

Unearned Premium & Unearned Commission



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What do the terms “Unearned Premium” and “Unearned Commission” mean?

Unearned Premium

In a typical loan transaction, a borrower usually puts up collateral as security for the money being borrowed. For example, when a person purchases a house, the house is used as collateral. In the event the loan goes into default (i.e. the borrower stops paying), the house becomes the property of the lender. The lender can then sell the house and use the proceeds to pay off the balance of the loan. In a premium finance loan, the unused portion of the insurance premium is used as collateral. This is possible because insurance is earned based upon the number of days coverage is in force.

A typical insurance policy is issued for a one year. In most cases each day that the coverage is in force, 1/365th of the policy premium is used. If the insured fails to pay the finance company, the finance company has the authority to direct that the insurance company to cancel the policy. This authority is granted in a “Power of Attorney” clause stipulated in the premium finance agreement. When the policy is cancelled, the earning of the insurance policy ceases. Because the policy premium is paid in advance by the finance company, the unused portion of the insurance premium is sent back to the finance company. The finance company can then apply that money to the balance of the loan.

Upon cancellation of the policy, there are several methods used in determining the amount of the insurance premium that is unearned. Moreover, there are several factors that go into determining which method of earning is used. Some states govern the earning schedule for all insurance policies written in that state. Some insurance companies determine the earning schedule based upon who requested the cancellation, the insured or the insurance company.

The following methods are commonly used in the industry:

- **Pro Rata** — In the pro rata earning schedule, the policy is earned equally each day. Using an example of a 365 day policy, 1/365th of the policy is earned each day. If the policy was in force for 265 days, then 165/365 of the policy is unearned. This unearned portion is what is returned in the event of cancellation.
- **Short Rate** — The short rate method of cancellation allows for an accelerated earning of the policy premium. There are typically two methods of calculating the short rate earning schedule. One calculation is based upon a table that indicates the percent of the premium that is earned for each day the policy is active. The second method of calculating short rate is to calculate 90% of the pro rata earning. This provides for a 10% acceleration in the earning.

Minimum Earned Premiums

Another important aspect is something called a minimum earned premium. Frequently, insurance carriers will earn a minimum amount of the annual policy premium even if the policy is only in force for a very short period of time. Insurance carriers do this in order to cover the costs of placing the risk and to insure that, on balance, they retain an adequate amount of premium to offset claims. A common example of this is a 25% minimum earned premium. This means that even if cancellation occurs very early in the policy term (for example, after one month), the unearned premium will never be less than 75% of the annual policy premium. This has a material impact on the collateral if the premium is financed.

Unearned Commission

The calculation of unearned commission coincides with the unearned premium calculation. An insurance agent is typically paid a commission by the insurance company for writing the policy. This commission is earned by the insurance agent using the same method that the insurance policy is earned. In the event of cancellation, that commission has not been earned in full, and the unearned portion is refundable to the insured.





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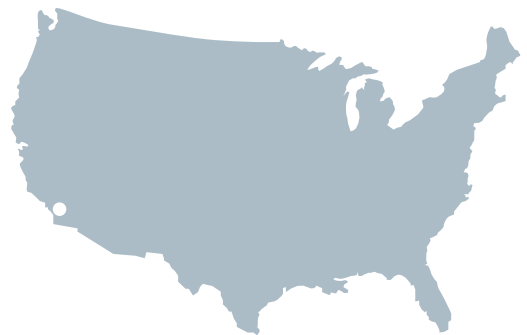
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