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REINSURANCE SECTION BREAKFAST AND TEACHING SESSION

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MR. GERALD KOPEL: I would like to take this opportunity to read John Culver Wooddy's (1915-1987) eulogy written by Robert J. Johansen. John's widespread influence on so many of us in reinsurance warrants this reading.

It was a privilege to have known John Culver Wooddy.

I first met John in one of several study groups that we shared while taking the Fellowship exams. At the time, John was an actuary for the American Telephone and Telegraph Company. As ever, John was a good-humored, active participant, very easily heard. On attaining Fellowship, John joined North American Reassurance Company where he spent the major part of his career. John was twice elected to our Society's Board of Governors and was also an Associate of the Casualty Actuarial Society.

John wrote an excellent on study note reinsurance, a subject he was most familiar with but also he was able to explain to students -- two faculties not often found together. Later, John wrote a study note on risk theory. I recall that John was concerned about treading a fine line between an adequate treatment and a note that could be understood by students not overly trained in statistical theory and studying on their own.

Some may recall when actuaries were concerned about how to approach the development of some measures of reserves for adverse deviations -- a subject still being investigated. As Chairman of the Committee on Theory of Risk, John guided the construction of a computer model of a stock life insurance company containing stochastic variables for mortality, lapse and market interest rates and even providing for income tax and dividends to stockholders. The model was quite detailed, realistic and, for its time, sophisticated. The model was run many consecutive times under various scenarios to develop estimates of adverse deviation reserves and was made available to members on a time-sharing basis. Results are available in Society publications.

The model was to be demonstrated at the Bal Harbor Society meeting by using a terminal and several monitors. When a hotel porter dropped the terminal, another was flown from New York, arriving only a short time before the session. As usual, John was unperturbed and prepared for anything -- the session went off without a hitch.

More recently, John was involved in the widespread use of Modified Coinsurance (Modco), which was intended to reduce the ridiculously large income taxes caused by a tax formula that was distorted by high interest rates. One result was a scrambling of company ranks by size; the other was a new tax law.

John was always a pleasure to be with, whether the occasion was business, a committee meeting or a social gathering. The latter would, of course, be enhanced if Lucy, John's charming wife, was there. Unfortunately, Lucy was seriously ill at the same time and died some months before him.

Interested in the international actuarial field, John Wooddy was not only a supporter of the International Actuarial Association but also Vice-President for the United States. John was in full and effective charge of his last international meeting, even though he required assistance onto the stage -- such was his intellect and strong will!

John Wooddy was a credit to our profession and an asset to the industry. He will be sorely missed by those who knew him, and those who come after will wish they had known him.

Even death could not stop John's dedication to his profession. His will provides for a scholarship fund for persons pursuing an actuarial science degree.

In addition, at Courtland Smith's suggestion, the John Culver Wooddy Fund has been established to provide a prize for actuarial research in reinsurance and the rationalization of the general process of assuming, segmenting and transferring risk. Prize fund contributions may be made to the AERF with a notation that the donation is for the Wooddy Fund and sent to the Director of Research at the Society office.

Nominations will be made by the Committee on Research on Theory and Applications and by the Reinsurance Section and then submitted to an awards committee. The first prize will be made in 1989 for work published in 1988.

On another matter, the Reinsurance Section developed "Guidelines for the Auditing of Administration and Reporting of Individual Life Reinsurance Assumed" as an official publication of the Section, and copies have already been distributed to members of the Reinsurance, Life Insurance Company, Financial Reporting, and Individual Life Insurance and Annuity Product Development Sections. We are publishing the document in the *Record* so that a permanent record exists in Society literature. This practical guide to conducting reinsurance audits is expected to be used widely throughout the industry as a guide and reference.

REINSURANCE SECTION BREAKFAST AND TEACHING SESSION

Guidelines for the Auditing of Administration and Reporting of Individual Life Reinsurance Assumed

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 The term "audit" is not used in its specialized accounting sense in this report. These guidelines include some auditing techniques which may be applied to the review of administration and reporting of reinsurance assumed.

SECTION MEETING

I. Introduction

This paper is a sequel to the Guidelines for the Reporting of Self-Administered Reinsurance dated January 1, 1986, and includes guidelines which are intended to apply to the administration and reporting of individual life reinsurance which is covered by a treaty or other written agreement between the ceding company and reinsurer. In the absence of a written agreement setting out the terms and conditions of reinsurance, the rights and responsibilities of the parties to the reinsurance may be so unclear that an audit as considered in this paper might be inappropriate.

Prior to the 1980s it was very rare for reinsurers to perform on-site audits of the records of ceding companies. For a variety of reasons, it is becoming increasingly common for such audits to be performed.

This paper includes a brief review of some of the developments which led to the need to conduct on-site audits. In addition, some suggestions as to the scope of audit are included along with some ideas on how to make the process efficient for both the ceding company and audit team.

