The Changing Face of Solvency Regulation and the Actuarial Contribution

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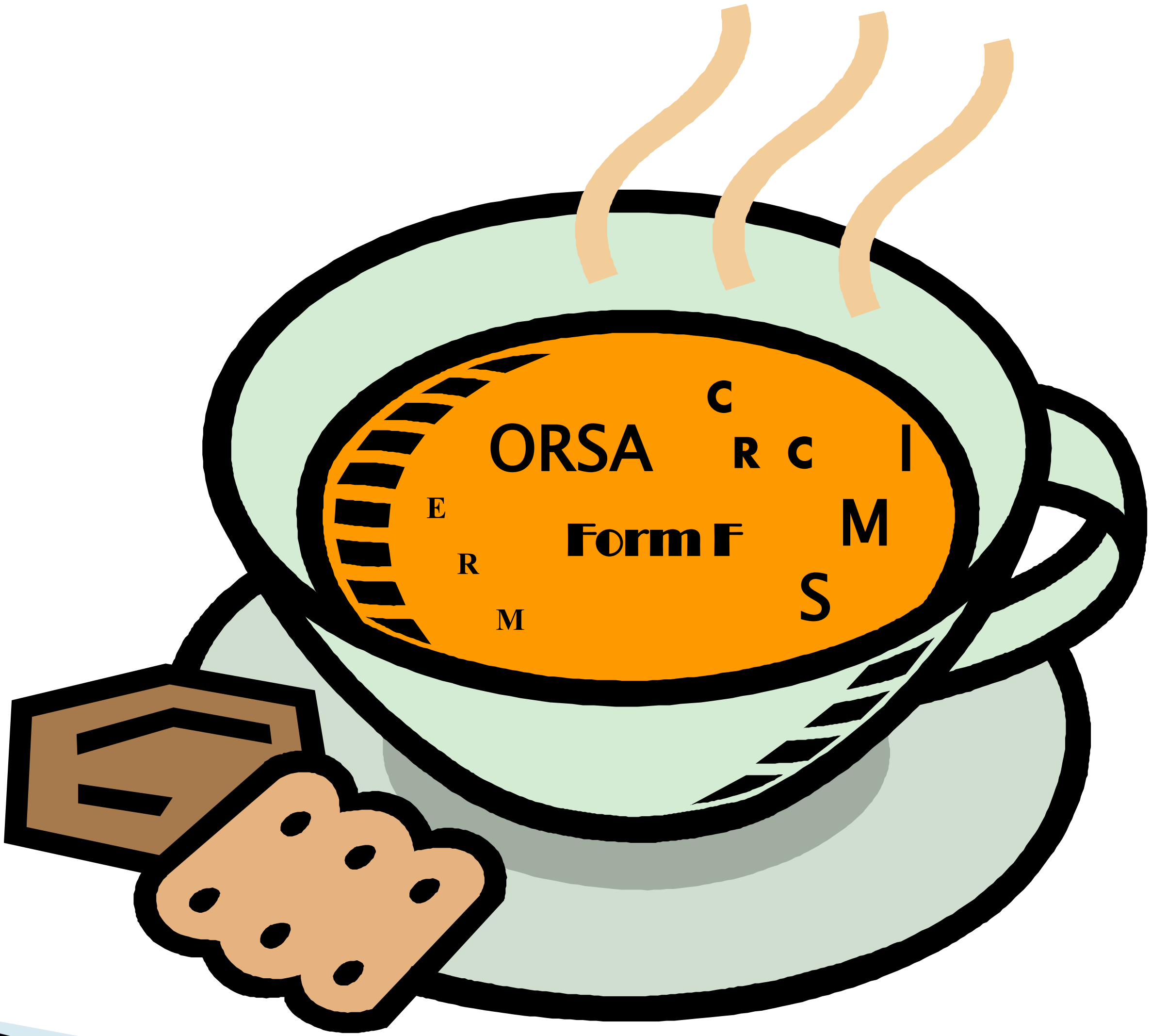
Topics of Discussion

- The NEW Alphabet Soup
  - SMI
  - ERM
  - ORSA
  - CRC
- NAIC's Risk Focused Examination Process
  - Lessons Learned – A Year Later
  - Prospective Risk
  - Pricing and Underwriting Risk
- Coordination / Communication Best Practices

Alphabet Soup



Solvency Modernization Initiative

- SMI was started in 2008 by state insurance regulators through the NAIC

- Purpose: a critical self-examination in regulators' continuous effort to look for improvements in the U.S. insurance financial regulation framework. The U.S. financial regulatory system, using general authority and exception-based rule setting (vs. a detailed/explicit authority based system), has been utilized for years and has been very effective and successful, without the need for intrusive regulation. U.S. regulators support improving on an already-good situation, where the cost of regulation is reasonable and not excessive, rather than starting from scratch with all new and yet-to-be proven theories.

