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INSURANCE DEPARTMENT
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ALBANY, NEW YORK 12257

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Circular Letter No. 11 (2010)
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TO: All Authorized Life Insurers, Fraternal Benefit Societies, and Accredited Life Reinsurers (“Insurers”)

RE: Deferred Premium Asset & Unearned Premium Reserve

STATUTORY REFERENCES: Insurance Law Sections 1304, 1308, 4217, and 4218

The purpose of this Circular Letter is two-fold: 1) to clarify the method by which an insurer must establish a deferred premium asset (“DPA”) or unearned premium reserve (“UPR”), and 2) to remind any ceding life insurer that takes reinsurance credit against its mean reserves or mid-terminal reserves that it must reduce any associated DPA proportionally by the amount reinsured, and that it must not reduce any associated UPR in excess of the amount reinsured, nor take into account the premium mode by which it remits premiums to its reinsurer nor any DPA or UPR established by the reinsurer.

When a life insurance company issues a policy, the insurer must establish a policy reserve to help ensure that it can pay the benefits promised under the policy. A policy reserve represents the present value of future benefits, less the present value of future valuation premiums. See N.Y. Ins. Law §§ 1304, 4217, 4218 (McKinney 2006 & 2007). A valuation premium is typically the “net premium,” which is the premium based on a formula set forth in Insurance Law § 4217, and less than the full premium collected by the insurer from the policyholder. In some instances, however, the valuation premium is the “gross premium” (i.e., the full premium collected by the insurer from its insured).

Policy reserves are measured as of a “valuation date,” which is the “as of” date for an annual or quarterly financial statement. On March 1st of each year, an insurer must file its annual statement with each state in which it is authorized to do business. Annual statements show policy reserves as a liability on the balance sheet as of December 31st of the previous year.

Insurers do not typically report an exact reserve. Instead, insurers typically use either the “mean reserve” method, or the “mid-terminal” method to estimate their exact reserves. Both reserve methodologies look at reserves that are held by the insurer at the end of two consecutive policy years. The mean reserve is calculated by assuming the policyholder pays an annual premium at the beginning of the policy year and adding the unearned portion of the annual valuation premium to the average of the reserves as of the previous policy year and the current policy year. The mid-terminal method averages the policy reserves as of the end of the previous year and the current policy year, without taking into account the payment of any premiums made during the policy year.

Calculation of the DPA

Except in instances where an insured pays policy premiums in full on the anniversary date of the policy, the mean reserve method results in an overstatement of reserves on the liability side of the insurer's balance sheet, because it assumes payment of the current policy year's entire premium. Consequently, an insurer typically enters a deferred premium asset on the asset side of an insurer's ledger to offset the overstatement.

Insurance Law § 4218 requires an insurer to replace its minimum reserve calculation using the gross premium when the gross premium is less than the net premium specified in Insurance Law § 4217. The Department has found that in many instances where an insurer calculates its mean reserves using gross premiums, the insurer calculates the associated DPA using larger net premiums, which results in higher DPAs on the asset sides of the balance sheet than the amount of the overstatement of reserves on the liability side.

Some insurers have claimed that SSAP No. 51, ¶ 23, which sets forth the calculation of the DPA associated with a mean reserve calculation, actually requires an insurer to use net premiums when calculating the DPA, because it mandates an insurer to reduce the gross premium by "loading" (i.e., the addition to the pure cost of insurance that reflects items such as agent commissions, premium taxes, and administrative costs). However, that interpretation conflicts with the plain language of SSAP No. 51, ¶ 23, which reads in pertinent part as follows:

> Deferred premiums are computed by taking the gross premium (or premiums) extending from (and including) the modal (monthly, quarterly, semiannual) premium due date or dates following the valuation date to the next policy anniversary date and subtracting any such deferred premiums that have actually been collected. Deferred premium assets shall also be reduced by loading.

Thus, the plain language of SSAP No. 51, ¶ 23 leaves no doubt that an insurer must use "gross premiums…reduced by loading," rather than simply net premiums.

In many instances, it may be that the gross premium, after reduction by loading, is equal to the amount of the net premiums. But where insurers are subject to Insurance Law § 4218, and where the gross premium reduced by loading and the net premium differ, the gross premium is the lesser premium of the two. In those instances, an insurer must use the gross premium to calculate the DPA. To do otherwise results in an overstatement of the DPA on the asset side of the insurer's balance sheet.

Calculation of the UPR

The mid-terminal method averages the policy reserves as of the end of the previous year and the current policy year, without taking into account the payment of any premiums made during the policy year. Therefore, when using the mid-terminal method, an insurer must establish a UPR on the liability side of its balance sheets to recognize premiums that have been paid but have not yet been earned.

