

Surplus Relief

Because of statutory accounting rules, an insurance company can only recognize premium income as it is earned over time. The policy premium is the written premium which the insurer books, but only 1/12 of the annual premium is “earned” or recognized as income during the first month (simplified version for explanation purposes only). Losses are recognized as an expense when they occur, not when paid. The entire acquisition expenses on the written premium is also recognized as an expense when incurred, or immediately. Therefore, the insurance company has an underwriting loss immediately even when no losses occur.

Example:	Written premium:	\$1,200,000
	Income Statement:	
	Earned (first month)	\$ 120,000
	Expense ratio (40%)	<u>(\$ 480,000)</u>
	Underwriting Profit	(\$ 360,000)

Because of regulatory rules regarding the premium-to-surplus ratio, an insurance company is restricted to writing a stated multiple of its policyholder surplus. If the regulator states that the ratio is 3 to 1, for each dollar of surplus, the insurer can write \$3 of premium. An underwriting loss of \$360,000 forces a reduction of written premium of \$1,080,000.

Pro-rata forms of reinsurance recapture part of the expense ratio through payment of a ceding commission. When the reinsurer receives the stated percentage of premium, they pay the stated percentage of ceding commission back to the primary insurer. Assume the ceding commission is 20%.

In the above example, if the pro-rata reinsurance is a 40/60 agreement, the reinsurer receives \$720,000, and pays a ceding commission of \$144,000 back to the primary insurer. This offsets part of the initial loss of \$360,000, reducing the surplus hit to \$216,000 and permits the primary carrier to reduce written premium only to \$648,000, not \$1,080,000.

