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Collateral Assignments for Loan Indemnification

Situation: Typically, this monthly publication focuses on technical life insurance concepts. However, this month we are taking a slightly different direction to describe how a collateral assignment of a life insurance policy can be used to help secure a loan from a bank or other lender. Often, when trying to get a loan, many lenders require life insurance simply because it ensures they can collect if the person taking out the loan passes away before the full loan amount is paid.

While this subject comes up with some frequency, I'm surprised at how many lenders are not familiar with the appropriate arrangement. Compounding the likelihood of missteps during the process is the recent use of electronic accelerated underwriting which places more reliance on the client communicating the appropriate information during the tele-underwriting process. Unfortunately, it's common for miscommunications to occur during the application process resulting in delays which can potentially lead to a reduced face amount being issued. To avoid this outcome, it's critical for the financial advisor to prepare their client. This Counselor's Corner is going to discuss some of the most common mistakes and how a financial advisor can proactively help their clients.

Solution: Let's start with a typical example of a situation which can result in a client requesting coverage to cover a loan.

Example: Mr. Business Owner went to his local bank to get a 10-year loan for $1,000,000 to fund the expansion of his successful business. As part of the loan arrangement the bank required that he sign for the loan, both as owner of the business and personally. The loan office also indicated that to qualify for the loan he must make the bank the "beneficiary" of a $1,000,000 life insurance policy. The business is a second generation closely held operation that employs 10 people in addition to the owner. One employee is a long-time friend of the owner, who is "in charge" of the operation, and another is the owner's college age child who works in the business during the summer. In your conversation with Mr. Business Owner he indicated a desire to pass the business to his son working in the business, but needs to retain his close friend and operations manager in the event of his death before the college age child is prepared to run the business. The owner stated that last year he netted $155,000 of income after expenses. Mr Business Owner is married, is 48, a nonsmoker in preferred health, and has two children. The youngest child just started high school. His spouse works part-time as a substitute teacher. Mr. Business Owner has asked you to find the "best" product to cover the loan. What do you need to know to make sure the process goes smoothly?

Financial Underwriting Guidelines Limit Amount of Coverage.

The first point that a financial advisor must be aware of in acquiring a policy to cover debt is that **carrier guidelines typically limit the face amount to between 60-70% of the outstanding loan**; however, some carriers may permit 100% if the loan is an SBA loan. The reason for this limitation is because carriers reasonably believe the insured will not die, at least from a medical condition, for several years and they assume that during this time the loan will decrease.

Often financial advisors are surprised to learn that typically an insured cannot receive life insurance for the full amount of the loan solely based on covering a loan. However, it is possible to get coverage equal to the full loan amount by adding an additional need for the insurance.

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So, the initial question that an advisor must address with the client is whether they want coverage for the full amount of the loan or if they are okay with covering a portion of the loan?

- If the client is fine covering a portion of the loan, then the advisor can tell the client that when they asked during the tele-underwriting process about the purpose of the coverage the client can simply respond, "it's to cover a loan obligation."
- Alternatively, if a financial advisor's client wants/needs to cover 100% of a loan the financial advisor must be prepared to identify additional reasons for the insurance coverage. The client's response to the question concerning purpose of the coverage depends on which of two approaches the client takes – as more fully discussed under policy structure below.
- In both situations they will be asked about the loan. Specifically, the underwriter will want to know the face amount of the loan and the term/length of the loan. The advisor should be aware that **most carriers will not underwrite short-term loans** because the carrier wants the coverage to stay in force long enough for it to recover its cost of processing the policy. Consequently, **the financial advisor should make sure the client is prepared to provide information about the length of the loan and the amount during the tele-underwriting interview.**

Lender or Investor It Makes a Difference. One last point: insurance carriers distinguish between lenders and investors. It's possible to get coverage to help liquidate business debts, but typically carriers will not insure an investor's risk of investment loss. So, carriers will want to know if there is an expectation of loan repayment.

Policy Structure: Who Should be the Insured, Owner and Beneficiary of the Policy?

The next point for an advisor to be aware of is that a carrier will demand an appropriate policy structure. Specifically, they will **expect the insured to be the person whose death will either trigger the loan repayment or will materially impact a business's ability to repay the loan.** Furthermore, **carriers will typically reject an application where the lender is the owner or beneficiary.** So, while it's not unusual for a banker to tell an insured that the bank needs to the "beneficiary" such a statement is not correct. Inproper policy structure is the area where clients make the most mistakes.

Too often our office has experienced the situation where the financial advisor has submitted the initial electronic form properly, only to have the client provide different information during the tele-underwriting process. This results in delays, confusion, and frustration for all parties involved. Thus, financial advisors need to spend time preparing the client for the tele-underwriting interview.

