Global Insurance Services

Executive Brief
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FTI CONSULTING

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Expanding Our Expertise

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Spotlight on Climate-Related Risks

Heightened climate risk exposures, storm intensities, and regulatory oversight and reporting are threatening insurance affordability and availability, and insurance companies are paying close attention.

Special Insights and Guidance Advisory

Our insurance company clients and prospects are in the midst of an ever-accelerating technological paradigm shift, in which Artificial Intelligence (AI), Machine Learning (ML)-enabled solutions are transforming how products and services are being built and delivered. These innovative tools are reshaping all industries and are even taking the wheel in newer cars we drive. Such progress, however, doesn't come without new risks, as rapid innovation often outpaces the adoption of aligned best practices and a commonly accepted code of ethics. Realizing that AI failures can have significant legal, reputational, operational and ethical implications, both insurance regulators and companies are becoming more focused on the potential for biased algorithms to violate traditional anti-discrimination laws in areas such as underwriting and pricing.

From the FTI Journal – Challenges and Risks When Outsourcing to Managing General Agents

Carriers may face different difficulties if they choose to outsource to non-affiliated third parties such as Managing General Agents (MGAs). As outsiders, these independent businesses expose carriers to risks beyond their usual commercial boundaries. Performing due diligence, having a comprehensive agreement in place, and carrying out routine inspections of MGAs and other intermediaries can help to protect the carrier against adverse impacts stemming from outsourcing.

Expanding Our Expertise

FTI Consulting Bolsters Insurance Practice with Addition of Vince Bodnar, Marshall Schlimer, Peter Schablik, and Steve Schoonveld in the U.S.

Vince Bodnar has specialized in the life and health insurance industries over the past 40 years and is recognized as one of the country's leading long-term care insurance experts, having worked with such products since the 1980s. Mr. Bodnar has led product design and pricing projects, distribution strategy, in-force management, experience analysis, strategic planning, M&A, financial analysis and projections, reinsurance, reserve valuations, operational reviews and company rehabilitations and liquidations. Read Vince's bio.

Peter Schablik has more than 30 years of experience in public and industry accounting with an extensive background in internal audit, ERP implementation, project management, relationship management and business development. Mr. Schablik has had success in establishing and leading a risk consulting practice for IT, M&A, SSAE 18 and other engagements. Read Peter's bio.

Marshall Schlimer has more than 30 years of experience providing audit, risk and advisory services to public and private organizations tackling complex accounting and control issues such as revenue recognition, goodwill, taxes, acquisitions, dispositions and public offerings. Mr. Schlimer has successfully led a number of high-profile projects, investigations, acquisitions and regulatory consent orders in the United States and abroad. Read Marshall's bio.

Steve Schoonveld has more than 30 years of experience in the long-term care, disability and accident & health insurance industries. Prior to joining FTI Consulting, Mr. Schoonveld was Head of Industry Partnerships & LTC Resource Solutions with Lincoln Financial Group as an Assistant Vice President, MoneyGuard Business Management. Read Steve's bio.

Spotlight on Climate-Related Risks

Heightened climate risk exposures, storm intensities, and regulatory oversight and reporting are threatening insurance affordability and availability, and insurance companies are paying close attention.[1] Simultaneously, the industry is aiding the development of innovative solutions to minimize protection gaps and help companies and society build climate resilience.[2]

To this end, insurance companies have the opportunity to play a unique and impactful role in the global transition to a low-carbon economy. The insurance sector will need to:

- Carefully and consistently reevaluate its approach to incorporating climate-related risks into its underwriting processes,
- Assess relevant risks embedded in portfolio holdings, and
- Clearly communicate the effective management of risks to stakeholders to ensure continued access to capital.

Given the insurance sector's role in the global economy as a facilitator of economic growth, it will increasingly have the ability to affect capital allocation and effect change, such as broad-based greenhouse gas ("GHG") emissions reductions, particularly as relevant disclosure from companies globally increase in quality and frequency.