Reviews of surplus relief or other financial reinsurance arrangements are outside the scope of this paper. Likewise, audits of activities such as underwriting which require speccial expertise and techniques not applicable to audits of administration and reporting are not covered by this paper.

A properly conducted audit should be beneficial to both the ceding company and the reinsurer(s) conducting the audit. Through such a process, each of the parties should become more familiar with the needs of the other and the problems encountered in trying to meet those needs. One anticipated result is a strengthening of the once traditional "gentlemen's agreement" nature of the reinsured/reinsurer relationship.

II. Traditional Method of Administration

Until recently, most ordinary life reinsurance in North America was administered under a traditional individual cession basis. The ceding company sent the reinsurer an individual "formal cession" or "application for reinsurance" documenting the details of each risk for which reinsurance was sought. In turn, the reinsurer created a "reinsurance guarantee" or "reinsurance certificate" which was sent to the ceding company as written evidence of acceptance of the risk by the reinsurer.

The reinsurer maintained its own records as to risks reinsured based on the details contained in the formal cessions received from ceding companies. With this basis of administration, reinsurers rarely found it necessary to inspect the records of ceding companies for a variety of reasons including the following:

1. The reinsurer sent monthly premium statements which were expected to be reviewed by the ceding company to identify any cases which had lapsed or been amended;

2. Annual in force and reserve listings would typically be sent to each ceding company for comparison with its records to assure that the reinsurer was carrying appropriate cessions in force;

3. Except for certain requirements, such as jumbo limits, formal cession details normally permitted the reinsurer to verify that treaty provisions were being met as to qualification for automatic cession, etc. (e.g., letter of alphabet, amount retained, plan of insurance, mortality classification); and

4. Facultative cessions were documented by a formal exchange of documents to support the reinsurer's acceptance of risk.

Reinsurers' concerns about ceding companies' internal controls over reinsurance ceded are minimal under the traditional individual cession basis of administration for reasons set out above. They are not, however, nonexistent.

It may well be that a ceding company whose reinsurance is administered solely on an individual cession basis will require an audit. The need to such an audit may be come evident in a variety of ways (e.g., from late-reported transactions or details of a claim). Specialized audits such as claims or underwriting audits which are not considered in this paper may be little affected by the basis of administration.

III. Development of the Need for Audits

A. Self-Administration

Self-administration of reinsurance ceded has become very common in recent years. Several reinsures have reported that over 50% of their business in force is self-administered by ceding companies, and the proportion seems to be increasing. Some of the factors influencing the shift to self-administration are as follows:

1. The development of flexible-premium, variable-benefit products resulted in reinsurance administration by traditional method becoming unwieldy;

2. The development of interest-sensitive products led to more sophisticated data processing systems for policy administration, with increased capabilities to provide reinsurance reporting as a by-product of routine processing;

3. Premium rate levels have continually declined in recent years, putting pressure on insurers and reinsurers to price for every lower per-unit expenses; and

4. Reinsurers sometimes provided more attractive allowances to ceding companies who agreed to self-administer their reinsured business. This is becoming less common, largely because both ceding companies and reinsurers are finding that self-administration may not be as efficient and cost-effective as it was once thought to be.

The widespread shift to self-administration of reinsurance resulted in the transfer of considerable control over various reporting activities from reinsurers to ceding companies. The reinsurer may not maintain a database for individual risks reported on a self-administered basis. Ceding companies find that they are not always able to provide information on individual risks in a format consistent with the reinsurer's needs. The result is that reinsurers typically have somewhat limited access to the details of individual risks.

Another effect of the changes in administration is that reinsurers have lost some control over the timeliness of their own reporting because they may have to wait until reports are received from ceding companies before their own reports can be prepared.

B. Other Factors

Naturally, reinsurers have always been interested in the timeliness, completeness, and accuracy of the details of reinsurance assumed. Prudent business judgment dictates that a reinsurer take reasonable steps to assure that adequate information is received from ceding companies or other responsible parties such as brokers and intermediaries.

Besides the shift to self-administration, other factors have led reinsurers to expand their activities to assure that the internal controls of ceding companies (as they affect reinsurance ceded) are adequate. One of the main factors has been the increase in complexity of placing reinsurance; some of the reasons for this are as follows:

1. Reinsurers may differ by plan and/or pricing classification;

2. Reinsurers may change over time for a given plan as treaties are renegotiated;

3. Exchange or replacement problems have led to confusion about how to reinsure replacement policies;

4. Extreme price competition among reinsurers has led some companies to reduce their retention limits on selected (typically term) plans; and

5. Rapid development of new products (e.g., interest-sensitive plans, cost-of-living adjustments, flexible- or indeterminate-premium plans or variable life plans) has outstripped the ability of ceding companies to get administrative systems in place to support these products so that, in many cases, reinsurance administration has received little or no support.

