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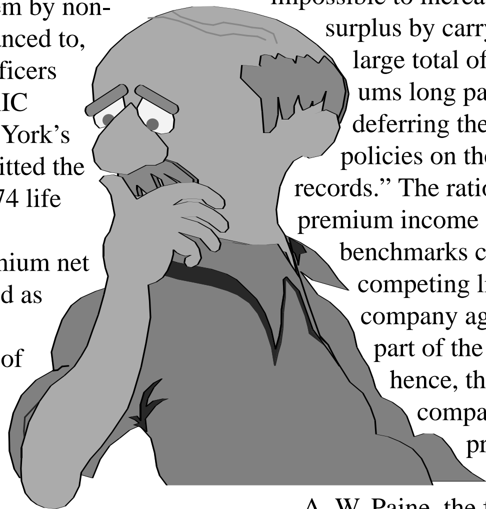
To Admit Or Not To Admit — Is That The Question?

by Kenneth W. Faig, Jr.

A learned historical treatise could probably be written about the accounting practices relating to the booking of due and uncollected premium for individual life and health insurance contracts in the United States.

In his 1937 RAIA paper, "The Convention Statement of Life Insurance Companies," Clinton Shepherd traced the history which led to New York's definition of non-admitted assets in 1871. The reporting forms specified for life and P&C companies in New York prior to 1860 did not provide for uncollected premiums as an asset; nevertheless, many companies established such assets and some of them even stated income without deduction of the prior year's uncollected premium asset. One of the most abused items in early balance sheets was the asset labeled "premiums in the hands of agents and in course of collection." In 1869, the total assets of the companies doing business in New York was reported at $229,000,000, of which $77,000,000, or 34%, was "premium notes and due and deferred premiums." In 1871, New York addressed this problem by non-admitting "cash advanced to, or in the hands of, officers and agents." The NAIC concurred with New York's actions and non-admitted the same assets in its 1874 life convention blank. Uncollected life premium net of loading was carried as a non-ledger asset.



The development of premium accrual accounting for individual life insurance undoubtedly has a strong relationship to the history of the grace period provision in these policies. In the absence of a grace period provision, a policy would terminate (or convert to a nonforfeiture option) immediately upon non-payment of any premium falling due. In time, a minimum 30-day grace period became a required policy provision in all jurisdictions. Many companies allowed policies with outstanding unpaid premiums to remain on their books for a longer period through the operation of "automatic" or "easy" reinstatement policies for policies with premium arrearage in the 30-90 day range. For individual life insurance, due and deferred net premium has traditionally been posted as an asset rather than a contra-liability to annual net premium-basis mean reserves. Cost of collection in excess of loading, formerly required as an additional liability, will disappear from the convention blank in 2001 under codified statutory accounting.

At the time Shepherd wrote in 1937, the life convention blank deducted under non-admitted assets "premium notes, policy loans, and other policy assets in excess of the net value and of other policy liabilities on individual policies." Shepherd explains the historical development of this provision by "the desire of the supervising authorities to make it impossible to increase the company's surplus by carrying in its assets a large total of uncollected premiums long past due merely by deferring the termination of such policies on the company's records." The ratio of expenses to premium income was one of the benchmarks commonly used by competing life insurance company agents during the latter part of the nineteenth century; hence, the motivation of company officers to state premium income as liberally as possible.

A. W. Paine, the first insurance commissioner in Maine and the first chairman of the NAIC's blanks committee, addressed the nature of the uncollected premium asset at the first meeting of the NAIC (then the National Convention of Insurance Commissioners) in 1871:

> For convenience, the credit [for due and deferred premium net of loading] is to be made on the credit side of the account, among the items of assets. It is not in any sense an "asset" or to be regarded as such in any other light than to reduce the apparent liability of the company as charged on the opposite side of the account.

From early on, insurance supervisory officials realized that uncollected life premiums did not represent a legal debt of the policyowner to the insurance company and were justified only as a contra-liability to the reserves based upon the assumption that such premiums had been collected. Shepherd quotes from the New York Superintendent's report of 1891 to demonstrate the intensity of the early focus on admitted premium:

> Mr. Paterson [a department examiner] ... listed every policy on which an uncollected or deferred premium or premium note was claimed as an asset, and where it was found that any such was in excess of the reserve on the policy, such excess was rejected as an asset. This was one of the slowest and most laborious portions of the examination.

