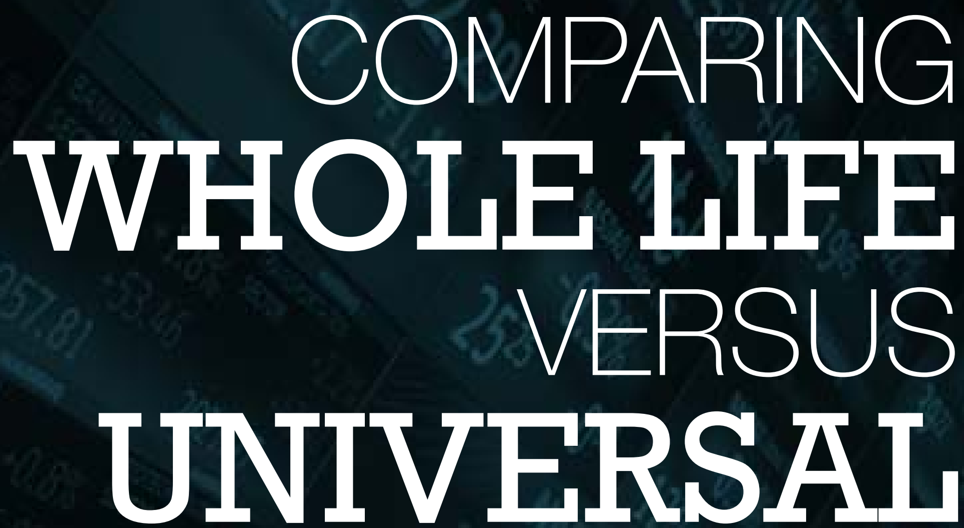

COMPARING WHOLE LIFE VERSUS UNIVERSAL

by Robert P. Murphy, PhD

In both the *Lara-Murphy Report* and our book, *How Privatized Banking **Really** Works,* Carlos and I explain the benefits of Nelson Nash's Infinite Banking Concept (IBC), which involves the disciplined use of dividend-paying life insurance policies. Since Nash himself couches the discussion in terms of *whole life* policies, we naturally did the same.

However, there are other categories of permanent life insurance policies that have "cash value" besides whole life, and people often ask us what the difference is. In the present article I'll sketch the comparison between whole life (WL) and universal life (UL) policies.

BECAUSE OF THE APPARENT BENEFITS **OF GREATER TRANSPARENCY AND FLEXIBILITY, AS WELL AS THE ABILITY TO BENEFIT MORE IMMEDIATELY FROM UNUSUALLY HIGH INTEREST RATES, THERE WAS A LARGE SHIFT IN THE INSURANCE INDUSTRY AWAY FROM WL AND INTO UL POLICIES DURING THE EARLY 1980S.**

THE ORIGIN OF UNIVERSAL LIFE

Subscribers to the *Lara-Murphy Report* will remember Carlos' article from the April 2012 issue, in which he laid out the history of the scathing 1979 FTC report on whole life. One of the major complaints was the lack of transparency, with consumer advocates claiming that policyholders had little understanding of how their contracts worked and what returns they were earning on their money. In short, the claim was that a typical WL policy was a black box, with various and hidden expenses taken out from the gross premium payments, leaving less available to build up as cash value.

To combat this alleged lack of transparency, insurers offered UL policies which were designed to "open up the hood" on permanent life insurance contracts. In any given period, the charges (such as mortality) assessed on a UL policy are explicitly and contractually specified, so that the policyholder can (in theory) understand exactly what happened to his gross premium payment.

In addition to breaking up the components of a standard WL policy into separate categories, the UL policy offered more flexibility—hence the name "universal." Rather than paying a fixed, level premium as with a WL policy, the UL policy allows the owner discretion to contribute whatever amount he wants. When cash flow is tight, the policyholder can contribute less, making up the difference when things are better.

Because of the apparent benefits of greater transparency and flexibility, as well as the ability to benefit more immediately from unusually high interest rates, there was a large shift

in the insurance industry away from WL and into UL policies during the early 1980s. In 1979 WL policies accounted for about 85% of new premiums sold, but by 1986 the figure had dropped to about 50%. The drop was almost entirely accounted for by the rise of UL.[1]

grew at the guaranteed interest rate.

