

► After the Reinsurance Audit

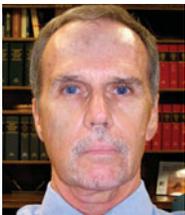


Donald Wustrow

By Donald Wustrow and
Richard Hughes

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Much has been written regarding the manner in which an audit should be conducted. Equally important, if not more so, is what should be done after the reinsurance audit has been completed. This next step depends on the reason for the audit, the findings from the audit, and the cedant's response to the findings.



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Why Reinsurers Audit

Reinsurers generally seek to exercise their right of inspection for one of the following reasons:

- **Comfort audit** – Such audits are typically performed while the reinsurer is at-risk on a treaty that has good experience. This type of audit is done to ensure that the business is being properly underwritten and ceded to the treaty, and may determine whether the reinsurer will renew its participation. Generally, a comfort audit is carried out by the reinsurer's own personnel, although a reinsurer may want to consider using an independent consultant to obtain an unbiased assessment of a portfolio in which the reinsurer has a significant participation. If the audit is done by the reinsurer's own personnel, it is best to use in-house audit

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staff rather than company underwriters to avoid any conflicts of interest.

- **Pre-commutation audit** – When the reinsurer and ceding company have agreed to consider the commutation of a portfolio, it is common for the reinsurer to ask for an audit to verify the figures before the actual negotiations are initiated. Often, this type of audit may go beyond an accounting reconciliation and include a review of underwriting and claims, to determine if there are issues that could be used as leverage in the commutation negotiations. A pre-commutation audit may be done by either the reinsurer or its consultant. If the reinsurer is using the services of a consultant to negotiate the commutation, typically the consultant will also perform the pre-commutation audit.
- **Investigative audit** – This type of audit is in response to a specific concern and can occur either when a reinsurer is at-risk or after the reinsurer has terminated its participation. Some common issues that prompt such audits include adverse experience, a sudden increase in claim activity, premium that varies significantly from the estimated premium, and apparent accounting irregularities, among other more specific issues. An investigative audit usually involves consultants at some point in the process, as such audits may become contentious and require the expertise that the consultants bring to the table. If an audit is deemed to be potentially contentious, the reinsurer should engage legal counsel to protect the work product, and all communications between the reinsurer and consultants should be transmitted through counsel.

Audit Findings

The purpose of any reinsurance audit is to determine whether the items being reviewed are in compliance with the terms and conditions of the reinsurance agreement and/or the representations made by the cedant about the subject portfolio.

Information from the cedant's files may be captured either on a written form or electronically, such as on an Excel spreadsheet or Access Database, to compare the file data to the treaty terms or cedant's representations. If apparent discrepancies are found during the audit, the

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auditor should discuss the specific treaty terms or representations at issue with the cedant for clarification, but not any findings of non-compliance at this time, if they are still deemed to exist after discussion with the cedant. Except in the very rare case in which everything is found to be in compliance, audit findings will either identify individual instances of non-compliance or recognize a global finding of non-compliance pervasive throughout the entire portfolio.

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Individual findings commonly relate to mistakes resulting from simple human error such as incorrect input of premium or claim figures into the computer system, or a miscoding that results in a cession to the wrong treaty or underwriting period. These types of errors are inevitable, but a frequency of similar errors could be a sign of a larger problem. Individual findings might also include isolated instances of policies or claims that apparently do not comply with the treaty terms or representations.

Global findings affect all cessions of either premium or claims and usually relate to interpretation of treaty language or representations. Examples of global findings include charging ceding commission on premium booked net of acquisition costs rather than on the original gross premium; the apparent cession of the cedant's retention to another treaty; or using a subsidiary claim facility and billing its claim handling activities as allocated loss adjustment expenses to individual claims.

Once the findings have been ascertained after the audit has been completed, a written report tailored to the type of audit should be prepared, which details the findings, quantifies the impact of the findings, and makes specific recommendations. The report for a comfort audit would include a recommendation to either maintain, increase, decrease, or terminate participation in the treaty. The pre-commutation report would include an assessment of the accuracy of the outstanding loss reserves and identify any issues that could be used as leverage in the commu-

tation negotiations. An investigative audit report would include a determination of the cause of the specific concern that gave rise to the audit and a recommendation for any future action.

The Cedant's Response to Audit Findings

The findings from the audit must be communicated to the cedant. This may be done by means of a wrap-up session at the conclusion of an audit, in which the findings are communicated verbally. A wrap-up session is best suited when the audit has been performed by the reinsurer rather than by an outside consultant acting on the reinsurer's behalf, and when the audit findings are deemed to be relatively insignificant. Alternatively, the reinsurer can submit its findings in a written letter or report to the ceding company. When the reinsurer has used an outside consultant to conduct the audit it is generally better for the consultant not to communicate the findings through a wrap up meeting. The outside auditor should first communicate findings to the reinsurer (client) so that the reinsurer can make its own evaluation of the findings before they are communicated to the cedant. Written communication should also be considered over a wrap-up if there are potentially serious issues that arise from the audit, in order to document the matter for a possible arbitration or legal proceeding.

