

SECTION 14

PRINCIPLES AND PRACTICE OF THE MANAGEMENT OF TRADE INSURANCE

CHAPTER I ORGANIZATION PRINCIPLES

CHAPTER II THE CANADIAN PERSPECTIVE

CHAPTER III MANAGEMENT OF MEDIUM TERM INSURANCE

**CHAPTER IV PRINCIPLES AND PRACTICE OF MANAGEMENT
OF AN I.T. TRADE INSURANCE SYSTEM**

CHAPTER I

ORGANIZATION PRINCIPLES

- Shared vision of objectives at all levels
- Good communication throughout the organisation
- Sound and comprehensive information systems
- Profitable performance as a key value
- Customer-driven business orientation
- Openness to outside influences
- Willingness to undertake new projects and programs
- Strong, consistent leadership
- Commitment to recruiting the best people
- Progressive Human Resources Development practices

CHAPTER II

The Canadian Perspective

Risk Management

Risk Management Office

- Optimises EDC's capacity and appetite, consistent with Corporate Business Plans and Objectives
- Assesses financial support for larger transactions recommended by business teams
- Formulates a policy framework and standards for all credit and insurance transactions
- Management of Corporate portfolio risk

- Risk Management Committee
 - Review and approve credit and concentration risks

- Asset Liability Committee
 - Membership includes President, Senior Vice Presidents of Operations and Treasury and Controller
 - Manages Asset Liability exposures on a Corporate basis including:
 - ⇒ Interest Rate, Foreign Exchange, Credit, Term Risks

- Reports to the Audit Committee of the Board of Directors

EDC Country Ratings

- Relating EDC Country Risk Ratings to probabilities of Default:

Once we determine EDC Country Risk Ratings for specific countries, we estimate expected annual probabilities of default for each EDC Country Risk Rating category.

Probabilities are estimated using:

- ⇒ EDC Economic's Department and International Markets Department analysis
- ⇒ Moody's and Standard & Poor historical data
- ⇒ OECD Consensus/Bernie Union historical data

EDC Country Limits

- After associating each country of the world into one of the 8 EDC Country Risk Rating categories, we determine an EDC Country Limit based on:
 - Probability of default pursuant to risk category
 - Canadian exporter demand
 - Country's annual exports income
 - Country's annual foreign debt service obligations
 - Country's economic variables and trends
 - Country's default history
 - Country's availability to funds from IMF programmes

Risk Analysis at Origination

- Transaction teams perform the roles of:
 - Relationship Management
 - Business Development and Marketing
 - Transaction Identification, Negotiating , and Structuring
 - Risk Credit Analyses and Presentation
- Transaction team can authorise EDC exposure subject to Delegation of Authorities
- All transactions in excess of USD5 million must be endorsed by Risk Management Office and/or Risk Management Committee

Risk Analysis at Origination

- Transaction team performs a risk analysis very similar to analysis performed by commercial bank, investment bank or insurance company
- EDC assesses and prices risk very similarly

- Credit limit and credit term of counterparty exposure is determined pursuant to risk analysis
- Commercial conditions, covenants, and events of default negotiated
- Credit surveillance benchmarks identified

Post-Commitment Portfolio Management

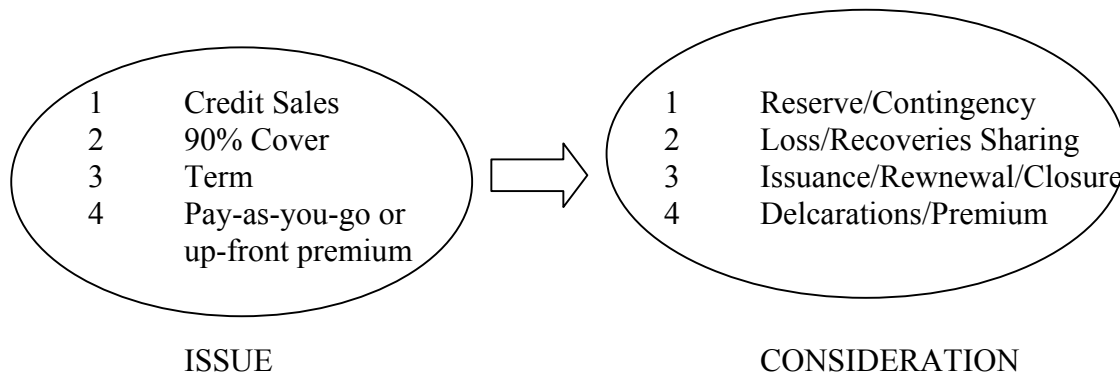
- Two Portfolio Management groups dedicated to monitoring EDC's book of assets and exposures after commitment:
 - Short term exposure
 - Long term exposure
- Monitor the credit-worthiness of all risk counterparties and country risk
- Monitor industries to which EDC has high concentration of assets or exposures
- Monitor loan covenant and conditions

Summary

- Speedy evolution of company structure in a high growth environment drives the controls needed
- Controls exist at the macro level and the micro level
- Inter linkages of all processes is growing as team focus evolves
- Controls on processes shaped by product and geared to proper financial management
- Financial Management takes place within the framework of the corporate Risk Management loop

Control Aspects & Issues

Control Considerations



Delegation of Authorities to EDC Employees

- Decision-making authorities based upon value are delegated to EDC employees to increase effectiveness of the service to the customer
- Delegation is based upon an employee's position, experience and competency
- 12 levels of authorities
 - Level 1 - Board of Directors
 - Level 12 - no delegated authorities
- The Table of Authorities sets out the dollar limits for each function of the employee

Premium Payment Process

- Short Term
 - Declaration form sent out, customised to each client
 - Entered in short term insurance computer system
- Medium Term
 - Premium paid in advance
 - Payment recorded in medium term computer system
 - Liability recorded

Claim Process

- Admissibility period based upon Risk Incurred
- Admissible Loss may be the full value declared, or less
- Verification of admissibility of the claim
 - Declarations
 - Period of cover
 - Other
- Payment decision by Claims Department
- Payment instructions to General Accounting
- Claims Accounting by Insurance Accounting

