



Internal Audit Report

Global Fronting 7/25/2018

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Auditable Entity	Multinational	Inherent Risk	Elevated
Audit Period	04/01/2017 to 03/31/2018	Audit Rating	Satisfactory
Audit Scope	<p>This audit evaluated the design and operating effectiveness of the key controls over the Global Fronting process, including:</p> <ul style="list-style-type: none"> • Oversight and governance of the Fronting portfolio; • Pre-bind assessment, e.g., credit checks and approvals, collateral; • Fee Rater calculation and usage; • Risk transfer validation; • Reinsurance templates and service terms; • Post bind monitoring; • Key application functionality and controls; • User access rights to network folders, Fee Rater, Credit Risk Database (CRDB). <p>This audit was IAG's first evaluation using our enhanced audit approach, whereby control assessment workshops/meetings were held with Global Fronting (GF) Underwriting and Credit Risk Management, Operational Risk Management (ORM) and Compliance to identify and agree on the key risk and controls in the Fronting process. This included regional Fronting Management assessing the design and operating effectiveness of their control environment.</p>		

Executive Summary

Global Fronting is defined as the use of an admitted (licensed) insurer, also known as a fronting company, to issue an insurance policy on behalf of the captive insurer and then transferring all or a portion of the risk from the fronting company to the captive insurer through a reinsurance agreement. As of December 31, 2017 there were 414 Global Fronting accounts with profit generated from fronting fees of \$78.85M.

In our opinion the design and operating effectiveness of key controls for the in-scope processes in place relating to Global Fronting **is Satisfactory. Two moderate issues** were identified as follows:

Credit Risk Monitoring

While there are monitoring and reporting processes in place, these are not adequately designed to accurately capture all credit risk and exposure data; potentially affecting the aggregate credit risk exposure at the overall AIG level. IAG noted inaccuracies in the Credit Exposure reports, generated from the CRDB, used by GF Credit Management to monitor aggregate exposures (\$12.2B) and receipt of collateral (\$2.2B). MN Management has indicated there are deficiencies with the CRDB and although enhancements have been explored, as well as other automated solutions, these have been delayed due to budget constraints.

Underwriting Supervision

Whilst there are processes in place to identify and address fronting underwriting issues both pre- and post-bind, these are not always consistent. Additionally, Global Fronting peer reviews are not currently included as part of the ongoing peer review enhancement process underway by Underwriting Quality Review (UQR). As a result, breaches of exposure appetite and legal requirements may not be identified prior to entering into a contract, leading to exposure above appetite, financial loss and reputational damage.

Management Self-Assessment of Key Controls

During this audit, we piloted our enhanced audit approach which included a detailed review of the key risks and controls in the end to end Global Fronting process. IAG engaged with the control process owners from the business, along with ORM, and Compliance to agree on the key risks and controls within the Global Fronting process. Management was asked to self-assess the operating effectiveness of these risks and controls. For the key risks and controls that were self-assessed as operating effectively, IAG independently tested their design and operating effectiveness.

As a result of these meetings, we agreed on testing **eight key risks** and **14 key controls**; **10 controls** were operating effectively and **four** were not. The chart below lists the specific instances where testing identified deficiencies as well as references to the two moderate issues noted.

Through discussions with management, we understand the CRDB has system limitations forcing GF Credit to manually upload exposure and collateral data; this control did not operate as intended in four months of the twelve month scope period. Further discussions with management noted this control could be automated and management will consider this as part of a future MN Xpress roll-out. Additionally, since the CRDB is deficient we noted instances where the reporting used by GF Credit was inaccurate. Lastly, GF peer reviews were not always performed by an underwriter of equal or greater authority. The Self-Checklist issue noted below is exclusive to EMEA as this is a key control performed only in that region.

This was the first time that an assurance function has independently tested these controls. Details of the key risks and key controls tested can be found in Appendix B; the grid immediately below highlights the key controls where IAG's testing of each control resulted in operating deficiencies. A Risk and Control Self-Assessment (RCSA) had not been performed for the Fronting Process at the time of the audit.