Because of the complexity of placing reinsurance, the subject of controls over reinsurance ceded or assumed has attracted attention from auditors, regulators, and shareholders. This has resulted in actions by the following groups:

1. The American Institute of Certified Public Accountants (AICPA) issued in November, 1984, a <u>Statement of Position</u> (SOP) on <u>Auditing Life Reinsurance</u>;

2. The National Association of Insurance Commissioners (NAIC) became increasingly interested in various aspects of reinsurance and established a Reinsurance and Antifraud Task Force which developed a Model Law on Credit for Reinsurance. In addition, the NAIC has developed a model regulation on surplus relief agreements and has formed a Study Group on Life Reinsurance that reports to the Accounting Practices and Procedures Task Force; and,

3. The Foreign Corrupt Practices Act of 1977 amended the Securities Exchange Act of 1934 to require all publicly held companies to maintain accurate records and adequate systems of internal control. This places an added burden on the management of those publicly traded insurance companies who engage in significant reinsurance activities. Those insurers who assume business from a ceding company under self-administration arrangements appear to have an added obligation to ensure that the controls used by the cedant in preparation of the reports are adequate.

The AICPA's SOP on Auditing Life Reinsurance, in conjunction with the other factors discussed above, focuses considerable attention on reinsurance arrangements and seems to make it almost mandatory for a reinsurer to perform on-site audits of some ceding companies. For example, paragraph 22 of the SOP states that "The absence of adequate procedures by the assuming company to obtain assurance regarding the accuracy and reliability of data received from the ceding company, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the assuming company's system of internal accounting control."

Typically, a reinsurer's large accounts, especially those which are self-administering reinsurance ceded, will most likely be candidates for on-site audits based on SOP. Other reasons to audit may include recent adoption of self-administration by a particular company, prior audit experience, system changes, or changes in management or staff.

IV. Terminology: Audit or Review

The public accountant views the terms 'audit' and 'review' very specifically. An audit is an examination of financial statements in accordance with generally accepted auditing standards for the express purpose of giving an opinion on the fair and consistent presentation of those statements. A review has been defined by the Auditing Standards Division of the AICPA in their Statement on Standards for Accounting and Review Services issued in December, 1978, and is significantly narrower in scope.

The procedures discussed in the writing of this paper are designed so that they may be performed by the staffs of the insurance companies involved and as such are not a true audit. Auditing techniques, however, are useful for helping to determine that all parties are properly complying with the terms of the reinsurance agreement.

A ceding company being audited should discuss any concerns it may have about terminology with the reinsurer conducting the audit. Naturally, the parties involved may agree upon whatever terminology convention they find most acceptable. Nevertheless, for convenience, the term "audit" is used in this paper to refer to the overall process of inspecting a company's reinsurance procedures, controls, and records.

V. Purpose of Audit

So far, we have described the general concerns which led to an increased interest in having reinsurers perform on-site audits of ceding companies. Each reinsurer wants to be sure that it is receiving all the reinsurance it is supposed to be getting, but only that which it should receive, that the reinsurance received is proper, that the correct premiums and allowances are paid, and that claims are paid only on valid, in force cases. Some specific goals for the audits are set out in this section:

1. Ascertain that all transactions are accurately recorded, properly valued, and reported in a timely manner;

2. Verify that both the ceding company and the reinsurer have a mutual understanding of the terms and conditions of the applicable treaty covering the reinsured policy;

3. Educate the reinsurer as to the day-to-day problems encountered by the ceding company in attempting to comply with treaty terms and conditions;

4. Review the ceding company's internal controls to assure that treaty terms and conditions are being followed;

5. Where confusion exists, clarify the ceding company's interpretation of treaty terms by reviewing the application to specific cases;

6. Assist the ceding company by providing a relatively objective review of systems and procedures by an interested party;

7. Establish a dialogue between ceding company and reinsurer to provide a framework for resolving misunderstandings which may arise from time to time;

8. Satisfy the management needs of both the ceding company and reinsurer to gain reasonable assurance that appropriate systems, procedures, and controls governing reinsurance administration are in place; and

9. Satisfy external auditors and regulators that the reinsurance relationship is functioning as intended, with appropriate controls to identify and correct administrative problems in a timely fashion. These controls should be of both a detective and a preventive nature.

Most reinsurer audits will pertain to reinsurance administration and will be general in nature. Occasionally, it may be necessary for the reinsurer to conduct a special purpose audit not covered by the guidelines in this paper. The scope of audit and audit procedures employed should be tailored to the particular purpose of such an audit.

