USE CAUTION IF EXCHANGING VARIABLE ANNUITIES

If you're considering swapping an existing variable annuity for a new one, or you've been approached to switch VAs, think twice before doing so, caution financial planners and regulators.

In the last few years, particularly as the stock market has declined, there has been a flurry of exchanges of variable annuity contracts. The Financial Research Corp. in Boston estimates that 60 percent of gross sales for variable annuities in 2003 came from exchanges rather than brand new sales—versus only 15 percent in 1996.

Experts say many of these exchanges are occurring **because salespeople are recommending them in order to generate new sales commissions.** The frequency of such transactions has become so high that the National Association of Securities Dealers and the Securities and Exchange Commission, along with some state regulators, have investigated many exchanges, and in some cases fined broker/dealers for executing unsuitable exchanges.

There can be sound reasons for exchanging an existing variable annuity for a new one. Many new annuities offer improved features not present in older versions, such as guaranteed minimum income or withdrawal benefits, "bonus" credits and increased guaranteed death benefits. A new annuity may offer more investment options or it may be less expensive than your current annuity (total expenses with added riders can easily run 2.5 percent to 3 percent). You may want to move into an annuity with a more credit-worthy company.

You can exchange one annuity for another, as long as you haven't annuitized it, without any tax liability. This is known as a tax-free 1035 exchange. But should you make the exchange? Many experts caution that it often does not—some say almost never—make financial sense to exchange policies.

First, some investors are exchanging policies because they are unhappy with how their VA sub-accounts—those are the mutual fund-type accounts that invest in securities—performed in recent years. But planners point out that many non-VA investments also performed poorly during the same period.

Second, a major drawback for exchanges is the potential for paying surrender fees. These are the penalties for canceling an annuity contract within a certain number of years after buying the annuity. A surrender fee might start around seven percent, for example, and decline to zero over seven years. Some surrender periods last ten years or more. If you exchange during that period, you could pay thousands of dollars in penalties. In addition, you'll be tied up with a fresh surrender period under the new contract.

Another factor to consider is whether it's worth the exchange just to get the new bells and whistles. Do you really need them? Are they worth the cost of the exchange, particularly if the old contract's surrender fees are high or the new annuity has higher costs due to the new bells and whistles?

In addition, you may end up with a newer life expectancy table than you had under the old annuity, which can lower payouts should you annuitize. That's because with people living longer today, newer life expectancy tables won't pay out as much for each dollar of annuity value, versus an older policy with a table based on a shorter life expectancy.

In some exchanges, you may lose a portion of your death benefits if the value of your annuity is less than the contractually guaranteed death benefit. This is a distinct possibility for annuities whose value declined during the recent bear market. If the value is less than your original investment, some planners recommend simply cashing out and taking a tax deduction.

None of this is to say exchanges should never be made. The important point is that every situation is unique and you need to conduct a thorough analysis to determine whether it is economically worth switching. In some cases, it might be better to keep the old annuity and buy a new variable annuity with new money if it has benefits you want.

You'll probably want to work it through with an objective financial advisor who knows how to make such a determination. A recent article in the *Journal of Financial Planning*, for example, shows financial planners a new method for calculating whether an exchange makes economic sense.

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