Direct Your Learning

12

Reinsurance Audits

Educational Objectives

After learning the content of this assignment, you should be able to:

- Explain why reinsurance audits are conducted.
- Describe the steps in the reinsurance audit process.
- Describe the objectives, sources of information, and possible recommendations for each of the following types of reinsurance audits:
  - Underwriting audits
  - Transactional audits
  - Claim audits
- Describe the considerations involved when performing a reinsurance audit of a managing general agent.

Outline

Reinsurance Audits

12

OVERVIEW OF REINSURANCE AUDITS

An audit is a formal examination of an organization's or individual's records. One of the most common types of audit is an examination of a company's financial and accounting records by a certified public accountant (CPA).

A reinsurance audit is a specific type of audit that involves examining a primary insurer's or reinsurer's records and practices. It can result in suggestions for improving the insurer's controls, procedures, and operations.

Reinsurance audits may be performed by an independent third party but are usually conducted by a party to the reinsurance transaction. Each party conducts an audit for a specific purpose. For example, before deciding whether to enter into a reinsurance agreement, a reinsurer can audit a primary insurer to evaluate its financial position, underwriting philosophy, operating systems, and internal controls. Alternatively, a primary insurer can audit a reinsurer before ceding business to it to verify solvency.

A reinsurance intermediary is not usually subject to reinsurance audits because it is generally not a party to the reinsurance agreement. However, a reinsurance intermediary serving as a primary insurer's agent is functioning in a fiduciary capacity and could be subject to reinsurance audits.

The primary purpose of most reinsurance audits is to evaluate the business ceded under treaties the reinsurer has with the primary insurer. The information gathered for this purpose may be specific, such as data on individual claims against the primary insurer, or general, such as a description of the primary insurer's claim reserving practices. Reinsurance auditors usually evaluate the primary insurer's management, underwriting, and claim handling philosophies, reinsurance accounting practices, and in-force policies.

Although most reinsurance audits are conducted by a reinsurer that is already doing business with a primary insurer, some are conducted by a reinsurer before it decides whether to do business with a primary insurer. An audit conducted by a reinsurer before committing to a new relationship is called a pre-quote audit. An audit made after a reinsurer has made a commitment to a primary insurer is called an at-risk audit.

One function of reinsurance is transferring underwriting expertise from a reinsurer to a primary insurer. A reinsurance audit can help fulfill that function. For example, during an underwriting audit, a reinsurer could provide advice on a type of insurance that the primary insurer plans to sell.

The reinsurance auditor should be familiar with the specific provisions of the treaty being reviewed. Understanding the treaty enables the auditor to evaluate whether the primary insurer's records and operations comply with treaty provisions.

A reinsurer's authority to audit a primary insurer is derived from the reinsurance agreement. Most reinsurance agreements contain an access to records clause, which gives the reinsurer authority to inspect the primary insurer's records that relate to the business conducted between parties. See the exhibit "Access to Records Clause."

Access to Records Clause

The Reinsurer or its duly authorized representative shall have the right to examine, at all offices of the Company at all reasonable times, all books and records of the Company relating to any business which is the subject of this Agreement. This right shall survive the termination of the Agreement and shall continue so long as either party has any rights or obligations under this Agreement. Upon request, the Company shall supply the Reinsurer, at the Reinsurer's expense, with copies of any such books or records.

[DA05449]

