

# The Actuary's Role in Risk Focused Examinations

Melissa Greiner, P&C Actuary  
Pennsylvania Insurance Department

# Antitrust Notice

- ▶ The Casualty Actuarial Society is committed to adhering strictly to the letter and spirit of the antitrust laws. Seminars conducted under the auspices of the CAS are designed solely to provide a forum for the expression of various points of view on topics described in the programs or agendas for such meetings.
- ▶ Under no circumstances shall CAS seminars be used as a means for competing companies or firms to reach any understanding – expressed or implied – that restricts competition or in any way impairs the ability of members to exercise independent business judgment regarding matters affecting competition.
- ▶ It is the responsibility of all seminar participants to be aware of antitrust regulations, to prevent any written or verbal discussions that appear to violate these laws, and to adhere in every respect to the CAS antitrust compliance policy.

# Widespread Applicability

- ▶ **This discussion benefits actuaries performing the following roles at an insurance company:**
  - Consulting Actuary providing exam services
    - “Examining Actuary”
  - Appointed Actuary
  - Chief Actuary
  - Company actuary in following activities:
    - Reserving
    - Rate making
    - ERM or Predictive Modeling
  - Insurance Department actuary
  - Actuarial student of any level

# Examining Actuaries Should Expect:

- ▶ To be involved throughout the entire examination
- ▶ To think like an auditor
- ▶ To evaluate risk and its impacts to an insurer
- ▶ To provide value added actuarial services before crunching a number
- ▶ That states will have different approaches and degrees of actuarial involvement with their examiners

# Examining Actuaries Should Expect:

- ▶ The Examiner-in-Charge (EIC) to take the lead in Communication and Coordination with respect to a risk focused examination
- ▶ To play an active role in Coordination and Communication
- ▶ To have periodic status meetings with and/or status reports to the EIC.
  - ▶ Some status meetings may involve Company management

# Company Actuaries Should Expect:

- ▶ To think about risk and how your company or management team manages risk
- ▶ To talk with examiners
  - Possibly be interviewed
  - Participate in process walkthroughs
- ▶ To provide documents to state examiners for review and inspection

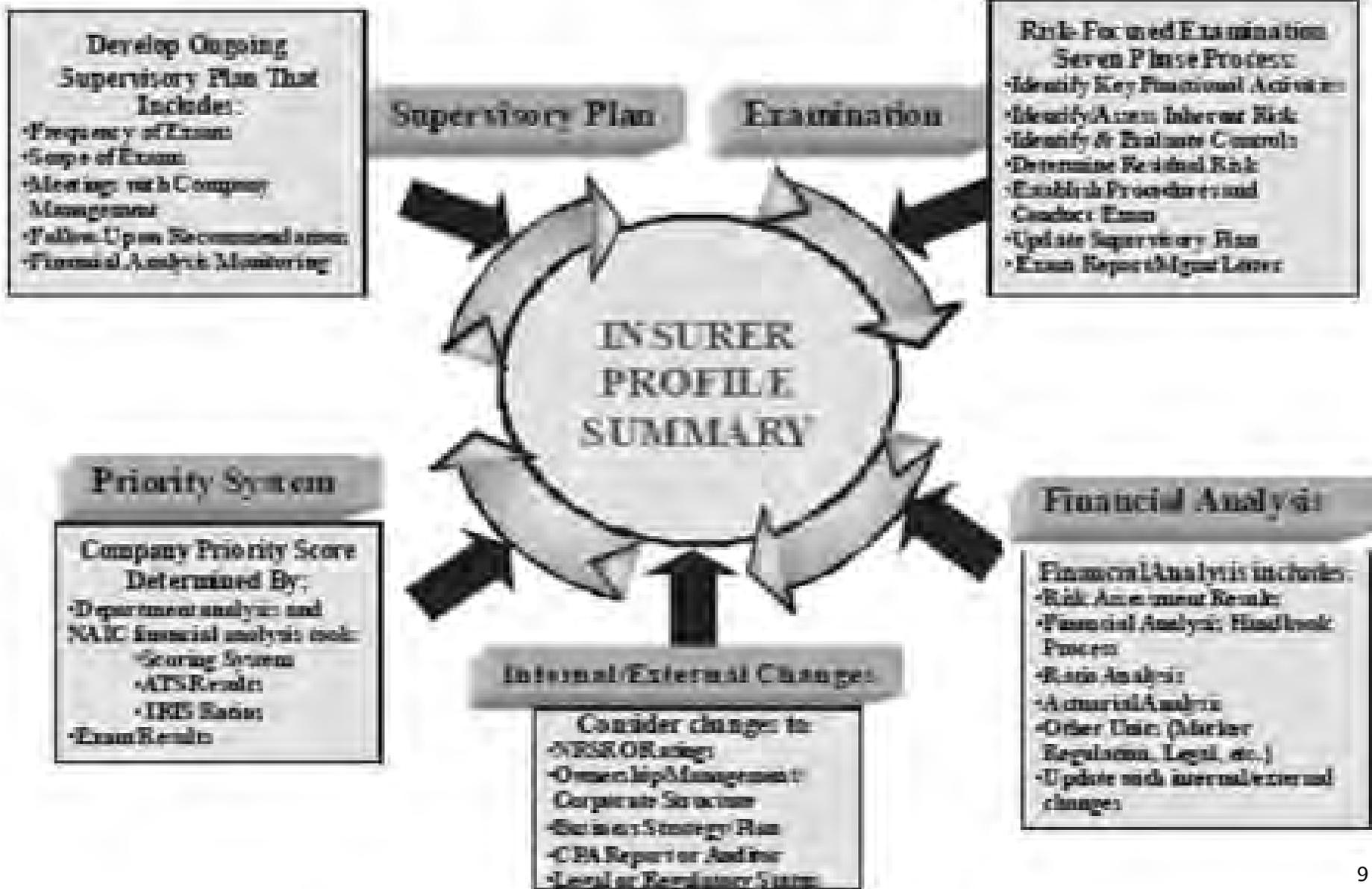
# Appointed Actuaries Should Expect:

