Universal Life; The Answer or the Problem?

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A quite mathematically detailed and negative critique of Canadian Universal Life Insurance programs. PDF (original)

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1 Why this matters

Here is the math behind why Canadian UL life insurance policies (known as VUL in the United States) do not work effectively as a "tax shelter". It is your responsibility as a financial "professional" to understand these concepts, and to assist owners of such policies to understand them, too! Remember, Canada is a free country; it's just fine for a client to choose to purchase any investment they wish, based on full and truthful disclosure. However, it is fraudulent to imply that an inferior investment is actually superior, and thus cause the client to make an incorrect choice! This is what is wrong with selling UL policies as an investment, a "tax shelter", a "Leveraged or Insured Retirement Plan", or even as "term insurance with a savings plan". It is simple to show that UL policies with certain types of extra fees cannot outperform a separate term policy + the identical investment. Their internal cost structures simply do not allow them to! To imply otherwise is to perpetrate a fraud. This particular word was very carefully chosen:

fraud (frôd) n.

1. A deception deliberately practiced in order to secure unfair or unlawful gain.
2. A piece of trickery; a trick.
3. One that defrauds; a cheat.
4. One who assumes a false pose; an imposter.

Of course, the following explanations depend on the client (and insurance agent) wanting to, and being able to read and understand their own contract. If a client purchases the product based completely on trust, and has no desire to read and understand where their money is going, then there is nothing that can be done to help them! It doesn't change the fact that the agent is responsible to tell them the whole truth in the first place; there just may not be anything you can do to help them...

2 Two General Classes of Fees

There are two broad classes of fees in most Universal Life policies; fixed up-front fees due to insurance costs, policy fees, and premium tax based on the amount of insurance purchased or the amount of money invested that year, and compounding annual fees on the growing investment amount within the policy. The fixed up-front fees are very similar to those found in most term insurance policies, so can be factored out of most comparisons of UL vs. BTID (Buy Term and Invest the Difference), because the same amount of money can purchase the same amount of insurance from the same company, either within the UL, or outside the UL program in the form of term insurance.

2.1 Up-Front Fees: Well Disclosed...

In fact, the additional 2% premium tax on the total deposits into UL policies generally allows more term insurance to be purchased outside the UL, for the same amount of money (because the portion going to savings outside a UL policy isn't subject to this tax). Even though the up-front fees are large, especially when the program is sold primarily as a tax-deferring investment rather than insurance (such as for this Universal Life Insurance "education savings plan" on a child), they are minor compared to the long term damage inflicted by the other type of fees. These up-front flat fees are well disclosed in UL projections.

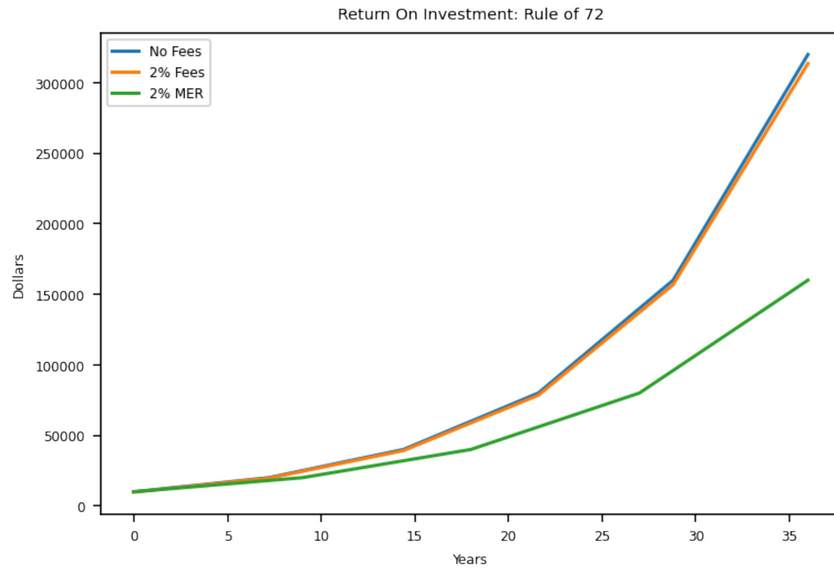
2.2 Compounding Fees: Not so much...

The excessive compounding annual fees (MERs) are the primary source of problems in UL programs, and are not disclosed diligently in most projections, and are misrepresented in those that disclose them at all! Typically from 2.5%/year (Zurich Life) to 6%/year (Standard Life Perspecta) gross (before bonuses give a portion back), these extra fees on the compounding investment account essential destroy any UL program's ability to preserve a client's estate, over any long period of time.

Since UL programs only work if maintained until death (the only point where the savings are paid out as a tax-free death benefit), the time periods are typically quite long (~35 years life expectancy for a 50 year old client).

The impact of an excess annual compounding fee can be estimated by using the rule of 72; if the net after-bonus extra fee is 2%/year, then the client will have half the assets after 36 years, as compared to the identical investment in an open investment account! If the net after-bonus extra fee is 3%/year, then the client will have about half the money in 24 years! These excess MER fees vastly outweigh any other fee the UL policy could charge (except in extreme circumstances). Here is an example of the difference in impact between a 2% up-front extra fee, and a 2% compounding annual fee, over 36 years:

Fee Type:	year	NoFee	year	2% Fee	year	2% MER
Net Return:		10.0%		10.0%		8.0%
Doubles in:	–	7.2 years	–	7.2 years	–	9.0 years
Initial Deposit:	0	$10000.00	0	$9800.00	0	$10000.00
(1st doubling)	7	$20000.00	7	$19600.00	9	$20000.00
(2nd)	14	$40000.00	14	$39200.00	18	$40000.00
(3rd)	22	$80000.00	22	$78400.00	27	$80000.00
(4th)	29	$160000.00	29	$156800.00	36	$160000.00
(5th)	36	$320000.00	36	$313600.00		



Now, of these two classes of fees, which do you think is the most important for the client to be well informed of? So, why are the up-front fees disclosed diligently, but the disclosure of excess net annual compounding fees (MER) is incorrect, or completely absent, and no one in the industry or regulatory body seems interested in challenging this? Perhaps the "goals and objectives" of the average UL client would suddenly change, when it is disclosed that they would lose half their assets over 36 years?

Since the exact same amount and type of life insurance is being purchased outside the UL policy, using the same amount of money, and the maximum tax rate on capital gains is 19.5% in Alberta, it follows that the client will A) have roughly double the money in the non-UL plan after 36 years, compounding at 2% greater annual ROR (Rate of Return) to draw income from during retirement, and B) the net after-tax combined death benefit of the non-UL plan will be greater at death, whether death occurs the day following the first premium payment, or at age 100.

In fact, the greater the amount of money invested in the UL program, and the longer the program exists, the more it reduces the total after-tax net benefit to the client! The idea of "ideal high net worth UL clients" is a sham! The only one who benefits more from an "ideal" client, is the agent!

3 Incomplete

See original.