VI. Scope of Audit

The reinsurer's audit is designed to permit a reasonable evaluation of a ceding company's internal controls over the receipt and initial set up of cases, including changes, and the related determination of the need for reinsurance. Although the audit will normally be restricted to an examination of ceding company records, systems and procedures which have a direct impact on the administration of reinsurance ceded, this may involve almost every aspect of the ceding company's policy issue and administration systems as well as claims administration. Where transactions affecting reinsurance involve processing with an EDP system, testing of input, processing, and output may be necessary.

Because of the potential exposure of the reinsurer due to actions or inactions of the ceding company's agency force, some reinsurers will want to review the ceding company's agency operations. The reinsurer will have an interest in the ceding company's attitude toward an agent that makes significant mistakes or intentionally takes positions adverse to the company and whether agents are required to maintain errors and omissions coverage.

It has to be appreciated that not all ceding companies and reinsurers will agree upon the interpretations to be given to specific treaty wordings. Similarly, there is not yet universal agreement in the life insurance/reinsurance industry as to how certain transactions are to be administered.

Because of the differing practices adopted by ceding companies and reinsurers, the scope of audit set out below may need to be modified in some respects to suit a particular situation. For example, the criteria for distinguishing new business from continuation policies may need to be worked out between the ceding company and reinsurer.

Most reinsurers do not want their audit teams to be put in the position of negotiating terms or conditions of reinsurance. Thus, the auditors typically are not authorized to make final decisions as to how particular transactions should be handled or how treaty terms are to be interpreted.

Accordingly, if a finding involves a financial adjustment or a significant question as to interpretation of treaty terms, the audit team will be expected to defer to its management to evaluate the situation and discuss the matter with the appropriate members of the management of the ceding company.

Specific items to be reviewed will typically include the following:

1. Reinsurance Agreements

    a. Provisions are maintained on a current basis

    b. Ceding company's and reinsurer's agreement files are consistent

    c. Essential details are disseminated fully and in a timely fashion to employees responsible for reinsurance administration;

2. New Business Policies Requiring Reinsurance

    a. Issued only in accordance with written company guidelines

        (1) Issued per underwriting classification (including any required Aviation Exclusion or other endorsement)

        (2) Issued in accordance with the proposed insured's signed Application for Insurance

        (3) Initial premium received

        (4) Appropriate nonsmoker or other declarations signed by proposed insured

        (5) Conditional receipt rules being followed

b. Allocated appropriately to each reinsurer

(1) Routed to appropriate person or department for processing

(2) Identified whether or not overall retention is exceeded on the current policy

(3) Confirmed that proper retention amount is kept (e.g., for automatic reinsurance requirements);

(4) Recorded properly in reinsurance in force, premium billing, and valuation files

(5) Followed facultative submission requirements (and any additional requirements of the reinsurer)

(6) Followed automatic and jumbo limits

(7) Reported to correct reinsurer in a timely manner

3. Changes to Policies In Force

a. Reinsurer notified in a timely manner

b. Conversions, exchanges, reissues, rollovers, reinstatements, reentries, or other changes reported in accordance with the reinsurance treaty. Such changes are commonly categorized as either

(1) Continuation to be reported to the original reinsurer, even if that reinsurer is not a reinsurer for current new business; or

(2) New business to be reported to the current reinsurer for the plan of insurance.

Questions which may be involved in deciding whether a particular policy qualifies as new business for reinsurance purposes are

(a) Was appropriate underwriting performed?

(b) Is the new policy unmodified as to suicide and incontestability?

(c) Was a full first year commission paid to the agent?

(d) Was any required nonsmoker declaration or other preferred risk documentation obtained?

c. Appropriate reinsurer approvals obtained (e.g. the reinsurer may need to underwrite re-entries, reinstatements, or increases in amount)

d. Appropriate endorsements included in continuation policies

(1) Suicide provision

(2) Incontestability provision

(3) Other (e.g., Aviation Exclusion)

e. Policy changes supported by appropriate forms signed by policyowner

f. Terminations documented

g. Changes to Extended Term Insurance (ETI) or Reduced Paid Up (RPU) properly reported to the reinsurer, and consistent with policy form and any policy loans outstanding (the needs here will vary by type of treaty and whether or not the reinsurer participates in policy loans or surrender values).

h. Contractual increases or decreases, such as COL adjustments, applied correctly

i. Recaptures made according to the treaty;

4. Claims (may be evaluated prior to audit)

a. Prompt notification given to the reinsurer

b. Appropriate details supplied to reinsurer

c. Reinsurer's approval obtained (if required) before claim is settled;

5. Valuation Reports

a. All in-force reinsured cessions are included in the reserve listing

b. Totals agree with reports to reinsurer

c. Valuation factors and methods are appropriate (different factors or methods may apply to reinsurer); and

6. Reinsurance Billings

a. Proper calculation of premiums, allowances, etc.

b. Proper payment of renewal premiums or allowances

c. Timely payments to reinsurers

d. Adequate controls on cash payments to assure that payments are consistent with amounts reported as due

e. Adequate control of accounts receivable or payable items.

