

# Financial Underwriting Highlights

## What Is Financial Underwriting?

Financial underwriting is the evaluation of a prospective insured's personal or business financial background and current economic situation. The analysis of an individual's financial situation takes place every time a case is underwritten although the depth of this evaluation is based on the amount of insurance applied for. The purpose of this evaluation is to determine the proposed insured's need for insurance and make sure that the amount of insurance applied for is reasonable and in line with his or her needs.

## Why Is Financial Underwriting Important?

Financial underwriting is important in order to prevent over-insurance. Over-insurance occurs when the amount of life insurance in force on an individual exceeds his or her economic—or “human life”—value. The primary purpose of life insurance is to protect against a loss (i.e., loss of income, loss due to payment of taxes, etc.). However, within certain well-defined and controlled parameters that ensure client understanding and provide protection against anti-selection, it may also be utilized to enhance wealth transfer.

## Insurable Interest

For a life insurance purchase to be valid, the beneficiary must have an insurable interest in the proposed insured. Insurable interest exists if the beneficiary benefits financially from the proposed insured's continued existence and would suffer a financial loss at the death of the insured.

## Affordability

Affordability is an important factor that must be evaluated to determine if a product recommendation is suitable to meet a customer's needs. There are two basic relationships that Underwriting looks at in evaluating whether a client will be able to sustain the premiums.

**Premium-to-Income Relationship.** In conjunction with the Income Factor Table (refer to the Income Factor Table section of this highlighter), the relationship of premium outlay to the proposed insured's gross annual income is considered. A good rule of thumb is that the total premium outlay for all life insurance policies supported by the premium payer's income should not exceed 10% of the premium payer's pre-tax income. In certain situations, it may be acceptable, from a financial underwriting perspective, for premiums to be as high as 20%. If you feel such a case is warranted, contact Underwriting before submitting an application for insurance. Be sure to provide Underwriting with a cover letter outlining why you believe the need and amount of coverage are warranted and why the premiums are affordable.

**Premium-to-Liquid-Net-Worth Relationship.** If the premium to pre-tax income relationship is greater than 10%,

premiums may need to be paid from a client's liquid assets. In that case, it becomes necessary to consider whether the premium payer's liquid net worth is sufficient to sustain the premiums and whether this is an appropriate use of these assets. The answers to these questions will depend on the proposed insured's overall financial situation. A good rule of thumb is that the premium should not exceed 25% of the premium payer's liquid net worth.

## Amount of Insurance

Underwriting will also evaluate how the amount of insurance being requested was determined. Results from a comprehensive needs analysis, or recommendations from an accountant, attorney, or other advisor, can make a difference when evaluating the case. If the proposed insured simply told you how much insurance he or she wanted to purchase, you should determine if that amount of insurance is reasonable and convey that information to Underwriting.

When determining the overall amount of insurance that will generally be granted to an individual, the underwriters take into account any existing insurance coverage he or she already has in force and any insurance being applied for with other companies.

A complete needs analysis takes these factors into account and is an important and useful tool in helping the producer, the client, and the underwriter understand how much insurance is required and why. (Note: A Financial Supplement form is required for applications with face amounts of \$5,000,000 up to age 70, \$2,500,000 or more for ages 71 to 80, and \$1,000,000 or more for age 81 and up if the case was submitted with a new application.)

In most situations, the amount of insurance applied for should be directly related to the need the life insurance was purchased to satisfy, such as to replace lost income, or cover a debt such as a mortgage or small business loan. From an underwriting point of view, insurance purchased for the following reasons is generally acceptable:

- ▶ Debt repayment (e.g., mortgage or college loans).
- ▶ Estate settlement.
- ▶ Income in Respect of a Decedent (IRD).
- ▶ Income replacement/survivors' income.
- ▶ Insurance to address business needs.
- ▶ Last expenses.

While life insurance has other specialty uses such as cash value accumulation, the primary purpose must be for death benefit protection.

## Income Replacement

A client's income is one of the factors looked at in determining the amount of insurance that will be granted for income replacement. An individual's total income can be comprised of earned and unearned income.

