



## Coverholder Auditing – A US Perspective

September 13, 2012

### Introduction

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As a Carrier, why Audit Your MGAs?

- The MGA is an extension of the Carrier and acts in its place in many respects.
- The MGA's action or inaction, can have considerable consequences to the Carrier's hard earned reputation, business levels and regulatory experience.
- The MGA binds risks on behalf of the Carrier creating legal and binding commitment responsibilities.
- The MGA has control over possibly considerable amounts of Premium and /or Claims funds. Mishandling can result in losses for the Carrier.
- MGAs come in all shapes and sizes - no two are exactly alike.
- While the relationship between a carrier and its MGA is intended to be a partnership built on trust and mutual benefit, the failure to closely monitor the actions of the MGA can have material adverse effects on the Carrier's results.

## Typical US Audit Approach

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Alan Gray, Inc. audit approach

Our approach is more process oriented than it is transaction oriented.

To the extent that we can determine that sound operating processes that govern the actions of the MGA personnel exist and are being adhered to, we can derive a greater degree of comfort that the transactions that we have not tested are in compliance with the Carrier's authorization.

To derive conclusions based solely on the results of the testing of a small sample runs the risk of Auditor sample selection bias and a risk that the transactions tested are non-representative of the whole.

## Overview

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- US MGA Financial / Transactional Audits
- US vs. UK MGA Audit Approaches
- Adapting Coverholder Audits for UK Clients
- Examples of Audit Findings

## US MGA Financial / Transactional Audits

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- Review of Program Administrator's Operations
- Assessment of Control Environment
- Transactional Review

## Program Administrator's Operations

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### Compliance with the Program Administrator Agreement

- Production
  - Prescribed territory
  - Nature of risks
  - Volume levels and limits
- Underwriting
  - Eligible risks and territory
  - Excluded risks and territory
  - Maximum policy terms
  - Maximum policy limits
- Billing
  - Timeliness
  - Accuracy
- Policy Issuance
  - Timeliness
  - Endorsement issuance standards

## Program Administrator's Operations

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### Compliance with the Program Administrator Agreement (cont'd)

- Premium Collection
  - Segregation of duties
  - Prompt deposit into Fiduciary Trust Account
  - Proper application of cash
- Claims
  - Where claims are handled internally at MGA
    - Key Staff
    - Claim allocation methodology amongst claim handlers
    - High level assessment of claims handling process
    - Use of independent adjusters
    - Referrals to Carrier for approval
  - Where claims handling is outsourced to TPA
    - Separate audit team

## Program Administrator's Operations

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### Compliance with the Program Administrator Agreement (cont'd)

- Required Reporting
  - Completeness of risks bound included on bordereaux
  - Commission levels
- Timeliness of remittance to the Carrier
- Policy cancellation in accordance with Carrier prescribed procedures
- Financial Stability
  - Assess prior 2 years financial results and Year To Date (YTD), if applicable
- Required Insurance
  - E&O
  - Fidelity Bond

## Program Administrator's Operations

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Compliance with the Program Administrator Agreement (cont'd)

- Business Continuation
  - Plan review
  - Assess results of last test
- Licenses
  - Assess that MGA has in-force licenses for all jurisdictions
- Bank Reconciliations
  - Timeliness
  - Evidence of Management review
  - Nature of ageing of reconciling items
- Premium Trust Account is "in trust"
  - [Premium receivable + cash balance > or = amount due Carrier(s)]

## Assessment of Control Environment

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Interview management to determine existing controls

- Document controls in work papers
- Assess Segregation of Duties / Compensating Controls
- Prepare walk-thru demonstrating controls for:
  - Cash receipts
  - Cash application
  - Premium Bordereaux completeness
  - Claims Bordereaux completeness

## Transactional Review

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Obtain transaction history for risk bound during the period

- Select a reasonable sample size
  - Past history
  - Carrier concerns
  - Adjust accordingly if necessary based on walk-thru or Carrier requirement

Perform attribute testing on selected sample items

- Assess the existence of claimed controls
  - Controls sometimes exist in name only and not adhered to or circumvented
- Document exceptions

Obtain transaction history for claims paid during period

- Assess replenishment of Imprest Account, if any

## Pre Audit Preparation

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Obtain program Administrator Agreement

Send Internal Control Questionnaires to MGA

- Premium Cash & Accounting (from billing when bound to remittance to carrier)
- Underwriting (staff experience, rating, binding, policy issuance, cancellation)
- Loss Processing (staff experience, adjusting procedures, reserve setting, file closing)
- Systems (hardware, software, access, back-up, business continuation)

