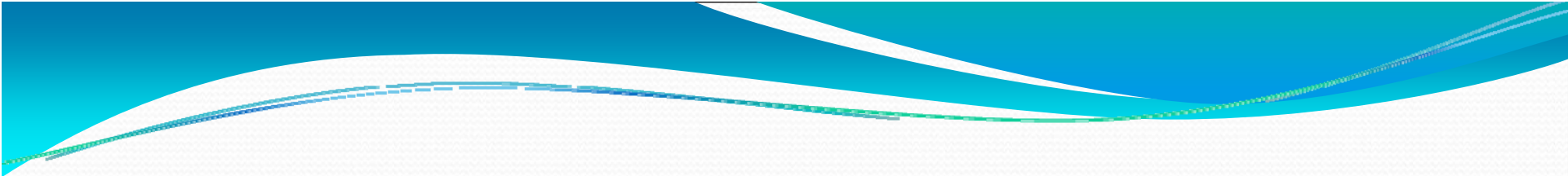


NAIC Risk-Focused Examinations

A Tale of Two States

2009 CLRS
September 14-15
Chicago, IL



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Risk Assessment and the NAIC

- Financial Analysts/Examiners have used Risk Assessment for many years - SRA's
- Focus was on the past – Balance Sheet
- Used to determine whether prior period financials were fairly stated

Development

- What triggered the change to a risk-based approach?
- Who developed the process?
- How had risk been considered in the exam process in the past?

Timing

- When were risk-based examinations first used?
- Which states currently use risk-based examinations?
- Will all states be required to do risk-based examinations?



Structure

- What are the major differences between the current exam structure and risk-based exams?
- How will consistency between states be ensured with risk-based examinations?

Structure

- Risk – Focused Surveillance Process
- Evolution or Revolution?
- In OH, CARRMEL Rating Determines Priority
- Coordinated Examinations
- Emphasis on
 - Corporate Governance
 - Quality of the Board
 - Risk Management

CARRMEL Rating

- Prioritization system
- Improves decision-making and communications
- Validated/Revised as part of the examination effort
- Facilitates analysis to identify strengths and weaknesses
- Scores management
- As time goes on, it becomes a better tool

CARRMEL

- Capital Adequacy
- Asset Quality
- Reserves
- Reinsurance
- Management
- Earnings
- Liquidity



Corporate Governance

- Board of Directors
- Senior Management
- Control Functions
 - Audit
 - Compliance
 - Risk management



Top-Down, Risk-Focused Surveillance Process

1. Assess external and internal audit functions
 - Maximize use where appropriate
2. Interview senior management
 - Assessing corporate governance and ERM
3. Focus on high risk areas (examples include):
 - Reserves
 - Reinsurance
 - Inter-company transactions



Objectives

- Identification of risks
- Assessment of governance structure
- Allocation of Department resources
- Assessment of risk management framework & practices
- Meaningful communication of findings with Board and/or Senior Management
- Update CARRMEL rating



Risk Management Principles

- Active Board and Senior Management oversight
- Adequate policies, limits and procedures
- Adequate risk management, monitoring and management information systems
- Comprehensive internal controls
- Compliance to law, regulations, and internal policies



Assessment of Risk Management Framework & Practices

- Tone at the top
 - Audit/compliance relationships
- Adherence to Board policies and procedures
- Internal control environment

Scope

- What are the major risk areas being considered in an exam?
- What are the major reasons insurers fail?
- What constitutes “poor control of the reserving process?”



Inherent Risks

- Credit
- Market
- Pricing/Underwriting
- Reserving
- Liquidity
- Operational
- Legal
- Strategic
- Reputation



Application of these Risks to Key Business Activities

- Pricing/Underwriting
- Reinsurance
- Investments
- Claims/Reserves
- Support
 - Accounting
 - Actuarial
 - IT
 - Legal
 - Human Resources



Format

- What can a company expect during an examination?
- Who is interviewed during the examination?
- How many interviews are performed?
- What questions will be asked during the interviews?