THE REINSURANCE AUDIT PROCESS

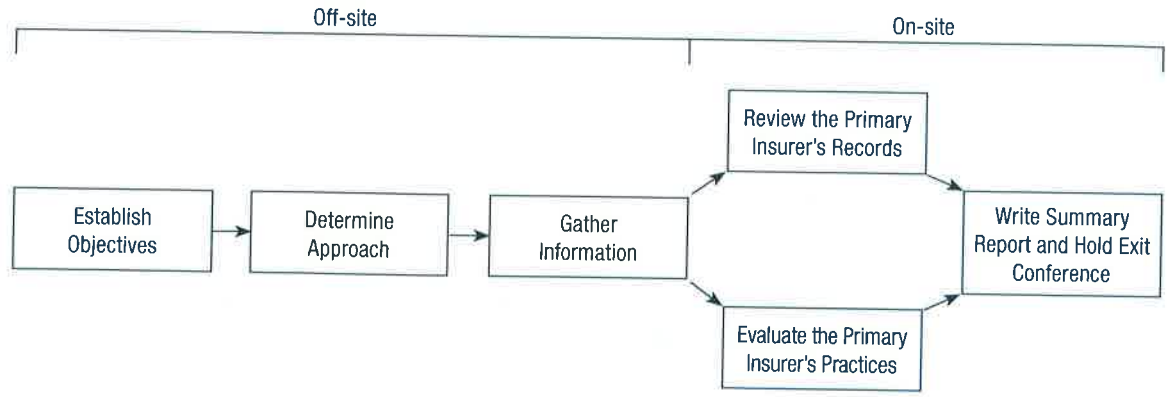
Insurance and reinsurance operations go through different types of audits, such as internal audits, statutory audits, and process audits. However, reinsurance audits are quite different from those and allow a reinsurer to make sure that the primary insurer is complying with the reinsurance agreement. Audits can also allow primary insurers to improve their business through an outside review of their operations.

Not all audits are conducted the same way. However, a reinsurance audit of a primary insurer generally includes these six steps:

1. Establish objectives
2. Determine approach
3. Gather information
4. Review the primary insurer's records
5. Evaluate the primary insurer's practices
6. Write a summary report and hold an exit conference

The first three steps are generally performed off-site, before the reinsurer's auditors travel to the primary insurer's office. The remaining steps are usually performed on-site, while the auditors are at the primary insurer's offices. The composition of the audit team reflects the audit's scope. For example, the auditors for a claim audit could include reinsurer claim personnel as well as the reinsurer account representative who is responsible for the primary insurer account. See the exhibit "The Reinsurance Audit Process."

The Reinsurance Audit Process



[DA05450]

Establish Objectives

The first step in the ~~general audit process~~ is to establish objectives. Many audit objectives target specific concerns, such as primary insurer underwriting ~~and claim handling procedures~~. Other audit objectives are general and relate to broad issues, such as loss and premium trends and the quality of a primary insurer's management.

An audit's objectives determine its scope—that is, whether it will include underwriting, transactional, and claim audit elements. For example, one objective may be to verify whether the correct policies for the treaty are submitted (underwriting audit). A second objective may be to review the adequacy of the primary insurer's loss and loss adjustment expense reserves (claim audit).

Determine Approach

The second step in the audit process is to determine approach. The auditors may choose either a structured or a flexible audit approach. A structured audit approach involves formal procedures to sample and evaluate the primary insurer's data. A flexible approach allows more latitude in the procedures used to sample and evaluate data. A primary insurer's attitude may influence the reinsurer's decision about which approach to use. Some primary insurers view a structured audit as confrontational. However, they may be more amenable to an informal review that takes a flexible approach.

Gather Information

The third step in the audit process is to gather information. Audit objectives influence the type of information the auditors must gather. For example, if one of the underwriting audit objectives is to ascertain whether the correct policies are submitted to the reinsurer, a random sample of the primary insurer's policies should be gathered as well as data on whether each policy was submitted to the reinsurance treaty.

The auditors should determine sources for the required information and, if feasible, design forms to facilitate its collection. Before starting an audit, the auditors should communicate their information needs to the primary insurer directly or through the reinsurance intermediary (if one is involved). Advance communication helps to ensure that the necessary information is available to the auditors once they arrive at the primary insurer's office.

Review the Primary Insurer's Records

The fourth step in the audit process is to review the primary insurer's records. Depending on an audit's objectives, auditors may decide to review any of these records held by the primary insurer:

- An underwriting audit may involve a review of the primary insurer's underwriting and treaty files.
- A transactional audit may involve a review of the primary insurer's bordereau and summary account statements, as well as a sample of policy and claim files.
- A claim audit may involve a review of the primary insurer's open reserves, loss development reports, and loss payments.

