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Financial Underwriting, Why Bother?

By Ross A. Morton

With 40 years of insurance industry experience, Ross Morton has evolved into a recognized mentor, advisor and reassurer. From 1994 to 2009 Ross has been used on various assignments around the world by RGA, and recently joined the Advisory Board for Logiq3. Ross can be found online at www.rossmorton.com

When an underwriting historian looks at the subject of financial underwriting, they quickly come to the realization that the conflict/confusion/befuddlement in the different perspectives between underwriter and advisor has existed since days when we could not agree on the value of the inventor of the wheel as a key man! History being so out of vogue today I will skip the horse and buggy, the two great wars, the moon landing and the Cold War so I can jump to 1956. Reading the Transactions of the Society of Actuaries 1956 Volume 8 Number 21 the conclusion by many at the time was "large case mortality was excellent" but still there was conversation about financial underwriting interspersed with concerns of too much accidental death benefit riders, pressure on non-medical insurance and the creeping concern of antiselection on cheap term products as they entered the product arsenal. Typical concerns of legendary actuaries who ran underwriting and where all real decision making was left to medical doctors. The lay underwriter was yet to be hatched although in the 1950s there emerged an experiment to try using trained clerks to make risk selection decisions!

By 1960 even greater concern arose amongst actuaries for the importance of doing some rudimentary financial underwriting. Fun reading is the transactions of the Society of Actuaries 1960 Volume 12 Number 34. Phrases like "policies for large amounts" were becoming common place. Reflections on the 1953-1958 mortality study showed mortality on cheap term insurance was 122 percent versus the mortality of 89 percent on permanent insurance. Fear of cheap term on young people in particular was eating away at the confidence of actuaries throughout North America. Alton Morton, the great guru of financial underwriting of the time, as well as other iconic actuaries had numerous company studies of varying merit to review. One such study of the time showed early mortality results on young people with cheap term policies exhibited early mortality of 170 percent. Alto would roll over in his grave if he saw the pricing models of 2010!

In 1973 wise men through the Society of Actuaries took a modern view of underwriting the large case (some progressives now believed big was any case where in force and applied for was $250,000). In that study, "Financial Underwriting For Individual Life Insurance" by Baskin and Marshall, transactions pages 509-571 (Transactions of SOA 1973 Volume 25 Part 1 Number 73), the conclusions were both applauded and questioned. A comment like the "spectacular large claims" was enough to scare everyone into action as some financial underwriting rules needed to be constructed. Thus we ended up with the 20-, 25- or 35-percent of income rule which stated how much of yearly income could be spent on life insurance (note: it was often graded so an income of $4,000 to $6,000 used 5 percent and an income of $15,000 used 20 percent). Aside from the poorly conceived percentage guides we had guides that reflected income and age bands (i.e., the top salary of $100,000 justified an insurance amount of $584,000 for someone between 45 and 47 years of age). All these rules grew even in the face of the last overall mortality results of 1970 being considered good.

Putting the paper into perspective and highlighting how inflation and realities have made the modern underwriter cynical of the findings, the reader has to understand three fundamental observations: they were still very big on using 20- to 25-percent of total income as the maximum amount spent on life insurance; a large case was defined as an amount of $100,000 or more; and they did not include the very large claims as they felt it would distort the results unfairly! It is hard to comprehend allowing someone to use 25 percent of income to buy life insurance today as a guide—think of how much term could be bought for that amount of premium. Even allowing for inflation, $100,000 seems too low an amount to use for a case to be considered "large"—a senior life underwriter in 1973 was earning over $8,000 per year. Why would they not include large claims since that is what financial underwriting is all about—would ignoring the large early claims really make the study too narrow and casts doubt on its conclusions?

The SOA has to my knowledge always been fair and published the detractors' and sceptics' opinions which to me balanced the papers conclusions and thus made all 60 pages worth the read. The detractors' opinions could be summarized in three points. First the study was too focused on numbers (wow, for actuaries to say this was profound) and not enough on practicalities of underwriting. Secondly there was too little emphasis on "insurable interest" and "does it make sense" (even actuaries quoted Charlie Will's famous phrase). Lastly, and Webster most eloquently stated it, "while financial information may be available, nearly always it is complicated." Great, a senior actuary admitting numbers can both confuse and distort by both their omission and inclusion.