Several relatively decentralized and independent efforts have progressed to mandate climate-related disclosures for insurance companies, the most noteworthy being the National Association of Insurance Commissioners ("NAIC") Climate Risk Disclosure Survey. The survey asks questions on topics including climate risk governance, climate risk management, modeling and analytics, stakeholder engagement, and greenhouse gas management.[3]

As of 2021, 14 U.S. states and Washington, D.C. mandate domestic insurers that write more than $100 million in annual net written premiums disclose the results of their climate-related risk assessments and strategies.[4] In 2020, 66 publicly traded insurance companies were required to provide disclosure pursuant to state law provisions and responded to the NAIC Climate Risk Disclosure Survey.[5]

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1 "Acting Superintendent Adrienne A. Harris Announces DFS Issues Final Guidance to New York Domestic Insurers on Managing the Financial Risks from Climate Change," Department of Financial Services web site, Nov. 15, 2021. Last accessed Aug. 16, 2022: https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202111151

2 "Guidance for New York Domestic Insurers on Managing the Financial Risks from Climate Change," New York Department of Financial Services web site, Nov. 15, 2021. Last accessed on Aug. 16, 2022: https://www.dfs.ny.gov/system/files/documents/2021/11/dfs-insurance-climate-guidance-2021_1.pdf

3 "NAIC Assesses, Provides Insight from Insurer Climate Risk Disclosure Survey Data", NAIC web site, (Nov. 23, 2020), last accessed on Nov. 16, 2022. https://content.naic.org/article/news-release-naic-assesses-provides-insight-insurer-climate-risk-disclosure-survey-data

4 Robert J. Mancuso, "NAIC Climate Risk Disclosure Survey Responses of Insurers Coming Into Sharper Focus", Faegre Drinker Biddle & Reath LLP web site, (Sept. 8, 2021), last accessed on Nov. 16, 2022. https://www.faegredrinker.com/en/insights/publications/2021/9/naic-climate-risk-disclosure-survey-responses-of-insurers-coming-into-sharper-focus

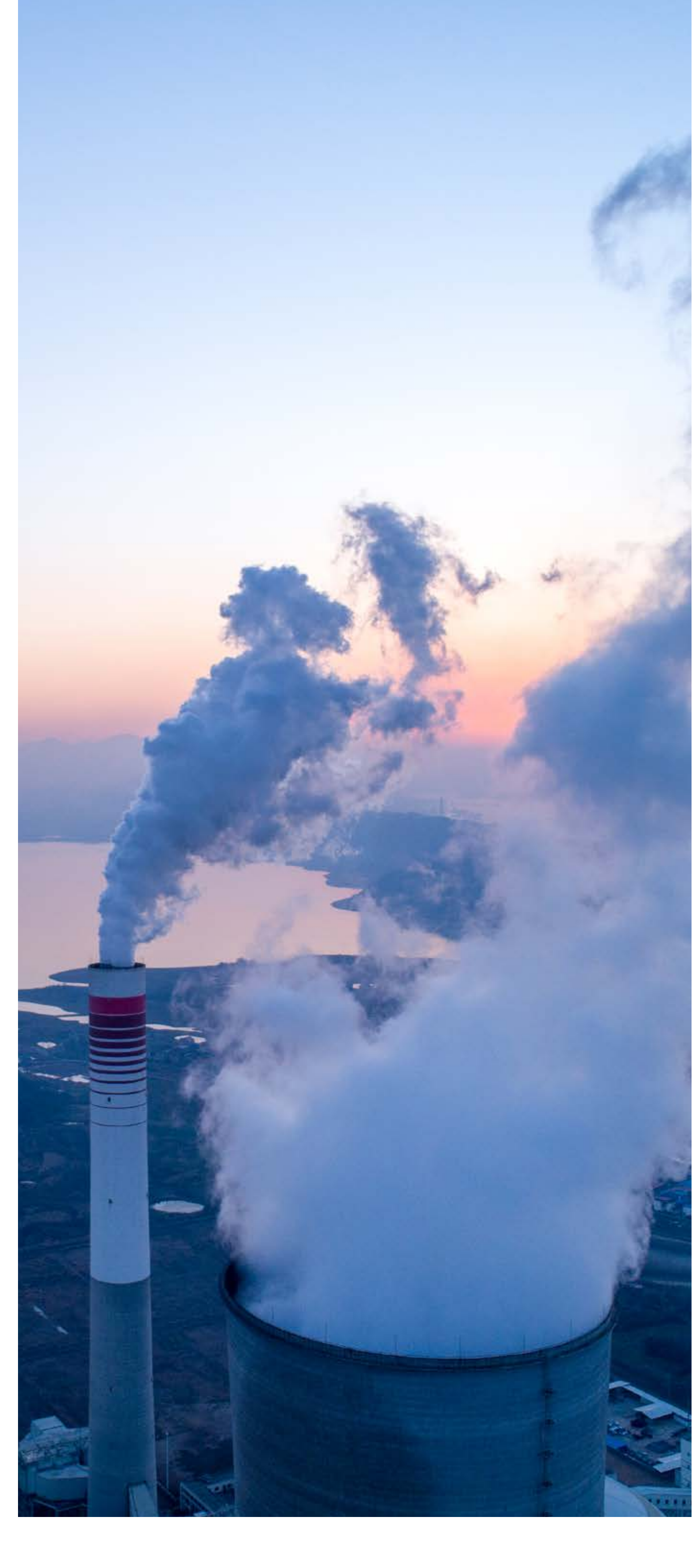
5 17 CFR 210, 229, 232, 239, and 249, page 297. https://www.sec.gov/rules/proposed/2022/33-11042.pdf