Evaluate the Primary Insurer's Practices

The fifth step in the audit process is to evaluate the primary insurer's practices. In doing so, auditors should consider these types of primary insurer operating controls:

- Input controls—Procedures that help to ensure that accurate data are input to information systems. For example, a primary insurer's internal auditors often sample documents from policy and claim files and compare them with actual data entered into the system.
- Processing controls—Procedures that help to ensure that data are processed correctly after they are entered into an information system. These procedures apply to the primary insurer's information system and involve workflows. For example, processing controls can prevent policy and claim information from being recorded under the wrong contracts and can prevent errors in calculating commissions or reserves. Processing controls

can also involve physical workflows. For example, auditors may verify that the primary insurer's mailroom promptly sends claim notices to claim examiners.

- Output controls—Procedures that reconcile output reports with input data. For example, a premium bordereau (output report) can be verified by comparing it with the input sheets that were used to enter premium data.

The scope of the operating control evaluation depends on the planned scope of the review of the primary insurer's records. For example, when the auditors plan to review underwriting and claim files, they should evaluate those operating controls related to the primary insurer's underwriting and claim operations. However, regardless of the review's scope, all three types of controls should be evaluated.

To evaluate operating controls, the auditor can consider audit reports developed by the primary insurer's internal and external auditors, questionnaires designed by reinsurance auditors and completed by the primary insurer, and first-hand observations of primary insurer's procedures.

Primary insurers are subject to audits performed by state insurance regulators, external accounting auditors, and internal auditors. Each of these audits reviews the insurer's operating controls to determine if material mistakes or intentional misrepresentations are occurring in financial reporting. Problems identified in these audits may be relevant to reinsurance reporting as well.

Reinsurance auditors often rely on questionnaires to gather basic information on the primary insurer's controls. For example, the claim component of a questionnaire may ask what authority is granted to individual claim representatives to settle claims and how use of that authority is monitored. Other questions may address how losses that exceed 50 percent of the primary insurer's retention and losses involving particular types of injuries (such as brain injury, burns, disfigurement, paralysis, and death) are handled. Completed questionnaires assist in audit planning and enable reinsurance auditors to familiarize themselves with the primary insurer's functional areas. The auditor may need to tailor content of the questionnaire to the primary insurer under review. For example, a questionnaire developed for a captive insurer or a small insurer selling a single type of insurance could differ significantly from that for a large multiline property-casualty insurer.

Another source of information reinsurance auditors typically use to evaluate operating controls is first-hand observation of the procedures that primary insurer employees follow in recording and reporting reinsurance transactions. For example, an auditor may ask a primary insurer underwriter to show how he or she would code a policy that would not be subject to the treaty or one that would be automatically included in the treaty were it not facultatively reinsured. While participating in this walk-through of regular activities, the auditor may witness procedures that are inconsistent with the reinsurance treaty's terms.

Write a Summary Report and Hold an Exit Conference

The final step in the audit process is to write a summary report and hold an exit conference.

To facilitate the timely resolution of findings, the auditors write summaries and distribute them to the primary insurer's personnel. These summaries document the reinsurer's expectations and whether its expectations are being met. They usually specify why unmet expectations are a problem for the reinsurer and what actions, if any, the reinsurer will take if the problems are not corrected. The summaries can also serve as an agenda for the exit conference, which should be scheduled at the conclusion of the audit.

The exit conference provides an opportunity for the primary insurer and the reinsurer to review and discuss findings. During this conference, the reinsurer should convey to the primary insurer both favorable and unfavorable audit findings and suggest ways the primary insurer can improve its controls, procedures, and operations.

TYPES OF REINSURANCE AUDITS

Underwriting audit
A review of underwriting files to ensure that individual underwriters are adhering to underwriting guidelines.

Transactional audit
A reinsurance audit that examines the premium, loss, and commission data reported by a primary insurer to a reinsurer.

Claim audit
A review of claim files to examine the technical details of claim settlements; ensure that claim procedures are followed; and verify that appropriate, thorough documentation is included.