Although Financial or Management Control Reports may be outside the scope of an administrative audit, some reinsurers will find it convenient and appropriate to obtain and review such documents as part of the audit. The reports to be reviewed might include any or all of the following:

1. Insurance Department Examination Report
2. Independent Auditor's Report
3. Internal Audit Reports
4. Letter relating to the adequacy of internal accounting controls filed with regulatory authorities
5. Annual Statement (Convention Blank)
6. NAIC Early Warning Test
7. GAAP Financial Statement

VII. Preparation for Audit

Many steps can be taken by both the ceding company and reinsurer prior to the on-site audit to help minimize the amount of time spent in the offices of the ceding company. By performing as many of the required steps as possible in advance, the disruption of the ceding company's routine and staff can be kept to a minimum.

A. Setting the Audit Date

The date and duration of the audit should be set well in advance. For the convenience of both the ceding company and reinsurer, a lead time of as much as two or three months could be desirable.

It is important to time the audit so that appropriate ceding company personnel will be present. To the extent possible, the timing of the audit should be at the convenience of the ceding company. Factors such as valuation periods, the extent of the audit, and vacations need to be allowed for.

Reinsurers may find it desirable to establish an audit date by informal discussions between the reinsurer's marketing representative and appropriate personnel at the ceding company. Once the date has been set, reinsurer personnel involved in the audit may then take over and follow up with various details involved in conducting the audit.

B. Audit Preparations by the Ceding Company and the Reinsurer

The reinsurer's audit team will need to be selected. Some reinsurers have staff permanently assigned to do reinsurance audits as part of the internal audit function (typically including CPAs under the direction of the President, Treasurer, Controller, or possibly the Board of Directors). Such staff may need to be augmented by personnel drawn from other areas of the company.

For example, it is common to include individuals from the Reinsurance Administration and Actuarial staff. Depending upon the nature of the audit and any special problems encountered or anticipated, it may be appropriate to include Claims or Underwriting staff on the audit team.

It is also important that the reinsurer send in writing to the ceding company the audit objectives as well as the items and procedures they will want to look at. This type of communication should minimize the confusion and discomfort the ceding company may have about being audited.

The reinsurer may find it helpful to prepare a summary of the basic details of the treaties covering the business to be audited. It could be helpful to send a copy of such a summary to the ceding company for their review. Not only is this a possibly helpful tool for the ceding company, it may facilitate early identification of any areas of misunderstanding of treaty terms.

The audit process can be further facilitated if the ceding company will send the audit team any written documentation setting out the general procedures, work flow and controls of the ceding company applicable to reinsurance administration. This will permit the team to focus more quickly on details and take up less of the coordinator's or other ceding company staff's time in becoming familiar with the administration system.

It is also helpful to have the ceding company send any necessary Financial and Management Control Reports to the audit team for its review prior to the on-site audit.

Some of the audit steps are best performed in the offices of the reinsurer prior to the on-site audit. For example, it may be possible for the reinsurer to verify most calculations of amounts at risk, premiums, allowances, bonuses, and chargebacks from the reports submitted by the ceding company.

Such a review should identify any systematic errors (EDP, or otherwise) that may be occurring. This early identification of calculation or other systematic problems will enable the audit team to quickly focus on problem areas during the on-site audit.

Another way to speed up the actual audit process is for the ceding company to give the audit team a set of sample forms identifying the fields which are relevant to reinsurance. The set could include, for example, various forms likely to be encountered in the policy files such as policy status sheets (showing status of policy according to the computer records) or underwriting worksheets showing the status of prior policies and the allocation of reinsurance on a current policy.

Depending on audit objectives, a sample of policy files to be reviewed should be made by the reinsurer prior to the audit. Such a sample would typically be drawn from self-administered reports submitted by the ceding company and might include the following:

1. A variety of plans of insurance

2. Different years of issue

3. Different transaction types such as

    a. New business

b. Terminations

c. Reissues/reinstatements/exchanges/conversions, etc.

d. Increases/decreases in amount

e. Claims (Life, WPD, ADB, etc.)

Most reinsurers make some effort to select the sample on a random basis. In addition, the sample size may be determined statistically based upon the amount of business covered by the treaty(ies) according to the ceding company reports. Naturally, if particular problems have been noted in the self-administered reports or on individual cessions, the sample selection may include more of the transactions in question than would arise from a purely random selection process.

Working exclusively from reports submitted by the ceding company may permit confirmation that reported cases are administered properly but cannot establish whether or not all cases are being properly reported. Accordingly, most audits will involve further samples selected on-site, possibly including a sample of cases drawn from the direct insurance master records of the ceding company.

If possible, the samples should be available in both alphabetical and numerical (by policy number) order. Some companies find it more convenient to access their files alphabetically while others prefer to utilize policy number.