Risk Assessment Steps

Identification of Inherent Risk

Plus

Assessment of Risk Management Processes

Equates to

Residual Risk Determination

Residual Risk Grid

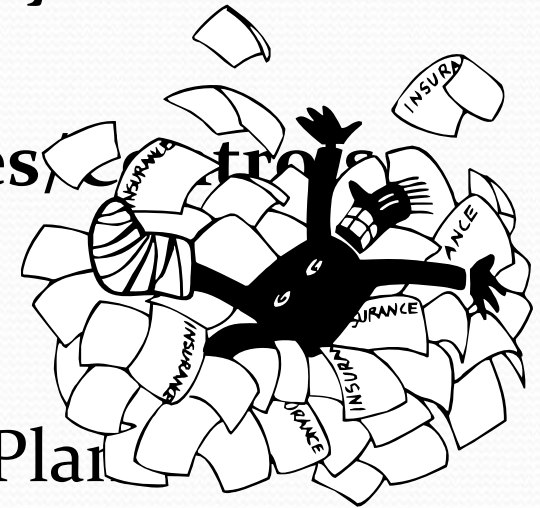
Inherent Risk	Strong Risk Controls	Acceptable Risk Controls	Weak Risk Controls
High	Moderate to High	Moderate to High	High
Moderate	Moderate	Moderate to High	Moderate to High
Low	Low	Low	Low to Moderate

Education

- What training will insurance department staff receive?
- Will examiners and actuaries need specialized training or credentials?
- How will staffing needs change within insurance departments?

7 Phases

- Phase 1 Understand Company/Key Activities
- Phase 2 Inherent Risk
- Phase 3 Risk Mitigation Strategies
- Phase 4 Residual Risk
- Phase 5 Exam Procedures
- Phase 6 Prioritization/Supervisory Plan
- Phase 7 Exam Report/Management Letter



Risky Business

Phase 1 – Understand Company/ Key Activities

1. Understanding the Company
 - Steps to Phase 1, Part 1
 1. Gather Necessary Planning Information
 2. Review the Gathered Information
 3. Perform Analytical and Operational Reviews
 4. Consider Information Technology Risk
 5. Update the Insurer Profile Summary
2. Understanding Corporate Governance Structure
3. Assessing Adequacy of Audit Function
4. Identifying Key Functional Activities
5. Consider Business and Prospective Risks

Examination Interviews

Why

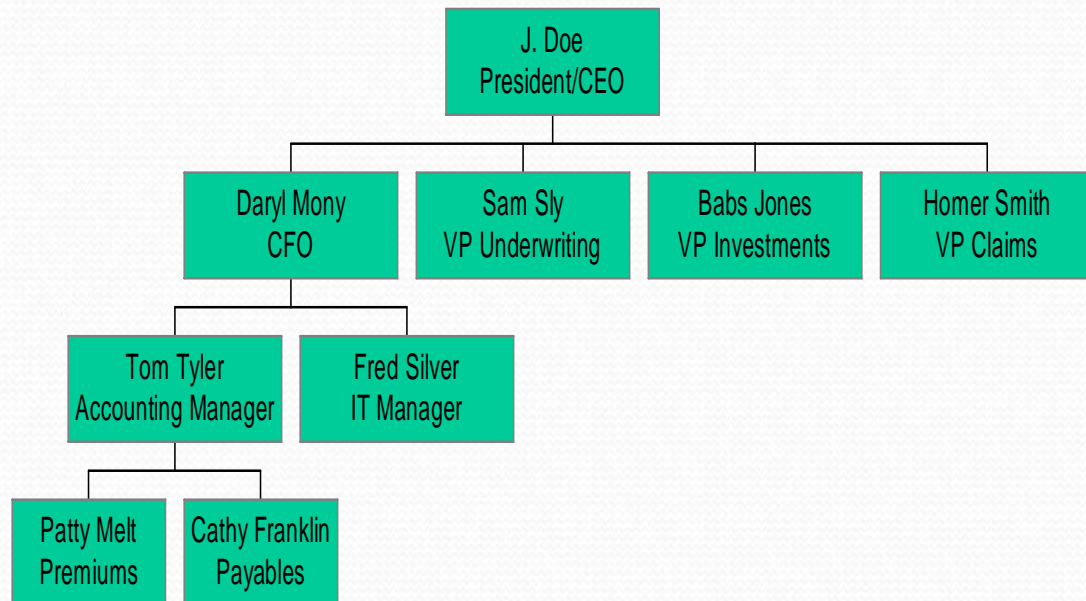
- Gather undocumented information
- Clarify information
- Interpret information
- Identify key activities
- Identify strengths
- Identify risks
- Identify risk mitigating strategies