There are several different types of reinsurance audits that allow reinsurers to better understand the business assumed and the scope of potential liability.

These are the most common types of reinsurance audits carried out by a reinsurer:

- **Underwriting audits**
- **Transactional audits**
- **Claim audits**

The exhibit presents each type, along with the corresponding objectives and records reviewed or employees consulted. See the exhibit "Types of Reinsurance Audits."

Underwriting Audits

Underwriting audits involve reviewing the primary insurer's coverage, pricing, and risk selection decisions.

Types of Reinsurance Audits

Type of Audit	Objectives	Records Reviewed/ Employees Consulted
Underwriting	• Assess coverage, pricing and selection decisions	• Underwriting and treaty files
	• Gain familiarity with primary insurer's underwriting philosophy	• Underwriters • Underwriting managers • Senior management
Transactional	• Verify accuracy of premium, loss, and commission data submitted to reinsurer	• Summary account • Bordereaux
	• Evaluate primary insurer's reinsurance reporting controls	• Reinsurance reporting records and transaction audit manuals
Claim	• Determine whether claims are covered by a treaty under review	• Open claim reports
	• Monitor trends in losses	• Loss development reports
	• Assess primary insurer's claim staff and claim handling procedures	• Claim procedure manuals • Claim department personnel
	• Discover information for a disputed claim	• Claim report

[DA05451]

These are among the objectives of underwriting audits:

- Verify that the primary insurer cedes the correct policies to the reinsurance treaty
- Gain familiarity with a primary insurer's management, underwriters, and in-force policies
- Recommend strategies to improve the underwriting operations of the primary insurer

Sources of Information

An underwriting audit's success depends on the type and quality of information available for review. Employees can be a valuable source of information. The auditors should interview the primary insurer's key employees, including senior managers, underwriting managers, and underwriters.

Senior managers can provide information about underwriting policy, operating controls, organizational structure, and future direction. Underwriting managers and underwriters know how procedures are implemented, including how items are processed. During the interviews, the auditors should also try to determine the workload and authority of the underwriters as well as the extent and suitability of any delegation of underwriting authority to producers.

Another source of underwriting audit information is the primary insurer's underwriting files. These files help auditors determine whether the treaty is operating as originally intended. Underwriting files selected for review should include active ones, representing the loss exposures subject to the treaty, and files for loss exposures the primary insurer nonrenewed, canceled, and declined.

The sample of underwriting files should also help auditors determine whether the primary insurer's risk selection and ~~rating plan are appl~~ied consistently, are documented appropriately, and address all loss exposures adequately. Any deviations from underwriting guidelines and rating plans by the primary insurer should be recorded and discussed with the primary insurer's management.

As part of their review of the ~~underwriting~~ files, the auditors should analyze a primary insurer's historical pricing levels. This analysis can help them determine the primary insurer's commitment to long-term price adequacy—which is particularly important to a reinsurer that provides pro rata reinsurance because all premiums and losses are shared in the same proportion between the primary insurer and the reinsurer.If the primary insurer's premiums do not adequately cover incurred losses, both the primary insurer and the reinsurer share in an equally unprofitable portfolio.

Auditors should also evaluate the primary insurer's ability to select loss exposures that yield profitable underwriting results. Reviewing selected underwriting files, including active files and those for nonrenewed, canceled, and declined risks, reveals the primary insurer's selection process. Files should document the characteristics of each insured loss exposure. Auditors should learn whether the primary insurer has procedures to handle high hazard or unusual loss exposures.

These are questions that auditors may ask the primary insurer:

- Do you exclude high hazard or unusual loss exposures?
- Do you require inspections or other engineering services for high hazard or unusual loss exposures that you insure?
- Do you adjust pricing for high hazard or unusual loss exposures that you insure?
- How do you determine whether a high hazard or unusual loss exposure is submitted to the reinsurance treaty?