Claim Process Controls

- Operating Standards written for use by all members of the department
- Every claim is entered on database when received
- Database identifies Business Team of client which leads to the Claim Officer responsible
- Sophisticated computer reporting to control flow of work
- Computer System (CRS) controls approvals

Claims and Recoveries System

Claim Asset Control

- Paid claims carry an estimate of recovery in percentage terms
- Recovery estimates will change: Write Ups/Downs
- Asset carried on the books as long as recovery is determined to be cost effective
- If recovery prospects are not cost effective ⇒ Write Off
- Decisions taken in Claims Dept, through CRS

Claim Recoveries Control

- All incoming cheques handled by General Accounting for recording and deposit
- Data entered on CRS by General Accounting including payee and references
- Amount allocated to claim by Claims Officer

- Effect is to adjust the asset Claims Paid

Claim Reporting

- CRS is a sub-system of the accounting system
- Cash transactions handled in the accounting system when triggered by CRS
- Information breakdown, eg claims by product, by program, etc, all drawn from CRS

Business Control Summary

- Controls evolve: increasing insured volumes driving process improvements
- System of checks & balances within processes to ensure appropriate behaviour
- Cross-checks between business process and accounting processes

The Future Structure and Controls

- As EDC Corporate structure evolves, processes, controls and accounting methods must adapt
- Technology will play an important role in the evolution of EDC
- Underwriting and Claim systems upgrades
- Looking at greater asset control for all of EDC's assets

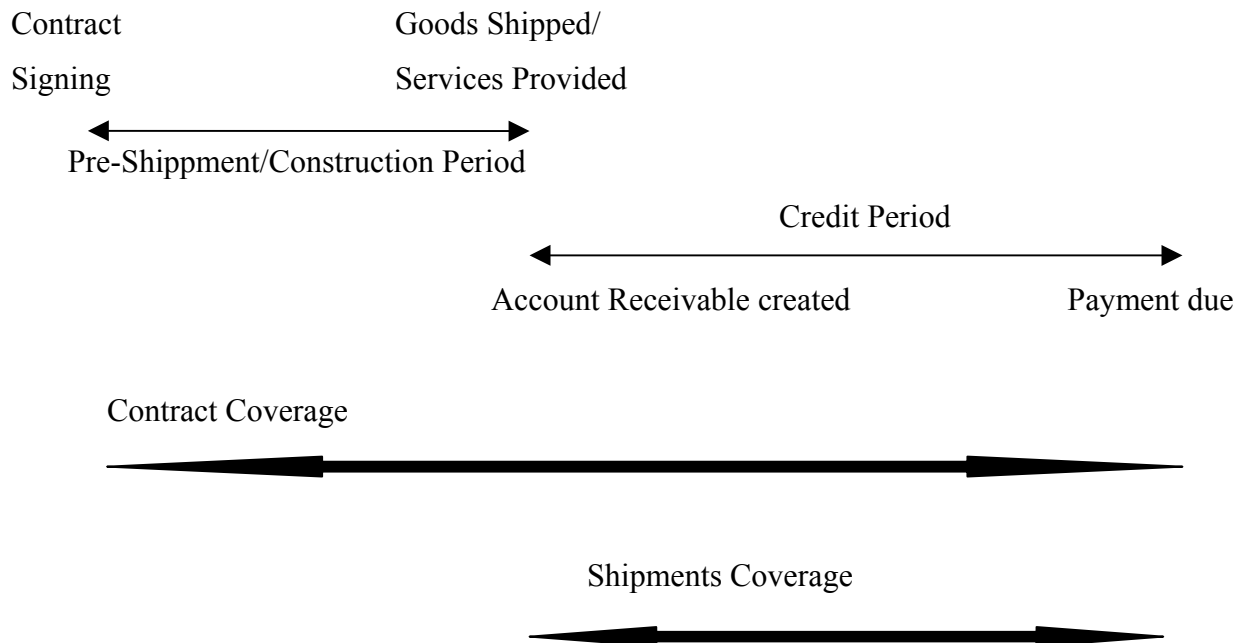
Management of Short Term Insurance

Short Term Insurance

Interface with other Systems

- Short Term Insurance pipeline
- Cash Receipts system
- Claims and Recoveries system
- General Ledger system
- Corporate Tables
- Credit Administration system