Examination Interviews

Who

- CEO
- CFO
- COO
- CIO
- Controller
- Chief Actuary
- Board's Audit Committee chairperson



Example: Phase 1, Part 1, Step 3

Analytical and Operational Reviews

- Management and reserving processes
 - Who determines reserves booked
 - What analyses performed
 - Unique types of losses
 - Surplus and/or RBC level
 - Basis for variable compensation

Phase 1, Part 2

Corporate Governance & Management

- Management controls and reserving
 - Management influence
 - Independence of appointed actuary and their assumptions
 - Changes to appointed actuary
 - Risk transfer due to ceded reinsurance
 - Reserving actuary meets with Board/Audit Committee

Phase 1, Part 2

Corporate Governance & Management

- ITEMS FOR REVIEW
 - Actuary participates in pricing meetings
 - Exposure growth is monitored regularly
 - Well-diversified book of business-geographical
 - Remedy bad situations promptly or drag on
 - ERM implemented
 - Carried reserves determined by actuary
 - Segregation of actuarial duties

Phase 2

Inherent Risk

- Inherent Risks:
 - Incorrect data
 - Misapplying methodologies
 - Invalid assumptions
 - Incorrect calculations
 - Improper reporting of reserves



Phase 2

Inherent Risk

- Pricing/Underwriting – P/C
 - Consider inherent risks related to:
 - An insurance product priced with little margin can lead to significant losses.
 - Are separate analyses conducted for certain unique types of losses (e.g., construction defects, class actions, catastrophes, environmental)?

Phase 3

Risk Mitigation Strategies/Controls

- Controls related to specific identified risk
- Look at controls over:
 - Reserving process
 - Staffing issues

Phase 3

Risk Mitigation Strategies/Controls

Best Practice Controls

- Pricing/Underwriting
 - Appropriate rate-setting methodologies
 - Quality assurance of underwriting guidelines
 - Experience level of underwriting staff (i.e., more complex issues handled by senior staff members)

Phase 4

Residual Risk

- Risk remaining after consideration of controls

Inherent Risk

– **Internal Controls**

Calculated Residual Risk

+/- **Examiner's Judgment**

Overall Residual Risk Assessment



Phase 5

Exam Procedures

- Procedures based on residual risk assessment
 - P/C
 - Larger, more volatile lines
 - New lines of business/segments
 - New geographic areas
 - Persistent adverse development



Effect on Insurance Companies

- What will be public information?
- Could information included in an exam report adversely affect companies or competition?
- How will large and small companies be affected by their size?



Phase 6

Prioritization & Supervisory Plan

Phase 7

Exam Report & Management Letter

- Exam report is a public document
- Management letter is not

Costs

- What will be the costs to insurance departments for education and hiring qualified staff?
- Will examinations cost more?
- Will exams take longer?
- Will there be more on-site work?



Consultants

- Will consulting actuaries need to obtain additional qualifications (such as CERA)?
- Will demand for consulting actuaries change?
- Will cost of actuarial services change?



Actual Results from Completed Examinations

- What results have been seen from completed risk-based examinations?
- How have companies and regulators accepted the new format?
- Do companies and regulators have a good understanding of the issues?
- Have there been any issues or problems?