Auditors should verify that the primary insurer is accepting loss exposures in accordance with its **underwriting guidelines (underwriting guide)**. The underwriting guide helps the primary insurer determine whether additional information may be needed to accept a loss exposure. For example, it indicates when inspections or additional financial information is necessary. Auditors should verify that each selected underwriting file complies with the primary insurer's underwriting guide.

Underwriting guidelines (underwriting guide)
A written manual that communicates an insurer's underwriting policy and that specifies the attributes of an account that an insurer is willing to insure.

The last source of underwriting audit information is treaty information. This includes contract wording, placement information, accounting records, correspondence, and loss experience reports. To help analyze these sources to identify any underwriting problems, auditors can interview the primary insurer's claim and accounting personnel. By doing so, auditors may discover that loss exposures submitted to the treaty do not meet certain underwriting standards or are not of a sufficient quantity, given the treaty's terms. These are both potential problems because the reinsurer expects a minimum level of quality for loss exposures and expects the primary insurer to submit a minimum number of loss exposures (for a pro rata treaty) or a minimum amount of written premiums from subject policies (for an excess of loss treaty).

If the function of the reinsurance treaty is to increase the primary insurer's premium capacity, auditors should verify that the additional capacity is used to insure loss exposures that are acceptable to the reinsurer. A review of selected policies subject to the treaty should verify that a process is in place to achieve this outcome.

Reviewing selected underwriting files can also verify that the treaty does not include loss exposures that are specifically excluded. If the primary insurer believes such loss exposures are covered under the treaty, then the reinsurer may need to discuss these loss exposures with the primary insurer, as well as the purpose and intent of the exclusions.

Recommendations

At the conclusion of an underwriting audit, auditors should understand the strengths and weaknesses of the primary insurer's underwriting. At this point, the auditors will write a summary report and usually hold an exit conference.

The auditors may recommend that the primary insurer change its selection process so that loss exposures of appropriate quality are submitted to the treaty; they may also recommend that the primary insurer modify its overall pricing. Any recommendations should be discussed with the primary insurer's management.

Transactional Audits

Transactional audits examine the premium, loss, and commission data a primary insurer reports to a reinsurer. Ideally, auditors should use a structured approach for a transactional audit to achieve these objectives:

- Verify the accuracy of data the primary insurer reports to the reinsurer
- Determine whether the primary insurer is complying with the reinsurance treaty terms
- Evaluate the primary insurer's reinsurance reporting controls

Transactional audits provide the reinsurer with an understanding of how the primary insurer processes transactions that are subject to the reinsurance treaty.

Sources of Information

As with other types of audits, the success of a transactional audit depends on the type and quality of information available for review. Information sources include premium and loss accounts prepared by the primary insurer and interviews with key employees.

Before starting a transactional audit, the auditors should request a summary account statement from the primary insurer that includes data on written premiums, ceding commissions, and paid losses. The summary account gives the auditors information on the total size of the primary insurer's premiums and losses as well as on the operation of the reinsurance treaty. See the exhibit "Example of a Reinsurance Summary Account."

Example of a Reinsurance Summary Account

Summary Account
80 Percent Quota Share
25 Percent Ceding Commission

	Primary Insurer	Reinsurer
Gross Written Premiums	$8,000,000	
Ceded Premium		$6,400,000
Ceding Commission		(1,600,000)
Paid Losses	$4,500,000	
Ceded Paid Losses		(3,600,000)
Paid Loss Adjustment Expenses	100,000	
Ceded Loss Adjustment Expenses		(80,000)
Net Due Reinsurer		**$1,120,000**

[DA05452]

Some auditors submit test data (hypothetical premiums and losses) to the primary insurer for processing in its information system. Based on the reinsurance treaty terms, auditors know what outputs the primary insurer's system should produce (ceded premiums, commissions, and ceded losses). For example, the transactional auditors' test premium data may include annual and six-month policies, policies canceled at policy inception, policies canceled during the policy term, policies paid in full at inception, and policies subject to adjustment beyond the policy term. Similarly, the test loss data may include losses in various stages of settlement.