Short Term Insurance Contract



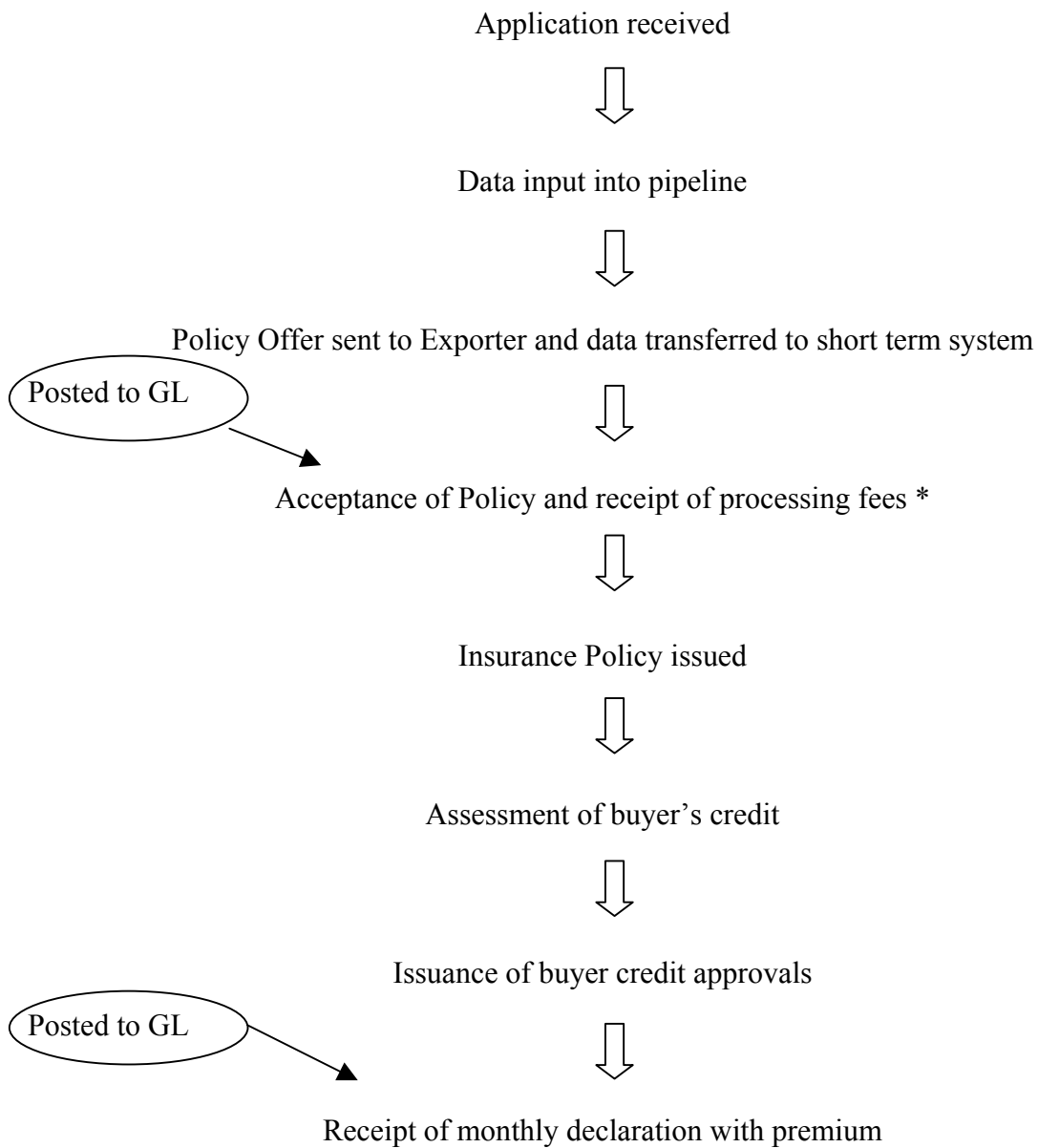
Credit Administration System

Analyse creditworthiness of buyer

- Credit reports
- Exporter's past experience
- Financial Statements

Identify level of risks related to the buyer. Also assess the buyer on a periodic basis to make sure that the level of risk remains acceptable to EDC.

Short Term Insurance



* Cheque for the processing fees is received by the Mailroom and input into the Cash Receipts system

Premiums

For short term insurance policies, premiums are taken into income at the commencement of coverage

Short Term Policy Example

EDC issues a short term Global Comprehensive policy. Coverage in the policy includes France. The processing fee is \$150.

Goods are to be shipped to France as per following schedule:

	Amount	Terms of payment
January	\$50,000	net 30 days
February	\$66,000	net 30 days
June	\$15,000	net 30 days

Policy Schedule

Country	Terms	Quoted Rate*
Canada	60 days	5.00
France	60 days	5.00
Germany	90 days	5.10
Japan	45 days	5.20

* per 100

Credit Approval

Buyer	Term	Amount
Abc Cie.	30 days	Cdn\$50,000
France		

Continuing Credit Approval

Shipment of goods

January 15, 1997, the exporter ships Cdn \$50,000 of goods to the Abc Cie. in France with terms of payment of 30 days.

By the 10th of February, EDC should receive from the exporter the declaration form together with a cheque for the premium due on the January shipments.

The declaration will be as follows:

Country	Term	Rate	Volume	Premium
France	30 days	5.00	50,000	2,500

Premium Accounting Entries

- GL Entries created upon issuance of policy and receipt of cheque processing fees

Bank	150
Short term bank suspense	150

- Money applied to proper policy in short term system

Short term bank suspense	150
Processing fees	150

Monthly Declaration

- Monthly declaration for previous month's shipment

Account receivable	2,500
Premium income	2,500

- Recognition of provision expense at 50%

Provision expense	1,250
Allowance for claims	1,250

- Receipt of premium and allocation to proper policy

Cash	2,500
Short term bank suspense	2,500

Short term bank suspense	2,500
Accounts receivable	2,500

Monthly Reconciliation

Short Term Insurance System

General Ledger

Statement of Account by policy = Accounts receivable by policy

Unallocated cash receipts = Suspense Account

General Expense

- Costs which vary indirectly with premiums such as administrative expenses are charged to expense as incurred
- Although indirect administrative expenses are not broken down by insurance program for Financial Statement presentation purposes, costs are allocated by program for internal program profitability reporting
- EDC recently installed “ABC”, an Activity Based Costing module for this purpose

Activity Based Costing

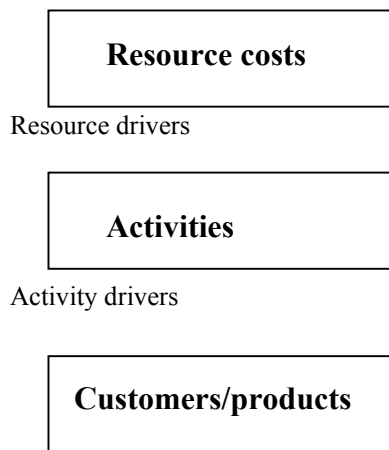
What is ABC?

