



The recent news from the financial world has brought the question of financial insolvency on the front page of major publications and news networks. The question of financial solvency in the insurance brokerage industry has acquired relevance because, if it happens, it can have severe consequences for insurance carriers as well as insurance consumers. One major insurance institution is known to have recently failed and was bailed out by the federal government.

Financial insolvencies are the result of insufficient cash assets and inability to pay debtors. Unless bailed out, failed institutions are forced to go into bankruptcy and possibly close their doors. When the federal government steps in to bail them out it does it at the tax payers' expense. Financial insolvencies will not only put at risk suppliers and creditors of failed institutions but have unpredictable ripple effects in the economy.

Financial insolvencies of P&C insurance agencies may be caused by either unsustainable operating losses or inability to manage premium funds. This paper will examine financial insolvencies caused by premium funds mismanagement. It will also discuss how new, recently developed technology will help prevent insolvency.

Trust Account (TA) Management

Agency TA "management" is not uniformly understood in the industry. Most believe the essence of it is to deposit premium payment checks received from insureds in the "trust" bank account and write remittance checks to carriers. This representation of trust account management is incomplete and misleading.

P&C insurance agencies receive millions of premium dollars from their customers, deposit them in trust bank accounts as required by law and then disburse them to legal owners within 60 days or less. In dealing with premium trust funds, many insurance agencies overlook their fiduciary nature and the "custodian" position insurance brokers assume in the premium transaction process. Insurance agencies are mandated by law to keep accurate accounting records and report the financial solvency of premium funds in meaningful reports that auditors can understand and use to verify compliance.

Basically, TA management is financial solvency management. Insurance Code states premiums and return premiums are "earmarked" funds. Premium dollars an agency receives under one insurance policy cannot be used to remit premium to insurance carriers on behalf of another

policy. This requirement, further referred to as “premium float integrity”, is set forth by the CA Insurance Code and constitutes the cornerstone of TA management. The earmarked nature of premium and return premium funds is fundamental to the distinction agencies have to make between premium funds and business operating funds.

By properly managing premium and return premium trust funds an agency should be able to:

- Create policy accounting records and report financial solvency, policy by policy
- Determine the trust account cash balance ownership (owners of the trust account premium float)
- Generate a TA balance sheet and demonstrate premium assets and liabilities are in balance
- Generate a statement of premium receipts and disbursements and determine the TA premium float

For reasons that will be discussed below, in the current management practice no agency currently performs at this level of detail.

Current Management Practice

With little or no understanding of fiduciary obligations, most agency personnel view the TA management process as a simple bank deposit and remittance check writing process. The agency commission is generally transferred out of the trust account on an “as needed” basis with no accounting records of “earned” commissions, policy by policy. Only the total amount is recorded as an “inter-account” bank transfer. Should an agency transfer more commission than it earns, its balance sheet will not show insolvency because both the trust and operating bank accounts are located on the same side of it. If un-earned commissions are moved from one account to the other, the total of the balance sheet assets remains unchanged and therefore, despite of the contrary, would indicate no insolvency.

Return premiums are entered in the ledger as “negative receivables” distorting the totals of the agency balance sheet and masking return premium “liabilities” as “negative assets”.

Trust account solvency is not routinely reported. Only CPAs can determine it through a process of adding and subtracting balances of the several premium accounts and their subsidiaries existing in the general ledger. Auditing a trust account is currently difficult if not impossible. Solvency is more a personal opinion than accounting fact based on reliable accounting records and accurate financial reporting.

Despite agency management products currently in use, P&C agencies are still unable to:

- Determine and report financial solvency, policy by policy, carrier by carrier or total trust funds
- Determine premium float ownership
- Generate a TA balance sheet and demonstrate premium assets and liabilities are in balance
- Verify TA cash balance against the premium float

None of the agency management products on the market today have been designed to help agencies manage trust account financial solvency. According to published statistics, one in three insurance agencies in California disburses premium funds for purposes other than those permitted by the Insurance Code. Many agencies operate out of trust without even knowing it. Without routine and accurate reporting, agency owners and managers are truly unable to determine if their fiduciary duty is carried out by the agency personnel as mandated by law.

A minor level of insolvency can slowly grow into a potentially severe menace to the agency overall financial position. Several insurance agencies have failed in the past due to trust account mismanagement causing insurance carriers financial losses and exposing insurance consumers to future higher premium rates.

Current Accounting Practice

The present shortcomings in trust account management can be easily traced to the premium invoice accounting. As demonstrated by the same authors in a 2005 article¹, premium invoice accounting should be different from that of a merchandise/service invoice. While the journal entry of a merchandise/service invoice creates assets in the seller's balance sheet and income in the P&L statement, a premium invoice should generate just premium assets and liabilities in the trust account ledger and no income.

Insurance premium accounting requires a different ledger of accounts (a Trust Ledger™, separate from the General Ledger) for the premium invoice journal entry to create premium assets and liability records. Only if such records are created can agencies generate trust funds balance sheets and report solvency. Placing premium accounting records in the agency general ledger is incompatible with the nature of trust account financial management and ultimately explains why agencies cannot currently report premium financial solvency.

GL accounting is currently used throughout the industry, although it is clearly inadequate for premium funds management. Agency owners and managers who bear legal responsibility for the solvency of premium funds have been long waiting for reliable financial tools to fulfill their fiduciary obligations. Managing money has never been easy. Managing premium funds is exponentially more difficult due to the premium's earmarked nature and regulatory mandates.

New TA Technology

New 21st century trust account technology has been developed to help independent P&C insurance agencies manage the financial solvency of premium funds reliably and efficiently. This technology responds to the industry need for a quick re-tooling in the area of

premium and return premium management. Its main attributes are summarized below:

1. New Trust Ledger TL™ accounting, separated from agency GL accounting
2. Data and accounting records created at the policy level
3. Complete automation of trust account daily operations: premium receivables, commission and remittance management, return premium credit and refunds
4. Ready-to-use financial solvency reporting system:
 - A. Separate TA balance Sheet
 - B. Premium Float Statement
 - C. TA Cash Balance Beneficiaries statement
 - D. Complete audit trails for all TL
5. Readily available of premium funds beneficiaries statements

As a backbone of our national economy P&C Insurance industry would perform better if the producing agencies had the financial tools necessary to fulfill their fiduciary obligations reliably and in a cost-effective manner. This technology is based on a new agency premium management concept and offers insurance agencies a new and more efficient business model. For more information on the new technology please go to www.paulmargroup.com.

The industry can continue to be a source of strength for the economy by renovating established business practices with refined methods of business and technology. With today's current economic climate, the P & C Insurance Industry must be committed to transforming its existing TA Management practices to avoid intrinsic problems faced in the banking industry.

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