Advice and Insight

The responsibility for the review and update of the Global Fronting Credit procedures has recently been transferred from Enterprise Risk Management (ERM) to GF Credit. A review of these procedures should be performed to confirm adequacy as the last review performed was more than two years ago.

A review of the Credit Officers' Credit Authority statements should be performed on a periodic basis to confirm ongoing adequacy and alignment with strategy. ERM confirmed that the last review was performed three years ago and a process is currently underway to review the Credit Risk Authority statements.

Below summarizes each of the key controls where management's self-assessment and IAG's testing of the operating effectiveness differed. Refer to Appendix B for the full assessment.

Control Name	Control Summary	Management Assessment	IAG Assessment		Issue Description
			Design Effectiveness	Operating Effectiveness	
Credit Exposure Review	The Credit officer uploads three (global) CRDB file extracts reports (CRDB Exposure file, Lexington file, and CRDB Collateral file) into Skynet and performs a reconciliation to confirm that all exposure and collateral information is complete and accurate.	Effective	Effective	Partially Effective	Moderate Issue – Credit Risk Monitoring (Issue #1)
Credit Risk Management	The Credit Officer (US) / Compliance Manager (EMEA) run credit risk reports (Legal document overdue report and collateral report) to identify any outstanding items/exceptions and follows up to resolve.	Effective	Partially Effective	Partially Effective	Moderate Issue – Credit Risk Monitoring (Issue #1)
Peer Reviews	Global Fronting (GF) underwriters are subject to monthly peer reviews, performed by a GF underwriter of the same delegated authority or higher.	Effective	Effective	Partially Effective	Moderate – Underwriting Supervision (issue #2)
Self-Checklists (EMEA only)	The MN Centre Of Excellence (MCOE) completes a self-checklist pre-bind confirming all requirements such as credit checks, collateral, pricing, program structure, legal, risk transfers, agreements, have been completed.	Effective	Effective	Partially Effective	Moderate – Underwriting Supervision (Issue #2)

* Refer to Appendix A for Detailed Issues and Management Action Plans

Appendix A - Detail Issues and Management Action Plans

Issue # - 1 - Credit Risk Monitoring		Moderate
<p>While there are monitoring and reporting processes in place, these are not adequately designed to accurately capture all credit risk and exposure data; potentially affecting the aggregate credit risk exposure at the overall AIG level. IAG noted inaccuracies in the Credit Exposure reports, generated from the CRDB, used by GF Credit Management to monitor aggregate exposures (\$12.2B) and receipt of collateral (\$2.2B). MN Management has indicated there are deficiencies with the CRDB and although enhancements have been explored, as well as other automated solutions, these have been delayed due to budget constraints. We noted the following:</p> <ul style="list-style-type: none"> For six of 35 global accounts selected, the collateral recorded in the Credit Exposure report, used for monitoring by GF Credit Management, was inaccurate, and did not reconcile to the correct collateral recorded in CRDB and fee rater. The reports used by GF Credit Management to monitor credit risk exposure and receipt of collateral, and by Corporate AIG Credit to monitor aggregate exposures across product lines were not uploaded to GXP/REM successfully. In five of the nine instances, errors were identified in the monthly uploading of the three CRDB files to Skynet (Lexington Exposure, Active Accounts Exposure and Collateral inventory), which further investigation identified null values not being recognized. <ul style="list-style-type: none"> Collateral Inventory report was not uploaded successfully from November 2017 through February 2018. Lexington Exposure report was not uploaded successfully in November 2017. <p>The AIG Credit Risk Policy, updated December 2017, dictates the business unit (GF Credit) is responsible for uploading the credit exposures and collateral amounts.</p> <ul style="list-style-type: none"> The GF Credit Officers did not receive the APAC Outstanding Credit Data Quality Report, which highlights any outstanding items by account, e.g. collateral and legal documents. This was corrected during the audit. 		
<p>Root Cause: Process - Process Design The CRDB has not been upgraded due to budget constraints. Report upload failures were not monitored.</p>		
ID	Management Action Plan	
1	<p>The Credit Risk Database (CRDB) is an outdated and inflexible system that has limited capabilities around risk reporting. MN Operations and Credit will collaborate to refine business requirements as we are looking to build out an integrated IT solution in 2019 (subject to budget approval).</p>	
	Business Segment	General Insurance
	LOB	Multinational
	Owner	Patrick Quilty, Pooja Barodekar
	Target Date	12/31/2019
ID	Management Action Plan	
2	<p>Global Fronting Credit Management will:</p> <ul style="list-style-type: none"> Consult with ERM to investigate why the up-loads failed and determine ownership going forward in order to ensure reports are uploaded completely and accurately. The AIG Credit Risk Policy should be updated to clarify roles and responsibilities. Consult with Compliance and meet with the Collateral Oversight Group to further clarify and baseline roles and responsibilities as they relate to tracking, monitoring and uploading collateral positions. This task is conducted once every month. 	
	Business Segment	General Insurance
	LOB	Multinational
	Owner	Patrick Quilty
	Target Date	09/30/2018