- ABC goes beyond the traditional cost view by responsibility centre by restating costs according to the way resources are consumed
- Provides adequate information to properly evaluate costs by customer and costs by product
- ABC resolves misallocations by using resource and activity drivers that reflect **unique consumption** patterns and **link cause and effect** to the cost-assignment process
- ABC provides a closer match between costs and output

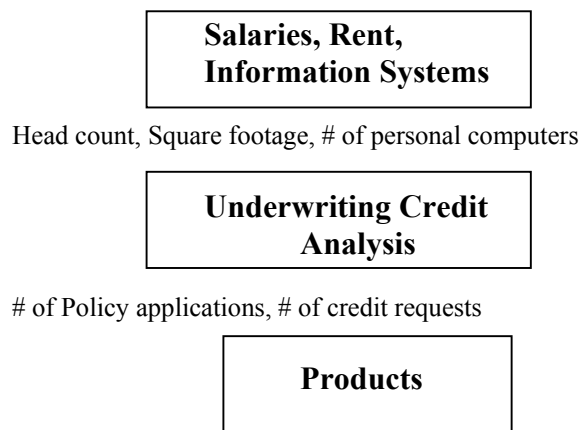
How does ABC Work

- ABC is a *two-stage* cost distribution system
 - Identify the activities that are performed within the organisation, and how these activities consume resources costs
 - Identify how these activities are consumed by each customer/product

Model



Example



Types of Activities

- There are three major types of activities:
 - **Business Sustaining:**
Costs associated with a function required to stay in business and which cannot logically be associated with Costs Objectives
 - **Cost Object Activity**
A cost object is an item that absorbs a cost and which can be reported on. Activities can be allocated to each cost object using activity drivers.
 - **Reallocation Activity**
Some activities performed may be support activities. The cost associated with these may need to be spread over other departments and activities.

INSURANCE ACCOUNTING

AGENDA

Part 2

1. Accounting Principles and Practice
2. Premiums and Expenses
3. Reinsurance
4. Claims Management
5. Foreign Exchange
6. Contingent Liabilities
7. Case Studies

Accounting Principles and Practices

- Financial Statements are in accordance with GAAP (Generally Accepted Accounting Principles)
- Canadian Institute of Chartered Accountants provides standards for complying to GAAP
- Canadian Institute of Chartered Accountants is a member of the International Accounting Standards Committee
- International Accounting Standards and Canadian pronouncements correspond very closely and differences will be pointed out

Accounting Principles and Practice

- Integrity and objectivity of Financial Statements are Management's responsibility
- Financial Statements must be approved by EDC's Board of Directors
- The Audit Committee of the Board composed of Board Members, meet regularly to review Financial Statement and accounting policies
- The Corporation is audited by the Auditor General of Canada
- The Corporation must comply with limits as set out in the Financial Administration Act

Financial Reporting in the Insurance Industry

Insurance Financial Statements are specialized due to the following reasons:

- Insurance deals in the sale of services rather than the purchase/manufacture and sale of goods. The terminology used in insurance accounting reflects this difference. However, despite these differences, the accounting principles applied are the same.
- Most business enterprises are faced with the challenge to reduce risk. However, the insurance industry deals with the assumption of risk, which is then managed by spreading it among a large population. It is this element of risk that makes the financial reporting of insurers so specialized.

Financial Reporting

- For example:
 - The major cost of the insurer (claims) can occur at any time, and sometimes not at all, during the period at risk for which the premium was received.
 - Claims can be reported to the insurer long after the expiry of the period of cover.
 - Unlike most businesses, the actual cost of the insurance product is not known at the time the product is sold. The cost, therefore, must be estimated and a liability set up. In addition developments such as inflation can affect a claim due to the timing differences between setting up of the claim estimate and the settlement date.

Financial Reporting

In view of these characteristics, problems can arise in the appropriate matching of revenue and expenses. The generally accepted approach is that.

- Premiums should be taken into the income statement evenly over the life of the policy,
- Claims should be recognized as a cost of operations and actuarial principles applied to determine appropriate reserves and
- Expenses should be charged to operations in a way to achieve a reasonable association with revenues.

Overview of Financial Statements

Balance Sheet

The Balance Sheet reflects the financial condition as at a point in time.

This statement reflects the type and value of assets, the nature and value of liabilities and the net worth of shareholders.

- **Assets**

Most of the assets of an insurer will be in the form of **investments** as most of the cash a company receives from the insurance of policies is not needed until losses occur. Since losses may occur at any time, a company must maintain a fairly liquid position. The remaining assets consist of receivables connected with normal business operations, fixed assets, deferred expenses and recoverable insurance claims.

- **Liabilities**

The two major liabilities of an insurance company are **Deferred Premiums** and the **Allowance for Claims**

Deferred Premiums (Unearned Premiums)(Premium Reserve)

Normally insurance premiums are received in advance, however, the liability only ends when either the policy expires or is cancelled. Since the premiums are received in advance the insurer has a continuing liability to return the unearned portion of the premium in the event of termination of the policy. It is, therefore, necessary for the insurer to carry this unearned portion as a liability.

Allowance for Claims (Unpaid Claims)(Claims Reserve)(Loss Reserve)

The insurer must show the liability for unpaid claims, which is intended to cover the amount necessary to settle claims which have been reported but not paid, incurred but not reported and also future claims not yet reported or incurred which will arise from the insurance policies in force.

Overview of Financial Statements

Income Statement

While the Balance Sheet is a snapshot of a company's financial condition at a particular date, the Income Statement reflects the underwriting and investment activities.

The major items of an insurer's Income Statement are:

1. Underwriting

Premiums and Fees Earned

Claims Expense (Claims Incurred)

Operating Expenses

Underwriting gain or loss

2. Investments

Investment Income

Investment Expenses

International Accounting and Reporting

- Historically, insurance accounting has varied significantly because of the different purposes for which insurers prepared annual accounts. In some countries more emphasis is placed on solvency of insurers and strength of Balance Sheet, whereas in other countries greater emphasis is placed on earnings.
- Situation has improved with European Community Directive which attempted to make difference transparent by requiring much more detail.
- The work of the International Accounting Standards Committee has improved the harmonization of regulations and accounting standards relating to the presentation of Financial Statements.
- For comparative purposes, however, it is still necessary to understand the available accounting and valuation options in each country.

