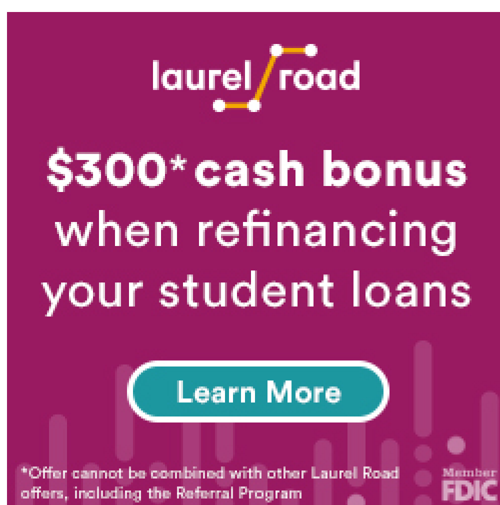
The Downsides of Whole Life Insurance

Long-term readers know I'm not a fan of whole life insurance. I have owned a policy in the past, but do not currently own one and honestly doubt I'll ever purchase one in the future. Long-term readers may not, however, be aware of an ongoing trend on this website. When I write a post on whole life insurance like this one, it gets a few comments from regular readers and then disappears down the list of blog posts. A few months later, as it starts gaining traction in the search engines, every few days a whole life insurance salesman, or simply someone who has completely drunk the Kool-aid, wanders in and tries to convince me I'm wrong. They are appalled by the fact that I don't agree with them that whole life insurance is the best thing since sliced bread. This makes for some intriguing and occasionally bizarre conversations that frankly typically devolve within a few posts into ad hominem attacks leading to the agent's IP address being blocked from the site. A few days later, a new agent shows up and does the same thing, ad nauseum, for years, on a dozen or most posts on this site.



However, recently I had two whole life "fanboys" show up who both claimed there were NO DOWNSIDES to a whole life policy.

It was incredibly bizarre. I mean, everyone knows that just about anything has upsides and downsides. If the downsides outweigh the upsides for you, then you avoid it. And vice versa. So today, I thought I'd make a little list of the upsides and downsides of whole life insurance.

Upsides of Whole Life Insurance

1 A life-long, tax-free, death benefit

At the end of the day, a life insurance policy is life insurance. If you die while owning life insurance, you get paid the death benefit. This includes whole life insurance. Unlike term insurance, which rapidly becomes astronomically expensive after the term ends and you start getting to those ages where you are actually likely to die, whole life insurance is designed to pay out when you die, even if that's at age 95. If this is a benefit you want, and you want that death benefit to slowly grow (it's way cheaper to buy a Guaranteed Universal Life policy if a flat death benefit is fine with you), then Whole Life does that for you. All life insurance death benefits are tax-free to the recipient, just like when you inherit other assets like mutual funds and investment properties thanks to the step-up in basis at death.

2 The ability to borrow money against your cash value at pre-set terms

You can access this death benefit even before you die by borrowing against it, as long as the policy isn't a Modified Endowment Contract (most aren't.) The insurance policy dictates the terms of your borrowing. Depending on what's happened in the economy since you bought the policy, those terms may be very attractive or very unattractive, but they are pre-set when you buy the policy. Note that when you die, the amount you've borrowed is subtracted from the death

benefit before it is paid to heirs. So any given dollar can only be used as EITHER borrowed cash value OR death benefit, not both. Of course, the loan is tax-free but not interest-free, just like borrowing against your house, your car, or your portfolio.

3 In some states, significant asset protection for the cash value in the event of bankruptcy

About half the states, including mine, provide 100% asset protection for whole life insurance policies payable to spouse or children. Partial protection is available in a number of other states. Before buying a policy for this reason, make sure your state actually provides significant protection. Bear in mind the likelihood of you actually being sued for a significant amount above your malpractice or umbrella policy limits is exceedingly small (I calculate my risk at <1/20,000 per year).

4 Non-direct recognition in some policies

In most policies, when you borrow money the dividend on the policy is based on the amount of cash value that is not being

"borrowed out" of (technically borrowed against) the policy. This is called "direct recognition." There are some policies, called "non-direct recognition" where the policy continues to pay dividends as though no money was borrowed against the policy. This is the most important characteristic of the policies that folks use to "Bank on Yourself" or do "Infinite Banking," one of the few reasonable uses of a whole life policy. The other characteristics are "wash loans" (where the dividend rate on the cash value is equal to [or greater than] the interest rate on the loan and maximizing the use of Paid Up Additions, which have a lower commission rate than the regular policy.

