

# The Reinsurance Underwriting Audit

**W**HILE MANY CHANGES HAVE TAKEN PLACE in the life insurance industry in the past 10 years, one item often overlooked is the shift in the location of the insurance risk. Direct writers are generally placing the mortality risk with a small number of reinsurers while retaining the investment risk and much of the expense risk themselves. What changes has this massive shift in insurance risk location meant for the enterprise risk management practices of the companies involved?

For direct writers, the financial stability of their reinsurer has taken on a higher profile. Reviews of reinsurer credit ratings are more common, and concentration of risk among reinsurers is a consideration now when it seldom was in the past.

For reinsurers, the changes in risk management practice are more extensive. Generally this has meant more auditing by reinsurers. Such audits have the potential to be advantageous to both parties when well planned and executed.

## The Underwriting Audit

Reinsurers and direct writers have always shared risks. While reinsurers are often able to assess these risks themselves, in many cases they rely on the assessment of the direct writer. As a result of this reliance, reinsurance treaties have contained clauses that allow the reinsurer to audit the work of the direct writer that relates to the reinsurance.

Audits are generally done in three areas of business: reinsurance administration, claims, and underwriting. While each of these areas has scope for judgment, the underwriting decision is the only one made before issuance of the contract and therefore isn't affected by the contractual provisions.

Other aspects of underwriting also increase its scope for judgment as many underwriting areas, such as preferred guidelines, aren't rigidly defined or applied. These aspects make underwriting an area where direct writers and reinsurers need to agree on practices. The audit is their main tool.

With the change from excess reinsurance to quota

share reinsurance agreements, the roles of direct writers and reinsurers in underwriting have changed. While reinsurers had traditionally relied on direct writers for underwriting, the reliance aspects changed when the balance shifted. Instead of direct writers keeping 80 percent to 90 percent on average, they now often keep only between 10 percent and 20 percent. This shift in the risk-bearing location of the business without any shift in the location of the underwriting decision-making has resulted in a large increase in the risk management actions of reinsurers in this area.

While various reviews of underwriting procedure can take place in advance of a reinsurance agreement, the main process in monitoring compliance with treaty underwriting terms is the reinsurance audit. This article de-



scribes the process of a reinsurance audit and the results of the underwriting audit program undertaken by our company in 2002.

## What to Expect from an Underwriting Audit

A reinsurance audit has three parts: preparation, on-site work, and reporting. During preparation, the auditor reviews the reinsurance agreements and the direct writing company policies already on file. Automatic policies are reviewed to determine a sample to be assessed during the on-site part of the audit. The sample could be a random

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selection or, more typically, is biased toward older ages, larger amounts, and rated policies.

Two to three weeks before the on-site visit, the list—probably 75 to 100 policies—is sent to the direct writer. Facultative cases and a few claims may be included in the sample to test procedures in these areas.

During the on-site portion of the audit, the auditors need access to the direct writer's underwriting records for the policies specified on the list. This usually involves system access via computer terminals. The on-site audit generally takes two or three days and involves one or two underwriters.

The on-site audit also involves a confirmation of general practices, including procedures for preferred strictness, waiving of requirements, and rules around business decisions. The auditor underwrites the cases that are being reviewed using the standards the direct writer uses. These might not be the standards the reinsurance underwriters use for their own work, but the audit is a check against the direct writer's standards rather than a check against standards the reinsurers may use in their own practice. Before the auditors leave, they should provide some verbal indication of their findings.

One area getting increased attention in underwriting audits is the accuracy of preferred assessments. The premium rate difference between preferred categories can be as significant as the difference between standard and rated policies. And more policies are affected by preferred differences, so the attention is understandable.

The main areas of review are the conditions to be met for each preferred classification and whether these were strictly adhered to in the underwriting process. Any company programs that might give underwriters latitude to make exceptions are also reviewed for compliance.

Deviations from standards depend on other favorable factors. Even in such cases, the changes should be well documented and low in number. Relaxation of standards without offsetting positive factors should, of course, be very rare.

The auditors should provide a written report to the company being audited. The report should be received within 60 to 90 days after the on-site work is complete. The report includes general findings, any recommendations or differences on the cases being reviewed, and a list of recommendations or required actions that have been determined as a result of the audit. A response is requested. Depend-

ing on the results of the audit, one of the recommendations might be for a future audit at a specific time.

#### What Is a Good Audit?

We recently surveyed a sample of direct writers to get their views on reinsurance underwriting audits.

There was general agreement that the areas of audit concentration should in-



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clude older-age business, substandard underwriting, and large face amounts. Eighty-nine percent of the companies felt that preferred criteria adherence was very important. Fifty percent of the companies felt that business decisions should be no more than 2 percent of the audit sample, and another 28 percent felt they should be no more than 4 percent. Eighty-seven percent of companies thought audits should be coordinated among reinsurers, although only 60 percent agreed that pool members could copy each other in on their audit results.

There was a large preference for having a standard audit format, especially for any scoring mechanism that might be used.

The majority of direct writers favor an audit every two years. This may have been influenced by the fact that two years was the longest time frame given as a possi-

ble response in the survey. We believe that most reinsurers would consider one audit every two years to be too long a gap between audits.

With most direct writers having agreements with four or more reinsurers, the number of potential audits can be significant. Efforts are under way to develop a coordinated approach to underwriting audits so an audit done by one reinsurer could be shared with other reinsurers on the same piece of business.

#### **Results of Swiss Re Audits**

During 2002, Swiss Re conducted numerous underwriting audits. At the time of this writing, 17 were available in enough detail to analyze. The average number of cases reviewed was 114.

In a large majority of cases, there was no difference in the assessment of the reinsurance auditor versus that of the origi-

nal underwriter. However, for every 100 cases reviewed, on average, the Swiss Re rating for all cases in total would have been higher by a total of 32 tables or 800 percent total extra mortality.

Of the 17 direct writers in this survey, there were four companies above the average and 13 companies below the average. The median value was 22 tables or 550 percent total extra mortality. For one policy, the Swiss Re rating would have been lower than the direct writer's.

The above rating differences are somewhat approximate since, in several instances, the reinsurer's rating would have declined while the direct writer quoted a specific number of tables. In these situations, a decline was treated as a rating of table 16. While samples biased to older ages and substandard ratings were present in the above group, the indication is that direct writers underwrite somewhat more leniently than reinsurers would.

#### **The Importance of Audits**

The main purpose of an underwriting audit is to determine whether the actual underwriting taking place is consistent with the commitments that were made at the time the price for the reinsured business was negotiated. Besides confirming adherence to general underwriting principles and the preferred criteria specified in the product design, areas of high scrutiny will be situations around waiving requirements, offering preferred criteria not justified by the facts of the case, and making offers not supported by the chosen underwriting criteria.

In addition to these verification steps, the audit is also a useful forum for information exchange on other items such as application form design, new testing procedures and limits, new products the company is planning, and others.

The underwriting audit is a useful service for both parties. Ask your reinsurer when you might schedule your next audit. ●