CLAIMS

CLAIMS ALLOWANCE

The allowance for claims on insurance is based on an actuarial review of net loss experience and potential net losses and represents Management's best estimate of the net present value of the liability under existing policies.

CLAIMS ALLOWANCE

There are two steps in booking the expected losses to the allowance:

1. Expected loss ratios of net claims paid to premiums are calculated based on 10 year historical claims experience. Monthly charges using these rates are booked against premium income over the life of the policy and charged to the provision expense on the income statement and the claims allowance on the balance sheet.
2. At year end an actuarial valuation is calculated by EDC's actuary and the provision expense and claims allowance are adjusted if necessary.

EXPECTED LOSS RATIO AVERAGE 10 YEAR RUNOFF

Underwriting Year	Premiums	Net Claims Paid		Expense Ratio*
		1987	→ 1996	
1987 ↓ 1996				
Totals				

- Net Claims Paid/Premiums

ACTUARIAL VALUATION OF THE CLAIMS ALLOWANCE

CLAIMS VALUATION

"The purpose of the claims valuation is to disclose the amount of policy and claim contingent liabilities in the Corporation's balance sheet that would make proper provision for future payments under the Corporation's **policies in force** as at December 31, 1996"

CLAIMS VALUATION

- The Valuation is comprised of:
- Provision for future claims
- Provision for incurred claims but not reported (IBNR)
- Claims reported but not yet paid (pending claims)

Claims valuation

Components:

- Provision for future claims
- Provision for incurred claims
but not reported (IBNR)
- Claims reported but not yet paid
(pending claims)

Balance Sheet

- Deferred premiums
- Allowance for claims

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Estimation of Future Claims

- Frequency and severity model
- Frequency is estimated probability of occurrence of a claim in a single year on a single policy
- Severity is the estimated cost of the claim, expressed as a proportion of the maximum claim (ie net of recovery)
- How to estimate is dealt with later

DATA

- Extracted from EDC systems
 - Credit Approval System, Short Term system, Medium Term system and Claims and Recoveries system
- Checks for
 - Consistency
 - Continuity
 - Trend
 - Reasonableness

General Methodology

1. Provision for Future Claims (ie Obligations Not Yet Incurred or Reported)

Policy obligations on policies in force on the valuation date that will arise due to events occurring after the valuation date are determined as the present value on the valuation date of future claim payouts net of recoveries.

Coverage Period and Discount Rate

- Coverage Period
 - Medium and Long Term - Balance of policy term
 - Short term - One Year
- Discount Rate - Government of Canada Medium Term Note

Modelling

- Monte Carlo method of simulation using frequency and severity
- Use 95% confidence level
- Average or mean = expected loss and difference between mean and reserve at 95% confidence level represents Provision for Adverse Deviation (PAD)

Concentration of Risk

- Size concentration

- Country concentration
- Industry concentration
- Project concentration
- Calculated policy liability must cover
 - Expected losses (mean)
 - Provision for adverse deviation (PAD)
- Policy liability should not cover
 - Excess statistical fluctuation
 - Catastrophe
 - It is the role of capital and surplus to provide for these

KEY ASSUMPTIONS (COMMERCIAL RISK)

FREQUENCY

- Short term
 - Future O/S credit approvals by buyer
 - Expected declarations in following year under policies in force
 - Expected loss frequency
 - >> Dun & Bradstreet (U.S.) default rates by industry
 - >> Non U.S. (from Economic Unit)
 - >> Short term economic outlook (from Economic Unit)
 - >> EDC experience
- Medium term
 - Medium/long term EDC experience
 - Medium term economic outlook

Severity

- Short Term
 - Ratio of submitted claim amounts to maximum authorised credit
 - Recovery rate average
 - Coinsurance
 - Deductibles
- Medium Term

- Medium/Long term EDC experience
- Medium term economic outlook
- For Foreign Investment insurance policies, economists in Political Risk Assessment department provide estimates of expected loss severities

KEY ASSUMPTIONS (POLITICAL RISK)

Frequency

- Based on risk in higher risk countries
- Aggregate risk for each program by country
 - Assumption: if one defaults they all do

Severity

- Varies by program

2. Valuation of Incurred Claims

- Reported, not yet paid (pending)
 - Inventory per Claims and Recoveries system
 - Cost, net of recovery estimated claim by claim by EDC
- IBNR (Incurred But Not Reported)
 - Short term
 - >> Determine based on past declarations and estimated lags
 - Medium Term
 - >> No specific calculation
 - >> Any "suspected" in pending
- No reductions for expected recoveries on paid claims because those shown as asset on balance sheet

RESERVE SUMMARY FOR SHORT TERM INSURANCE

Assumptions (Commercial)

96/12/31

1. Frequency	1%
2. Severity	
(a)% of authorised credit	50%
(b)% recovered	50%
(c) Severity	
(a) x {1.00-(b)}	25%

Results (\$M)

(a) Mean Loss	50
(b) PAD (@95%)	25
(c) Total Provision = (a) + (b)	75

CLAIMS ACCOUNTING ENTRIES

Example

- 1) On October 1, EDC pays a claim in the amount of \$50,000
- 2) At the end of October, the Claims Officer estimates \$30,000 of the \$50,000 paid is recoverable
- 3) In November, the Claims Officer incurs \$2,000 in travel expenses in attempting recovery of monies owned
- 4) EDC recovers \$50,000 in December

BALANCE SHEET (000'S) AS AT DEC 31**ASSETS**

Other Assets

Recoverable Insurance Claims

Opening Balance	0
Claims Paid	50
Claims Recovered	(50)
Write ups/downs	0
Total Recoverable Insurance Claims	0

LIABILITIES

Other Liabilities and Deferred Revenues

Allowance for Claims

Opening Balance	0
Provision for Claims	60
Claims Recovery Expenses	(2)
Re-evaluation of Recoverable Claims	0
Allowance for Claims at End of Period	58

CLAIMS ACCOUNTING ENTRIES1) Monthly provision expense booking (year to date)

Provision expense	60,000	
Allowance for claims		60,000

2) Claim Payment

Claims suspense account	50,000	
Bank		50,000

(claim payment)

3) Allocation of claim payment

Claims paid	50,000	
Claims suspense account		50,000

4) Anticipated recovery

Allowance for claims	20,000	
Recoverable insurance claims write-down		20,000

(Claims department estimates anticipated recovery is 60% of amount paid. Insurance accounting adjusts recoverable insurance claims account accordingly.)