Auditors should conduct interviews with the primary insurer's management and staff, including representatives from key departments such as underwriting, claims, accounting, and information systems. Management interviews provide auditors with an overview of the reinsurance reporting system and its major functions. Staff interviews provide details on how premium, loss, and commission data are processed.

In addition to the information gathered through interviews, auditors gather premium, loss, and commission data. For pro rata reinsurance agreements, auditors should request the premium and loss bordereau that support premium, loss, and commission data on the summary accounts. The auditors should then compare data on the bordereau with totals shown on the summary accounts. If the auditors cannot reconcile those accounts with the supporting premium bordereau, they should consult with the primary insurer to determine the cause of the discrepancy. If an error is discovered, the auditors should calculate the additional amount due to either the reinsurer or the primary insurer. If a reinsurance intermediary is involved in the reinsurance placement, he or she should be advised of any adjustments to the premium and loss bordereau.

The auditors should request documentation for premium totals shown on the summary accounts. This documentation may consist of treaty files or written and earned premium amounts shown in the primary insurer's annual statement from the National Association of Insurance Commissioners (NAIC). Auditors can review a sample of premium adjustments to determine whether premium adjustments have been calculated correctly.

Auditors should also verify loss and loss adjustment expense totals on the summary accounts. Information on paid losses, reserves, and loss adjustment expenses (both paid and reserved) can be derived from the primary insurer's NAIC Annual Statement. The auditors can sample claim files and verify the summary account data for each loss. For example, they can verify the policy and claim file numbers, insured's name, claimant's name, paid loss amounts, paid loss adjustment expenses, salvage, subrogation, and current outstanding loss and loss adjustment expense reserves.

Finally, the auditors should review a sample of policies ceded to the treaty. During this review, the auditors should ask questions such as these about premium, losses, and commissions for each policy:

- For what years has reinsurance coverage been provided?
- Can the reinsurer's share of each policy's premium be traced to the premium bordereau?
- Is premium sent to the reinsurer in a timely manner?
- Is each policy's premium applied to the correct underwriting period?
- Are all paid losses and paid loss adjustment expenses adequately supported by the contents of the claim file?
- Can all paid losses and paid loss adjustment expenses be traced to the loss bordereau?
- Is the reinsurance commission properly calculated for each bordereau?
- Do the commission totals on the bordereau match the totals on the summary accounts?

This policy and claim file review enables auditors to evaluate the accuracy of premium, loss, and commission data reported to the reinsurer and helps them to identify areas for improvement.

Evaluating reinsurance reporting controls is also part of a transactional audit. To facilitate this evaluation, auditors prepare questionnaires that address the four key functions of the primary insurer: underwriting, accounting, claims, and information systems. The underwriting, accounting, and information systems questionnaires indicate how the primary insurer's business is marketed and underwritten, how a premium is recorded and collected, and how a premium is reported and remitted to reinsurers. The claim questionnaire indicates how coverage is verified and how losses are shown on the primary insurer's accounting records and reported to reinsurers.

Recommendations

After all applicable information is gathered and analyzed for the transactional audit, auditors will write a summary report and usually hold an exit conference with the primary insurer.

One of the key reasons for conducting a transactional audit is to improve the primary insurer's recording and reporting procedures for premium and losses. Therefore, the auditors may recommend that the primary insurer change its procedures to better comply with reinsurance treaty terms. Specific suggestions for the primary insurer may include ways to improve the procedure for reconciling premium and loss bordereau with summary accounts and ways to speed the reporting of losses to the reinsurer.

Claim Audits

Claim audits involve reviewing a specific claim, specific types of claims, or a primary insurer's claim procedures, including its controls and the qualifications of its claim staff. Because of the increasing volume of asbestos, environmental, and toxic tort claims, claim audits for long-tail liability business have increased in importance.

These are among the objectives of claim audits:

- Review a single claim or series of claims to verify that they are covered by the underlying policy and are adequately reserved
- Monitor trends in incurred losses
- Review and evaluate the primary insurer's general reserving practices
- Assess the primary insurer's claim handling systems and controls
- Evaluate the credentials and skills of the primary insurer's claim staff

Sources of Information

As with the other reinsurance audits, the success of a claim audit depends on the type and quality of information available for review. Information sources include interviews with key employees, open claim reserve reports, loss development reports, and copies of internal claim procedure manuals.