We expect the depth, quality, and availability of climate-related disclosures to increase considerably given the expected enactment, in some capacity, of the U.S. Securities and Exchange Commission's ("SEC's") March 2022 proposed rule, "The Enhancement and Standardization of Climate-Related Disclosures for Investors." This rule would apply to all companies filing Securities Act or Exchange Act registration statements and annual reports with the SEC. It would require comprehensive disclosure aligned with the recommendations of the Task Force on Climate-Related Financial Disclosures ("TCFD") and guidance from the GHG Protocol.[6]

SEC-mandated climate disclosures will drastically affect applicable publicly traded companies across all sectors, including insurance companies. Better access to standardized, comparable, quantitative, and useful disclosures and data from thousands of publicly traded companies will benefit insurance companies by:

- Improving their ability to accurately price climate-related risks during underwriting,
- Creating specialized insurance solutions that enable economic growth, broad reductions in GHG emissions, and local resiliency, and
- Evaluating climate risks embedded in trillions of dollars' worth of investments.

Whether evaluating climate-related risks embedded in your organization's operations and investments, assessing the efficacy of your practices related to the integration of climate-related risks into your underwriting processes, preparing for SEC-mandated climate disclosures, completing climate scenario modeling, or calculating emissions and designing reduction strategies, FTI Consulting's ESG & Sustainability Advisory Practice and Global Insurance Services professionals can help you navigate the complex ESG environment.



[6] "SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors", SEC web site, (March 21, 2022), last accessed on Nov. 16, 2022. https://www.sec.gov/news/press-release/2022-46

Special Insights & Guidance Advisory

The insurance industry among others is in the midst of an ever-accelerating technological paradigm shift in which next generation tools such as artificial intelligence (AI) and machine learning (ML) are transforming how solution providers build and deliver their products and services.[7]

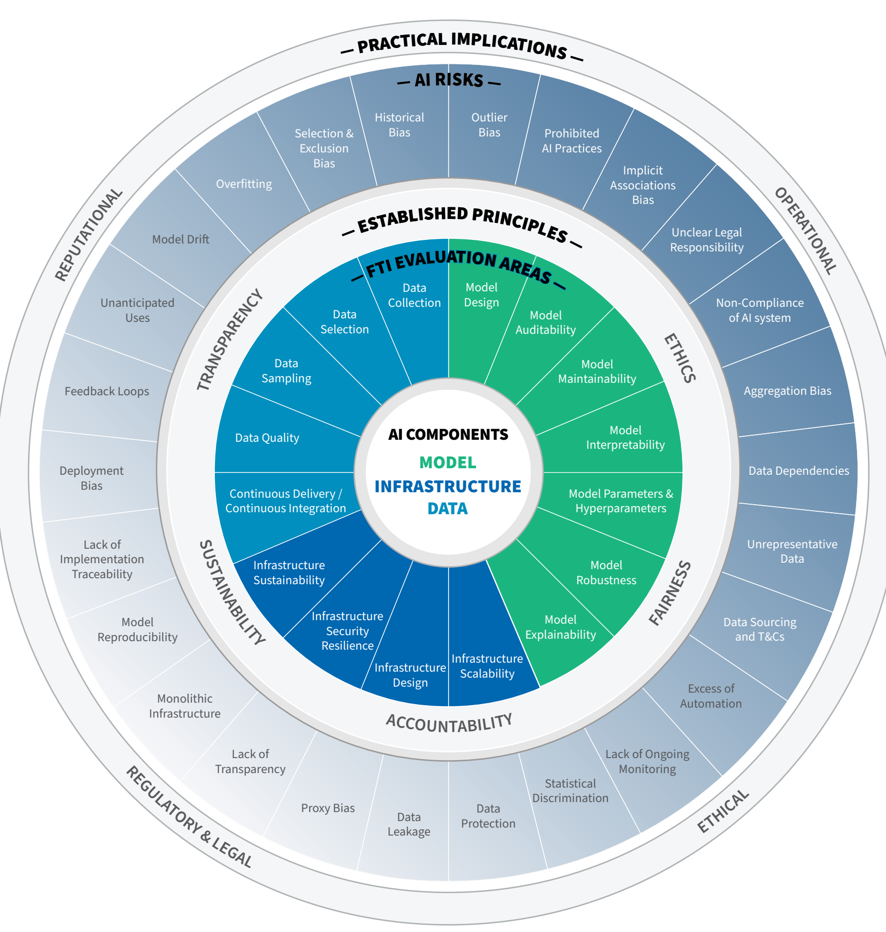
This phenomenal progress brings risks, as fast-paced innovation can outpace the development of best practices and a commonly accepted code of ethics. As a result, many organizations now rely on AI technologies (or more precisely, ML technologies) that are a source of considerable risk.