5) Claims incurs travel expenses in attempting recovery

Allowance for claims	2,000	
Bank		2,000

6) Claim payment recovered

Bank	50,000	
Claims recovered		50,000
(to record recovery)		
Recoverable insurance claims write-up	20,000	
Allowance for claims		20,000
(to reverse write-down)		

CLAIMS RECONCILIATION

Claims Suspense	Bank	Claims Paid	Write up/down Recoverable Insurance Claims
50,000(2)	50,000(2)	50,000(3)	20,000(4)
50,000(3)	2,000(5)		
	50,000(6)		20,000(6)

Allowance for Claims	Claims Recovered	Provision Expense
60,000(1)	50,000(6)	60,000(1)
20,000(4)		
2,000(5)		
20,000(6)		

CONSOLIDATED BALANCE SHEET AS AT DECEMBER 31, 1996

ASSETS

(\$Millions)

Cash and Investments

Cash and marketable securities	1,037
Investments	407
Accrued Interest	15

1,459

Loan Receivable

Net loans receivable	8,048
Accrued interest and fees	140

8,188

Other

Recoverable insurance claims	25
Other	34

59

9,706

CONSOLIDATED BALANCE SHEET AS AT DECEMBER 31, 1996
 LIABILITIES (\$millions)

Loans Payable	7,735
Loans Payable	94
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	7,829
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Other Liabilities and Deferred Revenues	
Accounts payable	80
Deferred insurance premiums	11
Allowance for claims and guarantees	205
Deferred loan revenues and other credits	164
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	460
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Shareholder's Equity	
Share capital	983
Retained earnings	434
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	1,417
	<hr/>
	9,706
	<hr/>

CAPITALIZATION & ALLOWANCES

	1992	1993	1994	1995	1996
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S/H Equity:					
Capital	788	788	813	851	983
R/E	91	107	278	322	434
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Capitalisation	879	895	1,091	1,172	1,417
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Allowances:					
Loans	609	751	935	1,256	1,458
Insurance	98	111	149	181	205
Treasury	6	13	13	20	20
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Allowances	713	875	1,097	1,457	1,683
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Capitalisation & Allowances	1,592	1,770	2,188	2,630	3100
Non-accrued capitalised Interest (NACI)	828	843	929	927	998
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Total Capitalisation & Allowances and NACI	2,420	2,613	3,117	3,557	4,098
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% increase from prior year		8.0%	19.3%	14.1%	15.2%
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FOREIGN EXCHANGE

- All ending monetary balances on the Balance Sheet are translated to Canadian dollars calculated at month end conversion rates.
- All monetary income and expense amounts for the period on the Income Statement are calculated at month average rates
- Foreign Exchange gains and losses arise when there is a difference between the exchange rate used on Financial Statement translation and the foreign exchange rate in effect on the transaction date (or previous month end close exchange rate for opening balances carried forward)
- Foreign exchange gains/losses should be taken into income as incurred to remove monthly distortions, EDC books gains and losses evenly over the year

FOREIGN EXCHANGE RISK

- Foreign exchange risk exists where there is a mismatch between assets and liabilities in any currency
- This risk should be measured, monitored and controlled
- Treasury Strategy Guidelines provide acceptable exposures

Contingent Liabilities

- Contingent liabilities are an off-balance sheet item and are disclosed in the Notes to the Financial Statements.
- The corporation is subject to a limit imposed by the Export Development Act on its contingent liability programs. The Act specifies that the corporation's contingent liabilities in respect of the principal amounts owing under all outstanding arrangements shall at no time exceed \$ 15 billion, an amount equal to ten times the authorised capital of the Corporation. As at December 31, 1996, the position against this limit is \$8.9billion (1995 - \$7.9 billion).
- The contingent liability is calculated as the insured volume x the cover rate (normally 90%) minus any claim payments.
- The contingent liability remains in force until the claims expiry date is reached.