The auditors should conduct interviews with management and selected claim department personnel. These interviews should reveal information about each person's workload, claim-settling authority, and involvement in setting loss and loss adjustment expense reserves. The interviews should also indicate the primary insurer's general claim handling and claim-settling philosophy.

These are questions auditors may ask the primary insurer:

- Have there been changes to claim reporting practices?
- Have there been changes to reserving practices?
- What is the claim representative's average case load?
- Have changes been made recently in claim representatives' authority?

Another source of claim audit information is the primary insurer's open claims and loss development reports. These reports should indicate whether claims are reported late to the primary insurer.

If a primary insurer's reserves develop unexpectedly over time because of late reported claims or increases in case reserves, the auditors should carefully examine the primary insurer's current level of incurred but not reported (IBNR) reserves. Inadequate primary insurer IBNR reserves usually indicate that the reinsurer has inadequate loss and loss adjustment reserves, particularly when excess of loss reinsurance is involved.

Finally, a primary insurer's internal claim procedure manuals can provide important claim audit information. These manuals describe the process the primary insurer uses to set reserves. They specify when and how reserves should be set and how changes in reserves should be made.

Procedures should be included in the manuals that require notification of a claim manager when significant reserve changes occur. Procedures should also be in place to notify the reinsurer of claims that potentially could exceed the primary insurer's retention. In addition, the manuals should describe the process for reporting claims that are covered by the reinsurance treaty and may indicate the primary insurer's general claim handling philosophy.

Claim auditors often examine individual claim files to assess the primary insurer's claim procedures. Selected files usually involve those claims that may trigger coverage from the reinsurance treaty and those that will likely involve a significant claim for the reinsurer. Auditors should look for evidence that the primary insurer encourages early comprehensive investigation of liability and damage. For example, when investigating a new claim, the primary insurer should determine whether the claim is covered by the policy and estimate the claim's value as soon as possible.

In some instances, auditors may suggest a strategy to manage the claim to an early settlement or recommend that the reserve be increased; however, the primary insurer is generally not required to follow the auditors' advice. Based on the auditors' findings, the reinsurer can establish an additional case reserve on its accounting records to reflect what it believes will be the ultimate value of the claim.

Recommendations

At the conclusion of a claim audit, the auditors will write a summary report and usually hold an exit conference with the primary insurer's claim personnel.

The reinsurer presents a summary of findings, acknowledges the primary insurer's strengths, and highlights those areas where deficiencies were identified. Auditors may suggest that the primary insurer should increase reserves on specific losses, or that it should settle claims more aggressively. The auditors may also request that specific claims not yet reported to the reinsurer by the primary insurer be reported as soon as possible, or they may require additional documentation for claims not yet paid by the reinsurer.

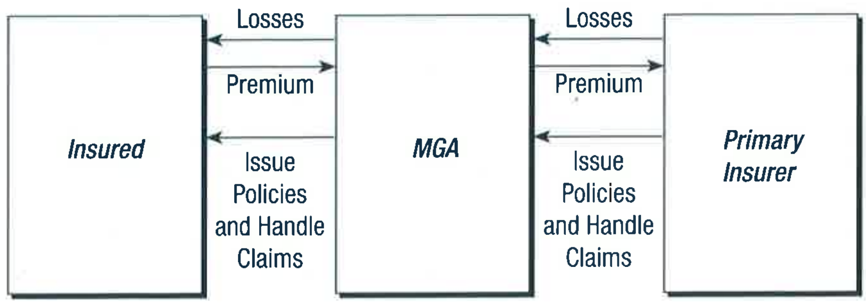
MANAGING GENERAL AGENT REINSURANCE AUDITS

Because of the broad range of coverage options and loss exposures that managing general agents handle, reinsurance is a key component of most managing general agents' business. A reinsurer can perform any of the types of audits—underwriting, transactional, or claims—on a primary insurer's managing general agent, if appropriate, and should present its findings to both the managing general agent and the primary insurer it represents.