Issue # - 2 - Underwriting Supervision		Moderate
<p>Whilst there are processes in place to identify and address fronting underwriting issues both pre- and post-bind, these are not always consistently performed. Additionally, Global Fronting peer reviews are not currently included as part of the ongoing peer review enhancement process underway by Underwriting Quality Review (UQR). As a result, breaches of exposure appetite and legal requirements may not be identified prior to entering into a contract, leading to exposure above appetite, financial loss and reputational damage.</p> <p>Specifically, we noted the following:</p> <p><i>Pre-Bind Checklists</i></p> <ul style="list-style-type: none"> Seven out of nine EMEA accounts selected did not have a completed pre-bind self-checklist on file prior to binding. The checklists also include post-bind activities that create overlap and duplication with the peer review process. <p><i>Post-Bind Peer Reviews</i></p> <ul style="list-style-type: none"> The questions within the Global Fronting peer review process require positive and negative affirmations which can be interpreted differently amongst each reader. This can result in issues or action items not being properly addressed. The Multinational Global Fronting Underwriting Guidelines state that peer reviews are required to be performed by an underwriter with equal or greater authority. Full population testing throughout the sample period identified six peer reviews (Americas) that were performed by someone with lower authority. Management stated that this is due to resourcing as there are a limited number of underwriters available to perform reviews. 		
<p>Root Cause: Process - Process Design</p> <p>The peer review process is time consuming and has elements of duplication. Peer Review questions have not been updated. Resource constraints can hinder Peer Review execution.</p>		
ID	Management Action Plan	
1	<p>As a result of employee turnover in the organization, Global Fronting does not have an adequate number of experts authorized to conduct peer reviews, hence, MN Management will re-evaluate the peer review process and frequency, and amend requirements in the Underwriting Manual accordingly. Management will monitor adherence to confirm the timeliness of these reviews.</p> <p>MN Management will update the current peer review framework, scope and oversight.</p>	
	Business Segment	General Insurance
	LOB	Multinational
	Owner	Pooja Barodekar
	Target Date	10/31/2018

APPENDIX B**Management and IAG Assessment of Control Environment**

The below table provides the full listing of risks and controls covered in this audit, along with the assessment performed by Global Fronting Management and IAG.