AI/ML failures can have significant legal, reputational, operational, ethical and financial implications, including among others:

- Biased algorithms that violate traditional and emerging anti-discrimination laws;
- Failure to comply with the drafted EU's Artificial Intelligence Act (AIA) and prospectively pending Digital Operational Resilience Act (DORA); and
- Data sourcing practices that violate the General Data Protection Regulation (GDPR).

FTI Consulting offers an end-to-end technical assessment of existing and in-development decision models. Our comprehensive service both identifies and quantifies potential AI modeling risks and provides clients with actionable recommendations for remediating these exposures and building trustworthy decision support systems.

FTI AI Assessment



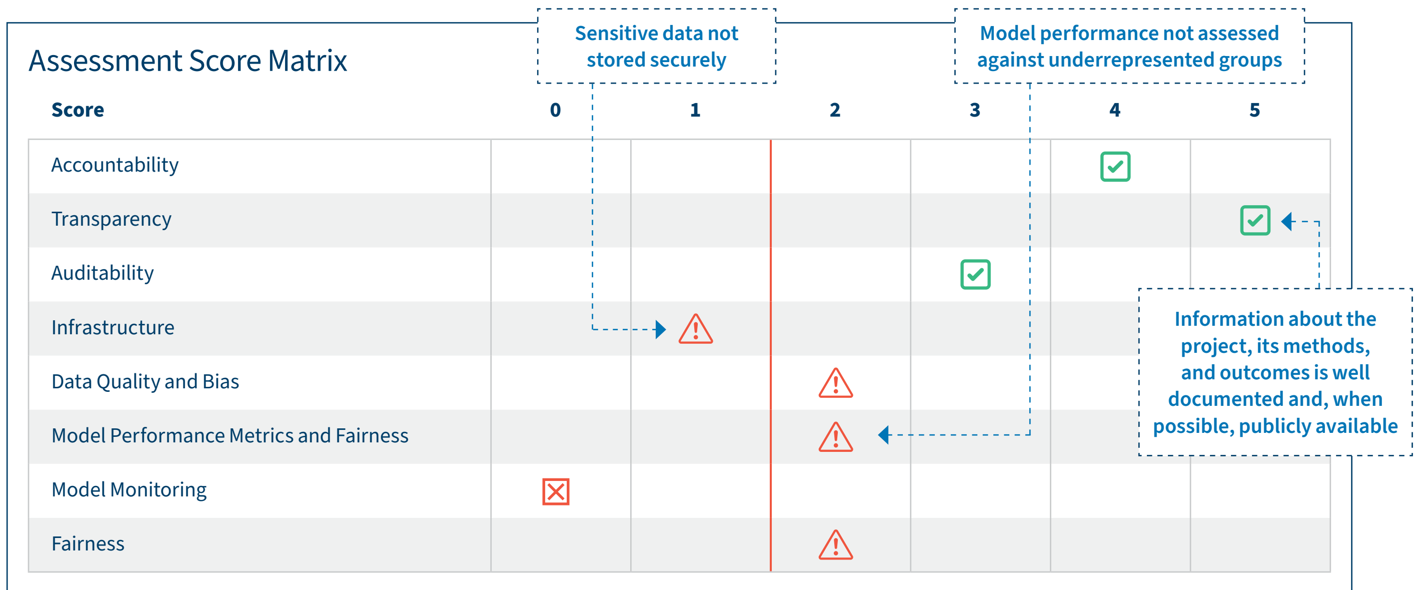
[7] "2019 Study Results: How U.S. Insurance Carriers are Using Artificial Intelligence and Machine Learning", LexisNexis Risk Solutions web site, last accessed on Nov. 16, 2022. https://risk.lexisnexis.com/insights-resources/research/state-of-ai-ml-in-the-insurance-industry