Solvency Modernization Initiatives

- There have been seismic shifts in regulatory approach by the NAIC and Insurance Department
- Retrospective → Prospective
- Company → Enterprise
- Financial Statement → Governance
- Rules → Principles
- Getting to Know the DNA of a Company
- Regulators are expecting more Board involvement in this new regulatory approach

History and Background

Key components of SMI:

- Group supervision
- Governance and risk management
- Capital requirements
- Statutory accounting
- Reinsurance

Solvency Modernization Initiatives

What are the buzz words of today?

- Internationally Active Insurance Groups
- Group Supervision
- Solvency Modernization
- Federal Insurance Office (FIO)
- ComFrame
- G-20/IMF
- Solvency II/Equivalence
- Insurance Core Principles
- Systemic Risk
- Systemically Important Financial Institutions (SIFI) (Global)
- Financial Sector Assessment Program
- Own Risk and Solvency Assessment (ORSA)
- The Way Forward

Form F – Enterprise Risk Report

Annual confidential supplement identifying material risks within the insurance holding company system that could pose financial and/or reputational contagion to the insurer

- Applies to all holding companies—no size distinction
- Note that Form F filing will be unique to each insurer

Form F – Enterprise Risk Report

- *Form F shall provide information regarding the following areas that could produce enterprise risk:*
  - Any material developments regarding strategy, internal audit findings, compliance or risk management affecting the insurance holding company system;
  - Acquisition or disposal of insurance entities and reallocating of existing financial or insurance entities within the insurance holding company system;
  - Any changes of shareholders of the insurance holding company system exceeding ten percent (10%) or more of voting securities.

Form F – Enterprise Risk Report

How will Actuaries benefit from (*or contribute to*) Form F?

Own Risk and Solvency Assessment (ORSA)

- ERM Framework
- Description of the Risk Management Policy
- Quantitative Measurements of Risk Exposure in Normal and Stressed Environments
- Group Risk Capital Assessment
- Prospective Solvency Assessment
- Who is required to file? (exemptions)
- ORSA will be unique for each Company
- Evergreen Approach to ORSA
- Group or Legal Entity Level

Risk Management and ORSA Model Act

- Vehicle that will be used to require the ORSA Summary Report to be filed
- Will provide for confidentiality provisions
- Lead State Concept
- Effective date: 1/1/2015
  - Will regulators be ready?

NAIC

National Association of Insurance Commissioners

NAIC OWN RISK AND SOLVENCY ASSESSMENT (ORSA) GUIDANCE MANUAL

As of March 2013

ORSA Key Questions for Companies

- What is our strategy?
- What level of risk are we willing to assume in pursuit of this strategy?
- What are the key risks that could hinder our ability to achieve our strategy?
- How much capital do we need to cover those key risks?
- What risks—individually or collectively—would subject us to losses that exceed our tolerance levels?
- What risk scenarios would cause us to fail or stop operating as a going concern?

How will Regulators Use the ORSA?

- Details to be worked out
- Reviewed Company's ORSA Summary Reports that were submitted voluntarily in July 2012
  - Will be done again in November 2013 with 2^{nd} pilot program
- Should "fit like a glove" with the Risk-Focused Exam Process
- Rating Agencies want to know about companies' ERM Process and their ORSA filings
  - Regulators want to know about rating agencies' process
- Quality ORSA and ERM starts with governance and ends with quality of companies' data

ORSA

How will Actuaries benefit from (*or contribute to*) ORSA?

How will Regulators Use the ORSA?

- Section 1 – Description of the Insurer's Enterprise Risk Management Framework
  - High level summary of the entities ERM framework principles

- Section 2 – Insurer assessment of Risk Exposures
  - High level summary of quantitative/qualitative assessments of risk exposure
    - Normal and stressed environments

- Section 3 – Group Assessment of Risk Capital and Prospective Solvency Assessment
  - Risk management policy + measures of risk exposure = level of financial resources needed

Objective of Implementing Critical Risk Categories (CRC)

- Increase the Review of Critical Prospective Risks
  - Larger impact on <u>future solvency</u> of an insurer

- <u>Reducing</u> unnecessary financial statement <u>verification</u> during an examination