Key Risk	Description of Control Activity	Management Assessment	IAG Assessment	
			Design Effectiveness	Operating Effectiveness
Poor operational and underwriting performance lead to financial loss as a result of lost market share opportunities and excessive risk exposure.	<u>Oversight Framework</u> The Multinational Heads review and update: detailed Oversight Framework, Underwriting Guidelines and Credit Guidelines annually: <ul style="list-style-type: none"> Global Fronting Underwriting Guidelines (Pooja Barodekar) AIG Credit Risk Policy (AIG Credit) ORR Captive Rating Methodology (Pat Quilty) Credit Exposure Methodology (Pat Quilty) Any necessary updates are made prior to distributing them.			
AIG enters into fronting arrangements with counterparties resulting in unforeseen credit exposures and potential financial loss.	<u>Credit Approval</u> The Credit Officer approves all clients in line with their Credit Authority Statements prior to Global Fronting undertaking business. Accounts that do not fall within the Credit Officers limits are referred to Global Credit Officers via e-mail approval.			
	<u>Credit Review</u> The Credit Officer performs on-going credit checks for approved accounts on an annual basis to assess credit risk, exposures/collateral, and transaction suitability.			
	<u>Credit Exposure Review</u> The Credit officer uploads three (global) CRDB file extracts reports (CRDB Exposure file, Lexington file, and CRDB Collateral file) into Skynet and performs a reconciliation to confirm that all exposure and collateral information is complete and accurate.			Credit Policy dictates GF Credit as the responsible party. Some uploads failed and were not followed up on (see comment above)
	<u>Credit Risk Management</u> The Credit Officer (US) / Compliance Manager (EMEA) run credit risk reports (<i>Legal document overdue report and collateral report</i>) in the Credit Risk database to identify any outstanding items/exceptions and follows up to		The CRDB has performance issues and reports are not always accurate	The CRDB has performance issues and reports are not always accurate

Key Risk	Description of Control Activity	Management Assessment	IAG Assessment	
			Design Effectiveness	Operating Effectiveness
	resolve.			
The fronting fee does not account for the credit risk assumed and the capital allocated, negatively impacting profitability and leading to financial loss.	<u>Fee Rater</u> The Global Fronting Fee Rater has mandatory fields that are required to be populated by the GF Underwriter with required information provided by Product, Credit, Actuarial, MCOE (EMEA Only) and the Reinsurance Servicing Office (RISO).			
	<u>ORR Reconciliation</u> On a monthly basis Global Fronting Operations reconciles the ORR indicated in the Fee Rater (per account) to the ORR recorded by credit (in the CRDB).			
	<u>Monitoring of Fee Rater Deviations</u> On a monthly basis Global Fronting Management monitors deviations from the fee calculated by the Global Fronting Fee Rater, investigating and tracking any deviations from the defined tolerance levels. Periodic reviews are performed to confirm appropriateness of the fees charged.			
Global Fronting Underwriters complete an inadequate assessment of account information (such as exposure assessment) leading to potential reputational damage, regulatory penalties and financial loss.	<u>Global Fronting Peer Reviews</u> On a monthly basis, each GF underwriter is subject to peer reviews, to be performed by a GF underwriter of the same delegated authority or higher, to assess that: <ul style="list-style-type: none"> • Risks have been written in line with the agreed PAS; • Risks are within appetite; • The correct standards and procedures have been followed; • Compliance with fronting authority; • Adequate referral and approval had been obtained prior to binding of the risk, where applicable; • Fronting arrangements are within risk appetite; • Global Fronting Fee Rater is adequately utilised; and • Credit approval from the Credit Officer prior to inception/binding. Any exceptions identified are followed up and tracked to resolution, with trends identified and remedial action identified. Monthly reports are produced to monitor the number of peer reviews completed and the outstanding actions/queries for each underwriter. Trend analyses are performed to identify any common themes requiring remediation.			Due to resource constraints not all peer reviews were performed by the required authority level

