

BUSINESS STRATEGIES

Fundamentals

Business Insurance: Getting it Issued

FINANCIAL UNDERWRITING TIPS

[PRESENTED BY:

[Joe Sample], [Designations per field stationery guidelines]

[Company Approved Title]

[Agency Name] [or] [DBA Name]

[The Prudential Insurance Company of America][if Agency Distribution]

[1234 Main Street, Suite 1, Floor 10]

[Anywhere], [ST] [12345]

[in required states] [<ST> Insurance License Number <1234567890>]

[Phone] [123-123-1234] Fax [123-123-1245]

[joe.sample@prudential.com]]

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Financial Underwriting

Purpose: To determine the economic feasibility of a life insurance contract

The Underwriter's Major Objectives:

- Determine whether there is an insurable interest.
- No Over-Insurance: To make sure that the amount of insurance applied for is reasonable and in line with the insured's need(s).
- Affordability: To ensure that the client will be able to sustain the future premium expense.

Financial Underwriting

For Underwriters: “DOES IT MAKE SENSE?”

- The question that most underwriters seek to answer when evaluating life insurance applications for financial risk.
- A carrier’s underwriting formulas & guidelines for a particular life insurance scenario are simply a tool for saying:

“THIS MAKES SENSE”

For the Producer: “DOES IT MAKE SENSE?”

- Does it fit within the carrier’s parameters?

Prudential's Parameters

Financial Underwriting Guidelines

Short 2-page tabular approach listing:

- Purpose
- General underwriting guidelines
- Recommended documentation
- Cover letter outlining needs

Financial Underwriting Highlighter

- More detailed 10-page discussion of the underwriting guidelines used in a variety of life insurance scenarios



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Purpose	General Underwriting Guidelines	Recommended Documentation	Cover Letter
Personal Insurance (Income Replacement for Income with Dependents)	Individuals that are married or with dependents HPI: NONE FICA: NONE or PL 10.00 \$ FY 20 - \$ 11.00 \$ FY 20 - \$ 12.00 \$ FY 20 - \$ 13.00 \$ FY 20 - \$ 14.00 \$ FY 20 - \$ 15.00 \$ FY 20 - \$ 16.00 \$ FY 20 - \$ 17.00 \$ FY 20 - \$ 18.00 \$ FY 20 - \$	Needs analysis whenever the amount applied for plus future needs; the guidelines in the table Copies of documents used in life insurance sales process (e.g., product literature, etc.)	Details of insurance in force and the amount applied for Details of breakdown of earned and accrued income
Estate Settlement Costs	Estate liquidity needs projected 9-10 years at reasonable rate of growth (approximately 7%) Most aggressive projections can be considered on an individual basis if supported by valid financial documentation.	Estate planning analysis and relevant supporting documents, including financial statements Copies of documents used in life insurance sales process (e.g., product literature, etc.)	Details of insurance in force and the amount applied for Details of related purchase of insurance Financial advisors who have been consulted (names and phone numbers)
Income in Respect of a Decedent	Estate liquidity needs projected 9-10 years at reasonable rate of growth (approximately 7%) Most aggressive projections can be considered on an individual basis if supported by valid financial documentation. Equal to projected income taxes	Estate planning analysis and relevant supporting documents, including financial statements Copies of documents used in life insurance sales process (e.g., product literature, etc.) Check for "Other Tax and Income" in "Personal Insurance section of the Worksheet in agent's Report of Long-Term App.	Details on: the need for the coverage and how to structure it the current value of the beneficiary and accumulation of how assets will grow how the plan is expected to work (income from capital income, minimum distribution, etc.) a cover name, equal net worth, and net worth
Debt Repayment (Business)	Equal to net collateralized portion of loan up to 75% of the loan amount	Details of loan amount, term, interest rate, amount, maturity	Details of insurance in force and the amount applied for

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What is Financial Underwriting?	Why is Financial Underwriting Important?	Insurable Interest	Premium Payer	Affordability
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.	Financial Underwriting is important 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 provide funds to help replace the economic loss that results from the premature death of the insured person. If the amount of insurance carried on an individual exceeds any possible loss on the part of the beneficiary, it could be considered speculative and it is not in the insured's or the company's best 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.	Who pays the premium is an important factor for underwriting to consider in evaluating a case. While the premium payer will most frequently be the insured, there are many acceptable reasons for someone else to pay the premium, including certain business and estate planning situations, or when coverage is requested in a dependent child or spouse. If someone other than the insured is paying the premiums, underwriting will look at the relationship of the premium payer to the insured and the reason for or who is paying the premium. The premium payer's income and the total amount of insurance the premium payer has on his or her own life are evaluated to determine the total amount of risk and the validity of the case.	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: Relation to Income Relationship. In conjunction with the Income Factor Tables (refer to the Income Factor Tables section of this highlighter for the tables), the relationship of premium payable to the proposed insured's gross annual income is considered. A good rule of thumb is that the total premium payable for all life insurance policies supported by the premium payer's income should not exceed 10% of the premium payer's before tax income. In certain situations, it may be acceptable, from a financial underwriting perspective, for premiums to be as high as 20%. If you find 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. Relation to Liquid Net Worth Relationship. If the premium is before 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 the appropriate use of those assets. The answers to these questions will be dependent 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.

