

# Conducting pre-co

Pre-commutation audits are increasingly used to gather information in advance of negotiations. Careful preparation will help to smooth the process, as **Dr Hubertus Labes\*** and **Russell Green\*\*** of Chilton International explain

Depending upon the type of business involved – short or long tail and the quality of their reinsurers, financially impaired or strong – cedants will be more or less willing to consider a commutation. Nevertheless, once they have accepted that a commutation of their outwards reinsurance is, in principle, in their interest, they have to be ready to be audited.

Irrespective of whether a pre-commutation audit is ‘friendly’ or not, a cedant will prefer not to receive it. The cedant will have to prepare an audit, personnel are tied up and the audit will disturb the company’s day-to-day work. This extra effort obviously is not appreciated. The fact is, however, that pre-commutation audits are being used more and more and their acceptance is slowly increasing.

The cedant has to understand that since the reinsurer is the party withdrawing from the contract (ie. paying to withdraw) he is the one who needs the cedant to provide him with the information so that he can properly evaluate a risk or prepare a commutation. Audits can mitigate this problem.

There are different types of audits depending on the purpose. Typical audit types are:

- Underwriting (pre commitment or pre renewal) audit
- Pre-acquisition (or due diligence) audit
- Coverholder or MGA audit
- Technical accounting audit
- Claims audit
- Operational audit



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- Combinations of the above, and of course
- Pre-commutation audit

This article focuses on the last of these.

## Pre-commutation audit

Often it is crucial to gather information in preparation for commutation negotiations. Whether a pre-commutation audit is advisable or not, very much depends on the amounts involved and the nature of the book of business. In order to keep costs and benefits in a sensible balance, pre-commutation audits should be restricted to those cases where problems would appear to exist or where the amounts at stake are large.

A pre-commutation audit needs one or two days for experienced auditors, even if the cedant is co-operative. If the cedant is less helpful, then a longer time on-site may be required.

The present business relationship with the potential audit target has to be considered prior to a request to audit. Although cedants have become used to pre-commutation audits, these sometimes still are regarded with suspicion. The perception very much depends on the markets involved.

In general it can be said that in Southern Europe, in countries such as in Italy or Spain, but also sometimes in France or Austria, audits are considered as an expression of mistrust (by the reinsurer). This is much less the case in Northern European countries such as Scandinavia, Germany, Switzerland, or the Netherlands.

In the UK or the USA, in particular, such an audit is considered very much the norm. An auditor operating in an international context is well advised to sound out not only the legal environment, but also the customs and practice prevailing in the markets he is working in.

## Preparation

Whatever the target country, the form and content of an audit request should be carefully considered and the audit itself needs to be well prepared in advance. The first step is a close review of the reinsurer’s own files, interviews of underwriters – in order to understand their intentions at the time of underwriting – and other staff members, as well as policies in question. This might include an actuarial review of the claims.

Careful preparation of an audit helps to disturb the cedant as little as possible and will also give the reinsurer a greater feeling of comfort as to how to proceed with the audit. Time on-site is the most valuable element of an audit and the preparation will enable the auditors to make the best advantage of this restricted commodity.

The audit team needs to understand

# commutation audits

the pre-commutation situation and must have the relevant knowledge of underwriting issues, accounting systems, and the type of claims involved. A team assigned is typically composed of a claims specialist and an accounting specialist. Clearly, it is helpful, if not imperative for all team members to be fluent in the relevant language of the cedant.

In the interests of cost savings, and if suitable resources are available, the audit team may be staffed internally. However, there are strong arguments in favour of delegating the audit to an external firm. Good consultants distinguish themselves by their technical knowledge, analytical ability and (where necessary) language skills. Whilst internal staff may have the technical expertise, the external firm is more likely to have greater experience of handling the political aspects of conducting an audit.

Furthermore, an independent report often carries more weight with third parties, and this may prove to be valuable if matters evolve into litigation or arbitration. Combining internal and external staff on a team also has its advantages, such as providing a know-how transfer for internal staff members.

The cedant should be contacted prior to the audit with a specific request as to pre-audit information necessary to prepare properly the on-site review. Delays are standard, therefore this pre-audit preparation needs to start preferably well before the date on which the on-site work is planned. The information requested will typically contain technical elements such as wordings, slips, bordereaux and claims information, but also logistical issues such as availability of staff to be interviewed, premises (power supply available?),



file availabilities, copying facilities, etc. Sometimes confidentiality agreements will be requested by the cedant.

Since time on-site is limited, the reinsurer cannot review a large number of risks. Therefore, the reinsurer needs to make a judicious sample selection. This selection is aimed at capturing pre-determined 'problem risks' or risks with significant amounts of premium or claim making them worthy of review. This method is often used together with random sampling without consideration of the relevance of the risk. The advantage of a random selection is that the results of the sample can be extrapolated to the portfolio as a whole.

