Examinations by the Insurance Commissioners' Office – What to Expect

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Washington State has more than 34,000 licensed resident insurance producers and brokers, many affiliated with the 3,800 insurance agencies operating throughout our state. That's quite an impressive number! Our state has consistently been on the forefront of insurance regulation and is one of the few states with a financial examination program to verify licensees are "playing by the rules" and following regulatory requirements for engaging in the business of insurance. RCW 48.03.020 grants us the authority to examine your records and we do. Here, we will demystify the process and let you know what to expect when you are selected for a standard financial exam.

How you are selected for examination

Licensees are generally selected for examination in accordance with the annual examination plan objectives. There are many criteria taken into consideration, including agency location, size, and time since the last examination. A randomizing factor may also be applied. There are other factors may that increase your chance of being selected for a financial exam:

- If the agency has been in operation for several years and has never been examined.
- Substantial changes in ownership structure, business operations, or significant web or media advertising.
- Regulatory change or interest in a business practice or particular aspect of the marketplace.
- Consumer complaints to our office.
- Cancellation of an appointment by an insurer for cause.

That said, being selected for a financial exam does not necessarily mean we've identified a problem.

What to expect during an exam

Most examination assignments follow a five-phase process.

1. **Notification.** We will send you a letter stating that your agency has been selected for an exam. We include the examiner's name and contact information, a fact sheet and a *target* date for the examiner to arrive. If the target date is not convenient, please let us know. We've been told that people have canceled vacations or missed important events in order to accommodate our target date. *That is absolutely not necessary*!

Examiners may be working several assignments simultaneously, so we can be flexible on the timing.

2. **Pre-exam research.** The examiner will send an advance copy of our interview questionnaire and arrange a phone conference one to two weeks before the on-site work begins. The questionnaire helps us to become familiar with your agency's business operation so we can better plan for the on-site work. The phone conference may take up to one hour. Some agencies find it helpful to include a member of the production team and the accounting manager or bookkeeper on the call to help answer some of the questions and discuss the records you can have compiled and prepared for the examiner. After the phone conference, we may contact some of your business partners to obtain documents pertinent to our review, such as:
    - Brokers for account current billing statements.
    - Insurers for sweep reports and production reports.
    - Premium finance companies for funding and payment transaction activity.
3. **On-site fieldwork.** Most examinations are targeted to areas of greatest concern and require two to three days onsite. Although the examiner reviews production records, bank statements, and other records, our process is limited to sampling some of the insurance transactions and performing some analytical review of the accounts. We understand these are very challenging economic times; many agencies are lean-staffed and face competing demands for your time. The examiner will work as rapidly and efficiently as possible to complete the assignment. If the records are organized and complete, the assignment often requires less time. If instances of noncompliance or concern are identified, we will:
    - Prepare an accounting review form for you to sign that itemizes the problems found and what you need to do to correct the problem.
    - Provide educational instruction to help you come into compliance.

   The examiner can provide a 1-hour continuing education presentation covering premium handling practices to anyone in your office. We encourage you to take advantage of this opportunity and consider including your support staff, so that everyone has a chance to ask questions and seek additional clarification.
4. **Report preparation.** Any open issues requiring more research or contact with other entities to acquire information are completed. The examiner prepares a draft report summarizing the work performed, documenting any noncompliance findings, and specifying any required action you need to implement. There should be no surprises in the report, because the accounting review form should have been provided to you before the report is issued. The summary section at the end of the report states whether the examination is considered to be an "acceptable" or "unacceptable" exam.

5. **Exam completion and report issuance.** All examination reports are reviewed by the Insurance Commissioner's management prior to issuance. Our goal is to issue the final report within two weeks of completing the assignment in order to provide timely feedback. If there are no serious findings, the examination process is terminated and the report is issued as an "Acceptable" exam. Most examinations do not result in serious findings.

   If there are serious findings, the exam report will be classified as "Unacceptable" and clearly state that a re-examination will be conducted in approximately 90 days. If you correct the noncompliance issues prior to the re-examination, then your agency will receive an "Acceptable" re-exam. If not, you may be referred for consideration of administrative action. Therefore, it is always in your best interest to promptly address the issues we identify during the first examination.

Records we may need

RCW 48.17.470 and RCW 48.17.480 require you to maintain records of the insurance contracts procured and the monies received and paid, including return premiums, for a period of five years. The following are examples of records the examiner may ask to look at:

- Commission statements
- Account current billing statements
- Check registers and cleared checks
- Bank statements and bank reconciliations
- Cash receipts and detailed (itemized) bank deposits
- Accounts receivable and accounts payable (insurer) records
- General ledgers
- Financial reports, such as balance sheets and income statements
- Policy files
- Fee disclosure forms
- Loan agreements and premium finance agreements
- Carrier agreements
- Any other relevant information to verify that the consumer's interests are protected.

Are you "in trust" and how that is determined

There are several methods that we can use to test the account based upon your business operation and the records available. We test the separate premium account to determine compliance with regulatory requirements and verify monies actually received and due to be paid out were conserved (fully intact) and are available to pay the carrier to secure insurance for the consumer. Licensees we've examined run the gamut of true captive agencies with no separate premium account to large independent agencies writing primarily surplus line business. Some agencies may apply virtually all of the consumer funds received into the carriers' account without the money passing through the agency's bank account (easy breezy, and less stress accounting).