How the cedant responds to the audit findings is critical in the post-audit process. If the findings are a few individual errors in data input or reinsurance coding, generally the cedant will admit the mistakes and agree to make the appropriate corrections in the accounts. The reinsurer has reason for concern if the cedant is not readily willing to correct obvious mistakes. If there are global findings that would require a re-accounting of the entire portfolio, the cedant is likely to be reluctant to make such corrections without taking the matter under advisement. The best possible outcome is, of course, that after due consideration the cedant agrees in principle and makes the corrections. Delays in responding or such responses as "You could have audited this treaty years ago and are only now auditing to look for reasons not to pay" indicate that the cedant may realize it has a problem but is trying to avoid making corrections. The most troubling outcome for the reinsurer is if the cedant totally disagrees with the principle behind the finding and refuses to make any corrections.

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Kathy Barker: Yes. We are working with companies that are looking for ways of defining solutions whether it might be to outsource it, to sell it or to look for some sort of reinsurance solution that would help them establish finality on a book of business.

Richard Hershman: As for us, Ali, and as I described before, we're already working on behalf of major investors whether it's a debt financing or equity financing. Our client-base is most of the leading investors in the world, so it is natural for us to recommend a capital solution.

Peter Scarpato: *I have no other questions. And again, on behalf of AIRROC and the Publications Committee, I want to thank everyone for your very insightful comments and views which will be of interest to our constituents. ■*

After the Reinsurance Audit *continued from Page 29***The Post-Audit Decision**

The reinsurer has to decide what action it will take based on the reason for the audit, the findings, and the cedant's response to the findings.

• **Comfort audit** – If the findings are relatively insignificant and the cedant agrees to make the necessary corrections, then the reinsurer should be comfortable remaining on and/or renewing its participation in the treaty. If the findings are significant and the cedant agrees to make corrections, the reinsurer should still feel fairly comfortable in its participation, but should perform periodic audits to ensure that the problems do not reoccur. Finally, if the cedant is uncooperative with regard to the audit findings, whether significant or not, the reinsurer should seriously consider issuing notice of cancellation. Any action beyond termination depends on the financial impact of the findings to the reinsurer.

• **Pre-commutation audit** – This type of audit is somewhat different in that the reinsurer will quantify the findings, which will become adjustments to the cedant's figures, and communicate the findings through a commutation offer. Typically, the reinsurer will maximize the quantum of the findings in the initial offer in an effort to negotiate the most favorable settlement. The cedant will hopefully acknowledge any accounting or coding errors and may tacitly accept any other findings in its counter-offer. It is unlikely that the cedant would

confirm its agreement with certain individual findings of a contractual nature or with any global findings in case commutation efforts fail. If the cedant appears to be negotiating in good faith, the reinsurer should be willing to compromise on its findings to reach an acceptable settlement figure. If, however, significant individual or global findings were uncovered during the audit and the cedant is unwilling to accept the reinsurer's maximum offer, then the reinsurer may have to consider arbitration or legal recourse.

• **Investigative audit** – The investigative audit should reveal the cause of the reinsurer's concern that prompted the audit, but that cause may not necessarily arise from any non-compliance of treaty terms or representations. Sometimes a treaty has adverse experience due to unforeseen circumstances, premium estimates are not met due to changing market conditions, or ceding company underwriters write unprofitable accounts although the risks were accepted in accordance with the treaty terms and underwriting guidelines. If this turns out to be the case, hopefully the audit will have some individual findings such as data input errors or miscodings to justify the audit to some extent. In other cases, however, the investigative audit will uncover numerous individual findings or global findings of apparent non-compliance that have resulted in significant financial impact to the reinsurer. In these cases it is unlikely that the cedant will readily agree with the audit findings, as the financial impact would shift from the reinsurer to the cedant if corrections are made based on the reinsurer's position. If the cedant is intransigent, the reinsurer should first suggest commutation to finalize the relationship rather than immediately seeking arbitration or litigation. In this manner, the cedant may tacitly accept the findings and agree to commute, in order to avoid the cost and uncertainty of arbitration or litigation. If an acceptable commutation settlement cannot be reached, the reinsurer will need to consider legal alternatives.

Reinsurers rarely undertake an audit with the goal of pursuing arbitration or litigation. However, when such action appears to be the only means of resolving issues arising from an audit, the reinsurer should first seek a legal opinion and weigh the costs of this action against the possible outcome before making the decision to arbitrate or litigate. Fortunately, what happens after the reinsurance audit in most cases is an amicable resolution of the findings and a better understanding of the reinsurance agreement by both the cedant and the reinsurer. ■