To repeat, in my article I was discussing *whole life* policies, even though the actual contracts for such policies don't promise the policyholder a detailed breakdown year by year of the mortality charges and other deductions

EQUIVALENT…IN THEORY

Perhaps ironically, from a theoretical accounting standpoint, WL and UL policies are actually quite similar. Indeed in the May 2012 issue of the *LMR*, in my article on guaranteed interest rates, I showed a table where the (gross) level premium on a WL policy had mortality expenses deducted each year based on the mortality rate and the Net Amount at Risk (NAR). After the mortality expense had been deducted, the balance of the premium went into the cash value of the policy, where it

out of the gross premium. Instead, the WL contract merely shows what the level premium payments will be, along with the string of guaranteed cash values and death benefit available at various future dates. But this parsimonious display hides the fact that *behind the scenes* the insurance company is running the same calculations that appear more explicitly in UL contracts, in order to properly price its WL contracts.

Here is another way of seeing the theoretical equivalence between WL and UL: If someone

has a UL policy set to the same death benefit, and with the same interest rate and mortality parameters, then by choosing to make the same premium payments as would apply to a comparable WL policy, the behavior of the UL policy would mimic the WL policy. Indeed, this is why some people argue that it is smarter to use UL policies even for privatized banking purposes, since a UL policy can always do the same as a WL policy, but it also carries more options.

In other words, the fans of UL are claiming that flexibility is inherently a good thing, and that the worst that can happen is a policyholder will elect *not* to take advantage of this freedom and will instead behave exactly as if he had taken out a WL policy.

cyholder can unwittingly eat away at the UL's cash value by underfunding it. Remember that there is no fixed premium payment that the policyholder must make. In a given period, if the contribution is less than the mortality and other expenses assessed on the policy, the cash value will go *down.* Nelson Nash writes:

Universal Life was invented in the early 1980s by E.F. Hutton, a stock brokerage firm that, in my opinion, knew nothing about life insurance….

This happened during a time of high interest rates and it "looked good" in the early years of the policy. When I first saw the policy I ran some illustrations and they kept "falling apart" when the insured attained age 65 to 70. The cost of one-year term became prohibitive at the advanced ages and "ate up the cash fund" from that point forward. Therefore, I never sold one of them when I was in the business—and I surely wouldn't buy one![2]

THERE ARE HORROR STORIES OF PEOPLE **SENDING PAYMENTS ON UL POLICIES TO THE INSURERS FOR DECADES, ONLY TO RECEIVE A LETTER INFORMING THEM OF HUGE AMOUNTS OWED JUST TO KEEP THE POLICIES FROM COLLAPSING.**

DIFFERENT…IN PRACTICE

Despite the claims of its advocates, however, there are fierce critics of UL policies. For one thing, continued tweaking of their structure has resulted in a situation where now the allegedly transparent UL policy is arguably more confusing to the customer than a traditional WL policy.

A much more serious problem is that a poli-

To understand the potential dangers of UL policies, consider: Many people in the early 1980s switched out of WL policies and into ULs, because agents showed them that in the high interest rate environment of the time, one could achieve the same death benefit coverage on a UL policy with a lower premium contri-

bution than was necessary on a WL policy. The problem is that when interest rates declined, some of these policyholders failed to increase their premium payments. Not realizing that these "free lunches" from the policy switch were a temporary phenomenon, these unsuspecting policyholders were eating away at their wealth. There are horror stories of people sending payments on UL policies to the insurers for decades, only to receive a letter informing them of huge amounts owed just to keep the policies from collapsing.

Now it's true, there are comparable dangers with a WL policy. The way to mimic underfunding of a UL policy, would be to pay the level premium (as contractually required) but then to borrow most of it right back. Depending on the relationship between the policy loan interest rate and the dividends paid on the WL policy, the insurer might send a similar notice to the owner, explaining that at least some of the interest on the loans would have to be paid, to keep the WL policy in force.

Naturally, such irresponsible borrowing isn't what Nelson Nash advocates—he tells his fans to "not steal the peas" and pay back policy loans on a systematic basis. Even so, my point is that one can get into trouble with a WL policy as well as with a UL policy, through excessive borrowing and failing to pay back the policy loans. This is the WL analog of someone who underfunds a UL policy. Yet notice that it takes a much more conscious decision to borrow against a WL policy, rather than the much more understandable mistake of (say) making the same premium payments on a UL policy, even though portfolio returns don't live up to expectations when the UL policy was first taken out.