The policy sample should be sent to the ceding company at least one or two weeks in advance of the audit. This gives the ceding company adequate time to pull the policy files requested (or any associated policy files which might affect the placement of reinsurance) without significantly disrupting normal operations.

C. Logistical Considerations

1. Audit Team: It is convenient for both the ceding company and reinsurer to know who will be involved in the audit. Where possible, the reinsurer should give the ceding company advance notice of who will be on the audit team and identify the team manager for purposes of coordination between the ceding company and the audit team.

2. Ceding Company Coordinator: Similarly, the audit team needs to know with whom it will be working at the ceding company. It is expected that contacts with ceding company personnel will be coordinated through one individual assigned as coordinator and who would also provide access to policy registers (e.g., new issues, terminations, changes, claims) or other records as needed.

The audit team should make it a point to know the name, location, and telephone number of the ceding company's coordinator and respect the wishes of the ceding company which may require that all staff contact be made through the coordinator. Ideally, there should be a deputy coordinator to be contacted in case the principal coordinator is unavailable (e.g., due to sickness or other business).

3. Access to Office: It will be necessary for the team members to know the usual office routine. For example, they will probably want to try to adhere to normal office hours. It may, however, be necessary for them to work before or after hours in order to get the job done. Accordingly, they need to know if work outside normal hours is acceptable to the ceding company and, if so, what special arrangements need to be made.

   If there are special security procedures to be followed, the team will need to be informed. There may be a need for security passes or for the team to have someone accompany them while on the ceding company premises (either at all times or outside normal office hours).

4. Access to Records/Files: It is important for the audit team to know the forms in which the ceding company records are kept (e.g., microfilm, microfiche, paper file, on-line computer record) and to have appropriate means of accessing those records. (e.g., microfilm reader, microfiche reader, video display terminal). If required access devices are not available, the audit team will have to provide its own.

   The ceding company may wish to limit the degree to which the audit team has access to records. There may also be some concerns about the audit team making hard copies of ceding company records. These issues should be resolved early on, preferably long before the audit commences, so that there will be no misunderstanding about these important activities.

5. Other Items: Other minor points ideally should be addressed in advance of the audit. Most audit teams expect to provide their own (usually portable) calculators; however, desk calculators are most convenient to use and some ceding companies choose to make them available to the audit team.

   The audit team will have frequent need to contact the coordinator. For this reason it would be most convenient to have access to at least one telephone.

   Naturally, the audit team will expect to make its own arrangements as to accommodations, meals, and travel. In special circumstances, the ceding company may find it desirable to advise the audit team.

VIII. Performance of the Audit

A. Initial On-Site Meeting

It is important for the on-site audit process to begin with a meeting of the audit team with ceding company personnel who will be involved with the review process so they can get to know each other. In addition, a discussion about how the audit will proceed in line with the audit objectives sent earlier and the basic steps to be taken will help to alleviate any misgivings about the review process.

At this time, the logistical considerations can be reviewed and the team will be assigned to a work space. In order to acquaint the audit team with the environment in which they will be working, some ceding company coordinators may find it worthwhile to give the team a brief guided tour of their offices or other facilities.

This initial meeting is probably a good time to set up a closing conference to be held at the end of the on-site audit. Naturally, the duration of the audit may not be fixed, so the meeting time may have to be revised as circumstances warrant.

B. Interviews With Ceding Company Personnel

Interviews with ceding company reinsurance administrative personnel will help the audit team gain an understanding of the general nature of the reinsurance administration and document flow. In addition, it may be helpful to interview selected key personnel involved in overall insurance administration to help gain an understanding of the way the company administers its direct business and evaluates that business for reinsurance administration purposes. These interviews should be controlled by the company coordinator.

C. Overview of Administrative System

A good starting point for the audit itself is to trace the physical flow of paperwork associated with underwriting and issue of new business. This may be accomplished by reviewing the written workflow provided by the ceding company prior to the audit. Another possibility is to have a "walk-through" of the path followed by various transactions as they relate to ceded reinsurance.

This will usually give the team a good overall picture of how the administration system works in general, and will help them to know where to look for appropriate controls. Some audit teams find it helpful to create a simplified flowchart of the administrative system and have this reviewed by ceding company staff to assure that the audit team's understanding of the system flow is essentially correct. The extent to which such a flowchart is needed depends in part upon the documentation provided by the ceding company.

The basic steps involved in policy issue can be observed in brief. For example, the usage of an alpha index or similar controls for verifying previous in force will be seen in the walk-through should this take place.

D. Further Sample Selection

Depending upon audit objectives, audit teams may want to select additional samples on-site to supplement those previously selected from the reports submitted by the ceding company. This may include samples drawn from a recent verifiable in force or reserve listing, a new business register, a claims register, or a terminations/changes register.

By making these sample selections early in the audit process, the ceding company staff can be assured of having adequate time to retrieve the appropriate policy files or other documentation.