Notwithstanding the information requested from the cedant prior to an audit and the files or information for the on-site review, it is vital to secure the right to select further files on-site if this should prove necessary. In some cases it makes sense to involve brokers in an audit preparation process, eg. when seeking information about a contact person.

From the legal perspective, the 'inspection of records clause' setting out the reinsurer's rights to inspect the cedant's records relating to the business under the reinsurance agreement, needs to be reviewed closely. Such clauses significantly vary.

Some impose certain restrictions on

the audit, such as time limits. Others do not allow the reinsurers to use third parties, or even restrict the inspection right to certain staff within the reinsurer. Therefore, it is essential to study the clause in detail prior to submitting an audit request.

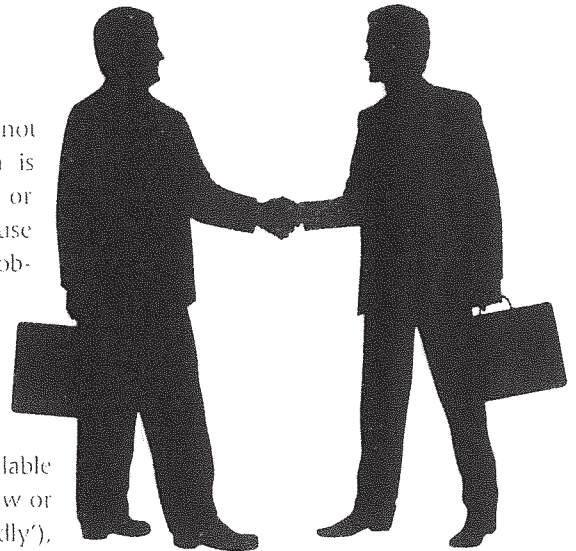
### Conducting the audit

One of the main purposes of an audit is to record all discrepancies which exist between the contractual parameters and the actual operation of the contract by the cedant. Further aims may be to ensure that claims are properly due or to make an evaluation of loss reserves, etc. The key areas of the review are underwriting, claims and accounting. More in-depth investigations require further and much more specific information, eg. in respect of IBNR or LOC procedures.

organised, very old or simply not provided. When information is only available electronically or on microfiche, this can cause particular time and access problems, often exacerbated by non-availability of terminals or printing facilities. Company internal abbreviations need to be clarified. Staff responsible may not be available during the period under review or just unfriendly (or 'over-friendly'), mistrustful, or unable to answer questions.

### Audit report

In many pre-commutation cases it is necessary to produce a formal report setting out the objectives, scope, approach, work performed, findings, technical details, factual find-



ings, observations and conclusions. Furthermore, it will contain a recommended course of action arising from the audit.

surer with whatever information will strengthen its position at the moment of negotiating the most favourable conclusion of the commutation. The audit report should quantify the audit findings to justify and support to the maximum extent possible proposed adjustments by the reinsurer to the cedant's figures – such as reductions in outstanding balances due to time bar or reserves due to claim redundancy.

Commutations bring advantages to both sides of the reinsurance contract: to cedants, through cash realisation of paper assets, and removal, even if on a reduced basis, of financially-impaired security; to reinsurers, through the achievement of finality (of problematic portfolios) and the release of (long-held) liabilities from the balance sheet; to both parties by reducing their ongoing and future administrative requirements.

Many books of outwards reinsurance remain to be closed off, especially in Continental Europe. If the benefits of commutations are to be achieved, particularly in Southern Europe, it is incumbent upon all sides to accept that pre-commutation audits are a necessary and normal part of the commutation process, not something to be feared and resisted.

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If, whilst the team is on-site, the cedant fails to provide significant documentation or information agreed in advance, consideration must be given to immediately curtailing and postponing the audit. There is likely to be a temptation to proceed with the audit and review what is made available, even if the material is inadequate.

Still, this is often not recommended as, in view of the inspection of records clause, the cedant could later reject a completion of the audit on the basis that the reinsurer had forfeited his right to audit. The auditor has to make an on-the-spot judgement call based upon level of information or files provided whilst as far as possible, if the decision is to continue, reserving the reinsurer's rights to return.

Further problems that may be encountered during an audit include files that are incomplete, missing, dis-

ings, observations and conclusions. Furthermore, it will contain a recommended course of action arising from the audit.

The report often needs to be prepared for management and, if appropriate, addressed to lawyers to consider any issues which have arisen and to preserve privilege. This is especially the case for findings of a serious nature, for example, details of contractual non-compliance or breaches of fiduciary duties. It might also identify major quantum differences which cannot be agreed between the parties. But more important, the report should provide the factual and subjective data required to improve the effectiveness of the subsequent commutation discussions.

### Conclusion

The principal purpose of a pre-commutation audit is to provide the rein-