WHEN SOMEONE TAKES OUT **A POLICY LOAN WITH A WL POLICY, THE MONEY DOES NOT "COME OUT OF THE POLICY."**

POLICY LOANS IN WL VS. UL

On the issue of policy loans, there is a formal distinction between the two classes that is actually not as significant in practice. When someone takes out a policy loan with a WL policy, the money does *not* "come out of the policy." Rather, the insurer lends the money as a distinct transaction, with the cash value of the WL policy merely serving as the collateral on the loan. The WL policy itself continues to operate just as before, with the only difference stemming from the policy loan being lower dividend payments, if the insurer practices direct recognition.

In contrast, taking out money from a UL policy is like making a negative premium contribution. It effectively withdraws the funds out of the available cash value, so that there is a lower total rolling over at the credited interest rate.

Although these formal treatments are different, in practice the impact on the policyholder is largely the same. It's true that withdrawing money from a UL policy leaves less available to grow at compounded interest. However, the upside is that there is no policy loan growing exponentially, either. In other words, even though the WL policy grows more quickly because money is never taken out of it, the *net* cash value available—determined by subtracting the total amount due on the policy loan—is the right figure to consider, for an apples to apples comparison of the two methods.

EQUITY EXPOSURE MEANS MORE RISK

In addition to a plain vanilla UL policy, there are also variants that seek to capture exposure to stock market gains. An *equity indexed universal life* (EIUL) policy has built-in floors, just like a WL policy, but it also promises to rise (albeit in a muted fashion) with the stock market.

Some analysts look at historical returns and conclude that EIULs provide more wealth in retirement years than a traditional WL policy. There are many pitfalls when making such comparisons, but one of the most obvious is that it ignores *risk*. After all, over long stretches the equity markets tend to outperform fixed income assets. Yet this greater expected rate of return compensates for the greater volatility.

In other words, it would be silly for someone to say, "Nobody should ever buy bonds, because stocks or real estate historically earn higher returns." This is because people often want to keep some of their wealth in very *safe* assets, which won't drop 40 percent in a year the way the S&P 500 did during the recent crisis. By

the same token, then, one can't dismiss WL policies merely because EIULs exhibited a greater rate of return over some historical period.

Todd Langford has published a scathing critique of EIUL policies.[3] One of his subtle points is that when the "side fund" goes down because of a drop in the stock market, the policyholder is hit with a double whammy. Not only does the side fund lose value, but now the pure term insurance component carries a higher mortality expense. This is because the insurance company—in order to cover itself vis-à-vis the face death benefit on the EIUL policy—has to effectively take out a one-year term insurance policy on the insured, with a death benefit equal to the "Net Amount at Risk," namely the face death benefit on the EIUL policy minus the market value of the side fund at that moment. Thus, when the side fund drops in value, the size of the implicit term insurance policy is bigger, and hence the EIUL policy's value absorbs a larger mortality expense.

CONCLUSION

Whole life policies are surprisingly complex creatures, where the contractually specified premium and projected cash values are derived from a host of calculations that remain hidden to the policyholder. In order to promote transparency, and facilitate comparisons with other financial products, universal life came on the scene in the early 1980s and quickly captured a large share of the market.

Theoretically, WL and UL policies can achieve similar results with the appropriate actions of the policyholder. However, a person can put a WL policy in a drawer and forget about it; the level premiums were designed to allow the policy to hit its cash value milestones year after year. In contrast, insufficient oversight can lead to a gutted UL policy; the risk of an underperforming portfolio is effectively on the policyholder. It is for this reason that we warn neophytes not to use UL policies for privatized banking purposes, since the "safety is off" as it were. From our vantage point, it is much safer to steer people into traditional WL policies, which can always be customized with various riders to satisfy financial objectives on a case by case basis.

Bibliography

1. Black, Kenneth and Harold Skipper. Life Insurance (NJ: Prentice Hall, 12th edition, 1994), Figure 4-1 on page 83.
2. Nash, Nelson. Becoming Your Own Banker (Birmingham, AL: Infinite Banking Concepts, LLC, 2008, Fifth Edition), p. 39.
3. Langford, Todd. "The Top 10 Reasons NOT to BUY Equity Indexed Universal Life." www.truthconcepts.com