payment schedules. At the same time, policy contracts included language that would make it easier for life insurers to raise future premium payment requirements, mortality charges and administrative costs.

In addition, the universal life family of products includes a *speculative component* that is not offered by whole life products. With whole life, the insurance company bears the responsibility for performance — the costs, premiums and coverage are guaranteed, and the overall profits of the company are distributed as a dividend[6] to its policyholders. Modern forms of universal life, including equity indexed universal life (also known as indexed universal life) and variable universal life, tie cash value directly or indirectly to stock market indexes, mutual fund-like sub-accounts and other investment funds in an attempt to grow the cash value faster.[7]

Over the past few years, it has become clear that those who embraced universal life in the last several decades have been paying a price. In addition to experiencing both the see-saw financial markets of those decades and low interest rates on their savings, policyholders who are in or approaching their retirement years **are at risk** for two key reasons:

- They are outliving their policies
- The flexibility built into the policy — e.g., the ability to change premiums or death benefit — eroded their cash value and death benefit, and they are now asked to pay excessive premiums to maintain value in the policy

Universal life's innovations were developed in an economy that is drastically different than the one we are experiencing today — and that its creators did not foresee.

Part II: A Detailed Comparison

Participating whole life insurance and universal life insurance policies are designed differently and therefore perform *differently.* They are also quite different in terms of the impact from any policy changes. Any change made to a whole life policy must maintain the current and future integrity of the policy. This is not the case with a universal life policy, where changes can be made without regard for the survival of the policy.

In this section, we will compare the seven critical components of whole life and universal life:

1. Flexibility of premiums and death benefit
2. Guaranteed death benefit
3. Premium payments
4. Policy cash value
5. Endowment
6. Reduced paid-up option
7. Risk

#1 Flexibility of Premiums and Death Benefit.

Universal Life Policies	Whole Life Policies
• Allow policyholders to change the payment amount and the death benefit. – Making these changes can be done without regard for the survival of the policy. • Universal life policy illustrations use *current* mortality charges (the amount the insurer charges for the death benefit), rather than maximum possible charges. – This means premiums on universal life policies can be artificially low and may be insufficient to carry the policy to death or maturity. – Premiums are unable to "catch up" once they have fallen behind.	• Allow policyholders to reduce the premium amount and the death benefit. – Any changes made must maintain the current and future integrity of the policy. • Generally speaking, with a whole life guaranteed illustration, what you see is what you get. Dividends, although not guaranteed, can only increase values if reinvested. – Whole life premiums are based on maximum possible costs. As a result, they guarantee completion: The policy will still pay the death benefit at the insured's death or endow with a cash value equal to the death benefit when they reach age 100 or 121.

Important Considerations

- All life insurance policies have costs. The challenge is to understand what these costs are, and whether they are guaranteed or not.
- Mortality charges exist in both types of policies. A universal life policy illustrates current **mortality charges**, which are based on current costs. If planned premiums are insufficient or actual mortality experience is worse, *the company withdraws the difference from the policy's cash value*. If maximum mortality charges occur, the policyholder is forced to pay *higher premiums*, often later in life, when the policyholder has passed their peak earning years or worse, is uninsurable.
- With universal life, **rising premiums** are often required to maintain policy value. There is rarely anything a policyholder can do except drop the policy.
- Whole life illustrates guaranteed mortality charges at **maximums**, and if mortality experience is better, there is a **credit back to cash value** in the form of a dividend.

#2 Guaranteed Death Benefit

Universal Life Policies	Whole Life Policies
• The guaranteed death benefit is typically offered as an optional rider to protect the death benefit to some specified age when the policy value does not perform as illustrated. – Any policy changes, delinquent or late premiums, loans or partial surrenders may invalidate this rider.	• As long as the policy premium is paid, the death benefit is fully guaranteed. – Most whole life policies increase their death benefit annually to account for inflation, assuming dividends are reinvested.

Important Considerations

- In any type of universal life policy, **late premiums can invalidate any guarantees in the policy**. Even if the policyholder finally pays the premium, once it is past due, the insurer is not obligated to support any guaranteed premiums, cash value amounts, riders or death benefits.
- In many cases, with a universal life policy, the financial professional and the policyholder may not even know that a premium was late, resulting in the forfeiture of any guarantees in the policy and riders.
- In a whole life policy, if the premium payment is not made, **an automatic premium loan (APL)** is typically taken against the policy's cash value, which **prevents the policy from lapsing**. This loan can be paid back later without affecting the policy's guarantees.

#3 Premiums

Universal Life Policies	Whole Life Policies
• There are no guaranteed premium amounts. Premiums may fluctuate, based on varying costs and changes within the economy. • Typically, the premium recommended on a universal life policy is lower than that of a comparable whole life premium.	The required premium is a guaranteed level amount—regardless of changes in the costs or the economy.