- ▶ Actuarial Opinions, Summaries and Reports will be thoroughly reviewed by regulators.
- ▶ The Opinion and Actuarial Report must be presented to the Board of Directors, or Audit Committee for their review and consideration.
- ▶ “A well prepared and documented Actuarial Report that is consistent with the spirit of ASOP 9 can provide a foundation for efficient reserve evaluation within a statutory examination.”

# Topics to Cover

- ▶ **NAIC's Risk Focused Examination Process**
  - Examination procedures changes
  - Changes in actuarial deliverables for the exam
  - Contracting for actuarial services
- ▶ **Challenges and Expectations for various Actuarial Roles**
- ▶ **Coordination / Communication Best Practices**

# RISK-FOCUSED SURVEILLANCE CYCLE



# NAIC's Risk Focused Examinations Process Overview

## Intent

Broaden and  
enhance the  
identification of  
risk inherent in  
an insurers'  
operations

Use that  
information

Formulate the  
ongoing  
surveillance of  
the insurer

# Old vs New Process

## as impacts an Examining Actuary

### Old Process

- Independent loss reserve analysis
- Evaluate reasonability of carried reserves
- No consideration of risk mitigation
- Minimal interaction with examiner
- Limited view of reserves only

### New Process

- Substantive testing limited to moderate or high risk areas
- Evaluate internal controls about reserving process
- Consider risk mitigation strategies
- Continual interaction with examiner
- Broader view of reserves, pricing, liquidity and reinsurance

# Expected Benefits of Risk Focused

- ▶ “Enhance effective use of regulatory resources through increased focus on higher risk areas.”
- ▶ “Increase regulatory understanding of the insurer’s quality of management, corporate governance and the characteristics of the insurer’s business and the risks it assumes.”

# Expected Benefits of Risk Focused

- ▶ “Expand risk assessment to provide a more comprehensive and prospective look at an insurer’s risks through identification of the insurer’s current and/or prospective high-risk areas.”