Following the FAST[1] and FATE[2] approaches, the FTI Consulting AI Assessment is based on a set of overarching and generally recognized principles, including:

- **Fairness:** Algorithms need to be equitable and not be biased or discriminatory.
- **Accountability:** Humans need to be accountable for their role in the design of AI solutions.
- **Sustainability:** Algorithms need to be safe and sustainable.
- **Transparency:** The design and implementation processes need to be justifiable.
- **Ethics:** Algorithms need to follow a system of moral principles and guidelines, including individual rights, privacy, nondiscrimination and non-manipulation.

Through these lenses and using market-proven proprietary tools and methodologies, FTI Consulting's data science, technology and statistics experts assess critical dimensions of each client's AI-driven decision systems – including data, model and underlying infrastructure – to assure their conformance with relevant regulatory mandates and directives. Seasoned FTI Consulting insurance experts – many with deep industry experience – are also engaged as needed to help assess model dimensions and strategy on remediations, if required.

The review of data quality, data collection, sample design and sample selection is foundational to assessing deployed AI models. Particular attention is given to model design, feature engineering and the selection of model parameters and hyperparameters. The robustness of model results and their adherence to the overarching analysis principles are rigorously tested. Finally, the infrastructure design and its maintainability, resilience and scalability are stress-tested. All assessed elements are then scored using FTI Consulting's Assessment Score Matrix and summarized (see below).



Breaches and high-risk areas are clearly identified. The Assessment Score Matrix also enables comparison and monitoring of performance over time and against appropriate industry benchmarks. Crucially, the AI Assessment process defines concrete actions aimed at neutralizing risks connected to underperforming dimensions, thereby enabling our client to confidently deploy trustworthy AI applications.

From the FTI Journal – Challenges and Risks When Outsourcing to Managing General Agents

Insurance carriers enter agency relationships with non-affiliated third parties. These agents or intermediaries include Program Administrators (PAs), Managing General Agents (MGAs) or Managing General Underwriters (MGUs). While these third parties (hereafter referred to as MGAs) may receive underwriting submissions, issue insurance quotes and policies, collect premiums, perform statutory reporting and/or process claims, they usually take on no underwriting risk.[8] MGAs are used by carriers to assume business in exchange for a percentage of the premium written.

At times because of the abuse of some of their roles and responsibilities with regard to underwriting policies and control and remittance of carrier funds, MGAs are sometimes viewed negatively because of the actions of a few that have resulted in misappropriation of funds,[9] and/or writing unprofitable business to increase commissions. In this article, we identify some specific issues that arise in the MGA relationship and how they can be mitigated.

Risk that the MGA will Deviate from the Underwriting Guidelines

Underwriting Authority Guidelines serve as the backbone to an insurer's book of business by setting specific parameters to which they define the MGA's ability to accept, modify, or reject a prospective insured. Establishing clear Guidelines and assuring they are consistently followed should be a top priority. A large risk would be if the MGA bound the Carrier to risks that were outside of their authority (i.e., limits, territories, lines of business, classes of business.

The Carrier could face significant reputational and financial repercussions if the MGA does not follow the Guidelines. For example, the MGA could have written in excess of reinsurance, leaving the Carrier exposed and un-reinsured for a portion or all this business. Other deviations from the Guidelines could lead to financial repercussions in the form of fines by the state Department of Insurance.

Fortunately, there are ways to mitigate the risk of the MGA writing business outside the guidelines. This includes setting up strict controls such as monitoring the limits, territories, and written premiums through monthly production bordereaux or risk reports, performing periodic Technical Underwriting Inspections, and requesting live access to the MGA Underwriting Administration System to perform spot checks of accounts written between periodic inspections.