Before I leave the history, there are two more wise and insightful actuaries who need quoting from those same pages of the transactions. Woodman stated the following in referencing papers that recommended "multiple tables" for use in arriving at how much insurance is allowed: "I caution all actuaries and underwriters to recognize that this is merely a reference point." Hale's words could be repeated today and probably in the next century as well: "... the chronic problem of trying to obtain adequate documentation ... The more adamant the refusal to provide documentation, the less likely the existence of an adequate financial basis."

Since the 1970s underwriters have leaned heavily on the income multiple tables as the answer to "how much is enough life insurance." The tables were constructed at a point in time using, one hopes, the best estimates of future inflation rates, interest rates and things like the cost of raising and educating offspring. All this was to have nice simple tables that according to one's age reflected how much life insurance was needed to protect the lifestyle of one's family at the death of the breadwinner (later to become the breadwinners, plural as dual incomes became the normal). For a 39-year-old in the 1970s, the underwriter used 12 as the multiple and steadfastly refused to issue more for no other reason than the table made them do it. For the same 39-year-old in the 1980s the underwriter used 15 as inflation took its toll on incomes. Now in 2009, we have what marketing gurus in companies call "progressive" underwriters in aggressive companies flexing their financial underwriting acumen and going to 30 times income as a number they feel comfortable with to prevent "over insurance." It is not the underwriters who are picking these numbers but rather the efficiency experts who press for simple rules in processing. The 30 times rule dictated from on high is just another "rule" or "process" underwriters must follow to keep the peace.

Not only have we leapt to a 30 multiple, but in some companies the guide heard repeatedly is, "no financial underwriting needed or done until the amount is for more than $1,000,000 (U.S. or Canadian)." The reaction of the advisor is to applaud this innovation in risk selection and hope it is forerunner of many more liberalizations. The reaction of the auditing underwriter is, "OK, but 'no financial underwriting' does not mean the underwriter forgets that there has to be insurable interest regardless of the amount." Regrettably the audits are turning up cases where there is no rhyme or reason why owner X is insuring person Y and the beneficiary is some unexplained numbered company in a country with no vowels in its name. OK, forget the amount since it is only $999,000, but make sure you see the insurable interest.

It has been a long time (some would argue too long while others would say not long enough) since the life insurance industry had a rash of large and/or questionable claims where either the amount made no sense or the beneficiary turns out to be totally unrelated to the deceased when viewed by the claim's adjudicator (a master of hindsight underwriting). Perhaps what we need is a string of those "biggies" and "dubious" cases torn apart by countless hindsight underwriters where the finger points straight at the underwriter for being too lackadaisical in financial underwriting. We then would have some very naive underwriters struggling to defend publicly their irrational attempts at streamlining financial underwriting. On the other hand what may emerge is real life examples for underwriting leadership to vociferously wrestle back control of procedures and guidelines from the process and marketing gnomes. Of course I am just trying to prod underwriters into not forgoing common sense in the search for expediency and cost savings, regardless of who initiates the changes. If you introduce a new "guide" make sure its phrasing is

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very understandable by the most junior of underwriters. Leave nothing to chance in how the "guide" is used.

Insurable interest cannot be dismissed since it is "the law" so to speak. The underwriter has an absolute obligation to ensure it exists at the time of the policy issue. Although many times challenged, some historical precedence remains the foundation for the need for insurable interest at time of issue:

- The Gambling Act of 1774 (English Parliament, 14 Geo. III, ch. 48) which states words to the effect that it is gambling if the owner of the policy has no interest in the insured.
- Later in the famous case in the USA of Grigsby v. Russell 222 U.S. 149 (1911) it was concluded that you cannot insure anyone you want and "the very meaning of insurable interest is an interest in having the life continue ..."
- Again in Grigsby v. Russell there was the point made that "if a person has a valid policy on his/her own life he/she can transfer it to another person whom he/she ... is not afraid to trust."

Underwriters would be wise to never lose sight of insurable interest and its definition. There are numerous definitions, but the more one searches through the myriad of words within the definitions the more any one or two will suffice for the underwriter. For example:

- "Princeton WordNet": states Insurable interest is an interest in a person or thing that will support the issuance of an insurance policy; an interest in the survival of the insured or in the preservation of the thing that is insured.