Obtain prior audit reports from the Carrier

Inquire of any concerns and or areas of focus from Carrier

Obtain Premium Bordereaux for the period under audit

- Select sample, request files be available for review upon arrival

Obtain Claims Bordereaux for the period under audit

- Select sample, request files be available for review upon arrival

## Timing of Pre Audit Preparation Work

5 Weeks Prior to inception of agreed audit date, request:

- Completed Internal Control Questionnaires from MGA
- Premium Bordereaux for the period under audit
- Claims Bordereaux for the period under audit

4 Weeks prior to inception of agreed audit date, provide listing to MGA containing:

- Selected premium files to review
- Selected Claims files to review

4 Weeks prior to inception of agreed audit date, request copies for review:

- Operating Policies and Procedures Manual
- Premium Trust bank account statements for the period under review
- Bank reconciliations for the period under review
- Trust reconciliations
- Declaration pages for E&O and Fidelity Bond coverage
- Financial Statements for the prior two years
- Business Continuation Plan
- Organization Chart

## US vs. UK MGA Audit Approaches

US

UK

Direct Carrier	<b>Primary Contact</b>	Broker
Sent to MGA 5 weeks prior to audit	<b>Pre-Audit Questionnaires</b>	Not Used
Considerable	<b>Assessment of Internal Controls</b>	Minimal
Performed, retained for Permanent file	<b>Process Walkthroughs</b>	Not performed
Considerably more	<b>Transaction reviewed</b>	Relatively fewer
Important but less emphasis	<b>Privacy</b>	Considerable emphasis
Important but less emphasis	<b>Money Laundering</b>	Considerable emphasis
Comprehensive	<b>Audit Report</b>	Executive Summary

## Adapting Coverholder Audits for UK Clients

- Enhance the efficiency of knowledge acquisition regarding the Coverholder operating policy and procedures and minimize Coverholder staff disruption by the use of Internal Control Questionnaires sent in advance of audit
- Initiate Internal Control Environment Assessment
- Document workflows to identify controls
  - Cash receipts to Carrier remittance
  - Underwriting to policy issuance & billing
  - Claims payments to Claims account replenishment
- Increase the number of files reviewed to ensure a representative sample and increased comfort level

## Examples of Audit Findings

### Segregation of Duties

Segregation of duties is an important facet of effective internal control. The requirement that two or more individuals are needed to process a transaction from inception to recording in the ledger reduces the risk of mistakes and inappropriate actions.

In general, no one person should be able to initiate a transaction, approve that transaction, record that transaction, reconcile balances containing that transaction or handle the assets of the subject transaction.

In the case of smaller MGAs, a detailed Supervisory review would be required as a compensating control activity if the above functions cannot be separated.

During the course of an MGA audit, our walkthrough revealed that one individual opened the mail and removed the premium checks, prepared the deposit slips, made all deposits at the bank, applied cash to the accounts (cleared receivables), received and reconciled the bank accounts, prepared all disbursements, was a bank Signatory and, had custody of the check stock. No oversight was applied by the owner of the business as his focus was directed to marketing and the operations of the business.

## Examples of Audit Findings

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### Misuse of Premium Trust Funds

1) During the course of an MGA audit, our testing of the Premium Trust Account revealed a consistent Out-of-Trust condition. While the Premium Checks as received were deposited intact into the Premium Trust Account, funds in excess of the agreed to commission rates pursuant to the Program Administrator Agreement were transferred to the Operating account to fund day-to-day operations. Further audit activities revealed declining business activity and financial stability.

2) During the course of an MGA audit, the audit team detected Premium Checks routinely being deposited into the Operating account in contravention of the Program Administrator Agreement. Further audit activities revealed that the Operating accounts were swept nightly into a Corporate-wide "Accumulation Account" wherein the Corporation's earning rate on the aggregated balance was higher than would otherwise be available on a disaggregated basis. The Premium funds were transferred to the Premium Trust Account in time to wire the funds to the Carrier at the required interval. Nevertheless, a failure at the Corporate level could subject the Carrier to losses.

## Examples of Audit Findings

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### Underwriting Risk Not Contemplated by the Program Administrator Agreement

Workman's Compensation Coverage was bound for an Amusement Park motorcycle rider wherein he would drive at a high rate of speed while rising from the bottom of a barrel to snatch dollars from spectators who were leaning down and over the sides of the barrel to hand him the dollars and to get a closer look.

### Excessive Premium Discount

During the course of an MGA audit, our testing of the Underwriting audit procedures revealed that the MGA bound risks at a discount to the rates prescribed by the Program Administrators Agreement. In one case, it was determined that a family member obtained coverage at 25% of expected, exposing the Carrier to uncompensated risk.

## Key Locations

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Boston  
88 Broad Street  
Boston, MA 02110  
617.426.6255

New York  
9 East 40<sup>th</sup> Street  
New York, NY 10016  
212.685.9026

London  
9 St. Claire Street  
London, England EC3N 1LQ  
44.20.7954.4366