

This Just In:

Premium Deficiency Reserves-Inconsistencies in Practice

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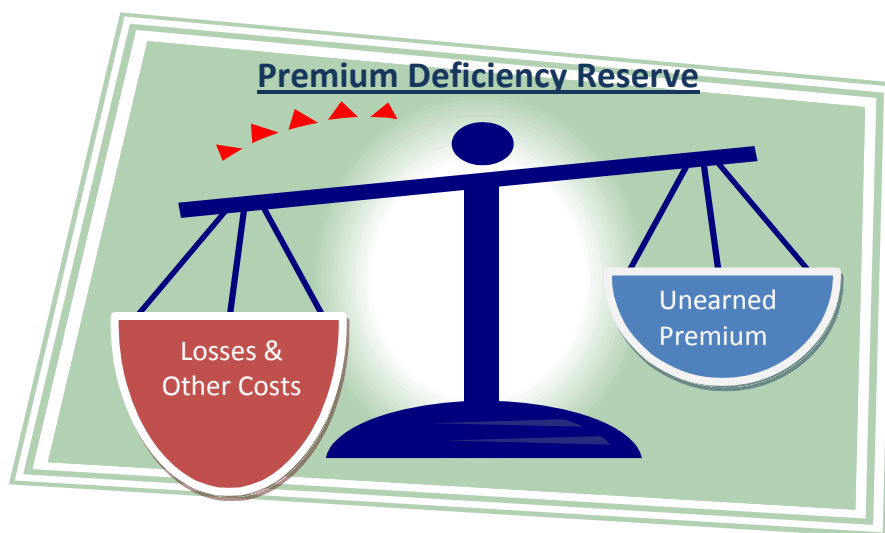
The extended soft market in the property casualty insurance industry and downturn in global economic markets has led many to ask about premium deficiency reserve (“PDR”) requirements. In the recent past, premium deficiency reserves have been concentrated in the life insurance industry and specialized pockets in the property casualty industry. Given additional pressures on premium rates and tough economic times, premium deficiency reserves are gaining more exposure in traditional property casualty lines of business. The increased activity surrounding premium deficiency reserves has highlighted divergence in practices regarding measurement of premium.

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Table of Contents

Introduction.....	1
Guidance on PDRs	2
PDR’s in Practice	2
PDR Measurement	3-4
Calculating PDRs.....	4
Final Thoughts	4
Authors’ Background.....	5
Resources	5

At a basic level, a premium deficiency exists when unearned premium and expected future premium are not sufficient to cover future estimated losses, loss adjustment expenses, policy acquisition costs and maintenance costs. In other words, a premium deficiency reserve is required if you expect a net loss in future periods for the particular policy, line of business, segment or company that has already been written and remain in-force. Another important note, if you do not have unearned premium or future expected premium commitments there is no need for a premium deficiency reserve!



Divergence in practice has evolved in terms of when it is appropriate to prepare a premium deficiency analysis and what method should be used to calculate any resulting reserve. Should one look to the policy level and perform a review of multiple contracts or do one high level review? Once you determine you have a premium deficiency how should you calculate the premium deficiency reserve?

To answer these questions we first have to understand the theory and guidance relative to premium deficiency reserves. We will also look quickly at how practices have evolved over time in different segments of the insurance industry.

Guidance on Premium Deficiency Reserves

Generally Accepted Accounting Principles (“GAAP”) and Statutory Accounting Principles (“SAP”) are fairly consistent in their definitions of premium deficiency reserves. The general premise is that a premium deficiency reserve is required when unearned premium at a specific balance sheet date would be insufficient to cover expected future losses and loss adjustment expenses. Under GAAP, one also considers the amortization of deferred policy acquisition costs and maintenance costs. As acquisition costs are expensed as incurred under statutory guidance they are excluded from a statutory analysis of premium deficiency. We recommend that companies begin analyzing for premium deficiency when loss ratios exceed 90% and unearned premiums due to unexpired policy periods are present.

In theory, traditional recognition of premium and losses under GAAP and statutory guidance rely on the concept of matching. Both GAAP and SAP defer future income and attempt to recognize the income during the same period as associated future losses. However, when future losses are expected to exceed premium such losses must be accrued for when determinable. This concept of accruing for losses when they are determinable creates the need for premium deficiency reserves.

Premium Deficiency Reserves in Practice

In order to understand premium deficiency reserves fully it helps to understand the industries in which they are more commonly found. Industries such as life insurance, mortgage guarantee insurance and warranty insurance are typically required to analyze for premium deficiency reserves. These industries normally collect premium monthly to cover losses incurred during the associated period. In such industries unearned premium is minimal due to the premium earning cycle. Additionally, losses are not recorded until actually reported, as claims not yet reported are considered to be associated with future premium payments received. In order to determine premium deficiency reserves in these industries actuaries have historically performed projections of expected future premium. The present value of expected future premium inflow is then measured against the present value of expected future claims and applicable costs to determine the need for premium deficiency reserves.