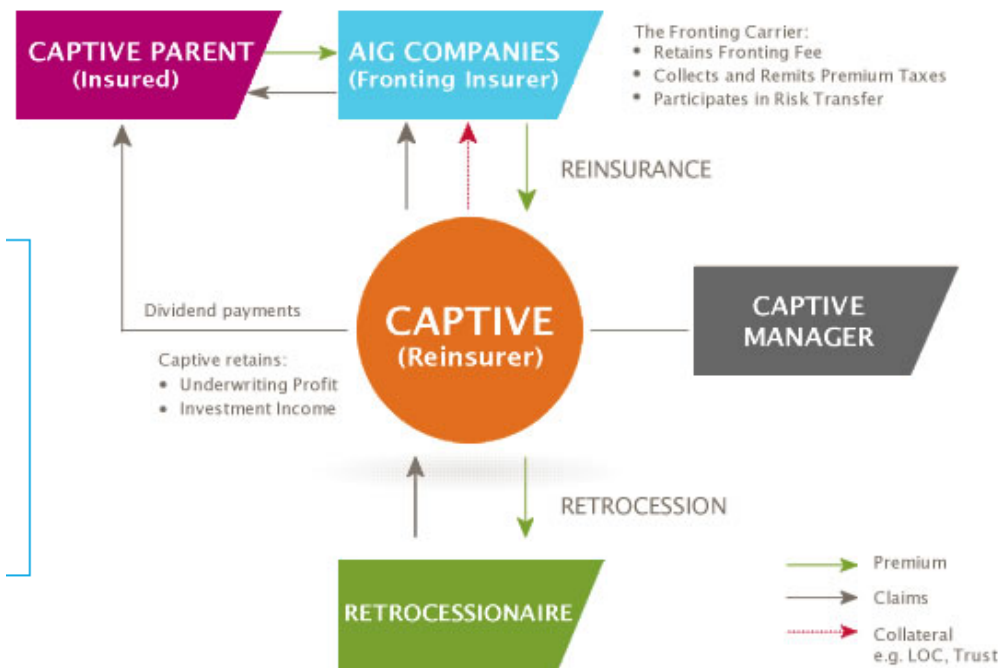
Key Risk	Description of Control Activity	Management Assessment	IAG Assessment	
			Design Effectiveness	Operating Effectiveness
	<u>Self-Checklist</u> The MN Centre Of Excellence (MCOE) completes a self-checklist pre-bind confirming all requirements such as credit checks, collateral, pricing, program structure, legal, risk transfers, agreements, have been completed for the arrangement.			Checklists are not consistently completed pre-bind. (EMEA Specific)
Required collateral is not obtained, or monitored on a regular basis, leading to an increased level of unsecured exposure potentially leading to financial loss.	<u>Outstanding Collateral Monitoring</u> GF Underwriter / Compliance Manager review a monthly report of outstanding collateral and follow up on any outstanding items			
Reinsurance agreements contain credit and legal terms and conditions that do not meet GF Legal standards resulting in potential credit exposure, financial loss and reputational damage	<u>RISO Review of Reinsurance Structure</u> RISO reviews and approves all Reinsurance structures, via OMeGA, prior to binding to ensure terms are reasonable and reinsurance is properly coded.			
Fronting program structures are not aligned with the strategy leading to unfavorable financial results and regulatory penalties.	<u>Global Fronting Peer Reviews</u> On a monthly basis, each GF underwriter is subject to peer reviews, to be performed by a GF underwriter of the same delegated authority or higher, to assess that: <ul style="list-style-type: none"> • Risk Transfer Validation is signed • Policy conditions are in line with binder information • FAC reinsurance was correctly placed Any exceptions identified are followed up and tracked to resolution, with trends identified and remedial action identified.			This control covers 2 risks and is therefore listed twice. Due to resource constraints not all peer reviews were performed by the required authority level
Poor performing books of business are not identified in a timely manner leading to financial loss.	<u>Review of AQI Reports</u> Regional Global Fronting Heads review/analyse the AQI Reports quarterly to assess portfolio performance. Issues are identified and actions are recommended to the GF UW Management team.			
Sensitive client information is lost or obtained by inappropriate parties	<u>User Access</u> MN Management complete recertifications on a basis to confirm that			

Key Risk	Description of Control Activity	Management Assessment	IAG Assessment	
			Design Effectiveness	Operating Effectiveness
resulting in reputational damage and potential legal action against the firm.	access is appropriately assigned for the following: <ul style="list-style-type: none"> • Network Drives • Credit Risk Database • Fee Rater 			

