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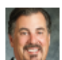
Retirement Disaster Looms For Universal Life Policyholders

 John E. Girouard , Contributor

The insurance industry has a dirty little secret that threatens the retirement plans of millions of unsuspecting families.

The problem is buried in the fine print of universal life policies, widely promoted since the 1980s as a new and improved version of the old-fashioned whole life insurance product our grandparents relied on as the surest way to save for retirement.

Based on my experience as a financial advisor, most people have no idea about what they've already lost and will discover in time that there was no "sure" in their insurance. Instead, the insurance companies shifted their risk on to to their policyholders.

The new and improved universal whole life policies were designed to take advantage of high interest rates and growth in stock prices to reduce premiums and boost cash values—the term for the built-in savings component of a life policy.

That was the same argument the financial industry used to kill off the defined-benefit pension plans our grandparents relied on in order to sell a new generation of savers on the idea that 401-Ks had the potential for higher returns. Those higher returns might have come true had the assumptions panned out, but instead they failed in the biggest possible way.

Universal policies became attractive because they offered a higher rate of return (the dividend) on the savings component than one could get from old-fashioned whole life. The trade-off was that, unlike old-fashioned whole life, the effective premiums for the universal policy death benefit rise as the policyholder ages.

The insurance companies set a minimum premium payment based on a policyholder's age at the time, and then used prevailing returns on stocks and bonds to argue that there would be enough profit on investments to cover both the rising premiums and the guaranteed dividend on the cash value.

In theory, the stock market would pay the added premium costs and the dividends. Millions bought universal life policies on the basis of those projections.

But most skipped the fine print, signed the papers, and squirreled them away in their safe deposit boxes where they've been for decades. Hidden in those policies was this potential time bomb: if the projected investment returns fail to materialize, the insurance company can make up the difference by reducing the cash value—taking money out of your cash value savings account—right down to zero, if necessary. And when that's exhausted, they can require the policyholder to make up the difference in the death benefit premiums, or risk the policy expiring worthless.

Unlike the 1980s and 1990s when many universal policies were sold, today's interest rates languish at historic lows. In the past 12 years the stock markets have suffered two historic collapses. For those reaching retirement age now—coupled with the housing bust and a crippled economy—this is a recipe for failure, and it's starting to hit home.

Universal life policyholders who faithfully paid all the minimum premium payments all those years are discovering that the cash values that were to be their retirement nest eggs are nearly exhausted, and many are having to cough up huge payments just to keep the death benefit from lapsing.

For example, people who bought universal life policies when they were in their early thirties, with a $100,000 death benefit, might have faithfully paid minimum premiums of about $3,500 year in and year out thinking all was well and they were building their nest eggs. When they were younger and cheaper to insure, they were–those premiums went into the cash value buckets and earned untaxed dividends.

But as they got older, the "real" premium—the cost of insuring them—rose. A person in his or her late 50s might have a policy whose cost of insurance—the real premiums—have doubled. Five years further on, the real premium could jump to tens of thousands of dollars.

Most policyholders don't realize they have a problem, until one day they need the cash value or discover that they will be left without even the life insurance.

How we got here is depressingly familiar in an age of financial mis-engineering. Up until the advent of universal whole life, the predominant form of life insurance for the middle class was participating—or mutual—whole life, where policyholders are treated as mutual owners of a non-public insurance company.

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In such a policy, premium payments never change and accumulate like cash in a bank account earning modest dividends—guaranteed by the company—that are not taxed. Policyholders can borrow the money they paid in anytime for any purpose, no questions asked, which in turn reduces the death benefit to compensate. Policyholders can repay the loans later and the death benefits go back up again. In effect, policyholders are borrowing from and repaying themselves just as they do with any bank or investment account.

Universal life is a modern invention that takes the "sure" out of insurance by tying the benefits to the performance of stock and bond markets. In contrast, mutual whole life has ancient roots, enduring the millennia because it's a simple and safe way to grow a nest egg while providing for one's heirs. The practice of pooling resources this way dates as early as Roman times when people formed burial clubs to pay funeral and living expenses for member families. The earliest mutual life insurance companies in the U.S. date to the 1700s, formed by church groups to benefit their congregants in time of need.

By the mid-twentieth century, the mutual insurance industry had become the Rock of Gibraltar in the financial lives of millions of Americans. Mutual insurance companies invested their members' premiums so conservatively that the industry survived the Great Depression intact. Those old-fashioned values have persisted and that's why most mutual insurance companies came through the recent Great Recession with their blue-chip ratings unsullied while publicly-owned stock companies had to be bailed out to avoid bankruptcy.

I know all this because I am a reformed universal life believer. In the 1980s I became successful by helping clients replace their old reliable mutual whole life policies with the new and improved universals. By the 1990s, when some of my clients began to reach retirement age, the hidden flaws showed up when the projections fell below their targets.

I felt betrayed by the companies that had persuaded me that universal life was a better policy because stock markets historically averaged a better return. I wondered what I'd done wrong, so I went back and studied the fine print, discovering that these policies were written to shift risk from the company to the policyholder. Universal life policies allow companies to

raise premiums or siphon off cash values if they can't make enough from investments to meet their costs and still earn a profit.

That uncertainty is exactly the opposite of what whole life is supposed to accomplish—a savings nest egg that will be there no matter what happens.

Universal life policyholders who want to learn where they stand can request from their insurance companies two in-force ledger illustrations: one showing the state of the benefits at the current premium; the other showing the cost to keep a policy in force to age 100.

There are some alternatives and options for universal life policyholders, depending on how insurable they still are and other circumstances. In some cases, it's possible to keep a policy in force at the current premium by reducing the death benefit.

For those interested in buying the right kinds of life insurance for their situations, start by determining whether a product being offered is from a mutual life insurance company that will be owned by you, or by a stockholder-owned company that is obligated above all to earn a profit for somebody else. Knowing the difference could determine the quality of your retirement.

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