[8] Larry Schiffer, "The Trouble with Giving Away the Pen," International Risk Management Institute, Inc. (June 2001), https://www.irmi.com/articles/expert-commentary/the-trouble-with-giving-away-the-pen

[9] "Insurance Fraud," Federal Bureau of Investigation (last visited November 17, 2022), https://www.fbi.gov/stats-services/publications/insurance-fraud

Risk of Improperly Reporting of Underwriting Production Reports to the Carrier

The proper reporting of the MGA's Underwriting Production plays a pivotal role in maintaining a functional and profitable business model between the MGA and the Carrier. Due to its severity, the Carrier typically establishes a monthly deadline for all underwriting results to be reported and in the format preferred and requested by the Carrier. Any deviations from this timeline, including but not limited to irregular frequencies of reporting, incomplete and/or inaccurate data, receiving summary data, data reported in a format other than the requested, or consistently missed deadlines, runs the risk that the Carrier may experience operational difficulties when handling the Program's claims, recording written premium, setting up a premium receivable, or any other production-dependent task. Further, the Carrier faces the risk of maintaining an incomplete and inaccurate population of production.

As an example, if a policy/transaction is not reported, the Carrier would not set up a receivable and thus have production underreported and underpaid. To mitigate these risks, the Carrier can enforce the monthly reporting of underwriting production to be performed via a data feed between the MGA and the Carrier's system, at a specific date, based upon when the production was bound and/or issued. Further, the data should be on a transactional level, whereby, all premiums, endorsements, cancellations, and/or claims are clearly identified and exhibited. The production reports should then be reconciled to the prior month's reports and applicable accounting files to identify any discrepancies.

Another way to mitigate this risk is to periodically request inception-to-date reports and compare control totals or detail policy level data between the data sources.

Risk of Improper Payment of Production Premiums to the Carrier

The typical Agreement between the MGA and the insurer requires payments to be made at regular monthly intervals; e.g., 30 or 45 days after the month ending in which the business was written. The Agreements allow for premium to be remitted on a written or collected basis. In instances when premium is to be remitted on a written basis the MGA is required to remit premium whether it has been collected or not. In these instances, the credit risk is maintained by the MGA. In instances when premium is to be remitted on a collected basis the MGA is not required to remit premium until it has been collected. In these instances, the credit risk and the risk that timely payment is not received is borne by the Carrier.

The Carrier can mitigate these risks by ensuring the Agreement requires remittance on a written basis. In addition, if the Carrier applies cash on a policy-by-policy basis it would allow the Carrier to identify all policies that have not been paid in full. In instances where the Carrier is unable to apply cash on a policy-by-policy basis, a monthly reconciliation can be performed to compare total premium remitted to total production, or a desk or field inspection can be carried out to perform this function analytically for all policies written.

Risks of the Financial Solvency of the MGA

Prior to an appointment of an MGA the Carrier should perform appropriate due diligence to assure the MGA's financial viability, sufficiency of operations and reputation of the MGA principals.

To assist in monitoring the financial solvency of the MGA, the Carrier should require the MGA to produce year-end, Audited Financial Statements on a yearly basis, as well as quarterly internal financial statements.

Further, the Carrier can require the MGA to maintain specific Errors & Omissions (E&O) and Fidelity coverage that will limit the financial burden on the insurer in the event the MGA becomes insolvent. Other ways to mitigate the risks are to obtain a personnel guarantee from the principals of the MGA or to hold collateral, either as a Letter of Credit or a commission hold back.

Risk Associated with Commingling of Carrier Trust Funds with Other Carrier or MGA Funds

Any time one company collects funds on behalf of another company, there are financial risks involved. When premium funds are collected by the MGA on the Carrier's behalf, there is a potential risk that the MGA may commingle premium trust funds with their company operating funds or other insurer's trust funds. The MGA may also deposit funds in a bank that is not FDIC insured or they may commingle all trust funds into one account. If the banking institution goes bankrupt and all premiums for multiple insurers and/or operating funds are deposited into a single bank account, the FDIC insurance is only $250,000 and there is a risk that the MGA's carriers will have to share and prorate their recoveries from the FDIC payout.

To reduce these risks, the Carrier should stipulate in the Agreement that premium trust funds should have their own individual accounts and these accounts should be in a banking institution insured by the FDIC and approved by the NAIC. This would ensure that if the banking institution goes bankrupt, the insurer would not have to split the recovery with another carrier or the MGA itself; they would get their full balance from the FDIC if funds were below the insurance threshold. Additionally, if the Carrier has multiple companies with business being written, then consideration should be given to having multiple Premium Trust Accounts, one for each insurance company. This will allow the maximum potential FDIC insurance recoverable, up to $250,000 per company.