S.T. Contingent Liability – Top 5 Countries

1. Iran
2. Mexico
3. Brazil
4. Canada
5. U.S.

Short – term contingent Liability 1996 - \$5,081 million

M.T. Contingent Liability – Top 5 Countries

United Kingdom

Argentina

Turkey

Colombia

Canada

1996 Medium – term contingent Liability \$2,351 million

CHAPTER III

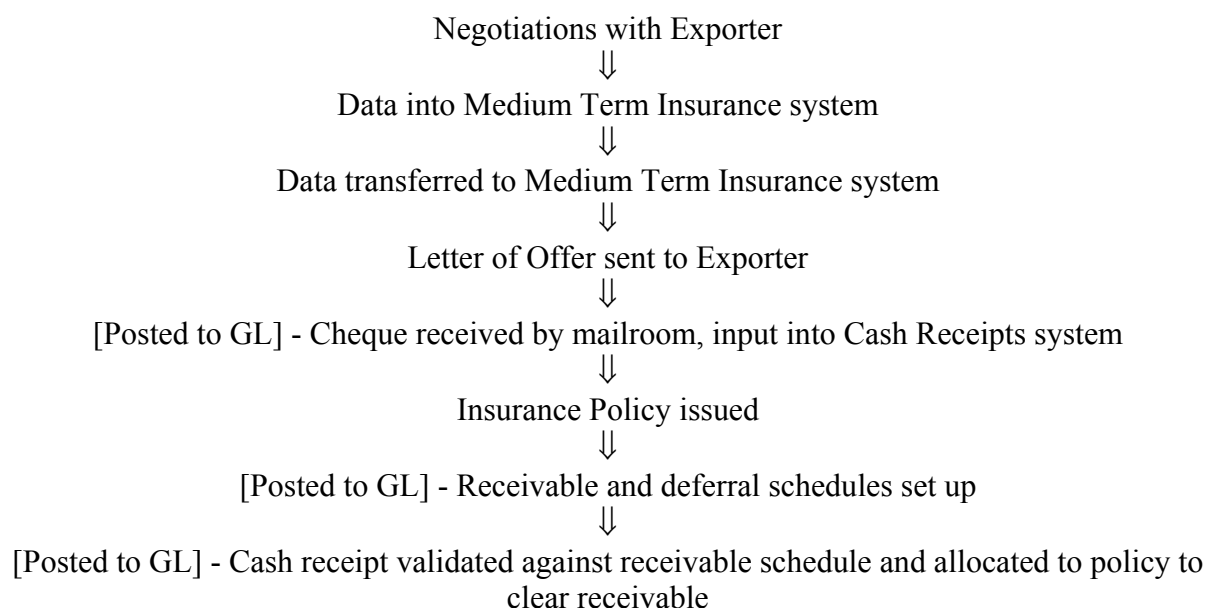
Management of Medium Term Insurance

Medium Term Insurance

Interface With Other Systems

- Medium Term Insurance Pipeline system
- Cash Receipts system
- Claims and Recoveries system
- General Ledger system
- Corporate Tables

Medium Term Insurance



Premiums

For medium term policies, premiums are taken into income using methods which reflect the exposures over the terms of the policies

Expenses

Direct Expenses

- Generally direct expenses should be expensed in the same period as the related revenue.
- Up front expenses such as broker fees and commissions which do not cover ongoing services and are not recoverable are expensed as incurred.

Indirect Expenses

- Indirect expenses are which cannot be directly allocated to a specific policy (eg general office expenses and salaries)
- Indirect expenses are expensed as incurred.

Medium Term Policy Example

Example 1

EDC issues a Specific Transaction insurance policy with a five year term to insure the export of Canadian goods to Venezuela. Total insured volume is \$1 million and total premium is \$60,000. The business is done through a broker and the broker fee is \$6,000. The expected average loss rate is 50% of net premium income.

*(In this case the broker **dose not provide ongoing service** and the broker fee expense is **not recoverable**. Expense, therefore, is expensed at commencement of coverage)*

Policy Details

Policy Number:	<u>STI-01-00001</u>	Status:	<u>Policy Issued</u>
Policy Holder:	<u>ABC Marine</u>	Status Date:	
Exporter:	<u>ABC MARINE</u>	Underwriter:	<u>Jane Doe</u>
Buyer:	<u>Atlas Ltd.</u>		
Country:	<u>Venezuela</u>		
Classification:	<u>High Risk</u>		
Selection of Act:	<u>Corporate Account</u>		
Insured Amount:	<u>\$1,000,000</u>		
Issued Date:	<u>Feb 1, 1997</u>		
Period of Cover From:	<u>Feb 1, 1997</u>	To:	<u>Jan 31, 2002</u>
Claims Expiry Date:	<u>April 30, 2002</u>		

Premium Accounting Entries

GL entries created upon issuance of policy

1) Set up of premium receivable

Premiums receivable	60,000	
Deferred Premiums		60,000

2) Set up of broker fee payable and expense broker fee

Broker fee expense	6,000	
Broker fee payable		6,000

3) Receipt of premium

Bank	60,000	
Medium term bank suspense		60,000

4) Allocation of cash receipt

Medium term bank suspense	60,000	
Premiums receivable		60,000

5) Cash disbursement

Broker fee payable	6,000	
Bank		6,000

6) Monthly recognition of premium income

Deferred Premiums	1,000 ¹	
Premium income		1,000
(recognition of monthly premium income)		

1. $60,000/5\text{yrs} = 12,000/12 = \underline{1,000}$

7) Monthly recognition of provision expense at 50%

Provision expense	500	
Allowance for claims		500

(1,000 * .50 = 500)

Accounting Reconciliation at End of Policy Term

Bank	Medium Term Suspense	Premiums Receivable
60,000(3)	60,000(4)	60,000(1)
6,000(5)	60,000(3)	60,000(4)
Deferred Premiums	Premium Income	Provision Expense
60,000(6)	60,000(6)	30,000(7)
60,000(1)		
Allowance for Claims	Broker Fee Payable	Broker Fee Expense
30,000(7)	6,000(2)	6,000(2)
	6,000(5)	

Financial Statement Presentation

BALANCE SHEET

ASSETS

Cash	\$54,000
Premium	<u>0</u>
TOTAL ASSETS	<u>\$54,000</u>

LIABILITIES AND SHAREHOLDER'S EQUITY

LIABILITIES

Broker fee payable	0
Deferred Premiums	0
Allowance for Claims	<u>30,000</u>
TOTAL LIABILITIES	<u>30,000</u>
NET INCOME	<u>24,000</u>

TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY	<u>\$54,000</u>
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INCOME STATEMENT

Premiums and Fees Earned	\$60,000
Broker Expense	<u>(6,000)</u>
Net Premiums and Fees Earned	<u>54,000</u>
Provision Expense	<u>(30,000)</u>
NET INCOME	<u>\$24,000</u>

Medium Term Insurance

Fee Summary		
Policy No: STI-01-00001		
Currency: Cdn		
Installment Type	Total Receivable	Total Received
Risk Premium	60,000	60,000

Cash Receipts						
Document#	Receipt Date	Curr	Receipt Amount	System ID	Unallocated AMT	APP
DDB5820	Feb 11,1997	Cdn	60,000	MTI	0	X

Medium Term Policy Example

Example 2

EDC issues a Specific Transaction insurance policy with a five year term to insure the export of Canadian goods to Venezuela. Total insured volume is \$1 million and total premium is \$60,000. The business is done through a broker and the broker fee is \$6,000. The expected average loss rate is 50% of net premium income.