In an era of investor-owned life insurance and premium financing it gets far more exciting in the underwriting department. We have some pompous insurers touting the fact that they do not condone or allow any such sales concept to be used with their product. At the same time, as an underwriter recently conveyed to me, it may be so for the public relations angle but in the trenches of underwriting we are charged with getting any premium on the book while turning a blind eye to what we surmise the policies eventual ownership will be. At the other end of the spectrum, the industry has seen the introduction of questions to help the underwriter conclude that there is indeed insurable interest now and in the near future (as best any one could). Those questions include: what is the intent of the policy, how and who will pay the premiums, has anyone prompted you to purchase life insurance? But with a two-year contestable period our protection has a shorter life span than the patience of the ever clever investors.

Not sure what the answer is but the question intrigues me. Were any underwriters involved in the "Dead Peasant Life Insurance"? DPLI follows the long lineage of acronyms such as STOLI, BOLI, COLI, etc. DPLI of course is in jest but is used to reflect the supposed $120 billion of life insurance issued on perhaps unwitting employees taken out by corporations producing sizable tax breaks for many a company. Did the insured agree to the policy? Was there indeed insurable interest? Was there mandatory surrender of the policy on the employee's termination of employment? I cannot find an underwriter who has the answers so I would like to think that these clever schemes, that had the allure of revenue, never had to pass the risk selection test.

Getting back to what underwriters can control, since dwelling on the surmised lack of full underwriting on the specialty products is futile, the underwriter faces the ever asked question "What is he/she worth?" Putting a value on a life is really tough since we cannot predict the future with certainty nor ever come to a real irrefutable value of a life, be it for personal or business protection. I wrote many years ago that the advisor and underwriter were singing (underwriting financially) from different hymn books (company produced or condoned guides)—and remains a must read article. I do not think either hymn book is right but is it too much to ask a company to insist both advisor and underwriter use the same one.

Leaping into tall buildings where insurers reside we find the infamous "income multiple tables" that the underwriter relies upon as a guide to determine just how much insurance is enough. They are simple tables with age bands and they attached multiple. Not happy with one company's table I tried a second. The outcomes are similar:

- Company A at age 62 uses five as the multiple guide and thus "enough" insurance is suggested as (five*$195,000)-$500,000 (the in force) equalling $475,000 of new insurance.
- Company B at age 62 is more aggressive in its multiple guide and uses five to seven and thus using seven the suggested is (seven*$195,000)-$500,000 equalling $865,000 of new insurance.

What we have here is a failure not to communicate but rather agree within our underwriting and distribution departments what is the ONE method for calculating "enough."

To be fair and to show the world is edging closer to sanity (in calculating "enough" but not necessarily in other areas of financial services) there are a couple of companies that now use 30 as a multiple at the key mid ages. I can now say I have lived through in this age band the multiples 12, 15, 19, 21, 23 and 30! Middle aged applicants are obviously worth more now than 40 years ago.

So why bother with financial underwriting? The answer is the legislation that states there must be an insurable interest at the time of issue. Failing to fulfill that mandate could impale our companies on the stake of litigation for allowing a stranger to take out (perhaps unbeknownst) insurance on anyone they feel like or to turn insurance into an act of gambling. So the underwriter pays strict attention to the owner, insured and beneficiary to make sure insurable interest exists. Then the attention is shifted to what is "enough" insurance and that is where we have to harness our wanting to fall back to the safety of "multiple tables." In my 40 years I have never seen a case at claim time where the claims adjudicator or senior executive chastised the underwriter for issuing 27 times when the guide said 22! What you see is that the insurable interest was not there or there were suspicious signs surrounding any of the three parties.

From the unexplained numbered company for which no information exists to the sale of insurance on one partner out of four without rational reasons for such. So yes, bother, but focus more on the principles and less on the sanctuary of the tables.

The advisor could do more as well. Open up to the underwriter on how you sold the policy with details that put them on your side before they even read the application or some third parties notes on the applicant. Most seasoned underwriters would agree that a well constructed story (fact not fiction) surrounding how the sale was made, what the funds are for, who is to receive the funds and is the proposed insured a nice and known person, go a long way to making an underwriter say yes.

Lastly the underwriter would be wise to concentrate on the "who is the advisor," and who, if any, lawyer and or accountant prepared the needs analysis. If the proposed insured and his or her advisor have sought accounting and legal advice and then concluded that $x,xxx,xxx is the amount of insurance needed (their opinion of "enough"), who is the underwriter to say the amount is too much because their guides say there is another number for "enough"?

Written about for at least seven decades. Argued over for the same seven decades. Solutions found—zero. Time spent on debate—immeasurable. Cost to the industry—priceless. Who will finally make it all disappear from the list of issues? Perhaps an underwriter! ■