People who do this are essentially trading a few downsides of whole life insurance for the ability to earn a little more on their savings in the long run, which can make a lot of sense when savings accounts are paying less than 1%, but not as much if you can get 5%+ in a money market fund like you could when I came out of residency. The only issue I have with the whole thing is the ridiculous amount of marketing and hype surrounding the concept which leads to people buying policies inappropriately and inappropriately structured policies being sold by agents. If you actually understand how it works, don't mind the downsides, and buy a policy that is actually structured well to do this, it doesn't bother me at all.

5 Life insurance cash value is an asset that doesn't appear on the FAFSA

This is actually a benefit, although not a very big one for those reading this site. For most of my readers, it doesn't matter that your cash value doesn't show up on your Free Application for Federal Student Aid (FAFSA) because your income does and that alone is enough to keep your kid from qualifying for any significant college aid. When you combine that with the fact that most "aid" is loans, this is a pretty minor upside, but upside it is.

6 Dividends aren’t taxed

Whole life insurance dividends are considered “return of premium,” i.e. you paid too much in premium for the benefit and thus the premium is paid back to you. This “income” isn’t taxed, because it isn’t really income. It’s like a rebate on a lawn mower. You can spend the dividends, use them to pay the next premium, or use them to buy more insurance. The third option is what most people do and is what allows for the tax-protected growth inside the policy and for the slowly increasing death benefit. This tax protection/growth is similar to a non-deductible traditional IRA, but pales in comparison to the up-front tax break given to you in a 401(k) and the tax-free withdrawals available in a Roth IRA, but it is an upside.

7 Works reasonably well in an irrevocable trust

Trust tax rates and estate tax rates are very high, so putting a whole life insurance policy into an irrevocable trust is a pretty good way to pass wealth on to your heirs IF you have an estate tax problem. Granted, very few high-income professionals have a federal estate tax problem these days given that the estate tax exemption has been raised to >$11M ($22M married), but the tax efficiency and simplicity of the policy, when put in the trust and left alone, is an upside.

Downsides

All right, let’s move on to the purpose of the post, the downsides of whole life insurance.

1 The insurance is really expensive

Life insurance is designed to pay a death benefit in the event of death. You buy a $1M policy. You die. Your heirs get $1M. Life insurance.

If you die after buying a $1M term policy, your heirs get $1M. If you die after you buy a $1M whole life policy, your heirs get $1M. Same life insurance.

But the problem is that the whole life policy costs 8-10 times as much. 8-10 times the premiums. Same death benefit. Remember your heirs don't get the death benefit AND the cash value. When you die, they get the death benefit.

To make matters worse, thanks to all the moving parts and policy differences, the whole life market is not as efficiently and competitively priced as the term life insurance market.

Term life insurance is basically a commodity for most young, healthy people with a life insurance need. It's like gasoline. You buy it based on price because it's all the same. Buying whole life insurance for the death benefit is like paying $30 a gallon to fill up your car.

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2 You're buying unnecessary insurance

On average, insurance is a bad deal for its purchasers. That's because the sum of all the benefits paid out must by necessity be less than the sum of the premiums paid, at least when accounting for the time value of money. That's because the premiums must cover the commissions to the salesmen, the expenses of the company, the profits of the company (unless mutual), AND the benefits. Benefits must be less than premiums or the company quickly goes out of business. So the general rule is to avoid buying insurance you don't need. Basically, you should insure well against true financial catastrophes, and self-insure against everything else.

The period of life when you need insurance usually starts when someone else (usually spouse and/or kids) begins depending on your income and ends when you become financially independent. This is usually a 30-40 year period, but can be as short as 5-10 years or not exist at all. With whole life insurance, you're buying insurance that covers you for your whole life, including those periods of time when you don't have a life insurance need. Mandated, unnecessary insurance is a downside of whole life insurance.

