

# NAIC Risk Focused Examinations

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# Presenters

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# Agenda

- What do I need to know?
- Traditional Financial Examinations
- Risk-Focused Financial Examinations
  - Goals of a Risk-Focused Examination
  - 7 Phases of a Risk-Focused Exam
- Actuarial Best Practices
- Risk Matrix Overview
- Q&A

# What do I need to know?

- Understand the Regulatory Process
  - Regulators review Actuarial Report, Opinion, and need to understand your role in the reserve setting process
- Company actuaries
  - Expanded role in assisting in financial examination
  - Interviews of Chief Actuary
- Consulting actuaries
  - In supporting financial examinations for state insurance departments, you might be called upon to assist in this process
  - Timing of actuarial review is much more inter-dependent on timing of overall examination

# Financial Examinations Overview

- Statutorily required financial audits
- Statutes generally call for a financial exam every 3-5 years
  - interim limited-scope exams can be called by the state as necessary
- Compliance with statutory accounting principles is a primary focus
- Primarily led by staff with accounting / auditing backgrounds

# Traditional Financial Examinations

- All material accounts are reviewed
- Goal of monitoring solvency at a point in time
- Focus was on the past
  - Balance Sheet at a past point in time
- Exams usually commenced after the Balance Sheet date
- Examiner relied on detailed testing to verify account balances

# Evolution of Exam Process

- 1997: SRA approach became an Accreditation requirement
  - SRAs key objective was meant to focus exam resources on high risk areas
- 2000: Risk Assessment Working Group formed to:
  - Review and enhance utilization of risk assessment
  - Consider the challenges of incorporating risk assessment into financial solvency oversight role

# Evolution of Exam Process

- 2004: NAIC adopts a Risk-Focused Surveillance Framework
- 2006: Adoption of Revisions to NAIC Financial Condition Examiners Handbook
- 2007-2009: Dual examination approach
- 2010: Accreditation Standard that all exams be completed using Risk Focused Approach



# Goals of a Risk-Focused Exam

- Determine the **risk** that **surplus** is materially **misstated**.
- Strengthen understanding of insurer's **corporate governance** and assess effectiveness of management.
- Increase the understanding of the:
  - characteristics of the insurer's business;
  - identification of risks associated with insurer's business; and
  - development and implementation of risk mitigation strategies.

# Goals of a Risk-Focused Exam

- Enhance effective use of regulatory resources by focusing on **high-risk areas** and avoiding duplication of work.
- Expand risk assessment to include **prospective risks**
  - Pricing and Underwriting in P&C company for example
- Provide **meaningful feedback** with Board and/or Senior Management.
- Provide input into the Department's **Supervisory Plan**.

# Benefits of Risk-Focused Exam

- Focus resources on high risk companies
  - Allow for more frequent reviews, as needed
- Focus resources on areas of highest risk within companies
- More emphasis on a company's internal control structure
- Better use of auditor work
  - Internal Audit
  - Independent Auditor / CPA
- Increase protection for ALL policyholders

# Traditional vs Risk-Focused Exams

<b>Traditional</b>	<b>Risk Focused</b>
Audit of all material accounts	Risk-focused determination of scope
Substantive testing	Control testing
No reliance upon the work of others	Potential reliance on Internal Audit and CPA
Focus on the balance sheet	Focus on quality of management and controlling of risk
Point in time	Both retrospective and prospective
Does not contemplate the risk profile of the insurer	Risk profile (e.g., reserves by line) explicitly considered

# Phases of a Risk-Focused Exam

- Phase 1: Understand the company and identify key functional activities to be reviewed
- Phase 2: Identify and assess inherent risk in activities
- Phase 3: Identify and evaluate risk mitigation strategies/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 based upon findings

# Phases of a Risk-Focused Exam

- Phase 1: Understand the company and identify key functional activities to be reviewed
  - Examiners will attempt to understand the business of the insurer and assess quality of management.
    - Gather and review Company prepared materials, including but not limited to Actuarial Reports, CPA workpapers, Board meeting minutes, Reserve Committee (if any) notes, procedure manuals, etc.
    - Exam Actuary can assist in this review and provide input
  - Examiners will conduct interviews of various C-Level staff
    - To help assess risks, key functional activities, and corporate governance environment.
    - Includes Chief Actuary

# Phases of a Risk-Focused Exam

- Phase 2: Identify and assess inherent risk in activities
  - Key functional areas will be examined in greater detail.
  - Reserving Risk
    - Examiners will review lines of business written and assess materiality and risk levels.
    - Corporate actuarial will likely conduct walk-throughs of the reserving process to help examiners understand inherent risks.
  - Pricing and Underwriting Risk
    - Examiners will understand processes, policies and risks in order to better determine plan for test of controls about pricing during Phase 3
    - Monitoring producer / MGA activity
    - Examiners will question what reports management uses to monitor use of debits / credits

# Phases of a Risk-Focused Exam

- Phase 3: Identify and evaluate risk mitigation strategies/controls
  - Examiners will review the programs, processes and procedures which make up the control environment (e.g. internal audit programs, SOX documentation, etc.)
  - IT general controls are critical, as they impact nearly every facet of the organization and its financial reporting capabilities.
  - Actuarial management and/or internal audit will be asked about internal management controls over data, analysis tools and the booking process.



# Phases of a Risk-Focused Exam

- Phase 3: Identify and evaluate risk mitigation strategies/controls
  - Examiners will make a formal assessment of the quality of internal audit and CPA to determine degree of reliance on their work.
  - Examiners will determine an appropriate plan for test of controls, based on level of testing performed by other independent parties.
  - Actuarial involvement is key in determination of actuarial related controls to be tested; involvement in actual testing is optional, but preferred.

# Phases of a Risk-Focused Exam

- Phase 4: Determine Residual Risk
  - Risk remaining after consideration of controls

Inherent Risk

- Internal Controls

Calculated Residual Risk

+/- Examiner's Judgment

Overall Residual Risk Assessment

# Phases of a Risk-Focused Exam

- Phase 5: Conduct Exam Procedures
  - Procedures based on residual risk assessment
  - Reserves testing may be limited to:
    - Larger, more volatile lines
    - New lines of business / segments
    - New geographic areas
    - Persistent adverse development
  - \*\* This is where bulk of examination detailed testing is done.

# Phases of a Risk-Focused Exam

- Phase 6: Prioritization and Supervisory Plan
  - Regulatory Actuary assists in developing recommendations, impacts to RBC, identifying areas needing monitoring between exams
- Phase 7: Exam Report and Management Letter
  - Exam Report is a public document
  - Management Letter is given confidential treatment

# Actuarial Best Practices

- Mind the data
  - Reconciliations between actuarial data and general ledger are considered critical.
- Communicate
  - Discussions between actuarial and claims, underwriting and senior management are integral to an effective risk mitigation strategy.
- Peer review
  - If it is feasible, peer review of one actuary's work by another is considered desirable.
  - Management meetings, monthly closing meetings, and reserve committees can also be effective in eliminating material misstatements.

# Actuarial Best Practices

- Protect your work
  - End-user computing (EUC) controls are often overlooked. Protecting workbooks from unauthorized changes to the data or formulas is a minimum step.
- Document
  - Control activities are not considered “Strong” if they cannot be documented.
  - If reliance is to be placed on a reserve committee or monthly CFO meeting, then minutes should be taken.
  - In order for the examination team to rely upon the actuarial report and Statement of Actuarial Opinion, both should sufficiently describe the analysis.

# Risk Matrix - Overview

[ReservesRiskMatrix.xls](#)

# Question & Answer

