BUSINESS FINANCIALS

An application for life insurance requires an analysis of not only a proposed insured's health, but also his or her financial needs. Financial underwriting can be a critical component of the underwriting process: a proposed insured may be in perfect health but unable to secure life insurance coverage because of lack of financial justification for the amount of coverage requested.

Financial underwriting consists of the assessment of an applicant's income, net worth, and financial situation. It is this financial picture that correlates directly to the presence or absence of insurable interest. Financial underwriting seeks to answer these questions:

- Are the applicant's insurance needs in line with the applied for amount? If the applied for amount exceeds the insurance need, there may be the indication of speculation, anti-selection, or questionable insurable interest.
- Is the client able to reasonably afford the premium associated with the applied for amount? If the premium does not appear affordable, there may be concern for policy lapse or an undisclosed method of premium payment.
- Does the amount of life insurance coverage make sense in terms of meeting a financial planning need?

The core of financial underwriting involves the valuation of continued human life. Associated factors in this valuation include age, occupation, dependents, income, and net worth. From this valuation of continued human life it is determined whether the amount of insurance requested is justified. Every life insurance application is evaluated for the presence of insurable interest that must exist at the inception of the insurance contract.

THE KEY TO BUSINESS SALES

Business Continuation

Business continuation planning is a common reason that life insurance is sought. Businesses often purchase insurance coverage on certain individuals to cover parties involved in contractual business relationships and to ensure that the terms of the contract are completed, even if premature death of one of the parties occurs. An insurable interest, that which meets the pecuniary or financial test, is usually present if the premature death of one party of a business relationship would cause a business or its surviving owners a financial loss.

A major underwriting consideration for business insurance is the fair market value (FMV) of the business. The technique used for the actual calculation of the FMV of the business is usually stated in the underlying legal document such as the buy-sell agreement. There are three basic valuation techniques. Valuation techniques can be complex but a ballpark figure is typically sought for underwriting purposes. The three business valuation techniques include:

- Book Value
- Market Value
- Capitalization of Earnings

> FOR ADDITIONAL INFORMATION
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> Questions about financial underwriting on a business case? Contact the AIN Member Underwriting Services Team:
>
> 800-350-2019
> underwriting@advantageinsurance.com

Buy-Sell Agreements

Buy-sell coverage is a form of business insurance with a purpose of assuring business continuation in the event of the death of a partner. For the analysis of buy-sell financial justification the maximum coverage is generally limited to the ownership value based on the fair market value of the business. A copy of the buy-sell agreement is useful to substantiate this financial need.

Sole Proprietorship

Sole proprietorship insurance is essentially personal insurance with the elements of a business situation. Insurance on the life of the sole proprietor beyond his or her personal needs is logical for two reasons. First, the decedent's family may need to pay the salary of someone hired to run the business after the sole proprietor's death. Secondly, the family may need to be compensated for lost potential income resulting from failure of the business if the sole proprietor's skills cannot be replaced.

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Alternatively, sole proprietor insurance may be part of an agreement where the employees of the business agree to purchase it after the sole proprietor's death.

Stock Redemption

Stock redemption is similar to partners' buy-sell insurance. Instead of an agreement between partners and a partnership, the agreement is between a corporation and its principal stockholders.

Key Person

Often businesses consider certain employees as "key" to the continued success of their business. The business may purchase life insurance on the key employee to protect against the financial loss that may result due to the premature death of that key employee. Key employees possess skills and talents that are vital to the continued profitability of the business. This may be related to their knowledge and expertise of the industry or their ability to raise capital through favorable debt arrangements. Officers of a closely held corporation, partners, high sales producers, and uniquely talented individuals are likely to be key person applicants. The business uses the death benefit to pay the costs of obtaining a suitable replacement for the key person and to help cover lost sales or revenue due to the loss of the key person. Five to ten times the key person's annual compensation is generally acceptable for face amount applied and in force. For key person coverage, the policy owner and beneficiary is the business/employer as well as premium payer.

Loans

When a loan or debt agreement is negotiated between two parties, credit insurance is often used to guarantee the payment of the remaining balance of the loan to the creditor if the debtor dies before the loan is repaid. Often, the creditor will request a collateral assignment on the policy. Life insurance underwriters typically allow up to 70% of the loan balance because of the declining nature of the loan balance. Credit insurance is typically evaluated to make sure it's not speculative by looking at cash flow of the business and the loan details.

Executive Benefits

There are numerous executive benefit concepts that use life insurance as the funding vehicle. The beneficiary is usually the spouse, children, or estate of the proposed insured. The death benefit payable to the employer is usually limited to a refund of the premiums the employer has paid on the employee's behalf.

Deferred Compensation

Deferred compensation is a salary arrangement offered to highly-paid key employees where a portion of the employee's income is deferred until a future date. It is often used to entice key employees to stay with the employer. The employee is paid the deferred earnings at retirement in addition to the company's retirement plan. The funding vehicle used to pay this deferred income is the accumulated cash value of a life insurance policy. If the employee dies before the deferred income is received in its entirety, then his or her designated beneficiary as outlined in the deferred salary arrangement receives the death benefit. The business is the policy owner and beneficiary as well as the premium payer.

UNDERWRITING BEST PRACTICES: BUSINESS INSURANCE

Financial Underwriting

For favorable financial underwriting it is imperative that the associated details are properly disclosed on the application, cover letter, and inspection report. Typically, large face amounts require supplemental supporting documentation that can involve third party verified financial statements, financial supplements, and tax forms. Consistency in the figures provided is crucial. The absence of consistency can result in additional underwriting scrutiny and requests for further financial documents and explanation.

The Cover Letter

The best source of financial documentation is a well-written cover letter. A cover letter details the purpose of the coverage, formulas used to derive the face amount applied for, and references documents used in the needs analysis. The cover letter can explain any unusual policy owner/beneficiary designations. Also, any medical or nonmedical aspects of the file that may pose underwriting concerns can be addressed.

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The Application

The application provides the initial financial picture. It contains the proposed insured's age, occupation, income, net worth, amount of insurance in force, any concurrent applications, the face amount applied for, and the cost of the coverage. The level of relationship between the policy owner, proposed insured, and beneficiary are examined for presence of insurable interest.

The Financial Statement

A third party verified financial statement is required for larger face amounts. For example, the client's CPA may provide a signed statement detailing the client's personal net worth.

The Inspection Report

The information provided on the application and in the cover letter is compared with data provided in the inspection report. The detail of the inspection report varies with the amount of insurance applied for and ranges from a personal history interview to a direct interview of the proposed insured and use of financial references such as the proposed insured's accountant or banker and pursuit of credit reports.

TYING IT ALL TOGETHER

In summary, financial underwriting is equally important to medical underwriting in the process of evaluating candidacy for life insurance coverage. Favorable financial underwriting is dependent on proper presentation of the financial need analysis and appropriate objective documentation with consistency in all figures and details.

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