E. Specific Review Assignments

In order to speed up the review process, audit team members may be assigned specific tasks to be undertaken concurrently. For example, one member may review treaty documentation while others are working on the system flowchart or selecting samples of new business or terminations/ changes. The review of claims may also proceed separately from the review of individual policy files from the initial samples.

F. Peer Review

Insurance/reinsurance transactions have become very complicated in recent years. Some reinsurers have found it helpful to have audit members cross-check each other, at least on a number of cases, to make sure that they agree on their interpretation of the documentation and the application of treaty terms to specific cases and to assure that all recorded notes are both legible and intelligible.

G. Noting Discrepancies

It is recommended that detailed notes be made of any apparent discrepancies that are found. These will be helpful for further research or for discussion with the company coordinator.

The audit team should review and summarize the types of discrepancies found. This summary will be needed for discussion with the company coordinator, both in the course of the audit and in the closing conference to be held later.

It is desirable for the audit team to thoroughly review its findings in time to permit follow-up of any loose ends before the closing conference begins. It is helpful to have any audit findings summarized in approximately the same order as the scope of audit which itself may be taken as a rough guide for both the closing conference and the audit report.

H. Closing Conference

It is important to have a "wrap up" session or closing conference so that the audit team can discuss its findings with the ceding company. It is strongly recommended that the company coordinator arrange to have as many as possible of the people involved in the audit attend the conference which will help minimize the likelihood that the ceding company will be surprised by any of the findings reported in the audit report.

In addition, it may be that the audit team has misunderstood some documentation or procedure. By reporting and discussing what it perceived as "discrepancies," the audit team assures the ceding company staff of having an opportunity to correct any such misperceptions in a timely fashion.

The conference may also cover any plans the ceding company may have for correcting any discrepancies found or for strengthening internal controls where necessary.

If not already arranged, it may at this time be decided to whom the audit report or summary letter will he submitted (original or copies). Normally, someone at the ceding company (typically the company coordinator) will want to review a draft audit report or summary letter before a final document is submitted to avoid unnecessary surprises. The final document is typically addressed to the ceding company's management.

I. Other Audit Procedures

Other actions might be taken by some reinsurers. For example, it might be arranged for the reinsurer to obtain information from the ceding company's external auditor about steps taken by the auditor to confirm directly with policyholders information in the ceding company's in force policy files. This could save considerable duplication of work and effort. This information would be obtained through the company coordinator.

If suitable arrangements cannot be made to obtain assurances that the policy files have been adequately confirmed, some reinsurers may want to undertake an independent verification of policyholder information contained in the ceding company files and used as a basis for self-administered reinsurance. Such a measure would be somewhat unusual because the treaty is between the ceding company and the reinsurer who has no direct relationship with the policyholders, and could normally be undertaken only with appropriate ceding company permission and cooperation.

It may also be desirable for the reinsurer's audit team to meet with the ceding company's internal auditors to review the steps they have taken to confirm the adequacy of reinsurance systems and procedures and the reliability of information in the policy files.

IX. <u>Audit Report</u>

The draft report should be prepared as quickly as possible after the audit. Invariably, some important points found or discussed will not have been reduced to writing; therefore, timely preparation of the audit report will maximize the likelihood that all important findings will be reflected in the report.

Some reinsurers prefer to address the audit report to their own management. They may send a copy of the formal report to the ceding company or, instead, they may send a letter summarizing the findings of the audit.

The draft report or summary letter should be submitted to the coordinator of the ceding company for review and comments. There should be some agreement on the time frame for reviewing the draft report.

Once the comments of the ceding company have been received and considered, the audit report can be put in final form. The report should then be submitted as agreed. The distribution of the report needs to be done with the approval of the ceding company.

As a rule, the audit report will stress the findings of the audit and should at least be copied to someone at a senior management level in the ceding company. In some cases, however, it may be appropriate to include reasons why certain things were done so as to avoid unnecessary questions and to put findings in the proper context.

The final audit report will probably contain a disclaimer to clarify that the audit may not necessarily disclose any or all material weaknesses in the ceding company's reinsurance administration systems and that the identification of, or failure to identify, specific problems or errors in any of the policies included in the review does not alter any of the terms or conditions of the governing reinsurance agreements.

X. Follow-Up to Audit

If the audit is to be of the greatest possible value to both the ceding company and reinsurer, there should be a definite plan for following up the findings and recommendations of the audit. This might involve having the reinsurer's marketing representative keep in touch on a regular basis with the ceding company to ascertain that appropriate steps are being taken to correct any deficiencies, strengthen internal controls, etc.

Sometimes, audits lead to a need to revise treaty terms or conditions. For example, it may be found that it is not feasible for the ceding company to meet some treaty requirements. If that is the case, it may be possible to change the arrangement to put it on a more workable basis with requirements that the ceding company will be able to fulfill.