#4 Policy Value

Universal Life Policies	Whole Life Policies
• Typically, a universal life policy illustration includes a guaranteed minimum gross earning rate, expressed as a percentage, along with guaranteed maximum monthly mortality and administrative expenses. There are no guaranteed cash values. – Since this figure is shown as a percentage, rather than a dollar amount, expenses will affect the actual cash value. – The illustration's guaranteed cash values will show at what age, and in what policy year, the cash value account is reduced to zero.	• A whole life policy illustration includes a guaranteed dollar amount, net of the guaranteed maximum monthly mortality and administrative expenses. – This minimum cash value, which is guaranteed to equal the death benefit at endowment age (100 or 121), assumes no dividends are paid. – In fact, the cash value is guaranteed to rise every year.

#5 Endowment

The endowment is the point when the policy's cash value is guaranteed to equal the death benefit.

Universal Life Policies	Whole Life Policies
With universal life policies, there is no endowment. In other words, the cash value is never guaranteed to equal the death benefit.	Whole life policies include an endowment age — usually 100 or 121 — at which point the cash value equals the death benefit, even if the insured is still alive.

#6 Reduced Paid-up Option

A reduced paid-up option allows the policyholder to reduce the death benefit amount, which guarantees no more premiums are due. In this scenario, the policyholder is able to retain the life insurance — albeit with a reduced death benefit — without owing further premiums.

Universal Life Policies	Whole Life Policies
Because a universal life policy never endows, it is never "paid up," or paid in full. As a result, there is no reduced paid-up option on any universal life policy.	In a whole life policy, the existence of a guaranteed future age at which the policy will endow makes it possible to reduce the death benefit amount so that it is guaranteed to be paid up, meaning no further premiums are due.

#7 Risk

1. The first risk of the life insurance policy is that the policyholder has to die in order to benefit fully from the policy's value.
2. The second is that if the premiums are insufficient to cover the cost of insurance, then you have to pay more. In a whole life policy, *the insurance company* carries the entire risk of performance. With universal life, *the policy owner* carries that risk.
3. The third risk is that the policy may or may not have cash value.
   – *In a universal life policy*, the cash value is based on the earnings performance of the underlying investments and the insurance company's costs; *the policy owner is carrying the risk*. The policy's cash value can be impacted **positively or negatively**.
   – *In a whole life policy*, the cash value is based on a guaranteed dollar amount plus earnings performance, and *the insurance company carries the risk*. Earnings can only impact cash value **positively** via dividends.

Considerations

The primary purpose of insurance is to offset risk — to shift the burden of risk to the insurance company. Universal life products move risk from the insurance company back to the policyholder.

Part III: Conclusions

When universal life was introduced — just like today — it was impossible to predict market performance, which endangered both universal life policies and retirement nest eggs. The downturns of the late 1980s, 1990s and 2000s wiped out preceding years' gains — and was followed by an extended low interest rate environment... just the opposite interest rate environment when universal life was created.

It is likely that we will again experience downturns that impact the performance of universal life policies, whether directly or indirectly. In fact, many universal life policies tied to current short-term interest rates are already in trouble, as their cash value is not growing fast enough to cover the increasing mortality costs. As a result, many financial professionals believe it is becoming increasingly difficult to justify the use of universal life as the foundational asset in a personal financial strategy, especially given the available alternatives.

Universal Life Changed the Nature of Insurance

Fundamentally, life insurance is designed to offset risk or loss. When the insurance industry began creating universal life products, they changed who bore and controlled the underlying risk. Essentially, they shifted the risk away from the insurance company and back onto the policyholders.

The risk scenario is further magnified when using a publicly held (stock) insurance company, where management's loyalty is to shareholders. As a result, they make decisions based on shareholder value, which often conflicts with the interests of policyholders.

By design, universal life products have a higher level of risk for the policyholder than whole life policies. The insurance company controls the seven critical components of these policies in exchange for the perceived value of flexibility. The policyholder can make changes to the premium, death benefit and payment schedules. However, with universal life policies, insurance companies also have the right to make changes at their discretion, and often to *their benefit.*

Whole Life Today and Tomorrow

Whole life insurance and mutual companies, where policyholders own the company, are over 300 years old. These businesses and products have survived great world crises — financial downturns, wars, empire building and much more. *The whole life insurance product purchased from a mutual insurance company is one of the most time-tested financial products around today.* It is a staple in the portfolios of the wealthiest individuals, families, businesses and banks.

Although whole life does not offer as much flexibility as universal life, insurance companies and financial professionals have created opportunities to design whole life with some flexibility. For instance, whole life policies can be designed to use a flexible paid-up additions rider[8], dividends or the Reduced Paid-up option.

One distinction of whole life is the number of guarantees offered, particularly in the seven critical components of our comparison. These guarantees remain as long as the premium is paid.