By way of contrast, nineteenth century fire and casualty insurers solved the uncollected premium problem neatly by deducting from uncollected premiums all those more than ninety days past due. Shepherd (p. 162) explains this difference in historical practice between life and P&C carriers as follows:

> Premium income on casualty and fire lines today is reported on a written or due basis; other items are reported on a paid basis, just as in the life statement. The explanation of this difference in treatment lies perhaps in the fact that fire and casualty premiums past due often represent bona fide obligation on the part of the policyholder; whereas unpaid life premiums do not, and are, therefore, only "offset" assets, as has been pointed out.

While even today mandatory insurance coverage is generally restricted to certain P&C lines (e.g., automobile liability), the legal obligation to carry property or life insurance in connection with borrowing has a long history. Nevertheless, it is rare for premium to constitute a legal debt of the policyowner to the insurer.

Individual A&H insurance, whether written in P&C or life companies, from early on tended to follow the P&C paradigm with respect to uncollected premium. Individual accident and health insurance was traditionally reserved on an unearned premium basis. For contracts requiring additional reserves, these reserves usually were computed on a mid-terminal basis; so the full year's net premium was not inherent in the additional reserve. Managing agents responsible for premium collection and other administrative functions were more common in the individual A&H insurance business than in the individual life insurance business, with the exception of industrial or debit business.

Thus, the perennial question of the admissibility of uncollected premiums and premiums in the hands of agents loomed larger in the A&H business than it did in the life insurance business. It is not surprising that it received a more restrictive solution (the 90-day/one modal premium criterion) in the A&H business than it did in the life insurance business.

The 1967 annual statement instructions as reproduced in Joseph C. Noback's *Life Insurance Accounting* (Appendix A) contain the following instructions for A&H premiums due and unpaid in Exhibit 14:

> In column (3) [non-admitted assets] due and unpaid premiums effective prior to October 1, and, on other than group, any premiums in excess of one periodic premium due and unpaid in the case of premiums payable more frequently than quarterly.

This was interpreted under the familiar dictum that for individual health insurance, not more than one modal premium not more than 90 days in arrears as of the valuation date could be admitted. One may find this rule restated in the IASA *Life Insurance Accounting* textbook (1994 edition, p. 5-8) and other references.

One ought to take note of a nuance which occurs in the final pre-codification edition of the NAIC Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Chapter 18, pp. 3-4):

On accident and health policies, other than group, with premiums payable more frequently than quarterly, *all* due and unpaid premiums are not admitted if more than one period premium is overdue. Group premiums more than 90 days overdue also are disallowed as an admitted asset.

The wording of the 1967 instruction leaves the impression that a premium arrearage may be allocated between admitted and non-admitted due premium. By way of contrast, the final pre-codification APPM appears to take a different position in requiring that the entire premium arrearage be classified as admitted or non-admitted. This requirement raises a problem when, as is usually the case, the most recent due premium has an associated unearned premium liability. There is no provision to non-admit an unearned premium liability established in respect of a non-admitted due premium.

Shepherd (1886-1950) was a forward-looking thinker, whose views were formed by his careful historical studies. (His 1939 RAIA paper, "The Legal Reserve System in the United States," provides for valuation and nonforfeiture the same rich developmental perspective that his 1937 RAIA paper provided for financial reporting.) In his 1937 paper, Shepherd opined on uncollected premium (p. 139):

> The problem is less complicated and serious in the fire and casualty lines and is satisfactorily dealt with by deducting from uncollected premiums all those more than ninety days past due. It might have been an improvement if a similar rule had been applied to life premiums to arrive at the non-admitted portion.

We will see that the framers of statutory codification have in essence opted for the admissibility of life insurance due premium the suggestion which Shepherd first made in his 1937 paper.

