Another Look at UL Insurance

Robert MacKenzie

About five years ago I spoke on Universal Life (UL) insurance at a *MoneySaver* event and concluded, that depending on the policy, it was a great product for estate planning when compared with regular index or mutual fund investments. In view of increases in the cost of UL's insurance, its administration fees and in reductions of personal tax rates and the capital gains inclusion rate, is UL still an outstanding product? We'll run a comparison and see.

What UL is Like

UL can combine aspects of one of the basic types of life insurance with an investment programme tied to GIC, mutual or index fund returns. It could make use of yearly renewable term insurance (YRT) which is cheaper in the early years and becomes more expensive as a person ages. Or it could employ Term to 100 insurance (T100) for which the same "level" premium is payable every year. Along with paying the annual premiums for YRT or T100 insurance the policyholder has the option of contributing extra money to a reserve fund within the UL plan that will be used to pay premiums in future years. This money can be invested in guaranteed vehicles (GICs) or in non-guaranteed accounts (linked to the performance of an index or mutual funds).

What is attractive about this reserve fund is that its growth is not subject to tax and will be paid out tax free at death along with the tax-free insurance death benefit amount. The tax-free advantage is also valuable in that annual premiums are paid out of the tax-free earnings, effectively reducing the cost of insurance from what it would be if the premium were paid with after-tax dollars from outside the plan.

Before I leave this section let me acknowledge that Universal Life is an exceedingly complex product that is often not well understood by either insurance agents or consumers. With diligent study its mysteries eventually become clear. So, if you are interested in it, make sure that you talk with a trusted and well-trained advisor who has made the effort to master it and who has your best interests at heart. Too many people have already been burned by hasty purchases!

Five Years Ago and Today

Five years ago I used, as an example, a UL policy whose reserve fund was linked to an underlying segregated fund (with an MER of 2.35%). There were no extra fund administration charges. As for its TSE 300 index fund option, the company retained the annual dividends (2% or less) for itself and levied no extra charges. Almost no monetary bonuses were paid to policyholders but they were rewarded for staying with the programme by guaranteed decreases in policy fees and other costs. That relatively simple formula is now long gone.

At present, almost all UL has higher investment fund administration fees imposed upon their index fund options, running at around 3 to 4%. If a reserve fund is linked to the performance of a mutual fund, a somewhat smaller charge of 2-3% or so may be piled on top of the fund's regular Management Expense Ratio (MER) of about 2.5%. In place of guaranteed decreases in policy costs, most companies now offer contingent bonus payments that are made only when the amount of money in the reserve fund reaches a certain level or the investment performance of the reserve fund achieves a certain rate of return. In addition, because interest rates have fallen and insurance companies depend on investment return to secure their long-term guaranteed death benefit commitments, the cost of permanent insurance has risen in recent years.

As for regular investments, top personal tax rates have fallen from 50% to about 45% in Ontario in the last five years and the capital gains inclusion rate has been cut from 75% to 50%. Both of these changes have made it more profitable to invest in equity (stock-based) shares and funds than it was five years back.

Doing the Math

How good is UL when compared with straight mutual or index fund investing? Five years ago when tax rates were higher and insurance costs were lower it looked great. Is this still the case? Using an actual insurance company illustration, we will compare a regular index fund investment with the same tax-sheltered index fund investment held in the reserve portion of the UL policy.

The UL assumptions used in the study are that a husband and wife are non-smokers and aged 55, purchase a $250,000 policy on a joint, last-to-die basis. This provides them the cheapest cost of insurance because it only pays out after both have died (representing less risk for the insurer). The annual cost of the insurance is about $1,450 and the minimum premium (a UL wrinkle) is $1,800. The policy tax is $120 annually, there is a 2% tax on premiums (it is 2% in Ontario, but it varies up to 4% according to province and company) and no automatic increases in the face value amount (another wrinkle!) are accepted. An amount of $7,000 is deposited to the plan every year for 4 years in one case and for 10 years in the second instance. This amount triggers the policy's periodic bonus payment.

The gross rate of return used in the UL illustration software is set at 9.75%. However, this rate must be reduced by the policy's investment fee deduction of 2.75%, yielding a net rate of return of 7%. The UL is not subject to taxation upon the death of both people insured.