While more frequent in lines of business with long-term contractual commitments such as life, warranty and mortgage guarantee insurance, we have seen an increase in premium deficiency questions and recognition due to the current soft market. We have also noted a divergence in practice in the area of premium deficiency measurement in companies with multiple lines of business and operating companies.

PDRs Defined

SAP: A premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, commissions and other acquisition costs and maintenance costs exceed the recorded unearned premium. Commissions and other acquisition costs need not be considered to the extent they have been previously expensed. (SSAP No. 53)

GAAP: A premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums. (ASC 944-60-25)

Premium Deficiency Measurement

Statutory and GAAP guidance both state that an insurance contract should be grouped in a manner consistent with how policies are marketed, serviced and measured. GAAP guidance adds that contracts should be grouped using the same method as a company uses to measure profitability of its insurance contracts. While these definitions appear to be clear and concise there has been much debate regarding the specific language for contract groupings.

Extremes in practice have gone from using the total amount from the NAIC Annual Statement (creating one group and one PDR projection) to policy groupings based on each policyholder (creating one projection per customer). The most common form of grouping we have encountered is found between these extremes, grouping applied by line of business or legal entity.

In practice, we have found that GAAP entities generally consider grouping on a consolidated entity basis and statutory entities generally group on a legal entity basis. Therefore, a company with twenty legal entities writing two lines of business may end up with twenty individual analysis under statutory guidance and two under GAAP.

The level of grouping matters because of different rules regarding offsets between groups versus within a group. As stated in SSAP 53, “Deficiencies shall not be offset by anticipated profits in other policy groupings.” A PDR can go no lower than zero for a particular group and therefore a negative indicated reserve for one group does not offset a positive indication in another group. However, unlimited offsetting is allowed within a group. Therefore, one group means unlimited offsetting and a lower PDR and multiple groups mean limited offsetting and a higher PDR.

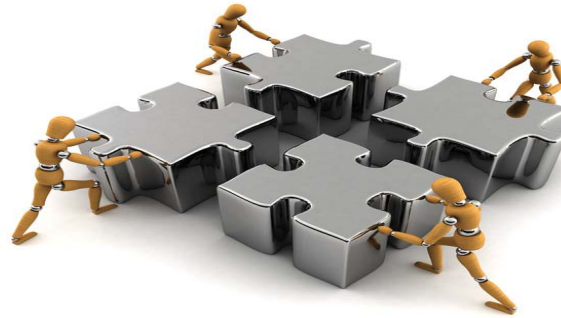
We believe that groupings will continue to vary from company to company; however, we recommend that companies base their measurement decisions on the guidance provided and clearly document their reasoning for their application. One item to consider is that policies grouped together by large insurance carriers may be very different than the policy grouping for smaller insurance companies or captive insurance companies. This is easily illustrated by looking at the three consideration areas of marketing, servicing and measurement and contrasting them between a large nationwide home and auto carrier and comparing them to a small home and auto carrier in the North East.

PDRs Measurement

SAP: Insurance contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each grouping where a premium deficiency is indicated. Deficiencies shall not be offset by anticipated profits in other policy groupings. (SSAP No. 53)

GAAP: Insurance contracts shall be grouped consistent with the enterprise’s manner of acquiring, servicing and measuring the profitability of its insurance contracts to determine if a premium deficiency exists. (ASC 944-60-25)

A nationwide home and auto carrier may group all of New England together as one market circle if their pricing and marketing strategy is consistent by geographic area. They may also service policies based upon the same geographically determined market circles. Servicing of proof of loss, eligibility determinations, billing processing and claims processing may be organized geographically by regional headquarters.



However, a small home and auto carrier in the North East may elect to build a market niche by focusing on a specific risk such as farms, vacation homes or mobile homes. It would follow that such a company would choose to organize departmentally into silos serving each market niche. Each company's business model is different so their grouping for a PDR analysis should also differ.

Calculating the Premium Deficiency

Once an analysis determines that there is a premium deficiency for a specific group of policies, one has to determine the value of the projected premium deficiency reserve. Doing so involves the actuarial determination of future claim costs, and premium inflows. There is no official guidance on what actuarial method should be used to calculate the anticipated investment income that may be included in the premium deficiency test. As a result, there are varying industry practices. The two primary methods used in practice are the expected investment income approach and the discounting approach. The expected investment income approach computes anticipated investment income on all of the cash flows generated by current in-force contracts. The discounting approach discounts expected future payments for claim costs, claim adjustment expenses and maintenance costs. Both methods incorporate the time value of money into the calculation of the premium deficiency reserve.

Final Thoughts

Statutory and GAAP guidance does not define a consistent method of measuring and calculating premium deficiency reserves. In fact, guidance allows flexibility and judgment in application of policy grouping and calculation methods utilized. Whichever approach taken, the company should clearly document their reasoning and justify the selection of groupings and calculation methodology based upon applicable statutory and GAAP guidance. To avoid the possibility of audit adjustments and post close fire drills we recommend that companies with loss ratios over 90% implement a well documented and consistently executed policy for determining a premium deficiency reserves. Doing so will greatly reduce inquires from your auditors and regulators.

Authors' Background



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