What is the impact of codification's SSAP No. 6 on "Uncollected Premium Balances, Bills Receivable, and Amounts Due From Agents and Brokers?" First of all, the SSAP specifically excludes uncollected and deferred premiums for life considerations, which are covered under paragraph 12 of SSAP No. 51 on Life Insurance. Paragraph 9(a) of SSAP No. 6 defines the criterion for non-admission of due and uncollected A&H premium:

> Uncollected Premium — To the extent that there is no related unearned premium, any uncollected premium balances which are over ninety days due shall be non-admitted. If any installment premium is over ninety days due, the amount over ninety days due *plus all future installments that have been recorded on the policy* shall be non-admitted.

The equivalent language for life insurance from Paragraph 12 ("Uncollected Premium Balances") of SSAP No. 51 is:

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> Gross premiums that are due and unpaid as of the reporting date, net of loading, shall be classified as uncollected premiums. Uncollected premium balances which are less than 90 days past due meet the definition of an asset, as defined in *SSAP No. 4 - Assets and Non-admitted Assets,* and are admitted assets to the extent they conform to the requirements of this section.

One may note that the requirements for admission of uncollected A&H premiums remain more stringent under codified statutory practice than the equivalent requirements for admission of uncollected life premiums. Under SSAP No. 6, one must look at the due date of the earliest unpaid modal premium. If it is over 90 days in arrears as of the valuation date, all unpaid modal premiums must be non-admitted. There appears to be a saving provision if the most recent unpaid modal premium has a corresponding unearned premium liability as of the valuation date. Suppose that an annual mode policy with a modal premium of $100 is paid to 07-01-2000 for a 12-31-2000 valuation and that a $50 gross unearned premium liability is posted for this policy.

The first sentence of Paragraph 9(a) of SSAP No. 6 would appear to "save" the admission of the due and uncollected premium of $100 even though it is over ninety days in arrears as of the valuation date. But it must be observed that the first and second sentences of Paragraph 9(a) appear to be in conflict on this subject.

For life insurance, note that Paragraph 12 of SSAP No. 51 says that gross premiums, net of loading, which are less than 90 days in arrears as of the valuation date, may be admitted. It does not specifically state that premiums 90 days or more in arrears should be non-admitted although one might draw that inference from the phraseology. Some commentators might argue that premiums 90 days or more in arrears need to be classified on a facts and circumstances basis with due regard to the definition of assets in SSAP No. 4. The question can also be raised as to whether SSAP No. 6 and SSAP No. 51 differ intentionally on the admissibility of a modal due premium exactly 90 days in arrears.

Before the reader decides that the classification of due premium assets is an obscure and perhaps unimportant part of codified statutory practice (which may or may not be adopted by his or her company's domiciliary state), it is worth noting that in the NAIC's 2001 compendium of annual statement instructions, the instruction for line 17 ("Accident and Health Premiums Due and Unpaid") in the asset section of the balance sheet contains the phrase "Refer to SSAP No. 6." If your domiciliary state adopts these annual statement instructions, SSAP No. 6 will govern not only your reconciliation to codified statutory practice as regards the status of A&H due premium assets, but also your domiciliary state annual statement.

Essentially, the admission or non-admission of A&H due premiums in both the domiciliary state annual statement balance sheet and the codified statutory balance sheet will be determined by the language of SSAP No. 6.

It would appear that the "safest" rule would be to non-admit all due and uncollected A&H premiums on a policy if the earliest unpaid modal premium is more than 90 days in arrears. However, since there is no corresponding provision for "non-admitting" an unearned premium liability, it appears that an uncollected premium with an associated unearned premium liability may nevertheless be admitted. Because of the inconsistency of the first and second sentences of Paragraph 9(a) of SSAP No. 6, there is some ground for arguing that an allocation of the total premium arrearage between admitted and non-admitted can still be undertaken where admissibility of the most recent unpaid modal premium is "saved" by the "unearned premium" clause of 9(a).