3 Returns are low

This is probably the biggest downside of a whole life policy. If the long-term return on these things were 8 or 10%, I'd be writing all kinds of posts about why you should own one. Unfortunately, that's not the case. In a reasonably well-structured whole life policy that is held from age 30 to your death 50+ years later, the return on your cash value is guaranteed at around 2% per year and projected at around 5%. I would expect something between those two numbers. I find it very hard to get excited about tying my money up for 5+ decades in order to get a sub 5% return on my investment, even if it comes with a death benefit.

4 The crummy returns are front-loaded

Here's another huge downside, as many WCI readers have discovered. Your initial returns on these policies are not 2-5%. They're negative. Very negative. In fact, the cumulative return on the whole life policy I owned for 7 years was -33% or so. Did you see that minus sign? That's right. Ignoring the value of the death benefit (which in these years is very low given the cost of comparable term insurance) you LOSE money for the first 5-15 years on these policies. It is not uncommon at all for me to meet a doctor who has paid $30K a year for 3 years in whole life insurance premiums, decided he doesn't want the policy, and discovers the surrender value is only $50-60K or worse. $90K in. $50K out. That is NOT a very good investment return. Why are the returns so low early on? The main reason is the commission paid to the agent selling it. A typical whole life insurance commission is 50-110% of the first year's premium. So if the premiums are $30k, that agent was paid $15-33K to sell it to you. Now you know why he was working so hard. He got paid what you have to see 400 patients to earn just to sell a single policy. Mad at that agent who sold you your policy yet? Join the club. Fees to the insurance company and the cost of the life-long insurance benefit also contribute to the low early returns on the cash value.

5 Most policies seemingly designed to maximize commissions to agent

There are ways to improve the returns on a policy. As mentioned above, maximizing the use of “paid up additions” while minimizing the amount of “regular policy” decreases the commission, and thus increases return. But is this the way most policies are structured? Nope. Why not? Well, it’s either because the agent wants to maximize his commission or is ignorant. Either way, it’s not a good thing for you. This isn’t so much a problem with the product itself as the way it is sold, which is the main beef I have with whole life insurance anyway. Speaking of which….

6 Most policies are sold inappropriately

Most whole life insurance policies are sold inappropriately. Thus, it isn’t surprising to see that 80%+ of whole life policies are surrendered prior to death, as their purchasers realize they are inappropriate for their life. These cases usually fall into one of three categories.

First, the purchaser has a better use for their money. This occurs when a policy is sold to someone with student loans. Why someone would buy an “investment” with terrible early returns and 2-5% long-term returns while carrying 6.8% debt is beyond me. But I know why that “investment” is sold to that borrower (see # 5 above.) This also occurs when someone has a policy but isn’t maxing out available retirement accounts like 401(k)s, 403(b)s, individual 401(k)s for the side gig, 457(b)s, Backdoor Roth IRAs, and HSAs. Even a defined benefit/cash balance plan with its generally lower returns (in comparison to a more aggressively invested and lower fee 401(k)) has far better tax benefits and asset protection benefits than whole life insurance. Whole life insurance doesn’t necessarily make sense if you’ve maxed out your

available tax-protected accounts, but it certainly isn't a good move if you haven't even done that. Likewise, a 529 has much better tax benefits (not to mention higher returns and dramatically lower costs) than [whole life insurance when saving for college education](#).

Second, far too many purchasers of whole life insurance don't even understand how it works. They're shocked when they discover they're underwater after 2 or 3 years of making payments. That's not a bug, that's a feature. It's just the way whole life insurance works. Wait until they find out they have to pay interest to get to their money later.

Third, salesmen use half-truths like "tax-free income" to get people to buy the policies. If you took out a home equity loan on your home, you wouldn't describe the proceeds as "income" would you? But that's exactly how borrowing against a whole life policy works. The only thing tax-free about whole life insurance is the death benefit. In that respect, it really isn't very different from passing along a house or a car or mutual fund shares to your heirs thanks to the step-up in basis at death. In fact, if you surrender (i.e. cash-out) a policy with a gain, you don't even get the lower long-term capital gains rates on the gain. You have to pay at your ordinary income tax rates. And if you have a loss, you can't deduct it against your taxes (even if you exchange it into a variable annuity before surrendering, a strategy that some people used prior to recent tax law changes.)