As for the index fund used for comparative purposes, it is the same index fund that is employed by the UL plan with the same 9.75% gross return as that of the UL's fund. A management fee of 0.5% has been assumed (it could be lower) and a deduction of 0.5% has been made to account for ongoing annual taxation (mainly on dividends) with no provision being made for increasing the adjusted cost base at the time of redemption to account for ongoing dividend reinvestments. The assumed net rate of return is, therefore, 8.75%. When the investment fund is redeemed after the death of both spouses, tax will be payable at a 22.5% rate or half of 45%, assuming the current 50% capital gains inclusion rate and 45% top personal tax rate.

If UL and index fund deposits of $7,000 are made for 4 years and then no more contributed, the UL reserve fund will be worth $57,000 in 30 years at age 85. Coupled with the $250,000 insurance death benefit, the total payout upon the death of both people will be $307,000. The index fund option will be worth $244,000 after taxes in 30 years. The insurance is ahead at this point by about 25%.

If UL and index fund contributions are made for 10 years, the UL reserve fund will total $311,000 and with the insurance death benefit the total payout will be $561,000 in 30 years. The index fund will total $490,000 after taxes in 30 years. Again the UL wins out.

In the years following year 30, as the index fund compounds at its greater net rate of return and the insurance death benefit comprises less and less of the total payout, the index fund's value will begin to exceed that of the UL.

These assumptions are skewed somewhat in favour of UL in that reserve investment fund deductions are often higher than 2.75% and Canadian dividends from index funds carry a tax credit. On the other hand, the fact that the UL is a joint last-to-die policy means that it is unlikely that both the insured people will die and the policy pays out before age 85. So the availability of the death benefit payment of the UL during the years that the index fund is slowly growing does not provide a favourable advantage to the insurance option. If only one person is insured in order to make the payment of the death benefit more likely, the face value of the insurance policy for the same annual premium amount would be less ($100,000 for the husband $125,000 for the wife instead of $250,000 jointly). The "catch-up point" for the index fund in relation to a single insured life would be about 26 years rather than 30 plus.

Summary Comparison

All in all, from a purely mathematical point of view it appears that UL is not a bad product even though it is more costly than it was five years ago. As long as a person does not want to use the money invested in the UL policy for themself but pass it on as part of an estate planning or succession planning strategy, it does an adequate job. It would take over 25 or 30 years for an index fund investment to catch up to what UL would pay to its beneficiaries.

That said, if the owner were to withdraw money from their UL policy before their death, not only would they not receive the death benefit but the money withdrawn would in great measure be subject to the highest tax rate as interest income rather than capital gain. (I am ignoring the option of borrowing against the cash value of the fund.) By way of comparison, if they took their money out of the policy after 30 years, a straight index fund would have exceeded that amount in only 10 years with 4 years of deposits, or fewer than 20 years with10 years of deposits.

With this in mind, the question for a potential buyer of UL to ask should be "Do I really want all this money to go only to my heirs?" If the answer is "Yes", then UL can provide a simple and convenient means to accomplish this aim. It provides for tax-free switching among investment funds and GICs, presents less temptation to be cashed in prematurely in the event of market crashes than a regular index fund would, and can be protected from creditors.

If the answer is "No, I may want access to that money," then a person should consider a straight index fund investment, a less volatile DRIP portfolio, a mutual fund or a life-insured segregated fund, all of which are continually available for redemption at favourable tax rates. Or to ensure that an estate benefit will always be present, a combination insurance and savings plan could be developed. Such a strategy would use Term 20 or Term to100 life insurance to make sure that a minimum estate value was always present during the years which the index fund is building up.

Unlike the insurance component of Universal Life, this T20 or T100 insurance could be shut down anytime with-out affecting the savings component of the overall plan. And any premium savings could be put to other uses, including ongoing investment. A T100 policy that is fully paid up in 20 years of payments and offers guaranteed cash values after year 15 is one attractive option to consider, depending on how long the insurance is to stay in force. Such a combination plan is not far off the intent of the old "buy term and invest the difference" strategy. It combines the best of both worlds, providing estate value and ready access to money when needed.

Robert MacKenzie, PhD, CFP, CIM, Financial Advisor, 1493 Merivale Road, Nepean, Ontario K2E 5P3 (613) 225-1500 or (888) 571-2444 rkmackenzie@sprint.ca