*(In this case broker **provides ongoing service** and the broker fee expense is **recoverable**. Broker fee is, therefore expensed in the same period as the related premium revenue.)*

Premium Accounting Entries

All journal entries are the same as required for Example 1 except for the following entries:

2) Set up of broker fee payable and deferral

Deferred premiums	6,000	
Broker fee payable		6,000

Monthly recognition of broker fee expense

Broker fee expense	100 ¹	
Deferred premium		100

1. $6,000/5\text{yrs} = 1,200/12 = \underline{100}$

Medium Term Insurance

Endorsements

- An endorsement is a change in an existing policy which may result in either an additional premium, a return premium, or no premium adjustment. Endorsements may be made at any time during the policy term.
- The accounting for endorsement premiums is the same as accounting for original premiums.
- Examples of endorsements include extending or reducing period of cover, increasing or decreasing insured amounts.
- An endorsement cannot adjust a prior period after the period has been balanced and closed.

Monthly Reconciliations

The Accounting Administrator:

- Reconciles receivable, deferral and revenue balances in the Medium Term Insurance System to ending balances in the General Ledger
- Reconciles unallocated cash receipts in Cash Receipts system to medium term suspense account balance in General Ledger
- Notifies underwriters of all policies with receivable balances

Case Studies

Premiums

Example 1

On October 1, a short - term policy is issued to cover insured volumes of \$ 1,000,000 in Algeria. The processing fee is \$200.

Required:

Record the journal entries required to account for the following events:

- 1) On October 1, the processing fee of \$200 is received.

- 2) On November 10 1997, a declaration is received from the exporter with a premium cheque in the amount of \$10,000. The expected loss rate is 50% of premium income.

Answer to Example 1

1) Bank	200	
Short term bank suspense (receipt of processing fee)		200
short term bank suspense	200	
processing fees (processing fee applied to policy)		200
2) Accounts receivable	10,000	
premium income (set up of accounts receivable and recognition of premium income)		10,000

Provision expense		
Allowance for claims		5,000
(recognition of provision expense)		
Bank	10,000	
Short term bank suspense		10,000
(receipt of premium)		
Short term bank suspense	10,000	
Accounts receivable		10,000
(allocation of premium to proper policy)		

Example 2

A medium term insurance policy with a premium amount of \$ 120,00 is issued to cover insured volumes of \$ 2,000,000. The period of cover s from January 1, 1997 to December 31, 2001 and the Claims Expiry date is December 31, 2002. The export's co-insurance ration is 10%. The expected loss rate is 50% of premium income. There is no broker involved.

- A) Record the journal entries required to account for the following events:
- 1) The policy is issued on January 1, 1997. Record the set up of the receivable and deferred accounts
 - 2) The premium amount of \$120,000 is received on January 10, 1997. Record the allocation of the cash receipt.
 - 3) Record the premium income and provision expense account entries for the month of January
- B) What is the balance remaining in the Deferred Premium account on December 31, 1997?
- C) What is the Contingent Liability for this policy?
- D) When does the Contingent Liability expire?

Answer to Example 2.

A)

1) Premium receivable	120,000	
Deferred premium		120,000
(to record premium receivable)		

2) Bank	120,000	
Medium term bank suspense		120,000
(to record receipt of premium)		

Medium term bank suspense	120,000	
Premium receivable		120,000
(to allocate receipt)		

3) Deferred premiums	2,000	
Premium income		2,000
(to record premium income = $\$ 120,000/5 = \$ 24,000/12 = \$ 2,000$)		
Provision expense	1,000	
Allowance for claims		1,000
(to record provision expense = $\$ 2,000*.50$)		

B) Deferred Premium at December 31, 1997

Opening Balance	\$ 120,000
Less premium earned	(24,000)
Ending Balance	\$96,000

C) Contingent Liability = \$ 1,800,000
($\$ 2,000,000* .90$)

E) The Contingent Liability expires on December 31, 2002 which is the claim expiry date

Case Studies

Expenses

Example 3

Refer to example 2.

What additional accounting entries would be required if a broker was involved in providing the business and a non-recoverable fee of \$10,000 was charged by the broker?

Answer to Example 3

Broker fee expense	10,000	
Broker fee payable		10,000
(to record set up of broker fee payable and expense)		
Broker fee payable	10,00	
Bank		10,000
(to record payment of broker fee)		

Example 4

If the broker in example 3 provided ongoing services throughout the policy, describe how the accounting treatment would differ from example 3.

Answer

The broker fee would be expensed over the life of the policy.

Case Studies

Foreign Exchange

Example 5

On October 3, 1997, premium in the amount of U.S. \$ 100,000 is received for an insurance policy. The Financial Statements of the insurer are translated to Canadian dollars.

The daily close exchange rates are as follows:

October 3, 1997	US\$ = \$1.40 Cdn.
October 31, 1997	US\$ = \$1.50 Cdn
November 30, 1997	US\$ = 1.35 Cdn

- 1) What is the exchange rate gain or loss on the Income Statement for the period ended October 31, 1997?
- 2) What is the exchange rate gain or loss on the Income Statement for the period ended November 30, 1997?

Answer to Example 5

<u>1) Assets</u>	<u>US\$</u>	<u>Exchange Rate</u>	<u>Cdn Equivalent \$</u>
Oct 3, 1997	\$100,000	1.4	\$140,000
Oct 31 1997	\$100,000	1.5	\$150,000
Foreign Exchange Grain			<u>\$10,000</u>

Note: In this case the US\$ has appreciated in value relative to the Cdn \$, therefore since this is an asset account there is a foreign exchange gain on translation.

<u>2) Assets</u>	<u>US\$</u>	<u>Exchange Rate</u>	<u>Cdn Equivalent \$</u>
Oct 31, 1997	\$100,000	1.5	\$150,000
Nov 30, 1997	\$100,000	1.35	\$135,000
Foreign Exchange Loss			<u>(\$ 15,000)</u>

Note: In this case the US\$ has depreciated in value relative to the Cdn\$, therefore since this is an asset account there is a foreign exchange loss on translation.