

Jim's Perspective...

The Kenney Theory

The Midwest spring and summer storm season is upon us. As you know, extensive wind and hail storms can have a significant impact on the financial condition of an insurance company. All of this potential property loss also highlights the important role played by property insurance in the economy. As we all appreciate, without the risk management benefits provided by insurance, significant damage to property caused by weather events would inflict severe financial distress on property owners.

Of course insurance consumers pay the premium up front with the expectation that if the insured property sustains damage due to a covered weather event, the insurer will be there to pay the claim. Property and casualty insurer solvency is, therefore, the number one responsibility of the regulator. State law regulates how an insurer must maintain premium dollars received from policyholders. State financial examiners conduct a financial exam of an insurer roughly once every four years. While state regulation has successfully maintained solid solvency standards for insurers, it is still good business practice for agents to check the financial condition of insurers with whom they place business.

We all know the traditional rule of thumb used to gauge the financial health of an insurer. The insurer is deemed financially sound if for every three dollars of premium written it has at least one dollar of policyholder surplus on the books. A company with a ratio of six or seven dollars of premium written to one dollar of policyholder surplus needs to be carefully examined! The “three to one” ratio has been around a long time, and while it is one useful way to look at insurer solvency, there are other theories of solvency that can be helpful.

Another useful measure of insurer financial strength is the Kenney Theory of Fire Insurance Strength.¹ The Kenney rule states that, other things being equal, the ratio of *policyholders' surplus* to the *unearned premium reserve* determines the relative strength of property and casualty insurance companies. A property and casualty insurer is financially sound when it has one dollar of surplus for every dollar of unearned premium reserve. The policyholders' surplus (composed of capital, surplus and general contingency reserves) is essentially the net assets of the insurer. The unearned premium reserve, on the other hand, is a measure of the outstanding potential liability of the company in the form of risks accepted. Stated differently, the unearned premium reserve represents that portion of the premiums which is held “in trust” and is not yet earned because of the fact that the policyholders have not yet received the full term of protection for which the premium was collected. The unearned premium reserve comes into being as the natural result of collecting a price in advance and delivering the product in the future.

The premiums paid for a typical property and casualty insurance policy do not immediately find their way into the treasury of the company to be used as management sees fit. When a new policy is issued, the company assumes to itself – automatically – an unearned premium liability

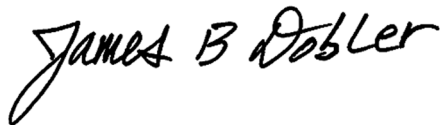
¹ Roger Kenney, *Fundamentals of Fire and Casualty Insurance Strength*, (The Kenney Insurance Studies, Dedham, Massachusetts, 1967)

equal to the premium under the new contract. In addition, the company also incurs a liability for underwriting expenses such as agents' commissions, taxes and other fees. So because the company can't use the new premium collected until it is earned, and it incurs up-front underwriting expenses when the policy is issued, the company must have adequate surplus to cover all of this "expense." It needs surplus to write business.

The sanctity of the unearned premium reserve cannot be overstated. It is a "trust fund" in my opinion. To be considered solvent, a company must at all times maintain its unearned premium reserve intact. Should the company for some reason decide to retire from business, it must return all of the unearned premium reserve to its customers. Finally, in contrast to the unearned premium reserve, the policyholders' surplus is truly the property of the company, representing the margin of assets over and above liabilities.

The Kenney Theory of a ratio of one-to-one between the policyholders' surplus and the unearned premium reserve of a "fire insurance company" was something first developed by the New York Department of Insurance in the 1930's. I think Roger Kenney worked as a financial examiner for the Department and he formalized this rule in the 1940's. His book in the footnote above was in the office library of Dwight Perkins who was president and CEO of Farmers Mutual of Nebraska from roughly the late 50's until about 1980. Mr. Perkins graduated from Lincoln High School. He received his undergraduate degree and law degree from Harvard University. I started working at Farmers Mutual at about the time Mr. Perkins retired. One day he called me into his office and explained the Kenney Theory, and then went to the bookshelf in his office and gave me his copy of Roger Kenney's book. Mr. Perkins was not the only Harvard law graduate at Farmers Mutual. Jack Pace was General Counsel for the company roughly at the same time Mr. Perkins was President. Jack also graduated from Harvard Law School. He was one of the lead attorneys for the International Military Tribunal for the Far East, also known as the Tokyo War Crimes Tribunal. He started at Farmers Mutual after returning from the war. Jack Pace and his wife Mary were good friends with my wife's parents, Lee and Anne Hendry. However, the Hendrys had other connections with Farmers Mutual. Anne played in a bridge group that included the Secretary of Farmers Mutual, Helen Calcaterra. It doesn't stop there! The auto underwriting manager in the late 60's and early 70's was Ed Jiracek. Ed and his wife Jean knew Lee and Anne as parishioners of Saint Teresa Parish. Anne and Jean worked together in the Saint Teresa Altar Society.

Well, I'm sorry. I kind of drifted off of the main topic; property and casualty insurance company financial strength. Social scientists have a phrase to describe my wandering. Older people are described by social scientists as easily susceptible to "Off Topic Verbosity." Ha ha!



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