EXHIBIT DD
CRITICAL RISK CATEGORIES

One of the goals of a risk-focused examination is to focus on the most critical financial solvency risks facing an insurer. To assist the examination team in meeting this goal, a list of critical risk categories has been developed for consideration in reviewing the adequacy of risk statements developed for each examination. The initial identification of risks in Phase 2 should utilize the understanding of the company gained in Phase 1 as well as a consideration of branded risk categories, exam assertions, etc. The critical risk categories can then be used at the end of Phase 2 to ensure that the risks identified through this process cover some of the most commonly identified solvency risks identified by insurance regulators. The expectation is that each critical risk category will be addressed by at least one risk statement on a key activity matrix (or Exhibit V). Alternately, if the exam team determines that a particular category is not applicable or critical to the company being examined, an explanation may be provided within the Examination Planning Memorandum.

The critical risk categories take into consideration both financial reporting and other than financial reporting risks, which categories would be common to most insurers and the typical impact of a risk category on the current and prospective financial solvency of an insurer. Additional risks beyond the critical risk categories are expected to be identified and reviewed through the examination process at the discretion of each examination team as described in Section 2 of the Handbook.

To demonstrate that the examination has covered each of the relevant critical risk categories, the template below should be completed to demonstrate where in the exam file each critical risk area is addressed. This may be accomplished by providing reference to each individual risk statement that addresses each critical risk category. In situations where a particular critical risk category is not addressed by at least one risk statement, the exam team should provide reference to an explanation provided within the Examination Planning Memorandum.

Critical Risk Category Reporting Template

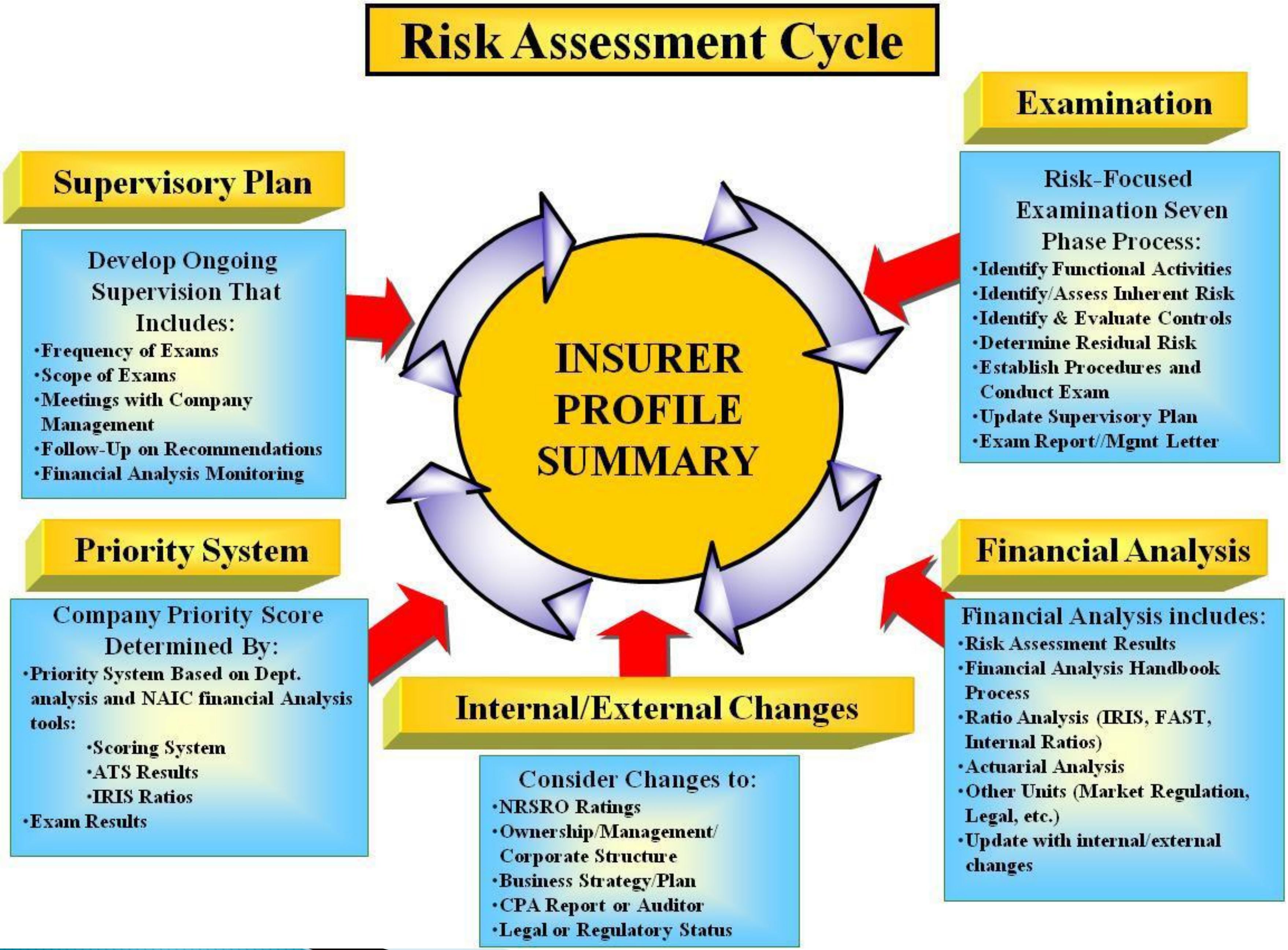
Risk Category	Description	Where Addressed
Valuation/ Impairment of Complex or Subjectively Valued Invested Assets	This category encompasses the valuation of particularly complex or subjectively valued investment holdings significant to the insurer, including assets that are hard-to-value, high-risk and/or subject to significant price variation, with a focus on current valuation. The likelihood of security impairment and determination of whether those impairments are other than temporary would also be an area to consider.	*Example Comment: See Risks 2.1 and 3.1 on the Investments Matrix*
Liquidity Considerations	This category encompasses the ability of the insurance company to meet current contractual obligations, which could include liquidating assets or obtaining adequate funding without incurring unacceptable losses. This category is most relevant for near-term cash flow needs that could impact the insurer (1-2 years).	*Example Comment: This critical risk category was not deemed relevant. See a discussion in the EPM at A.5.3.*
Appropriateness of Investment Portfolio and Strategy	This category encompasses whether the insurer's investment portfolio and strategy are appropriately structured to support its ongoing business plan. Considerations may include elements of the ongoing investment strategy such as asset diversification, quality, maturities, and risk/reward considerations, which could impact the insurer's vulnerability to future market fluctuations and impairments. For long-term lines of business in particular, these considerations would address asset adequacy testing/liability matching.	*Example Comment: See Risks 5 and 6 on Exhibit V at A.7.3.*