Risk of Insufficient Insurance Coverages for Carrier's Benefit

One of the risks that is not always considered when hiring an MGA is the potential that the MGA does not have adequate E&O policy or Fidelity bond/Crime policy in good standing. The agreement between the insurer and MGA should include required minimum limits and appropriate deductibles on E&O and Fidelity/Crime policies as well as listing the insurer as an additional named insured in the event of a loss.

Mitigation of the risk includes requesting the E&O and Fidelity policies on a yearly basis and ensuring that the minimum limits and maximum deductibles are in place.

Risks Associated with Conflicts of Interest/Adverse Selection Amongst Multiple Carriers

Due to the nature of the MGA and Carrier business model, it is not unusual for MGAs to write business for multiple carriers. Typically, this does not cause a concern, unless the MGA writes business for multiple insurers that offer the same or similar programs. In this circumstance, the MGA may have a financial incentive to favor writing business for the Carrier that provides the more attractive commission rates, those who offer reimbursement for various administration expenses, or are generally less strict in the contractual requirements. This behavior could lead to adverse selection of one carrier over the other.

To mitigate this risk, the insurer should ensure that the MGA has a defined plan to provide business to one carrier vs. another to take out as much subjectivity as possible. This can be done by territory, size of risk based upon a predetermined criterion or by alternating risks as the submissions are presented to the MGA. Adherence to this requirement can be further examined during an inspection.

Risk of Not Having Proper Information Technology (IT) Security Controls in Place

The significant risks associated with data being compromised is more prevalent than ever before. Currently where data breaches and ransomware are on the rise, having good IT security protocols are required. MGAs should have best practice IT security protocols in place. Strong password requirements are the first line of defense. Educating employees about phishing schemes can help prevent data breaches and potential ransomware. Proper Segregation of Duties (SoD) process and controls assuring that no single person is able to perform incompatible roles is an important IT security control.

Carriers can mitigate many of the risks noted by having requirements in the MGA Agreement as well as examining the implementation of the key controls noted above during an inspection.

Risk Associated with Disaster Recovery Plan and Business Continuity Plan Not Comprehensive to Protect the Carrier in the Event of a Disruption of Service

During COVID-19 when businesses were forced to work remotely, the importance of having a Disaster Recovery Plan (DRP) and a Business Continuity Plan (BCP) became obvious. Were MGAs able to transact business effectively and efficiently? Was there a disruption in client service? Were the carriers able to manage the relationship? Continuing business operations and being able to report data is a critical risk associated with outsourcing business to MGAs. This would include having comprehensive data back-up plans, identification of alternative worksites as well as proper testing of restoration at regular intervals.

As guidance on the requirements of a DRP/BCP is not always included in the MGA Agreement, addressing it in some manner in the Agreement is recommended. As part of the annual review of the MGA, carriers should request a copy of the DRP/BCP.

Risk Associated Cash Handled by MGA

Overall controls and processes surrounding carrier cash is always a risk. This includes the process and controls by which premiums are deposited into an MGA-controlled bank account; who has access to the cash account as well as the ability to authorize check, wire transfers or ACH payments. In addition, processes should be in place to assure complete, accurate and timely preparation of bank reconciliations of carrier cash, whether is it maintained in a premium trust account or in the MGA's operating account.

Having a lockbox or using a desktop application to deposit checks into the bank helps mitigate the risk of checks being lost or potentially misappropriated. Having proper segregation of duties in recording of payments, remitting payments and in preparing bank reconciliations are important controls over cash. In addition, one way a carrier can mitigate risks surrounding cash is to have a requirement in the Agreement whereby they are an authorized signer on a separate premium trust account which is used for all deposits.

Conclusion

Outsourcing to a third party can be risky but implementing appropriate mitigation can help reduce the risk. The mitigation starts with careful drafting of the MGA Agreement and continues through implementation of the regular monitoring of MGA activities. This monitoring should be supplemented by regular inspections of the MGA activities and controls in place.

Happy Holidays

from FTI Consulting's
Global Insurance Services Team!

We wish you a joyous and safe holiday season with your loved ones and look forward to a happy 2023!

As a leading independent advisor and consultancy to the insurance industry, Global Insurance Services helps clients identify opportunities and define strategies to manage risk, improve operational and financial performance, and drive growth.

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