

A school of sharks swimming in deep blue water. The sharks are silhouetted against the blue background, with some showing their dorsal fins and gills. The lighting is dim, creating a mysterious and somewhat ominous atmosphere.

Reinsurance Treaties and Audits

Results and Resolutions

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MARC's general approach to client audits (reviews)

Background – AICPA

Basic elements of a reinsurance treaty

The review process

How we deal with the results

AICPA Statement of Position in 1984

The reinsurer must have internal accounting control procedures regarding assumed reinsurance and those should describe the related auditing procedures necessary for

- assessing the accuracy and reliability of data received from the ceding company, and
- visiting the ceding company and reviewing and evaluating its underwriting, benefits processing, and actuarial policies and procedures.

The accounting firms began to look at the topic in the mid 1980's when ceding companies began to self report the business. Moving away from cession based reinsurance

The AICPA adopted the following in 1984. There are similar provisions that deal with how the ceding company should look at their reinsurers.

We have been audited by our clients,
we supply you with our financial information, and will provide financial accounting for our treaties

Reasons to perform audits

Outside auditors require it

State examiners require it

Good business demands it

Since 1985, MARC has performed almost 500 audits.

KPMG will review our files to see who has been audited, and our processes for determining who gets reviewed

The State of Georgia includes a review of our audit program and will comment upon it in their findings

We need to know what is included, and what is omitted from our financial reporting. Items such as IBNR, and accruals for unreported business demand that we know what is, and more importantly, what is not reported.

We have some obligation to verify what we have been told or sent, particularly in a Sarbannes-Oxley world.

What is MARC trying to accomplish?

- assess the accuracy and reliability of data
- review and evaluate the ceding company's underwriting and benefits processing procedures
- understand the way you handle your business
- communicate any areas MARC believes can be improved or which differ from MARC's expectations

The data provided by the ceding company feeds our valuation, and projection systems

We will look at

- plan codes
- Issue ages
- Benefit and elimination periods
- Issue dates

There will be a review of internal processes to determine

- the likelihood of unreported new business
- Late reported lapses

We will compare actual underwriting and claims practices with the information in our files and records.

These are required by the AICPA, but more importantly

We will try to understand the work load, approval authorities, and internal control processes for your operation, Similarly the systems constraints and general corporate culture of your operation

We want to communicate any areas where we may have concerns in the business being reinsured

Key treaty provisions that we refer to in a review

Article 2	Automatic Reinsurance
Article 6	Premium Accounting
Article 8	Exchanges and Replacements
Article 9	Claims
Article 13.4	Inspection of Records

Everything we do must have a basis in the treaty.

We feel that the treaty remains a gentlemen's agreement, but that it is the documentation of the basics of that agreement

The articles referred to above are out of our standard treaty template, which should have been handed out, your agreement may differ in some respects, and your treaty would govern how we look at things.

I will refer to the specific language later, so you may want to follow along with the handouts.

- Automatic reinsurance outlines the basic conditions of the reinsurance
- Premium accounting describes what is paid and when it is due
- Exchanges and replacements are especially important with DI and LTC policies as the policies tend to get upgraded over time. This provision should clarify which policies/exchanges/increases are reinsured with MARC, and which are not
- The claims article will deal with the reporting of claims and the method that claims will be adjudicated

13.4 Inspection of Records

This article gives both companies the right to review.

13.4 Inspection of Records

MARC and the Ceding Company, or their duly authorized representatives, will have the right to inspect original papers, records, and all documents relating to the business reinsured under this Agreement, including underwriting, claims processing, and administration. Such access will be provided during regular business hours at the office of the inspected party.

This article is the basis of the audit process

It is a long standing treaty provision and has been around, relatively unchanged for the 30 years that I have been reviewing treaty language.

Article 2 Automatic Reinsurance

2.1 General Conditions

The Ceding Company will automatically cede to MARC new business as defined in Article 8.3 on the disability income insurance policies, supplementary benefits, and riders listed in Exhibit B issued on and after the effective date of this Agreement.

The automatic reinsurance provision is probably the most important treaty article. It describes what is covered by the treaty and what is not.

Policies not covered by this article cannot be covered by the Errors and Omissions clause, because they are not defined as part of the treaty

We'll go over it rather carefully, looking at the key terms

They are

New business as defined in article 8.3

Policies listed in Exhibit B

Must be issued on or after the effective date

Article 2 Automatic Reinsurance - continued

MARC will automatically accept the Reinsured Proportion for the above-referenced policies, benefits and riders provided that:

- a) The insured, at the time of the application, must be a permanent resident of the United States or Canada, and
- b) The Ceding Company keeps its retention, as specified in Exhibit A.