SSAP No. 51, ¶ 24 sets forth the UPR calculation under the mid-terminal method:

> Under the mid-terminal method, the policy reserves are calculated as the average of the terminal reserves on the previous and the next policy anniversaries. These reserves shall be accompanied by an unearned premium reserve consisting of the portion of valuation premiums paid or due covering the period from the valuation date to the next policy anniversary date.

Thus, when calculating its mid-terminal reserve and UPR, an insurer must use the appropriate valuation premium (i.e., either the net premium or the gross premium).

Treatment of DPA upon reinsurance

Under Insurance Law § 1308(a), an insurer may receive credit, and thereby reduce its reserves on the liability side of its balance sheet, for ceding its risk pursuant to a reinsurance contract. However, the Department has found that in some instances where insurers cede risk to reinsurers, the ceding insurers have failed to reduce accordingly their DPAs on the asset sides of their balance sheets.

A life insurer often may collect premium from its insureds on a monthly basis, but pay reinsurance premium on the same risk to its reinsurer on a semi-annual basis. In those instances, the reinsurer establishes its own DPA. In some cases, ceding insurers have reduced the reinsurance reserve credit on their balance sheets by the amount of the DPA established by the reinsurer, as opposed to reducing their own DPAs proportionally by the amount that the life insurer cedes. Thus, by failing to reduce their DPAs proportionally by the amount they cede, some life insurers in New York have overstated their surpluses (i.e., their admitted assets minus liabilities).

SSAP No. 61, ¶ 25 governs the treatment of reinsurance premiums. By its terms, SSAP 61, ¶ 25 states in pertinent part that:

> The ceding entity shall reduce its deferred and uncollected premiums reported as an asset by the corresponding proportionate amount of any deferred and uncollected premium attributable to those insurance policies reinsured.

Thus, the plain language of SSAP 61, ¶ 25 requires a ceding insurer to reduce the DPA that it books as an asset on its balance sheet when that same risk is ceded to a reinsurer. And since the DPA exists solely to offset the overstatement inherent in the mean reserve, failure to reduce the DPA properly also results in a reinsurance reserve credit in excess of the actual risk ceded to the reinsurer.

<u>Treatment of UPR upon reinsurance</u>

In instances where the ceding insurer reinsures its risk, the reinsurer establishes its own UPR. For example, a ceding insurer may receive premiums from its policyholder on a monthly basis, but pay its reinsurance premiums on a semi-annual basis. In that scenario, the reinsurer's UPR is much larger than that established by the ceding insurer.

It has come to the Department's attention that some insurers take a reinsurance reserve credit on the liability sides of their balance sheets in an amount equal to the reinsurer's UPR, as opposed to reducing their own UPRs proportionally by the amount that they cede. Put another way, ceding insurers often decrease the reserves for risks on the liability sides of their balance sheet by the reinsurer's UPR even though the ceding insurer's own UPRs for such risks are much smaller. This practice results in a reinsurance reserve credit in excess of the actual risk ceded.

Insurance Law § 1308(b)(2) explicitly prohibits an insurer from receiving credit for reinsurance by way of deduction from its reserve liability in an amount exceeding the reserve on the reinsured portion of the risk. That statute reads as follows:

> (b) In determining the ceding insurer's financial condition, if reinsurance is effected by the ceding insurer in any assuming insurer, the ceding insurer shall, in addition to any credit allowed against its loss reserves, and any reduction of reserves allowed pursuant to paragraph nine of subsection (a) of section one thousand three hundred one of this article for reinsurance recoverable from insurers not authorized in this state, receive credit for reinsurance effected with any assuming insurer authorized to do such business in this state, calculated as follows:
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> (2) as to reinsurance of all or any part of any life insurance or annuity or non-cancellable disability risk, by way of deduction from its reserve liability, in an amount not exceeding the reserve on the reinsured portion of such risk which the ceding insurer would have maintained if such portion had not been reinsured.

Therefore, a ceding insurer must not take into consideration the UPR that its reinsurer has established when determining the amount of the ceding insurer's reserve credit.

<u>Compliance</u>

Every authorized life insurer, fraternal benefit society, and accredited life reinsurer should acknowledge receipt of this Circular Letter by October 1, 2010 by confirming in writing to the Department that it will comply with these requirements for statutory financial statements filed as of December 31, 2010 and later. The acknowledgment should be sent via e-mail to ALBLIF@ins.state.ny.us, and include confirmation of future compliance herewith, together with an estimated financial impact statement as of December 31, 2010. The financial impact statement should show the change in DPA and UPR, prior to and after reinsurance, if any, in accordance with this Circular Letter.

Please contact Amanda Fenwick, Supervising Actuary, at (518) 474-7929 or afenwick@ins.state.ny.us with any questions regarding this Circular Letter.

Sincerely,

Michael Maffei
Assistant Deputy Superintendent
and Chief
Life Bureau