



The Basics

Be wary of offers to 'replace' your current policy

Here's when it's a good idea to get a new life insurance policy and when you're better off with what you've got.

By Ginger Applegarth

It's the dirty word of the life insurance business.

When it comes to "replacement" policies, the best advice typically is don't do it. The concept sounds simple enough, but there's a kicker. Every time a life insurance policy is replaced or sold by an agent or financial planner who gets a commission on that sale, it comes out of the policyholder's pocket.

A sorry history

Replacement became a huge problem (and a source of embarrassment) in the insurance industry in the 1970s and '80s when interest rates were high.

Several relatively new and aggressive life insurance companies produced payout projections beating anything the traditional stalwarts were offering. But it was all a paper mirage. Many of the companies were taken over by their state insurance commissions because they were insolvent, leaving the policyholders without insurance or a payout.

Partly out of a reaction to this debacle and to make the insurance industry more professional, most life insurance applications now include a question asking if this new policy is replacing an old one. If so, the agent must provide a detailed explanation. Additionally, most states now require life insurance agents to file "notifications of replacement" with their state insurance commissions and to comply with various regulations.

The cost of replacing your life insurance

If you think about it, you replace other investments all the time. So why not life insurance? Because those other investments don't have the upfront costs that insurance charges. There are underwriting expenses, marketing and administrative fees, sales commissions, and the list goes on. Those upfront fees often exceed the premium you've got to pay as well. Replacing term insurance doesn't matter as much, because you're generally buying by the numbers; you're seeking the cheapest policy for the time period needed.

The major problem is with permanent insurance, because the agent has the most to gain (the commissions are usually much higher than for term insurance) and the consumer has the most to lose (paying those commissions).

Here's how it works: You meet with your life insurance agent or financial planner who tells you that the policy you bought three years ago just isn't right for you anymore, but there's a new version that's just perfect. You buy the new policy because it looks great on paper. However, for you, it's like going back to the starting line, because you have to pay the same start-up costs as before. That means it will be just that much longer before your cash value equals the premiums you paid. Frankly, unless you're buying a new no-load (commission-free) policy, you're paying two commissions.

Higher commissions for your agent

Now you may wonder why it matters if it's the same agent who sold you the first policy selling you the second. The agent's already getting a commission off the first policy, right? The difference is in the amount of the commission. The commissions are much higher during the first few years of a policy. A permanent insurance policy might pay 50% of the first year's premium as commission, 20% in the second year, and 5% for the next five years. The total paid in commissions often exceeds the cost of the first year of your premium.

If you balk at paying these commissions and go to a fee-only financial planner instead, remember that you need to factor in the fees you paid that financial planner to really compare apples with

apples. A fee-only financial planner's fee is not a commission, but it's still money that you paid to get the insurance advice.

When it makes sense to replace a policy

[The Society of Financial Service Professionals](#), formerly the American Society of Chartered Life Underwriters and/or Chartered Financial Consultants, says, "Replacing an existing life insurance policy with a new one generally is not in the policyholder's best interest." Replacement is not something you should avoid altogether, because there are circumstances where it makes sense to replace an old policy with a new one.

Here are some examples:

Term insurance rates are lower now than they were several years ago, so your new premium may be lower.

Companies vary widely in price for the same amount of insurance for one person, and you may not have gotten the best deal the first time around.

A new term life insurance policy may allow you to lock in a longer guaranteed premium.

Your needs may have changed. Perhaps when you purchased the old policy you thought you needed it for five years, but now you need it for 15 years. The new 15-year guaranteed premium may be cheaper than that of your old policy. Even within the same company, rates may have dropped so that new annual renewable term policies may be less expensive than older equivalent policies.

The benefits of replacing a permanent life insurance policy are less obvious:

Your needs have changed (or maybe you were sold the wrong policy in the first place) and you need term instead of permanent insurance because you only need the death benefit for 10 years.

You purchased a permanent insurance policy that you did not understand, and you find that you have a variable life policy (requiring investment decisions on your part and having no guaranteed cash value). What you really wanted was a whole life or universal life policy where there are guaranteed cash values and you don't have to make any of the decisions.

You want to wipe out a large loan on the old policy by using its cash value.

You purchased a permanent life insurance policy from a company that's not financially sound.

You purchased a policy in the 1970s or before and the guaranteed returns of 2% to 3% are so low that replacing them with new ones actually does make sense.

You're in the first three years of a permanent insurance policy for which you paid commissions and determine you'd be better off starting over with a new low-load, no-commission policy.

The In-Force Ledger

When comparing an existing permanent insurance policy with a new one, your agent must get an "In-Force Ledger" (how your existing policy is expected to perform from now on) and compare that, year-for-year, with the new policy. You need to compare calendar years, not years of the policy. If you have owned a policy for five years, do not compare the fifth-year values of the old policy with the fifth-year values of the new policy. You are comparing differences in guaranteed and illustrated cash values and death benefits for current and future calendar years. Unfortunately, this is a sales technique that has often been used to persuade life insurance owners to switch policies.

Replacement questionnaire is available

Replacement is a complex issue, and it may seem impossible to tell when it's right for you. The Society of Financial Service Professionals developed a replacement questionnaire to help life insurance agents and financial planners determine whether replacement is a good idea.

This is a guide for the salesperson, but it's also useful for fee-only planners. The replacement questionnaire is a comprehensive analysis of the existing and proposed policies and is comprised of 13 detailed questions. Unless it's obvious why a replacement is needed, ask the person selling or recommending the new policy to complete the replacement questionnaire based on new illustrations for the current and proposed policies and then to show all three documents to you.

Showing their true colors

This takes time, and if someone is just trying to make a quick buck, that should end the conversation fast. This analysis can take several hours, so unless you see a compelling reason to replace a policy, you may not want to pay hourly fees to a fee-only financial planner to make this analysis. And if a salesperson says, "You don't need to go through all of that," you should leave immediately.

The final issue to consider is whether your old policy has important tax savings provisions that have been grandfathered in from any tax changes in subsequent years. The replacement questionnaire lists nine such grandfather provisions. The changes could be worth thousands of dollars to you.

The insurance industry has come a long way from turning a blind eye to the replacement excesses of the 1960s, '70s and '80s. Most say it's probably not in the best interest of the client to replace an existing policy. Your best bet is to heed the words of the Society of Financial Service Professionals -- unless there is clear proof that a replacement policy is a better deal, stick with what you've got.