XI. Alternatives to On-Site Audits

Ceding companies frequently ask if there is anything they can do to eliminate or minimize the need for audits by reinsurers. For some companies, especially those which reinsure large volumes of reinsurance on a self-administered basis, there will be an ongoing need for reinsurer audits.

The frequency of such audits may, however, be reduced if current audits indicate that the ceding company has adequate procedures and controls to assure that policies requiring or involving reinsurance are properly identified and reported to the reinsurer in a complete, accurate, and timely manner. Obviously, if the company is seen to be doing a very responsible and thorough job in its reinsurance administration, the reinsurer will be inclined to spend its resources auditing other companies where the track record may not be as good. Such a demonstration might be made by sharing a copy of the audit report made by another reinsurer.

A. Audit Reports

Some reinsurers would be willing to have ceding companies conduct "self-audits" or quality control reviews and report the results to the reinsurer. Another method of supplying this information is through actuarial certification of reserves and in force. These reports would not replace reinsurer audits entirely, but could help reduce the frequency or extent of reinsurer audits by providing assurance that the ceding company has an ongoing program for reviewing its reinsurance administration.

A ceding company might find it helpful to obtain special letters or reports from its external auditors or state examiners covering the ceding company's reinsurance administration. If such letters or reports indicate that the ceding company has adequate internal controls over reinsurance ceded, the reinsurer may be able to defer or even forego an on-site audit.

Each of these sources must be reviewed in the light of the purpose served and the expertise with which each was executed. In any case these audits should not be relied upon solely.

B. Electronic Data Transfer

At least one reinsurer utilizes a procedure whereby the ceding company supplies the reinsurer with an abbreviated copy (e.g., on magnetic tape) of their entire policy masterfile. The reinsurer then combines all policies on the same insured, based on name and birthdate, and compares the total face amount to the retention of the ceding company as of each policy date.

If the sum of policy amounts is greater than the ceding company's retention and there is no reinsurance indicator, a listing of these policies is then printed out to be checked by the ceding company. If jumbo policies are involved they should be checked to make sure they were submitted facultatively.

If the sum of policy amounts is within the ceding company's retention but there is a reinsurance indicator, this information is also listed and reported to the ceding company. These cases should be checked to reconcile the apparent inconsistency.

If the ceding company denotes reinsurance by reinsurer, it is possible to compare all the policies that are reinsured against the reinsurer's records. The comparison is based on the ceding company's policy number. The reinsurer checks to make sure that each policy shown as reinsured with them is on its reinsurance masterfile, and any policy on its masterfile is also shown as an active policy on the ceding company's file. The reinsurer indicates discrepancies for the amount issued by the ceding company, birthdate, policy date, and name of insured and reports this information to the ceding company for further investigation and appropriate corrective action.

XII. <u>Joint-Reinsurer or Shared Audits</u>

There may be situations in which consideration should be given to the possibility of reinsurers sharing in an audit of a ceding company. The most common situation involves reinsurance pools. The audit can take the form of either two or more reinsurers providing personnel to make up a single audit team (joint-reinsurer audit), or one reinsurer undertaking the audit of a ceding company on behalf of all interested reinsurers and supplying the results directly to them (shared audit).

Some of the advantages of joint-reinsurer or shared audits include the following:

1. Convenience to the ceding company (by reducing the number of on-site audits);

2. Expense savings, primarily for the reinsurers but, to some extent, for the ceding company as well; and

3. Increased likelihood that the several reinsurers will adopt consistent interpretations of treaty wordings which may not have originated with any one of them.

There can be distinct disadvantages to joint-reinsurer or shared audits; some of them are as follows:

1. There may be issues regarding impermissible sharing of information between competitors (this is probably not significant if the only connections among the reinsurers and the ceding company relate to a common reinsurance pool);

2. Some reinsurers may not wish to rely upon the standards and care used by another reinsurer conducting an audit; and

3. If the lead (or other appointed) reinsurer performs an audit and reports to other reinsurers, there may be issues of (1) liability as to any problem not identified, and (2) disputes with the ceding company as to any negative comments communicated to third parties.

In many cases, the reinsurers may have agreements with the ceding company other than a pool agreement. If so, the reinsurers may have very different points of view about the significance of specific findings. For example, one reinsurer may have an ongoing relationship for reinsuring new business while other reinsurers may have only "runoff" agreements. In addition, some reinsurers may be reluctant to have the specific terms and conditions of their agreements, including various exchanges of correspondence, shared freely with other reinsurers.

Given the potentially serious concerns associated with joint-reinsurer or shared audits, such an undertaking should be approached very carefully. Good communication among all the parties involved in such an audit is a must.

The subject of joint-reinsurer or shared audits may, if sufficient interest is identified, be the subject of a separate paper.