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Speeding Up the Process

Application

- Full and complete details to each question
- Avoid “conflicting statements”

Cover letter

- Large face amount cases
- Smaller cases with unusual facts and/or circumstances
- Clear statement of purpose
- Clear proof of need(s)
- Consistency throughout

Creating the Cover Letter

Remember: First Impressions are Lasting

- An organized and well-written cover letter

Company Profile

- What? Tax structure of the business
- Who? Owners, % ownership
- History? Of the business; Owner's accomplishments
- Any other relevant information?

Insurance Purpose(s)

Business Purpose

- Key Person Coverage
- Buy-Sell Planning
- Business Loan/Collateral
- Executive Benefits

Business Purpose

Key Person Coverage

- Business is owner and beneficiary.
- Indemnifies the business for the loss of a key person.

Measuring Key Person Value

- Is using a multiple of income the only method?
- What is the true financial loss to the business?

Business Purpose

Buy-Sell Planning

- Details of the buy-sell agreement.
- Face amounts issued in proportion to the owners' shares of the fair market value of the business.

Fair Market Value of the Business

- Key to determining the face amounts that can be issued.

Business Purpose

Fair Market Value of the Business

- Formal business valuation (not likely).
- Value derived from the financial statements (most common).
- Capitalization of “adjusted” net income.

Balance Sheet: B/S

Financial health of a business at a specific point in time.

- What the business owns, owes and has in reserve
- $\text{Assets} - \text{Liabilities} = \text{Owners' Equity}$
- $\text{Owners' Equity} = \text{Net Worth}$

Rarely reflects the FMV of the business since the balance sheet is based on historical numbers.

- (Historical cost, not current FMV)

Income Statement: I/S

Also known as the Profit and Loss Statement

- Tells us how the business has “performed” over the reporting period.
- Tells us whether net income/loss flows to the balance sheet are increasing or decreasing the owners’ equity.
 - Revenue – Expenses = Net Income
- Starting point for most business valuations is net income.
- Valuing the business as a “going concern.”

Income Statement: I/S

Capitalizing the income

- What would a buyer be willing to pay for such a “money machine”?
- Capitalization Process has two components:
 - PVBUS = “Adjusted” Net Income
 - Desired ROR (Cap Rate)
- Income multiplier is the inverse of the capitalization rate:
 - $IM = 1/\text{Cap rate}$
- Income multipliers commonly used by underwriters.

Income Statement: I/S

Income Component

- Average: 3 to 5 years after-tax profits.
- Normalize the income statements.
 - Adjust income to reflect the “true” earnings power of the business.
 - Common adjustments:
 - Owners’ and family compensation—too much or too little.
 - Owners’ perks.
 - Non-recurring income and expenses.

Income Statement: I/S

Capitalization Rate

- Number used to convert an income stream into a present value.
- Dictated by the market, it essentially reflects the investor's desired rate of return.
 - Subjective, requiring the judgment of an expert.
 - Best we can do:
 - Use common sense
 - Use “rules of thumb”

Income Statement: I/S

Capitalization Rates

- Lower #: Stable business, less risk.
- Higher #: Newer business, or a business that depends on one or two key accounts.
- Industry tables with suggested capitalization rates.
- Adjustments for expected future growth.

Income Statement: I/S

Business Categories	Cap Rate	Income Multiplier
Safe, established, stable earnings Low to Medium Risk	6-8%	15-12
Newer, average or variable earnings Medium to High Risk	10-15%	10-7
Speculative, competitive market High Risk	20-50%	5-2

Cash Flow Statement

Records changes in cash flow during a reporting period

- From Operations
- From Investments
- From Financing Activities

Indicates how much money the business has actually generated

- Income adjusted for non-cash items

Answers the question, Can it generate the needed premium dollars?

Financial Statements

- Footnotes list everything that could not be included in the numerical transaction, but that is important to statement users.
- If you aren't reading the footnotes, you are missing out on important information and qualifiers.
- Footnotes often hold the answer to number discrepancies, explain one-time occurrences, detail the terms of loan repayments, etc.

Financial Statements

- Financial statements are the backbone of a business case.
- Don't just be a “transmitter” of information. Become an advocate by taking the role of a “translator” for the underwriter.
- Seek additional information.
- Paint the right picture the first time.

Financial Justification



Objectivity, Credibility and Reliance

Sources:

- Financial Statements
- Tax Returns
- Needs Analysis
- Legal Agreements
- Recent Transactions

Use the Internet

Is there a company website?

- Public Companies
 - ✓ www.freedgar.com
- Private Companies
 - ✓ www.hoovers.com
 - ✓ www.experian.com
 - ✓ www.bizstats.com
- UCC Filings (Uniform Commercial Code) Private Companies
 - ✓ Debt filing by state
- Internet Search Engines: google.com, yahoo.com, bing.com, etc.

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Remember—Look for the BIG PICTURE



Does It Make Sense?

[Thank You!]

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