The examiner will generally apply one of two calculation methods to test the account.

- Financial statement calculation: Balance sheet accounts directly related to insurance transactions are used to compare assets to the liabilities. The assets should equal or exceed the liabilities. A bank deposit account must meet the requirements of WAC 284-12-080(3) to be included as a "trust" asset.

- "Cutoff" money flow test: Premium funds received are traced from point of receipt to deposit into the premium bank account and matched to payments from the account. Premium received and not yet paid is now identifiable as "outstanding" or "fiduciary funds owed to others." The account balance on the bank statement is compared to the outstanding amounts owed. This comparison helps identify reserves maintained in the account or shortages.

Your Agency may want to consider performing a test calculation on the account as part of the monthly reconciliation process. It is possible to have an unidentified shortage in the separate premium account that has occurred over a long period of time, even though there is a sizeable amount of money in the bank account, and the account has never experience an overdraft.

General Issues of concern to the Insurance Commissioner

In 2012, the Insurance Commissioner's Office met with insurance industry representatives and further clarified separate premium account requirements through a rule change process to address premium handling concerns. As a financial examiner, the one that causes me the most concern is failure to maintain proper segregation of funds "comingling," because that leads to misuse of client funds, shortages in accounts, and inability to pay insurers entitled to the premium. Examples of comingling include:

- Premium money deposited directly into the operating account. Or depositing cancellation return premium funds received from brokers or insurers into the operating account.
- Depositing direct bill commissions in the separate premium account.
- Significant bank fees coming out of the premium account and not being replenished from operating funds. Bank fees are an operating expense and the consumer's money cannot be used to pay them. RCW 48.17.600(3) and WAC284-12-080(2)(a) permit you to

maintain additional funds in the account to pay bank charges and cover other "contingencies."

- Using a credit card as a general use vehicle to remit premium funds to insurers <u>and</u> to pay general agency expenses. Your agency may only use a credit card to remit premium funds when the dedicated purpose of the credit card is solely to remit premium funds. The balance owed to the credit card provider should be paid off each month out of the separate premium account. And, the examiner's test of the premium account will not consider the premium paid to insurers as a discharge of your fiduciary obligation until the credit card charge has been paid to the financial institution. (Remember, the client premium funds you received must have been deposited into the separate premium account and retained in the account fully intact. So, it is important to ensure that any associated credit card fees incurred are paid from operating funds. You can either maintain additional funds in the account to cover the fees or replenish the account as the fees are incurred.)
- Poor recordkeeping practices that result in transferring more producer fee and agency-bill commission income from the separate premium account than the agency is entitled to. When the Agency transfers funds to the operating account, it must have supporting documentation, itemized down to the policy level, that the Agency is transferring only money to which it is entitled.

Another common cause of shortages in your separate premium account can occur from agency-bill cancellations. Although WAC 284-12-080(4)(d) permits transferring agency bill commissions to the operating account, if the policy cancels, the unearned commission must be returned to the premium account per WAC 284-12-080(5)(b). So, it is always a good practice to retain a ready reserve in the account to cover unearned commissions. Some agencies choose to retain the full agency bill commission in the premium account until the policy term lapses to ensure there are always sufficient available funds to cover a cancellation.

Less common, but devastating, are large shortages in the accounts that occur through skimming. Skimming occurs when not all of the funds received are deposited into the separate premium account. The risk of this happening increases when the agency collects substantial premiums in the form of currency and coin. Look for insurer sweeps or other payments coming out of the bank account without a corresponding receipt of premium money. Monitoring policy cancellations for unusual trends and investigating any uptick in client complaints may also help to spot this.

Maintaining sufficiently detailed accounting records for client premium funds is another concern. The agency should be issuing receipts to establish a permanent record of taking custody of client premium, and these receipts are an important part of establishing the audit trail. [When you are accepting a lot of premium in currency, it can be virtually impossible at the end of the day to reconstruct who paid how much without receipts that were properly prepared at the time the funds were actually received.] A receipt should be provided for all client premiums you process, even if the transaction is to apply the client's credit card payment directly into the insurer's account. If the consumer is not in the office at the time a payment is received, you can scan and email them a receipt. The accounting records should be appropriate for the complexity of your business operations and sufficiently detailed that it is possible to trace the funds received through the system from point of receipt to deposit into the premium account and through to payment to the various parties entitled to the funds. The record retention requirement is 5 years per RCW 48.17.470.

Another aspect of accounting for premium includes reconciling the accounts in a timely manner each month and following up on any unusual items or uncollected accounts.

Some reference tools are on the Insurance Commissioner's website, to help you comply with separate premium account requirements. We hope you will find these helpful to useful. Go to the "For Producers" tab and select the "Compliance" section and you will find an entire section with guidance under "Separate premium accounts."

Your financial examination can require less time and be a stress-free experience when you maintain the proper records. If you have questions, please email AskMike@oic.wa.gov or Mary Tunis at MaryT@oic.wa.gov or call Mary at (360) 725-7109. Consumer inquiries can be referred to either AskMike@oic.wa.gov or to the Office of Insurance Commissioner's consumer hotline at (800) 562-6900.