The guarantees of a whole life policy disclose the worst-case scenario. When the performance of any aspect of the policy is better than the worst case, the policyholder gets a cash value credit, or a dividend. Dividends (while non-guaranteed) are declared and paid annually. Once a dividend is paid, it becomes a part of the guaranteed cash value, and resets the minimum guarantee to a higher level. If a company announces no dividend, there is always a minimum guaranteed cash value increase.

When combined with a separate convertible term insurance policy, a whole life policy provides long-term guaranteed benefits; a convertible term insurance policy protects human life value in case of the main financial provider's early death.

When it comes to risk and performance, whole life positions risk equitably with the insurance company and offers guaranteed performance throughout the life of the contract. Few financial products can provide the certainty and security of whole life.

Key Takeaways

If you are thinking about purchasing a universal life insurance product, consider the following:

- **Universal life insurance products are <u>not</u> similar to whole life insurance**. Universal life products place the risk on the *policyholder*, and it can be difficult to guarantee their performance.
- **Universal life products place many risks upon consumers, their families and their assets**. These

insurance contracts are complex policies with many moving parts, resulting from both their flexibility and the use of an investment or savings product for building cash value.

- **Remember that comparing a universal life illustration to a whole life illustration is <u>not</u> comparing apples to apples**. It is easy for universal life illustrations to look good. The question is: Will they look good for your *whole life*? Since there is no way to illustrate potential changes accurately, we simply don't know. When considering a universal life policy, read the illustration carefully… especially the fine print. *And remember*: The current illustration's numbers show only what's happening *at that moment in time*, **<u>not</u> what will happen in the future**. Note that a universal life policy's guaranteed section reveals a more accurate picture of how much risk (exposure to loss) you could be opening yourself up to, as well as what kind of performance you can expect.

- **If you want life insurance with a death benefit, buy whole life**. If you want investments, buy stocks, bonds, real estate or other alternative investments. When you mash the two products together, as universal life products do, you may find that you got a camel instead of a thoroughbred.

- **In all cases, be sure to read policy documents <u>carefully</u>**. Consumers are responsible for reading every page of their insurance contract. Whether it's a whole life, universal life or term policy, it is a private contract between the policyholder and the insurer. While financial professionals can help you understand the risk and performance of the policies they recommend, *you* make the final decision.

Last… Flexibility seems to have provided more benefits to the universal life insurance company rather than to the policyholder.

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[1] "Participating" refers to an insurance contract that pays dividends from the insurance company. The policyholder shares, or "participates," in the insurance company's surplus income in the form of a dividend. This designation is an indication that the whole life insurance policy was sold by a mutual insurance company. Dividends are not guaranteed. They are declared annually by an insurance company's Board of Directors.

[2] Because all universal life-based products are designed with the same basic structure, we use the umbrella term "universal life" throughout this document to represent all variations of the entire universal life product family, such as equity indexed, indexed universal life and variable universal life.

[3] When we talk about whole life, we mean participating whole life policies sold by a mutual company, which makes all decisions in the best interests of and is answerable to the policyholders. With a whole life policy sold by a stock-owned firm, the company makes all decisions in the best interests of the stockholders, with less consideration for the policyholders' interests.

[4] Policy guarantees are subject to the payment of all required premiums and the claims-paying ability of the issuing insurance company. Policy loans and withdrawals affect the guarantees by reducing the policy's death benefit and cash values.

[5] It is important to note that if the premium is not sufficient to cover the actual annual administrative and mortality costs, the difference comes out of the cash value or savings portion of the policy. The initial illustration of a universal life policy typically shows the "minimum" costs, which enables the insurer to show a lower, more attractive premium. When costs rise, the company makes up the difference from the cash value, then increases premiums to maintain cash value.

[6] Dividends are not guaranteed. They are declared annually by a company's Board of Directors. The total dividend calculation includes mortality experience and expense management as well as investment results.

[7] Equity indexed or indexed universal life was created in 1997, while variable universal life was created in 1994.

[8] Paid-up Additions (PUA) are purchases of additional insurance (death benefit) that have a cash value. These purchases are made with dividends and/or a rider that allows the policyholder to pay an additional premium over and above the base premium. This creates the growth of death benefit and cash values in a participating whole life policy. Adding large amounts of paid-up additions may create a Modified Endowment Contract (MEC). A MEC is a type of life insurance contract that is subject to last-in-first-out (LIFO) ordinary income tax treatment, similar to distributions from an annuity. The distribution may also be subject to a 10% federal tax penalty on the gain portion of the policy if the owner is under age 59½. The death benefit is generally income tax free.

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Richard Aronwald
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600 Parsippany Road Suite 200
Parsippany, NJ 07054
973 263-0622
raronwald@cfsllc.com

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