# NAIC's Risk Focused Examinations

- ▶ All examinations beginning January 1, 2010
  - Several states were “early adopters”
  - Some states did not implement until 2010
- ▶ Varied levels of understanding across state insurance departments' staff and contract vendors
- ▶ Implementation challenges

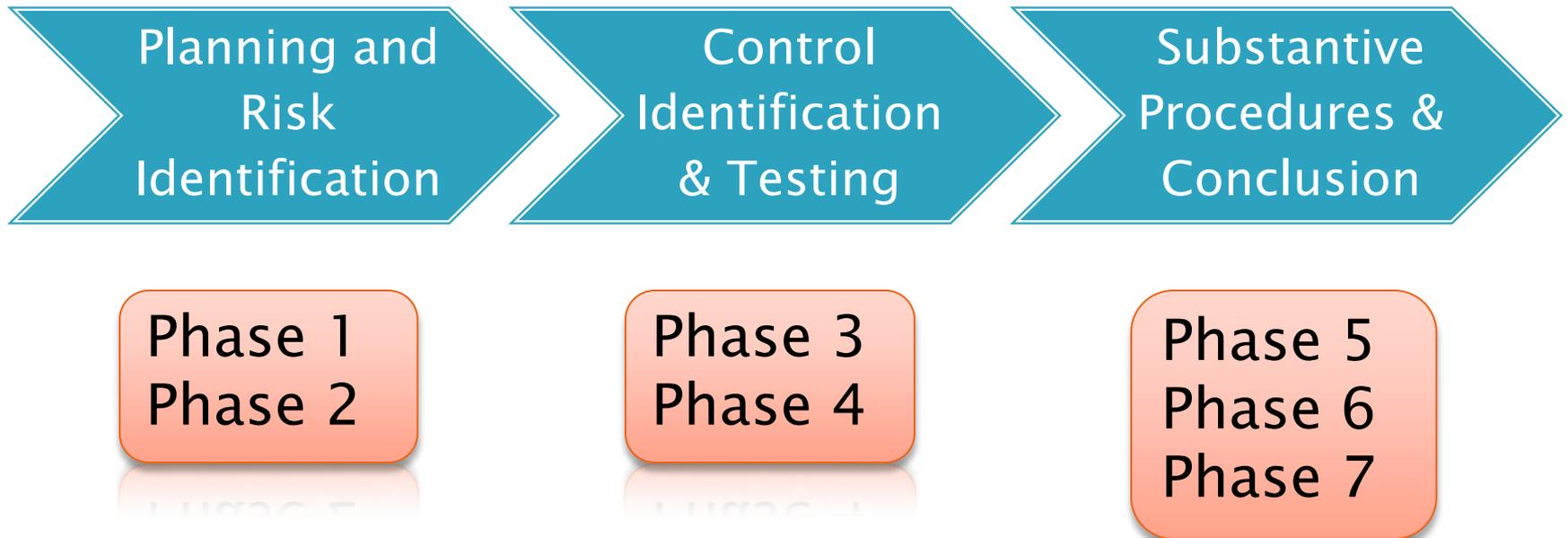
# Seven Phases of RFE

- ▶ Phase 1: Understand the company and identify key functional activities
- ▶ Phase 2: Identify and assess inherent risk
- ▶ Phase 3: Identify and evaluate risk mitigation strategies/controls
- ▶ Phase 4: Determine residual risk
- ▶ Phase 5: Establish and conduct substantive testing procedures
- ▶ Phase 6: Update prioritization and supervisory plan
- ▶ Phase 7: Draft exam report and management letter

# Seven Phases of RFE

- ▶ Phase 1: Understand the company and identify key functional activities
- ▶ Phase 2: Identify and assess inherent risk
- ▶ Phase 3: Identify and evaluate risk mitigation strategies/controls
- ▶ Phase 4: Determine residual risk
- ▶ Phase 5: Establish and conduct substantive testing procedures
- ▶ Phase 6: Update prioritization and supervisory plan
- ▶ Phase 7: Draft exam report and management letter

# Seven Phases of RFE – one view



# Challenges in Risk Focused Exams

Examining Actuaries

Company Actuaries

Appointed Actuaries

# Challenge to Examining Actuary

- ▶ The State Insurance Department examiner is still asking me to provide an independent analysis of the Company's carried loss reserves, including a full actuarial report. I thought this was the OLD way of conducting exams. What should I do?