## Financial Underwriting Highlights (Continued)

Earned income is defined as income that will normally cease upon the death of the insured, such as salaries, pensions, Social Security, and cash distributions from a business. Life insurance may be considered as a means to replace lost earned income upon the death of the insured.

Unlike earned income, unearned income does not cease upon the death of the insured. Unearned income includes pure investment income and distributions from 401(k) plans and IRAs. Life insurance may be needed to cover any potential tax liability on this unearned income upon the insured's death. (Refer to the "Amount of Insurance" section of this highlighter for additional information.)

Unearned income increases one's ability to pay premiums and may be available to help offset some of the financial losses the survivors may experience. However, these available proceeds may decrease the need for insurance after the potential tax liability has been taken into consideration.

A software-generated income needs analysis can be useful in determining the amount of income that should generally be replaced by life insurance.

Needs typically covered by income protection include mortgage protection, education needs, and providing continuing income to support dependents upon the death of the insured.

### Asset Repositioning

Life insurance when used as a vehicle for enhancing or leveraging a legacy for wealth transfer purposes may, depending on the type of policy used, provide the consumer with:

- ▶ A guaranteed death benefit.
- ▶ The ability to avoid the time and expense of probate.
- ▶ An option to avoid market risk by providing a specific amount of coverage, regardless of what takes place in the investment markets.

It is important to note that any assets or income being repositioned into life insurance to enhance or leverage a legacy for wealth transfer purposes should not be needed for support in retirement or create any future financial hardship.

### Sources of Information

In most cases, the information received during the client interview is sufficient to determine if the amount of insurance applied for is appropriate. For very large or

complex cases—including estate settlement or business situations—more extensive information may be required. These cases involve higher risks and require the evaluation of more than just income and ability to pay. It may, therefore, be necessary to submit financial documents that are generally not required for smaller amounts of coverage. In these situations, Underwriting is looking for information that will substantiate the amount of insurance being applied for. The information should answer questions such as:

- ▶ What is the purpose of the insurance?
- ▶ How was the amount of the insurance applied for determined?
- ▶ Who will be the policyowner and premium payer?
- ▶ What is the current amount of in-force and applied-for insurance?

The proposed insured, as well as his or her advisors, attorneys, or accountants, may also be required to submit documentation to support the need for the amount of insurance requested. This documentation may include personal or business financial statements such as W-2 forms or tax returns, employment contracts, loan or trust agreements, and buy-sell agreements. It is always a good idea to inform clients, attorneys, accountants, and other financial advisors that they may be required to provide additional information. This type of financial documentation is required on face amounts of \$10,000,000 or more for ages 18 – 70, \$2,500,000 or more for ages 71 – 80, and \$1,000,000 or more for age 80 and older. In addition to third-party financial documentation, we will require proof of income at age 71 and older at the face amounts mentioned above.

### SUMMARY

The most important source of information about a proposed insured is you. As you analyze a potential client's insurance needs, you gain knowledge of his or her worth and income. Any pertinent information should be communicated to Underwriting. It may be advisable to submit a cover letter to Underwriting that explains how the amount of insurance requested was determined. Any documentation used during this process should be included with the cover letter. If the purpose of insurance is an asset repositioning concept, then the use of a cover letter at the time of the application is strongly encouraged outlining all the required financial details and information around the sale.

The Confidential Financial Questionnaire may be used to capture some of this financial information. The extent of this information depends on the amount of insurance you are recommending and the purpose for which it is intended.

## INCOME FACTOR TABLE

The Income Factor Table is a guide to help determine the maximum amount of insurance (excluding group coverage) that is generally acceptable in relation to the earned income of an individual with or without dependents. To estimate the maximum amount of insurance, multiply the proposed insured's earned income by the corresponding factor based on his or her age at the time of application (Income x Age-Specific Factor = Amount of Insurance).

AGES	FACTOR
– 40	35
41 – 50	25
51 – 60	20
61 – 70	10
71 – 80	5