Evolution of the Risk-Focused Examination Process

Presented by:
Marlys Rulon from Eide Bailly and Kathy Mae Schmidt from ADOI
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Selected information as indicated is extracted from the NAIC Financial Condition Examiner’s Handbook:
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Topics for Today:

1. The Risk Focused Exam Process
2. Significant evolution to the RFE process
3. Tools and preparation for efficiency
4. The ADOI, the Exam Team & the Company
Five Elements of Risk-Focused Surveillance Cycle

- Risk-Focused Examinations
- Off-Site Risk-Focused Financial Analysis
- Review of Internal/External Changes
- Priority System
- Supervisory Plan

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Source: Financial Condition Exam Handbook
**RISK ASSESSMENT CYCLE**

**Supervisory Plan**
- Develop Ongoing Supervisory Plan That Includes:
  - Frequency of Exams
  - Scope of Exams
  - Meetings with Company Management
  - Follow-Up on Recommendations
  - Financial Analysis Monitoring

**Examination**
- Risk-Focused Examination
  - Identify Key Functional Activities
  - Identify/Assess Inherent Risk
  - Identify & Evaluate Controls
  - Determine Residual Risk
  - Establish Procedures and Conduct Exam
  - Update CARRMEL
  - Update Supervisory Plan
  - Exam Report/Mgmt Letter

**Internal/External Changes**
- Consider Changes to:
  - NRSRO Ratings
  - Ownership/Management/Corporate Structure
  - Business Strategy/Plan
  - CPA Report or Auditor
  - Legal or Regulatory Status

**Priority Systems**
- CARRMEL, FAST, IRIS Ratios. CARRMEL Components:
  - Capital Adequacy
  - Asset Quality
  - Reinsurance
  - Reserves
  - Management
  - Earnings
  - Liquidity

**Off-Site Risk-Focused Financial Analysis**
- Financial Analysis includes:
  - Risk Assessment Results
  - Financial Analysis Handbook Process
  - Ratio Analysis (IRIS, FAST, Internal Ratios)
  - Actuarial Analysis
  - Update with internal/external changes

Source: Handbook – Introduction Page 11
Are All State Examinations the Same?

In general, yes, due to:

1. Accreditation standards over state insurance departments, and
2. Accreditation standards over examiners, and
3. NAIC Financial Condition Examiner’s handbook.
4. Some state variations such as: Frequency, Reporting and Financing
Risk-Focused Examination

Previous examination approach was “risk-focused” approach, but dealt with account balances and did not interact with corporate governance, consider other than financial risks or prospective risks, etc.
Why Risk-Focused?

• Historically, solvency problems have been caused by inadequate management oversight
• Previously focus on financial reporting issues (balance sheet accounts)
• Broader risk assessment that also focuses on strategic and operational issues
• Process for evaluating the entire solvency risks inherent in an insurer’s operations
• Broader risk focus to become more proactive in identifying emerging solvency issues
• Enhance the qualitative aspects of examination and financial analysis functions
Goals of Risk-Focused Examinations

- Assess the quality and reliability of corporate governance to identify, assess and manage the risk environment facing the insurer in order to identify current or prospective solvency risk areas

- Assess the risks that a company’s surplus is materially misstated
Key Concepts

• Examiner professional judgment
• Flexibility of the established process
• Responsibility to report on the insurer’s financial condition
• Responsibility to consider the insurer’s corporate governance, prospective risks and risk management processes
Key Concepts (cont.)

- Consideration of “Other than Financial” risks
- Utilization of external auditor/Sarbanes-Oxley & Internal Audit documentation
- Utilization of examination results to modify and update insurer’s priority determination
- Interviews with “C-level” executives
What are the significant changes?

4 years ago:

All **Material Account Balances** had to be tested by examiners and testing must be typically increased to the reliability levels required for exam purposes. (CPA vs Exam sample sizes).

Evolution of “**Significant Accounts**” meaning all material accounts no longer had to be tested unless they were deemed significant. Significant = estimates, subjective or difficult to value assets, completeness of data.
What are the significant changes?


Evolution of the **“Critical Risk Categories”** which are required to be documented for all examinations. Eliminates the requirement that all line items above tolerable error be addressed through a risk statement.

Evolution of **IT Exam – COBIT guidelines**

Evolution of **Exam Communication/branded risks**
Reliance on Audit Procedures

Audit Review Procedures

Must determine whether a review of financial reporting risks can be reduced based on the effectiveness of the insurer’s audit function

• An effective audit function may allow the exam team to identify fewer financial reporting risks
• Conversely, if the audit function is deemed inadequate, the exam team may choose to review more financial reporting risks
Exam looks at risks likely to cause Company failure in addition to financial reporting risks. For example:

- Prospective Risks
- Other than Financial Risks
- Corporate Governance Oversight and Monitoring
- Increased focus on strategies, processes, controls
- Related Party Agreements and Allocations
The Critical Risk Categories that MUST be evaluated during an examination with at least one risk statement are:

1. Valuation/Impairment of Complex or Subjectively Valued Assets
2. Liquidity Considerations
3. Appropriateness of Investment Portfolio and Strategy
4. Appropriateness/Adequacy of Reinsurance Program
5. Reinsurance Reporting and Collectability
6. Underwriting Pricing Strategy/Quality
7. Reserve Data
8. Reserve Adequacy
9. Related Party/Holding Company considerations
10. Capital Management

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Risk Assessment Drives the Exam Process.