# Challenge to Examining Actuary

- ▶ The State Insurance Department examiner is still asking me to provide an independent analysis of the Company's carried loss reserves, including a full actuarial report. I thought this was the OLD way of conducting exams. What should I do?
- ▶ Have a conversation with your examiner
- ▶ Ask examiner if he is in the planning stage, or has completed risk assessment
- ▶ **Actuary should be involved from beginning**

# Challenge to Examining Actuary

- ▶ Scope of engagement letter (contract letter) may look dramatically different and should include some form of the following:
  - Involvement with various phases of work
  - Timing of deliverables
  - Regular status reporting
  - Interview logistics
  - Budget and time constraints
  - Responsibility for matrices
  - TeamMate expectations
  - Phase 5 work at the direction and approval of the Insurance Department

# Challenge to Examining Actuary

- ▶ The State Insurance Department examiner is asking me to assist in writing risk statements for him, but I don't know anything about the Company. How can I get this information?

# Challenge to Examining Actuary

- ▶ The State Insurance Department examiner is asking me to assist in writing risk statements for him, but I don't know anything about the Company. How can I get this information?
- ▶ Have a conversation with your examiner
- ▶ This takes us to Phase 1 of RFE Process

# Phase 1 – Understand the Company and Identify Key Functional Activities

Key activities are identified using background information gathered from various sources

- Annual and Quarterly Statements
- 10Ks
- Statements of Actuarial Opinion
- Actuarial Opinion Summaries

Examiner should have information, not traditionally shared with actuaries

- CPA Audit work papers
- Internal control documents
- ERM process narratives
- Financial Analysis reports

# Challenge to Company Actuary

- ▶ Every year my company hires an outside actuarial firm to write the Statutory Opinion filed with the Annual Statement. Why do the state examiners still want to talk to me and my staff? We are already busy trying to keep up with management's demands for our time.

# Challenge to Company Actuary

- ▶ Every year my company hires an outside actuarial firm to write the Statutory Opinion filed with the Annual Statement. Why do the state examiners still want to talk to me and my staff? We are already busy trying to keep up with management's demands for our time.
- ▶ The examiner has noted that the carried reserve is not the same as the appointed actuary reserve.
- ▶ The examiner may be interested to hear about your other projects.
- ▶ Examiners want to hear from you how risks are identified and managed.

# Phase 1 – Understand the Company and Identify Key Functional Activities

## Interviews

- ▶ Provide valuable information about Company history, future plans, areas of risk, key activities
- ▶ Actuary may be asked to participate:
  - Be present during the interview
  - Lead the interview
  - Prepare interview questions
- ▶ Directed to C–Level employees
  - CEO, COO, CFO
  - Chief Underwriter, Chief Claims Officer
  - Chief Actuary, Chief Risk Officer, etc

# Challenge to Examining Actuary

- ▶ The State Insurance Department examiner is asking me to assist in the inherent risk assessment process and writing risk statements. What are risk statements and how do I do that?

# Challenge to Examining Actuary

- ▶ The State Insurance Department examiner is asking me to assist in the inherent risk assessment process and writing risk statements. What are risk statements and how do I do that?
- ▶ The Examiner or the *NAIC Financial Condition Examiners Handbook* can guide you.
- ▶ Phase 2 of the RFE process involves this step.

# Phase 2

## Identify Inherent Risk

Inherent risk is the risk of economic loss or inaccurate financial reporting before considering internal controls.

The examiner or actuary asks, “What can go wrong?”

# Phase 2

## Writing Risk Statements

The reserving assumptions and methodologies used by the insurer are not appropriate for the lines of business written.

Changes in claims handling process implemented by the new VP of claims are not considered in insurer's reserves.

Policies are issued without complying with written underwriting policies and procedures.

Anticipated salvage & subrogation recoveries are overstated, resulting in understated carried reserves.

# Phase 2

## Assessing Inherent Risk

“The reserving assumptions and methodologies used by the insurer are not appropriate for the lines of business written.”

