Beware of the Exchange of Life Insurance Policies and Annuity Products

The National Association of Securities Dealers (NASD) has issued investor alerts cautioning against exchanging or replacing one life insurance policy for another, and exchanging or replacing one annuity for another. Let's examine why individuals should beware of such exchanges.

Annuities

Regarding annuities, the NASD is concerned that financial services firms have convinced individuals to exchange fixed annuities either for variable annuities or for equity-indexed annuities. Among other reasons, fixed annuities have earnings and payouts that are guaranteed by the insurance company. By comparison, variable annuities are securities and, as such, their returns vary. Likewise, equity-indexed annuities carry more risk than fixed annuities.

Additionally, the NASD warns that variable annuities impose a variety of fees. These are: surrender charges (a financial penalty for early withdrawal); mortality and expense charges (to compensate the insurance company for risks that it takes on the annuity); special features charges (to compensate the insurance company for benefits such as the stepped-up death benefit or a guaranteed minimum income benefit); and administrative fees. Many commentators have argued that the charges and fees imposed are far greater than the benefits received.

The NASD cautions that an exchange "generally" is "not a good idea" because of the following reasons:

- While many annuity contracts offer a premium credit, or "bonus", toward the value of the annuity contract, this credit is "usually offset by the insurance company's adding other charges it makes to you"
- A new annuity contract imposes new surrender charges and these may increase the period for which the surrender charge applies
- Higher charges, such as annual fees, may be imposed
- Individuals "may not need the costly new features of the new contract"
- The broker many times is paid a higher commission

Notably, while an exchange is tax-free, a replacement is not. Thus, replacements (of both annuities and life insurance) especially are suspect.

Life Insurance

The NASD warns that "increasingly, life insurance exchanges involve variable products." That means that individuals are being convinced to exchange or replace term life insurance, whole life insurance and universal life insurance with products that may be unsuitable - variable life insurance and variable universal life insurance.

The NASD recognizes that there may be reasons to exchange a life insurance policy, possibly such as lower premiums, concerns with the solvency of the insurance company or more desirable features or

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or benefits. Nonetheless, the NASD states that an exchange may not be a good idea for several reasons, including:

- Cash value in the original policy may be applied to the new policy's first year expenses, including commissions
- Surrender charges can reduce the original policy's cash value, and the new policy will have its own surrender charge schedule, which may extend beyond that of the original policy
- Higher, not lower, premiums may result if health has deteriorated
- The new policy will have a new, two-year contestability period
- If an existing policy is surrendered, there may be unfavorable tax consequences, such as a tax on outstanding policy loans

Additionally, the NASD cautions against using existing insurance policy values (such as by taking policy loans or making withdrawals) to pay premiums for a new life insurance policy. Such "financing" of premiums "may not be appropriate" because it may cause adverse tax consequences, reduced death benefits and even financial strain if additional, out of pocket premium payments become necessary.

Both for life insurance and annuity exchanges, the NASD lists the following questions that individuals should ask their financial adviser before making the exchange:

- What is the total cost to me of this exchange?
- What are the new features being offered? Why do I need those features?
- Are these features worth the cost?
- Can the existing policy be modified or supplemented to provide some or all of these same features?
- Will you be paid a commission for the exchange, and if so, how much is it?

Remember, financial advisers must disclose all important facts - the pros and the cons -- about such exchanges to potential customers. Further, the NASD states that a financial adviser cannot recommend an exchange unless it is in the customer's "best interest", and only after evaluating the customer's "personal and financial situation and needs, tolerance for risk, and the financial ability to pay for the proposed insurance policy." Note that NASD examinations have found the unsuitable recommendation of variable life insurance policies and variable annuities, and that the firms employing the financial advisers failed to supervise them properly to prevent those unsuitable recommendations. So, be careful!

James J. Eccleston is a securities attorney, representing customers as well as brokers and brokerage firms nationwide in arbitration, litigation and regulatory matters. He maintains an informative website at www.FinancialCounsel.com. He is an equity partner with Shaheen, Novoselsky, Staat, Filipowski & Eccleston, and can be reached at 312-621-4400.

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20 North Wacker Drive, Suite 2900, Chicago, Illinois 60606
Telephone: 312-621-4400 | Fax: 312-621-0268