Carriers expect to see the following policy structure:

- Business as the owner and beneficiary for a business loan, and
- Insured as owner with the spouse/family the beneficiary for a personal loan.

However, often with business loans owners sign both for the business and personally, as in the example. Furthermore, if an individual wants to cover 100% of the loan the insured will need to provide an additional reason for the insurance coverage beyond the need to cover the debt. Of course, the additional insurance need must match up with the policy structure.

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There are two possible options to getting coverage for the full loan amount. The option taken will depend on whom the insured ultimately wants to benefit as the loan balance decreases:

Option #1: It might be possible to justify full coverage on the basis that the person being covered is a key person. Where the reason for the coverage is key person, the carrier will expect the business to be the owner and beneficiary which means as the loan amount is paid down the balance of the death benefit will benefit the business. Carriers will typically limit the face amount of key person coverage to ten times the income the insured derives from the business. In our example the insured had an additional need for insurance coverage, namely to provide a smooth transition by retaining a key person. By including a cover letter explaining the additional need for coverage it may be possible for a financial advisor's client to cover the full loan amount. Also, the insured makes $155,000 which should give him the ability to qualify for over $1.5million of coverage – more than enough to cover the loan.

If this option is selected the financial advisor will want to prepare the client to respond to the tele-underwriter when asked who will be the policy owner and beneficiary that the business will be the owner and beneficiary and that the reason for the coverage is both key person and to cover a loan. Of course, in this situation the financial advisor will also need to make sure the client understands that the carrier will ask about the income s/he derives from the business. The financial advisor should make sure the client understands that this is not the time for the client to play down the amount received because the amount of insurance coverage is based on the income reported by the client. For business owners income can include business distributions as well as the cost of company perks not given to rank and file employees.

Option #2: Where the insured is not a business owner, or where the business loan amount exceeds the amount that an insured can qualify for on the basis of key person the alternative option is to justify the reason for the coverage on the basis of personal coverage such as the need to provide a income to surviving family members on top of the desire to eliminate debt. Where the reason for the coverage is to provide for the family the carrier will expect the insured to be the owner and the spouse/family or trust to be the beneficiary. The amount a carrier will permit on the basis of survivor income is based on the individual insured's age and income. The younger the insured the larger the multiple of income a carrier will typically permit because the surviving family has a longer time where they are dependent on an income stream. For a person in their late 40s a carrier will typically permit twenty times income. For our example twenty time $155,000 would give the insured the ability to qualify for over $3 million of coverage.

If this option is selected the financial advisor will want to prepare the client to respond to the tele-underwriter when asked who will be the policy owner and beneficiary that the insured will be the owner and spouse/family or trust the beneficiary and that the reason for the coverage is to both provide for survivor income and to cover a loan. It's important to note, even if the business is going to pay the premiums on this personally owned policy the business is not the beneficiary. This is another common mistake made by insureds.

Once your client has made it though the tele-underwriting process, with the policy structure and the reason for the coverage all been propertly communicated, the only item that remains is the medical analysis by the carrier. Assuming the client is healthy the policy is issued as applied. The final step in the process is to execute the collateral assignment form.

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The Process of Obtaining a Collateral Assignment.

Instead of naming the lender as a beneficiary or partial beneficiary, carriers usually want you to use a collateral assignment form because with a collateral assignment the amount of death benefit that a lender receives decreases as the loan amount decreases while a beneficiary designation may result in the lender receiving a specific death benefit that may be more than the amount of outstanding loan. The assignment form also prevents the policyholder from releasing the assignment without the consent of the lender, thus, protecting the interest of the lender.

The form can be provided by the insurance carrier, bank or drafted by client's legal advisor. When using a bank assignment form or one drafted by the client's legal advisor the insurance carrier will want to approve the form before its use. Ultimately, the form is filed with the carrier and restricts the policy owner's rights until the assignment is released.

In Summary.

One of the primary reasons individuals purchase life insurance is to cover debt. Most of the time term insurance is purchased using one of the many electronic accelerated underwriting processes developed in response to COVID in recent years. This new technology puts more responsibility on the client communicating the appropriate owner and beneficiary designation. Unfortunately, clients are not well versed on the nuances of insurance and mistakes are made. It's imperative that financial advisors help their client prepare for the tele-underwriting process especially as it relates to the owner/beneficiary structure. The advisor should also make clients aware that a collateral assignment form will need to be executed after the policy is issued to make sure that the lender only receives the portion of the death benefit equal to the loan balance.

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