- ▶ What is the likelihood of this occurring?
- ▶ What is the magnitude of impact?
  - How is surplus impacted?
  - What level of management would need to be involved to address the risk?

# Phase 2

## Assessing Inherent Risk

“Policies are issued without complying with written underwriting policies and procedures”

- ▶ What is the likelihood of this occurring?
- ▶ What is the magnitude of impact?
  - How is surplus impacted?
  - What level of management would need to be involved to address the risk?

# Phase 2

## Assessing Inherent Risk

**Examiners will expect examining actuaries to:**

- ▶ Make/contribute to such assessments for all key activities and sub-activities.
- ▶ Document those assessments
  - Memorandum
  - Risk Matrix
  - Teammate
- ▶ Conduct Phase 5 Testing to a degree consistent with this assessment

# NAIC Handbook – Repositories

The screenshot shows a Microsoft Word document titled 'Document1 - Microsoft Word'. The ribbon is set to 'Home', and the 'Normal' style is selected. The document content is a table of contents for 'SECTION 3 — EXAMINATION REPOSITORIES'. The table lists various categories and their corresponding page numbers. The status bar at the bottom indicates 'Page: 1 of 1' and 'Words: 0'. The Windows taskbar at the bottom shows the Start button, several open applications, and the system clock displaying '10:36 AM Sunday 4/1/2012'.

SECTION 3 — EXAMINATION REPOSITORIES	
BACKGROUND .....	183
<b>KEY ACTIVITIES RELATING TO:</b>	
PREMIUMS (LIFE) .....	187
PREMIUMS (PROPERTY / CASUALTY) .....	197
PREMIUMS (HEALTH) .....	207
CLAIMS HANDLING (LIFE) .....	219
CLAIMS HANDLING (PROPERTY / CASUALTY) .....	235
CLAIMS HANDLING (HEALTH) .....	253
REINSURANCE – CEDING INSURER (ALL LINES) .....	271
REINSURANCE – ASSUMING INSURER (ALL LINES) .....	283
RESERVES (LIFE) .....	293
RESERVES (PROPERTY / CASUALTY) .....	305
RESERVES (HEALTH) .....	319
INVESTMENTS (ALL LINES) .....	333
OTHER ASSETS (HEALTH) .....	355
TAXES (ALL LINES) .....	361
RELATED PARTY (ALL LINES) .....	367
EXPENSES (ALL LINES) .....	375
OTHER LIABILITIES AND SURPLUS (ALL LINES) .....	381
UNDERWRITING (ALL LINES) .....	385

# Challenge to Examining Actuary

- ▶ The State Insurance Department examiner has asked for my thoughts on the company's controls about their reserving process. I don't remember control testing being addressed on any of my actuarial exams. What is he talking about?

# Challenge to Examining Actuary

- ▶ The State Insurance Department examiner has asked for my thoughts on the company's controls about their reserving process. I don't remember control testing being addressed on any of my actuarial exams. What is he talking about?
- ▶ Actuary is expected to think like an auditor.
- ▶ This takes us to Phase 3 of the RFE Process.

# Phase 3

## Identify and Evaluate Risk Mitigation Strategies / Controls

- ▶ Ask yourself, what is the insurer doing to manage risks?
- ▶ Sample procedures that an insurer may have in place:
  - Peer review of actuarial documents
  - Quarterly reserve committee meetings
  - Monthly price monitor report to management

# Challenge to Appointed Actuary

- ▶ As Appointed Actuary for my client, my Opinion says reserves are reasonable and there is no risk of material adverse deviation. The Company's carried reserves are always within my range of estimates, so why do the state examiners want to talk with me?

# Challenge to Appointed Actuary

- ▶ As Appointed Actuary for my client, my Opinion says reserves are reasonable and there is no risk of material adverse deviation. The Company's carried reserves are always within my range of estimates, so why do the state examiners want to talk with me?
- ▶ Examiner's understanding on your interaction (or lack thereof) with management.
- ▶ Views on risk compared to management's views on risk
- ▶ Regulators review your work for overall compliance.

# Challenge to Examining Actuary

- ▶ The State examiner is asking me for my Residual Risk assessment. What does that mean and how do I determine the answer?