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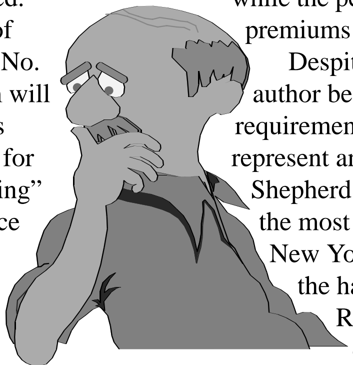
Other questions can certainly arise. In some companies, certain policies may be billed "off-modeaversary." Thus, an annual mode policy issued January 1 may nevertheless be billed July 1 to July 1. Under one convention, unpaid premiums on such policies are restored to "normal" billing mode at the earliest possible date. Thus, a January 1-dated annual mode policy with $100 annual premium paid to July 1, 2000 as of December 31, 2000 would have a due and uncollected pro-rata premium of $50 and a gross unearned premium of $0 as of the valuation date. A second convention would allow this policy a due and uncollected premium of $100 and a gross unearned premium of $50 as of the valuation date. Under the second convention, it might be argued that the due and uncollected premium, despite being 180 days in arrears as of the valuation date, is admitted because of the "unearned premium" clause of Paragraph 9(a).

For financial statements dated January 1, 2001 and later, both life and health valuation actuaries should review the practices of their companies with regard to admitting/non-admitting due premium on the asset side of the balance sheet. The concept of non-admitting life insurance due premium will be new to most insurers. They will need to make a judgment as to whether the language of Paragraph 12 of SSAP No. 51 specifically requires premium 90 days or more in arrears be non-admitted. Similarly, the language of Paragraph 9(a) of SSAP No. 6 for A&H due premium will suggest some differences from historical practices for A&H insurers. The "saving" clause of the first sentence of Paragraph 9(a) will need to be reconciled with the "all or nothing" clause of the second sentence.



One simple solution to the Paragraph 9(a) conundrum would be to follow the rule of the second sentence but to allow a contra-liability for any unearned premium liability held in respect of a non-admitted due premium. Another approach would be to admit only exactly as much due premium as corresponds to the premium liability; thus, if $50 unearned premium liability was held in respect of a $100 due premium otherwise non-admissible, $50 of the due premium would be admitted and $50 would be non-admitted. The requirement that the collectibility (and therefore admissibility) of an entire premium arrearage be judged by the earliest arrearage certainly makes common sense. If one allocates a premium arrearage between non-admitted and admitted components, the puzzling result is that the ultimate modal due premium is admitted while the penultimate and earlier due premiums are non-admitted.

Despite the potential confusion, the author believes that codification's requirements for admitting due premium represent an advance in practice such as Shepherd envisioned in 1937, perhaps the most significant advance since New York non-admitted premiums in the hands of agents in 1871. Rational solutions for the disputed points are available.

Regulatory guidance will probably follow based on emerging company practice and comment. The result of the process should be greater uniformity in insurance company financial statements relating to the balance sheet and income statement treatment of business kept on the books for administrative reasons for some period following the contractual termination date.

Some commentators may maintain that no recent abuse of normative administrative practices relating to the maintenance of inforce files justifies codification's admitted premium changes. Other commentators may maintain that norms for the administrative practices themselves, rather than norms for admitted due premiums, would address any potential abuse more directly. The author responds that codification's admitted premium requirements build, in a continuous manner, upon historical financial reporting practices. Without limiting administrative practices themselves, codification's admitted premium requirements impose a practical limitation upon the financial leverage obtainable through abuse of normative administrative practices. They should make for a fairer, safer future for life and A&H businesses — a goal shared by all competitors, consumers, and industry regulators.

Kenneth W. Faig, Jr., FSA, MAAA, is manager of actuarial services at PolySystems, Inc. in Chicago. He can be reached at **kfaig@polysystems.com.**

Notice To All New York Actuaries

Volunteers are needed to help with the planning of the Annual Meeting of the Actuarial Society of New York (ASNY). Work is already underway and Mel Feinberg (FSA, New York Life) is currently chairing the Annual Meeting Committee.

Volunteers are needed to either participate on the Committee or to assist in suggesting topics and speakers for the program.

So, if you are interested and you live in the New York area, call Mel at 212-576-6454 to lend your services. They will be greatly appreciated!