

HOW TO POSITION YOUR CASE FOR SMOOTH UNDERWRITING

Insurance Professionals Can Encounter Two Primary Challenges when Working with Business Owners:

- ▶ Convincing business owners that life insurance can help protect their business and then motivating them to take action.
- ▶ Getting the insurance carrier to issue the amount applied for.

Once you get past the first hurdle with a signed application, you have to “make the case” to the underwriter. That’s why packaging the case from a financial underwriting perspective is critical, particularly when large amounts are being requested. Your goal should be to help the underwriter at the life insurance carrier understand the financial basis for the customer’s coverage request. Having everything in order will result in a smoother underwriting process.

Use these tips to help you position your case.

General Tips and Guidelines for Positioning the Case

Have a clear understanding of the parameters that will be applied to a particular business situation. Familiarize yourself with the insurance company’s financial underwriting guidelines before you submit the case. If the requested amount applied for falls outside the guidelines, realize that you will need to provide additional supporting facts to win the case. These facts are outlined in the cover letter.

What to Include in a Cover Letter

Always submit a cover letter with documentation that addresses all the important and relevant information from the underwriter’s perspective. If your case is for key person coverage and buy-sell funding, there are additional details that you will want to include. Try to anticipate the underwriter’s questions.

At a minimum, the cover letter should state:

- ▶ The purpose of the insurance. If the insurance is to cover more than one need, identify all the intended purposes. **State a clear business purpose that the life insurance policy will serve.** In the business market, the life insurance case generally falls within one of four basic uses:
 - Key person coverage
 - Funding of buy-sell agreements
 - Financing of executive benefit plans
 - Business loan protection
- ▶ The policyowner’s relationship to the insured—make sure there is a clear insurable interest.
- ▶ How the requested coverage amount was determined. (Note: If your case is for key person coverage, see tips below for additional information you need to include.)
- ▶ The amount of insurance currently in force.
- ▶ The purpose of the current coverage and whether the new coverage will be a replacement.
- ▶ The business’ plans to “afford” the insurance if cash flow from operations is poor.
- ▶ The ownership/beneficiary structure you propose. This must match the typical format for the business need you are funding (e.g., for key person coverage, the business generally is the owner and beneficiary of the policy). If it does not match the typical format, make sure you explain the reason for the difference.

Additions to the cover letter for a business start-up:

It is particularly important that you tell the whole business story in a business start-up situation.

- ▶ Submit the business plan. (If a brand-new business does not have a business plan, it may be difficult to successfully process the application through underwriting.) The business plan should:
 - Discuss the company's strategic position in the market.
 - Identify competitors.
 - Identify ownership.
 - Detail growth plans.
- ▶ Include capitalization data. Your best applicants will be those who are well capitalized by established institutions.
- ▶ Provide a detailed biography of each key employee of the business.
- ▶ Include additional supporting data. Don't hesitate to use the Internet to search for information on the business, its owners, the industry outlook, etc. You may be amazed by what you can find by doing a simple Internet search!

Make Sure You Tell the Same Story!

The application, cover letter, and supporting documentation should all tell the same story. Conflicting statements and numbers need to be explained. Build the strengths that support the coverage you are requesting, but don't hide the negatives—explain them.

TWO BUSINESS AREAS WHERE FINANCIAL DATA IS CRITICAL ARE KEY PERSON COVERAGE AND BUY-SELL FUNDING.

Specific Tips for Positioning Key Person Coverage in the Cover Letter

Where the coverage requested is based on the need to help offset the loss caused by the death of a person whose services are important to the success of a business, include in the cover letter:

- ▶ An explanation of why the individual is key and how the amount of coverage was determined.
 - Include supporting documentation such as tax returns and a detailed bio of the key individual reflecting experience, education, specific talents, and skills.
 - Ensure the amount of insurance coverage reflects the estimated monetary loss the business would suffer from the death of the key employee. In the absence of documentation, estimate the monetary loss to the business.

Estimating key employee compensation pointers

- ▶ The method most frequently used is based on either a generic multiple of the key employee's income or a percentage of an existing debt.
- ▶ Salary is often only a portion of a key person's compensation. Perks such as stay bonuses, stock options, and benefits such as nonqualified plans can often be included.
- ▶ For key people who have an ownership interest in the business, look to the tax structure of the entity.
 - Distributions are often made to key employees who have ownership interests in S corporations, or guaranteed payments may be made to key employees in partnerships. Such payments will be included in a key employee's income tax return.
 - In new start-up businesses, key employees may have taken a decrease in income at the time they joined the business. If so, historical income records may be more reflective of their value.
 - Don't forget to relate data regarding the degree to which the key person's ability is contributing to the ongoing growth of the company, its profits, and its borrowing capabilities. These abilities may be specialized skills, or knowledge and influence.

- ▶ Debt liquidation coverage is often intertwined with key person coverage. Where this is the case:
 - Clearly outline the terms of the debt including the amount of the debt, the length of the loan, and the interest rate.
 - If the debt is a line of credit, indicate the average outstanding debt for the last two to three years.
 - Indicate whether the key person has personally guaranteed the debt and whether the business will experience credit difficulties at the key person’s death. (Generally, underwriters will cover only a percentage of the outstanding debt. Often this is in the 60% to 70% range.)

NOTE: Coverage may be justified beyond the normal income multiple or percentage of debt guidelines, but you will need to build your case.

Specific Tips for Positioning Funding for Buy-Sell Agreements in the Cover Letter

Where the coverage requested is to provide cash to help survivors purchase the interest of a deceased owner under the terms of a buy-sell agreement, it is important for the cover letter to clearly establish how the buyout will occur and the parties involved.

- ▶ The ownership of the policies should mirror the buy-sell agreement.
- ▶ If the buy-sell is not in a common format (such as the entity approach, where the business is the owner and beneficiary of the policies, or the cross-purchase arrangement, where each owner purchases a policy on each of the other owners):
 - Outline the type of buy-sell plan.
 - Provide support of the insured’s pro rata share of the current business’ fair market value with adjustments made for the business’ future financial growth.
- ▶ Provide a formal business valuation done by an accredited appraiser, if possible. If not, use the value of the business found in the business’ financial statements. The focus is generally on the income and cash flow statements, not the balance sheet—unless you have an asset-intensive business.

Essentially, an earnings approach values the business as a “going concern,” equating future income flows to the sum an investor would be willing to pay to own such an investment under current market conditions. **This method is referred to as the capitalization method.** Under the capitalization method, income flow from the business is converted into a present value number by dividing it by the desired rate of return that an investor would reasonably expect to earn. This divisor is commonly referred to as the capitalization rate or “cap rate.”

The same results can be obtained by multiplying earnings by a number that is the inverse of the desired cap rate. **For example**, a 5% cap rate translates to a multiple of 20. While the mathematical calculation of the present value of the business is simple, the determination of the two components—income and cap rate—is more of an art. The cap rate for most closely held businesses ranges from 11.5% to 35.5%. If you are asking for coverage in excess of these multiples, you will need to build your case.

Close the Case with the Client and the Underwriter

Packaging a case from a financial underwriting perspective is critical. By using these tips, you will help the underwriter at the life insurance carrier understand the financial basis for the client’s coverage request, positioning the case for a smooth underwriting process.

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