# Challenge to Examining Actuary

- ▶ The State examiner is asking me for my Residual Risk assessment. What does that mean and how do I determine the answer?
- ▶ Determining how well the controls mitigate the inherent risks of an insurer's activities
- ▶ This takes us to Phase 4 – Determining Residual Risk

# Phase 4 – Determine Residual Risk

- ▶ Calculated residual risk per the NAIC Handbook

**Inherent Risk + Controls = Residual Risk**

- ▶ High Inherent Risk + Strong Controls = Moderate or High Residual Risk
- ▶ Professional judgment must be applied in determining residual risk in this scenario

# Phase 4 – Determine Residual Risk

- ▶ Professional judgment should include:
  - Past experience with Company
  - Qualifications of appointed and/or company actuaries
  - Changes in company's book of business
  - Financial results of operations
  - Level of formalized ERM
  - Overall assessment of Corporate Governance

# Challenge to Examining Actuary

- ▶ The State examiner advised that residual risk for the reserves process is moderate and he needs help with substantive testing. What kind of actuarial analysis is acceptable?

# Challenge to Examining Actuary

- ▶ The State examiner advised that residual risk for the reserves process is moderate and he needs help with substantive testing. What kind of actuarial analysis is acceptable?
- ▶ Several forms are acceptable, and not all involve ground up analysis of all lines of business
- ▶ This takes us to Phase 5 – Substantive Testing

# Phase 5 – Substantive Testing

May include any of the following:

- ▶ Peer review of reports or work papers
- ▶ Analytical Procedures
- ▶ Sensitivity Testing
- ▶ Independent Analysis
- ▶ Any combination of the above

# Phase 5 – Substantive Testing

Examining Actuary may rely on:

- ▶ Appointed Actuary Report
- ▶ Auditor work papers
- ▶ Internal actuarial work papers
- ▶ Their own actuarial analysis of Company data and/or information to form an independent conclusion

# Phase 5 – Substantive Testing

## Change in Paradigm for Examining Actuary

- ▶ Strong risk management indicates management effectively identifies and controls all material types of risks posed by a relevant activity
- ▶ The Examining Actuary's response to this must be consistent with the control assessment rating
- ▶ Expected reduction (may be significant) in actuarial re-calculations

# Phase 5 – Substantive Testing

## Change in Paradigm for Examining Actuary

- ▶ Focus should be on only the highest residual risk areas
- ▶ Reserving is generally thought of as a High Inherent Risk and Residual Risk activity
- ▶ Determine which components of reserves are the highest risks:
  - Lines of business
  - Products or Segments
  - Blocks of business
  - Transactions

# Coordination / Communication

## Best Practices – Examining Actuary

- ▶ Two Way Communication
  - EIC should take the lead
  - Actuary also plays an active role
  - Periodic status meetings or status reports
  - Defined in engagement letter
- ▶ C-Level Interviews
  - Actuaries encouraged to participate or even lead certain interviews
  - Interview agendas should be a coordinated effort

# Coordination / Communication

## Best Practices – Examining Actuary

- ▶ Familiarity with risk focused concepts
  - Take NAIC training
  - Understand the Handbook and Risk Repositories
- ▶ Reasonable and acceptable to spend more time on planning and risk assessment than actuarial re-calculations.
- ▶ Specify expectations of examining actuary's involvement in contract agreement with state insurance department

# Coordination / Communication

## Best Practices – Company Actuary

- ▶ Document your work
  - Maintain documentation
  - Keep evidence of sign-off or peer review steps
  - Applies to all aspects of actuarial deliverables from reserving to rate making and other activities
- ▶ Make yourself available to state examinations staff
- ▶ Assist with identification of risk mitigation strategies or internal controls over actuarial risks

# Coordination / Communication

## Best Practices – Appointed Actuary

- ▶ Document your work
  - Explain your judgment
  - Prepare a good Actuarial Report that is consistent with ASOPs and NAIC Annual Statement Instructions
- ▶ Make yourself available to state examinations staff
- ▶ Communicate with company management\
- ▶ Maintain a good relationship with your domestic regulator

# Questions or Comments?