The Critical Risk Categories and the Accreditation Standards represent the MINIMUM requirements for the examination process.
The IT General Controls Procedures for the exam fall into 5 main quadrants:

1. Align, Plan and Organize (APO)
2. Build, Acquire and Implement (BAI)
3. Deliver, Service and Support (DSS)
4. Monitor, Evaluate and Assess (MEA)
5. Cybersecurity Concerns
Overview of the Exam Process

• Let’s do a quick walk through of the Risk Focused Exam process:
Exam Kickoff – ADOI Activities - KAT

- Contract Actuary, Examiner, Supervisor and Reinsurance and Investment experts if needed.
- The Call Letter
- Confidentiality
- The Exam Planning Questionnaire (Exhibit B) and
- The IT Planning Questionnaire
- The CPA workpapers
- The Kickoff Meeting
Risk-Focused Examination Process

The Exam has 7 Phases:
• Phase 1 – Understanding the Company
• Phase 2 – Identify and Assess Inherent Risk in Activities
• Phase 3 – Identify/Evaluate Risk Mitigation Controls
• Phase 4 – Determine Residual Risk
• Phase 5 – Establish/Conduct Examination Procedures
• Phase 6 – Update Prioritization and Supervisory Plan
• Phase 7 – Draft Examination Report and Management Letter
Risk-Focused Examination Process

Phase 1
– Understanding the Company and Identifying Key Functional Areas to be Reviewed

• C-level interviews
• Gather information about the Company, its Corporate Governance, the internal and external audit processes, and insurance department analytics and communications. Identify risks through gaining an understanding of the Company, consideration of branded risks and exam assertions.
Phase 2 Overview

• Identify & Assess Inherent Risk in Activities
  Sources include: internal risk assessment, internal and external audit risk assessment, SEC filing requirements, SOX requirements

• Identify and document inherent risks

• Likelihood of occurrence and magnitude of impact determined using judgment
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Completion of Planning - KAT

- Chief Examiner reviews the planning memo which outlines the company history and products, its corporate governance framework identified risks and all of the risk matrices, and the detailed exam approach including the budget.
Phase 3 Overview

- Identify and Evaluate Risk Mitigation Strategies/Controls
- Identify and evaluate mitigating controls
- Assess how well they mitigate risks
- Strategies/Controls = management oversight, policies and procedures, risk measurements, control monitoring, and compliance with laws and regulations
Phase 4 Overview

- Determine Residual Risk
- Determine residual risk for individual risks identified to arrive at overall residual risk
- How well do controls reduce the level of inherent risk
- Once riskier activities are identified, exam resources and be focused and determination of nature and extent of testing
Phase 5 Overview

- Establish/Conduct Examination Procedures
- Most like traditional exam
- Focus testing procedures on those areas identified in Phase 4 with high residual risk
- Subsequent Events review including minutes, financial statements, new agreements
- Fraud Systems Testing
Phases 6 and 7 – ADOI activity - KAT

Phase 6
– Update Prioritization and Supervisory Plan

Phase 7 – ADOI takes over
– Draft Reports
  • Examination Report is a public document
  • Management Letter is a private document
What Should Insurance Company Do to Prepare?

Learn the Language of Risk

1. Risk Environment and Types
2. Risk Classifications
A company that is aware of their risk universe is more adaptable and responsive.
The following risk classifications are based on the NAIC Financial Examiners Handbook

- **Reserving Risk**
  - Projection risk
  - Monitoring risk
  - Reporting risk
- **Liquidity Risk**
  - Cash flow risk
  - Investment risk
  - Premium risk
- **Credit Risk**
  - Interest-Rate Risk
  - Exchange Risk
  - Reinvestment Risk
- **Legal/Regulatory Risk**
  - SAP requirements
  - Tax Liability
  - State regulation
  - Guarantee Fund Assessments
- **Reputation Risk**
  - Negative public opinion
  - Ability to establish new relationships
  - Exposure to litigation
- **Pricing & Underwriting Risk**
  - Rate risk
  - Experience risk
  - Reinsurance risk
- **Market Risk**
  - Interest-Rate Risk
  - Liquidity Risk
  - Pricing Risk
  - Exchange Risk
  - Reinvestment Risk
- **Operational Risk**
  - Information systems
  - Internet and data security
  - Business processes
  - Internal controls
- **Strategic Risk**
  - Unity of strategic goals
  - Strategies developed
  - Resources used
  - Quality of the plans
What Should Insurance Company Do to Prepare? - The General Concepts

1. Understand the risk-focused examination process
2. Understand your corporate risk universe
3. Develop a risk management process
4. Document your key controls
5. Be aware of the regulatory environment
   - Model Audit Rule
   - Corporate Governance Model Act
   - ORSA/ERM reporting
   - Risk Retention Model Act including Corp Gov.
The Specifics to Aid Exam Efficiency

1. Complete the questionnaires and provide documentation – if you need help- ask!
2. One main exam contact who maintains the information request log.
3. Create a listing of Agreements and sort them by related party/affiliate and non-affiliate. Be prepared to provide EXECUTED key agreements to examiners even if filed with the Department.
4. Executed Board minutes need to be provided to examiners from the beginning of the exam period through the end of exam field work.
5. Key Committee minutes need to be provided to examiners for at least the exam “as of” date and through the end of fieldwork.
6. Key Board materials that address critical risks are extremely helpful.
7. An organization chart for each department from manager and above that indicates the experience level of the key players in each department.
8. Risk identification for financial reporting, other than financial reporting and prospective risks
9. Narratives of key internal controls over financial reporting risks
10. Documentation that key controls are in place and working effectively.
Questions?

• Marlys Rulon (602) 264-8614
• mrulon@eidebailly.com