7 'Til death do you part

Due to the low early returns and the nasty tax consequences of surrendering policies with gains, a whole life insurance policy is not something you should buy for just a few years or even a few decades. Before buying it, you'd better be sure you really want to hold on to this thing for the rest of your life

because, like marriage, it's going to cost you a lot of money and hassle to get out of it. That doesn't mean that if you were sold a crummy policy inappropriately a few years ago that you should keep it. If you're in that situation (like tons of other WCI readers), either pay someone else to evaluate your in-force illustration or evaluate it yourself and then if your evaluation convinces you that it's still not a good investment going forward, dump it either through an exchange to a low-cost VA or by just walking away with your cash value, poorer but smarter.

The main problem with a life-long commitment to something like a whole life policy is that life changes. It's tough to project your income and family situation for the next decade, much less the next half century. While there is some flexibility to restructure a policy, by decreasing the benefit or using the dividends and cash value to make the premium payments, these actions generally decrease the benefits you bought the policy for in the first place. Plus, there is precious little flexibility in the first few years before much cash value has built up. One way some people minimize this risk is by getting a "7-pay" or "10-pay" policy that you only have to pay on for 7-10 years. It would be great to find a "1-pay" policy, but unfortunately, these get classified as Modified Endowment Contracts from which you can't even borrow tax-free.

8 Borrowing terms often terrible

As noted under the upsides, you can borrow against your cash value at pre-set terms. The problem is those terms are usually terrible. Like 8% interest. Interest rates are going to have to rise a long way for you to be able to get excited about using this source of funds unless your financial life is such a mess that you can't get money any other way in a timely manner. In which case, you probably can't make your whole life premiums anyway.

9 Many people can't obtain a policy

Due to poor health or dangerous hobbies, many people can't purchase a whole life insurance policy at any sort of reasonable price. No problem, say the agents. Just buy a policy on your spouse, kids, friend, or family member. The problem is now you're likely buying a policy on someone for whom there is no need for life insurance. It was bad enough before when you were buying a policy for periods of your life when you didn't need life insurance. Now you're buying completely unnecessary insurance. That doesn't come free.

10 Returns on tiny policies even lower

Speaking of buying insurance on your kids, I'm amazed how many people buy life insurance from the same company they buy baby food from. One of the big issues with buying life insurance on your kid is that the policy is typically tiny. This was the

issue with the policy I was sold as a medical student. It had a face value of only $20K. Policies that small still have the same policy fees. Those fees make up a much larger percentage of the premium, dividend, and cash value, thus lowering your returns.

11 Leaving difficult decisions to your adult kids

I am frequently emailed by someone whose parents bought them a policy as a child and have now gifted it to them as an adult, along with the required ongoing premium payments. It always makes them sad when I point out that nobody needed that death benefit for the first 20 or 30 years of their life and that if their parents had just given them shares of a mutual fund they might have received eight times as much money. They get even more depressed when they see their in-force illustration and realize that their ongoing returns won't even be the 2-5%/year that a halfway decent policy might bring. If your kid has to email someone in 30 years to figure out what to do with this crappy policy you were swindled into buying, did you really do them much of a service?

In addition, it likely only offers a minimal amount of death benefit (especially after 30 years of inflation) that didn't preserve any significant amount of insurability for them (now that they're entering the period of their life when they actually have a life insurance need.) If you're the recipient of a policy like this, be sure to thank your parents for trying to do something nice for you. Don't mention what they should have done instead. Then surrender the policy, take your $1500 of cash value, and put it toward student loans or a Roth IRA.

The Bottom Line

Now, if you understand the upsides and the downsides of whole life insurance and you still want a policy, knock yourself out and buy as many as you want. It really doesn't bother me; I don't get paid one way or the other. I would guess 1% of doctors and an even lower percentage of the middle class wants a policy once they understand how it works. However, if the person advising you to buy a whole life insurance policy can't even see, much less articulate, the downsides of the policy, you need to go see someone else. In fact, if I were in the market for a whole life policy, I'd be seeing at least two agents AND one real financial advisor who wasn't going to profit at all from the purchase before making a decision.

What do you think? Did I miss any upsides or downsides of whole life insurance? Comment below!

[As usual, ad hominem attacks posted by insurance agents in this comments section years from now will be deleted and your IP address blocked, so don't bother. I'm the only one who will ever read them, so you might as well just email them to me so it will be quicker for me to delete.]