A managing general agent (MGA) is an authorized agent of the primary insurer that manages all or part of the primary insurer's insurance activities, usually in a specific geographic area. The extent of authority held by an MGA varies and depends on the written contract between the MGA and the primary insurer. For example, an MGA may have complete underwriting and claim authority on behalf of a primary insurer.

The auditors are responsible for making a qualitative evaluation of the relationship between the MGA and the primary insurer. If the primary insurer takes a hands-off approach with the MGA, the auditors may have to take additional steps to verify that the MGA is meeting its obligations under the contract. If the primary insurer's relationship with the MGA includes regular audits of the MGA to verify compliance with the contract, the auditors should review those audit reports. See the exhibit "Example of a Relationship Between an MGA and a Primary Insurer."

Example of a Relationship Between an MGA and a Primary Insurer



[DA05453]

When auditing an MGA, auditors should establish objectives and gather information that goes beyond the normal audit inquiry. For example, they should take special care to understand the nature, scope, and quality of the agency relationship between the MGA and the primary insurer. In addition, the auditors should decide whether the MGA has the financial strength and technical expertise to protect the interests of both the primary insurer and the reinsurer.

The auditors should also review the written contract that governs the relationship between the primary insurer and the MGA. This contract specifies the authority that the primary insurer delegated to the MGA, including underwriting authority for specific types of insurance, claim investigation and settlement authority, and reinsurance placement authority. It also usually specifies the MGA's premium and loss reporting obligations to the primary insurer as well as compensation to be provided to the MGA.

The underwriting authority of the MGA should be reviewed, with any restrictions on premiums, limits, types of insurance, or geographic exposure noted. The auditors should then analyze the insurance ceded to the reinsurer to ensure that it complies with the MGA's underwriting authority. Inconsistencies should be brought to the MGA's and the primary insurer's attention. The auditors should also review the internal operating controls of the MGA and ascertain whether it is complying with record keeping and reporting requirements.

Finally, the auditors should assess the competency and financial strength of the MGA. Although the primary insurer is ultimately responsible for the MGA's actions, any weakness in the MGA's operations could result in unprofitable underwriting results for both the primary insurer and the reinsurer, particularly when the MGA practices poor claim administration and underwriting. Auditors should carefully evaluate an MGA that does not have a sufficient financial stake in the policies it issues but has an incentive to sell insurance to earn commissions, whether or not that business is profitable.

SUMMARY

Both the primary insurer and the reinsurer can benefit from the reinsurance audit process. Well-conducted, sound reinsurance audits can improve communication between the primary insurer and reinsurer and foster enduring professional relationships that focus on mutually identifying and resolving problems. A primary insurer sometimes audits a reinsurer to verify solvency; however, reinsurance audits more often involve a reinsurer auditing a primary insurer. A reinsurer's authority to audit a primary insurer is derived from the access to records clause in the reinsurance agreement.

The reinsurance audit process may include these six steps: (1) establish objectives, (2) determine an approach, (3) gather information, (4) review primary insurer records, (5) evaluate the primary insurer's operating controls, and (6) write a summary report and hold an exit conference.

The most common types of reinsurance audits are underwriting, transactional, and claim. An underwriting audit examines the primary insurer's coverage, pricing, and loss exposure selection decisions. A transactional audit examines the premium, loss, and commission data reported by a primary insurer to a reinsurer. A claim audit examines a primary insurer's claim reporting, claim payment, and reserving practices. At the beginning of a reinsurance audit, the auditor usually interviews the primary insurer's senior staff and staff of the department involved in the audit (underwriters, claim supervisors, and accounting supervisors). Audits generally conclude with a summary report and an exit conference. Contents of the report should be discussed with the primary insurer and accessible for future audits.

Some reinsurance audits focus on an MGA. When auditing an MGA, a reinsurance auditor should focus on the nature and scope of the MGA's authority, the relationship between the MGA and the primary insurer, and the MGA's stability.