



# What You Need to Know About... Financial Underwriting (Personal)

## INTRODUCTION

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.

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:

1. 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.
2. Questions about the affordability of the premium lead to concerns that the method used to pay the premium has not been fully disclosed or that the policy will eventually lapse.
3. 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.

## TYPES OF PERSONAL FINANCIAL UNDERWRITING

### Income Replacement

The most fundamental need met by life insurance is to provide a continued source of income for dependents upon the untimely or unexpected death of a provider. This is called personal insurance coverage and underwriters use an income replacement calculation to derive the appropriate amount. This calculation is based on life insurance carriers' guidelines. The proposed insured's age is a determinant based on the premise that a person's economic worth is equal to the present value of the income the person is likely to earn through age 65. This need may be supplemented by additional amounts in consideration of the potential earning power of a young professional who is in the process of establishing a career.

### Wealth Conservation

Another need category is wealth conservation through tax planning techniques and the use of life insurance. Wealth created exclusively by payment of life insurance proceeds is considered speculation and not a suitable insurance need.

Whereas income replacement coverage is used to guard against the loss of a future income stream, wealth conservation is used to prevent the erosion of a person's owned property or estate upon his or her death. Estate planning encompasses the accumulation, conservation, and distribution of an estate. Therefore, another example of a personal need includes insurance purchased to cover the cost of estate taxes. The forced sale of assets to pay estate taxes resulting from an unexpected death could result in a substantial loss compared with the price the same assets may have demanded in a more favorable market. Insurance to cover estate taxes eliminates the need for such a forced asset sale. The need for insurance includes coverage for estate taxes without regard to the underlying liquidity of the assets because estate taxes are legitimate and indemnifiable expenses.

The gross estate is the sum of all assets owned by a person. At death, all assets are valued at their fair market value for estate taxation purposes. Funeral expenses, claims against the estate, unpaid mortgages and loans, casualty and theft loss from the estate, and administrative expenses are subtracted from the gross estate. The result is called the adjusted gross estate and from this the marital deduction and charitable deduction are subtracted to arrive at the taxable estate. In financial underwriting, the proposed insured's net worth is often used for calculating the estate protection need due to its similarity to the adjusted gross estate.

### Dependent Spouse

There is often need for dependent spouse coverage and this need is based on the present value of the homemaker and child care services provided by the spouse that stays at home on a full-time basis. The last expenses of the dependent spouse are also covered with this insurance. A face amount applied for and in force of one-half that of the providing spouse is generally acceptable. The dependent spouse may have an additional estate planning need separate from this calculation.



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## Juvenile

Juvenile insurance is often sought by parents and grandparents with a goal of providing a savings vehicle for needs such as college education expenses or guaranteeing insurability for the future. Generally, underwriters evaluate to make sure that the face amount or premium are the same for all children including both in force and applied for coverage. Typically, the parents must have at least two times the coverage applied for on the juvenile. This is to discourage anti-selection and helps ensure that the parents' insurance needs are satisfied.

## Retirees/Unemployed Individuals

Unemployed individuals, older-age individuals with minimal unearned income and net worth, and government-assistance recipients often apply for life insurance. Typically, the insurance need for minimal coverage is to pay for funeral expenses. Nominal amounts of the minimum face amount of \$25,000 are generally allowable in these situations.

## Charitable Bequests

A less common personal insurance need involves recipients of charitable bequests. If an individual has been making regular contributions to a qualified charity, then the contributions will cease upon the individual's premature death. The face amount applied for is generally acceptable if approximately equal to the present value of future contributions based on a life expectancy calculation. The regular, recurring nature of the charitable contributions needs to be established and typically the charity needs to be recognized by the IRS.

## HOW TO HELP GET THE MOST FAVORABLE FINANCIAL UNDERWRITING

### Favorable 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.

## 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 policyowner, proposed insured, and beneficiary are examined for presence of insurable interest.

## 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 policyowner/beneficiary designations. Also, any medical or nonmedical aspects of the file that may pose underwriting concerns can be addressed.

## 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.

## 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.

## CONCLUSION

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 needs analysis and appropriate objective documentation with consistency in all figures and details.