Continuing the same article

Key points are:

Permanent resident

And company must keep its retention

Article 2 Automatic Reinsurance – normal underwriting

MARC will automatically accept the Reinsured Proportion of the above-referenced policies, benefits and riders provided that:

- c) The Ceding Company applies its normal underwriting standards and guidelines in accordance with Section 2.3 of this Article,

2.3 Underwriting Standards

The parties hereby declare and agree that all policies, benefits and riders covered under this Agreement will be issued in accordance with the Ceding Company's normal underwriting standards and guidelines which are in effect at the commencement date of this Agreement. Any subsequent material changes or exceptions to the underwriting standards and guidelines will be subject to the approval of MARC in writing before being applied to policies and benefits to be covered by this Agreement.

Within the same article there is a general condition that normal underwriting is applied to the individual case

The article then goes on to state that the reinsurer must approve any changes to those standards

Why?

We base everything on your underwriting standards, and policy design and we trust you to follow them. If you need to change them due in any material sense, we should have the opportunity to look at the treaty to see if it should be modified, before we should be expected to be subject to those changes.

What are normal underwriting standards and guidelines?

Ceding Company's underwriting manual, application, limits, and procedures

Reliance on sound underwriting judgment

Ceding company must use due standard of care

Business exceptions, without underwriting justification, and errors are not considered "*normal underwriting*"

This tends to be a real key issue today. Hank George and recent on the risk articles on the topic

Not as difficult with individual health, because there typically is 1 or 2 reinsurers, and Ceding company retains a significant portion of the risk.

Included in the definition are the manual you use, the requirement that you have, your internal limits and procedures

We recognize that no two cases are the same, and realize that for the health lines there are many potential underwriting decisions such as exclusions, or reduced benefit periods, that judgment must be considered

We ask that the ceding company use an appropriate standard of care. What do we mean?

- that junior underwriters do not have approval authority for large or complicated cases
- That there are appropriate internal control procedures to prevent a "rogue underwriter"
- That the underwriters have the appropriate training to handle the types of risks that they underwrite

Decisions that do not have a sound basis in appropriate risk selection do not qualify under automatic coverage. We would gladly consult on these cases, and they should be submitted facultatively.

Automatic Reinsurance - Automatic Binding Limits and Participation Limits

MARC will automatically accept the Reinsured Proportion of the above-referenced policies, benefits and riders provided that:

- d) The total of the issued and applied for amount of insurance including contractual increases, on a risk does not exceed the Automatic Binding Limits and Participation Limits set out in Exhibit C,
- e) The application has not been submitted facultatively to MARC or any other reinsurer. Simultaneous or previous facultative submissions on one Product Type, as defined in Section 2.3 of this Article, will only preclude automatic reinsurance coverage on that specific Product Type.

Continuing the article on automatic reinsurance

- There is an automatic binding and participation limits, and cases exceeding that limit cannot be ceded automatically. MARC has its own retention to manage, and requires these limits

- And a case that has been sent facultatively cannot be submitted automatically. We allow that there are different types of disability products and that a facultative submission for a business overhead policy, would not preclude reinsuring a disability income product automatically.

Article 6 Premium Accounting

6.1 Reinsurance Premiums

Reinsurance premium rates and allowances for disability income insurance and other benefits reinsured under this Agreement are shown in Exhibit D.

6.2 Payment of Premiums

Reinsurance premiums are payable monthly and in arrears. The Ceding Company will calculate the amount of reinsurance premium due and, within ten (10) business days after the end of the calendar month, will send MARC a statement that contains the information shown in Exhibit E, showing reinsurance premiums due for that period.

The administrative audits will review the premium accounting

- Much of this work can be determined internally at MARC, but may be complicated by state variations and modal factors that cannot be reviewed offsite.

- We will try to see that all of the reinsured policies are being reported, and on a timely basis.

Article 8 Exchanges and Replacements

- 8.1 Original Policy is reinsured with MARC
- 8.2 Original Policy Not Reinsured with MARC
- 8.3 New Business

Again, there are a large number of policy exchanges and replacements for the individual health products.

The text in your treaties may be different from what is in your handout. But the article tries to identify which types of exchanges are reinsured under this treaty and which are not.

The definition of new business is also here and would typically include the 3 conditions

- Full new business underwriting
- New contestability clause
- Full first year compensation

Article 9 Claims

9.2 Proofs

The Ceding Company will promptly provide MARC with proper claim proofs at the initial reporting of the claim if the monthly claim amount exceeds the claim limit shown in Exhibit C.