Appendix C – Business Overview & Background

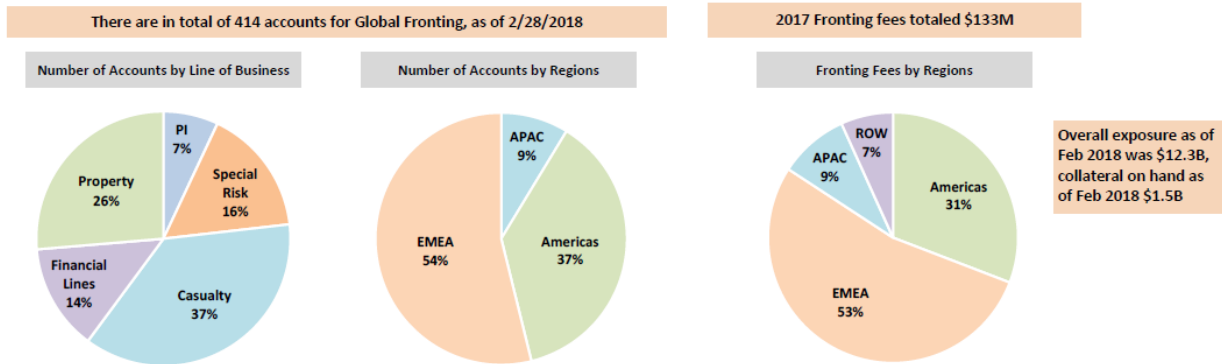
Captive Fronting is defined as the use of an admitted (licensed) insurer, also known as a fronting company, to issue an insurance policy on behalf of the captive insurer and then transferring the risk fully from the fronting company to the captive insurer through a reinsurance agreement. The fronting company will retain a fronting fee for this service and collect collateral as the fronting insurer will be obligated to pay any insurance claims made on the policy issued in the event that the captive insurer becomes insolvent.

The principal motivation behind the establishment of a fronting program is to create a compliant insurance program that allows an enterprise to assume an element of its risk, usually through a captive insurance company, and simultaneously continue to access the policy administration, claims handling, and reporting services traditionally performed by insurance companies. The diagram below explains how this arrangement is carried out:



- **AIG** as the **Fronting Insurer** collects premium, carries out policy administration, processes claims and retains a fronting fee; it insures and then reinsures risks directly or indirectly to the captive.
- **Captive Parent** is the insured for whom the program is established.
- **Captive Reinsurer** assumes all or part of the responsibility for the risk of the program. The Captive is the reinsurer of AIG.
- **Retrocessionaire** is the reinsurer of the Captive. The Captive determines the breakdown of the reinsurance.
- **Captive Management** - provides administrative and advisory services relating to the feasibility, structuring, formation and management of captives in accordance with the relevant domicile's regulatory requirements. For all AIG global fronting programs this role is performed by the broker.

2017 Global Fronting performance outlined below:



Appendix D – Report and Issue Rating Definitions

Report Rating	Description
Satisfactory	Controls are adequately designed and operating effectively. No significant control weaknesses were noted.
Needs Improvement	Certain controls are not adequately designed and effective. Control weaknesses are only partially mitigated.
Unsatisfactory	Controls are not adequately designed or effective. Significant control weaknesses exist without sufficient mitigation.

Issue Rating	Description
Critical	<p>Critical issues require immediate attention by senior management. If not remediated, there is a risk that a critical issue could:</p> <ul style="list-style-type: none"> • Result in a significant adverse impact on the control environment, processes and systems, and the business meeting its control objectives. • Undermine the integrity of the reported financial results, even if material financial impact did not occur. • Possibly result in significant regulatory sanctions and/or penalties. • Cause substantial reputational damage and/or loss of key clients/relationships.
Moderate	<p>Moderate issues require timely attention by management. If not remediated, there is a risk that a moderate issue could:</p> <ul style="list-style-type: none"> • Result in an adverse impact on the control environment, processes and systems, and the auditable entity meeting its control objectives. • Possibly undermine the integrity of the reported financial results, even if financial impact did not occur. • Possibly result in moderate regulatory sanctions and/or penalties. • Cause possible reputational damage and/or loss of key clients/relationships.
Minor	<p>Minor issues require timely attention by the control owner. If not remediated, there is a risk that a minor issue could:</p> <ul style="list-style-type: none"> • Result in an impact on the control environment, processes and systems, and the auditable entity meeting some of its control objectives. • Possibly result in limited regulatory sanctions/ and or penalties. • Cause minimal or isolated reputational damage and/or client dissatisfaction. • A minor issue typically does not compromise the integrity of the reported financial results.

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