9.3 Claims Management Standards

The Ceding Company's adherence to its claims management standards and guidelines is a condition precedent to the continuation of payments of reinsured claims under this reinsurance Agreement.

Key Points that we look at in this article are:

The prompt reporting of claims

And compliance with ceding company's standards

If the treaty has a limit on the amount of a settlement of a claim, we may review any reinsured settlements for compliance as well.

The review process at MARC

Much of the work is performed with data supplied by the ceding company

On-site audits chosen by account evaluation sub-committees

The people who work with your account also work on your audit

The leader of the audit is an officer

Most of the audit work is done internally and you don't see it, unless a question has been raised. Karen, Kathie and their people will look at the data, reports and claim files and contact your people if there are questions.

Describe MARC's AEC structure and the Individual Health Sub-committee.

Multi-discipline, audits based upon size of account, and time from last audit. Sometimes audit for cause.

Unlike other reinsurers, we use the people who work with account on a daily basis to audit. They know you, know your business and work with the reports regularly. They will write the reports, and know that they will have to deal with you later. MARC feels that this leads to a better, and fairer report.

The audit manager is an officer of MARC and has the background to understand the issues that might come up.

Audit Process

The sample is not random, we deliberately look at tough cases and early claims

We pick 100-200 recently issued policies to review

We have a closing conference to identify any preliminary issues we may have

A draft report is reviewed internally before being sent to the client

When we do an audit, we do not use a random sample, but try to focus on things that would more likely go wrong. Why?

We have a limited time and limited resources, so by focusing on those areas we feel that it is more efficient process. If another reinsurer uses a purely random approach they may have different parameters. It would not be uncommon for us to have a comment in our report.

We look at recent cases. Old cases do not give a view on the current practices. The number of cases is what we can handle during a 3-5 day time frame, and would be large enough to give us an indication of your practices. We cannot look at every case.

Before we leave your offices there should be a closing conference where MARC should give you an indication of any significant findings. A report, prepared under the direction of the officer leading the audit is reviewed by the sub-committee and committee before being sent to you.

Audit Process continued

The draft report will identify any recommended corrective action

The report will give you the opportunity to provide any additional information or additional points of view

Following this, a final report will be issued, which will include the ceding company's comments

In the report and cover letter we inform you of any suggested corrective action. Again, we do not want you to be misled. Don't want a "My cousin Vinnie".

The report is sent in draft form and invites your comments and any additional information that our team may have missed.

Often, when the comments, or information are received, the case or issue is removed from the report.

If not, your comments will be added along with ours so that everyone has a complete picture of any issues uncovered.

Resolutions

There may be some recommendations

- Improved processes or internal controls
- treaty amendments to cover items identified
- comments on underwriting cases
- Payment of proper underwriting assessment
- MARC may offer to take cases on a facultative basis
- Rarely will we ask a case to be removed

There is generally a recommendations section in the report. Those recommendations will be followed up by someone within MARC. The list of recommendations is not meant to be all inclusive, but illustrates some that we have used in the past.

In some cases there will be a recommendation of an improvement in internal control, such as a review that the policy is issued according to what the underwriting department intended

In other cases there may a recommendation to amend the treaty because the review shows that the intent and reporting are inconsistent with treaty wording. Such as amend the effective date, or add a policy form

There may be comments on underwriting cases where we would have handled the case differently. These are covered by the treaty, but serve to communicate our expectations.

In some cases we may ask to be paid the appropriate rate, particularly if the underlying policy was mis-rated.

We may take the position that the cases sited do not qualify as automatic reinsurance, e.g. auto bind violation, and ask to reinsure them facultatively

In rare cases we have asked the ceding company to fully retain the risk. This is usually a clear decline by the ceding company's own guidelines.

Overall comments

Better to resolve issues before claim

The resolution of review items helps serve as precedence

Talk with us if there is an underwriting stretch, or business decision

Documentation is often the difference between underwriting judgment and underwriting error

Communication!

Earlier I mentioned that reinsurance audits are good business.

It is our experience that it is much easier to deal with difficult issues before there is a claim. There are more options open to both parties to resolve the issue.

The resolution of open issues helps cement the partnership between the companies and leads to realistic expectations. It also can serve as a precedent in handling similar issues, because any audit only can identify a relatively few issues.

By having consultation on difficult cases and business decisions, there is no ambiguity of whether there is reinsurance in the case. Hopefully you find that our underwriting team is both knowledgeable and cooperative

Documentation of the reasoning used in a case can be crucial. Because after there is a claim it is much more difficult to reconstruct.

As in any partnership- Communication is the key to making it work. Neither party should simply assume that the other will go along. And both parties should continue to explain their expectations

Thank you! Are there any questions?