Critical Risk Statements (CRC) Related to Actuaries?

- Valuation/Impairment of Significant, Complex Invested Assets
- Liquidity Considerations
- Appropriateness of Investment Portfolio and Strategy
- Appropriateness/Adequacy of Reinsurance Program
- Reinsurance Reporting and Collectability
- Underwriting and Pricing Strategy/Quality
- Reserve Data
- Reserve Adequacy
- Related Party/Holding Company Considerations
- Capital Management

NAIC's Risk Focused Examinations

- All examinations beginning January 1, 2010
  - Several states were "early adopters"
  - Some states did not implement until 2010
- Wide range of levels of understanding across state insurance departments' staff
- Implementation challenges



Risk Assessment Cycle
INSURER PROFILE SUMMARY
Supervisory Plan
Develop Ongoing Supervision That Includes:
•Frequency of Exams
•Scope of Exams
•Meetings with Company Management
•Follow-Up on Recommendations
•Financial Analysis Monitoring
Examination
Risk-Focused Examination Seven Phase Process:
•Identify Functional Activities
•Identify/Assess Inherent Risk
•Identify & Evaluate Controls
•Determine Residual Risk
•Establish Procedures and Conduct Exam
•Update Supervisory Plan
•Exam Report//Mgmt Letter
Priority System
Company Priority Score Determined By:
•Priority System Based on Dept. analysis and NAIC financial Analysis tools:
•Scoring System
•ATS Results
•IRIS Ratios
•Exam Results
Internal/External Changes
Consider Changes to:
•NRSRO Ratings
•Ownership/Management/ Corporate Structure
•Business Strategy/Plan
•CPA Report or Auditor
•Legal or Regulatory Status
Financial Analysis
Financial Analysis includes:
•Risk Assessment Results
•Financial Analysis Handbook Process
•Ratio Analysis (IRIS, FAST, Internal Ratios)
•Actuarial Analysis
•Other Units (Market Regulation, Legal, etc.)
•Update with internal/external changes

NAIC's Risk Focused Examinations

Review of Intent

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

Use that information

Formulate the ongoing surveillance of the insurer

EXAMINING ACTUARIES

Involved through entire examination

Think like an auditor

Evaluate risk and its impacts to an insurer

Provide value added actuarial services before crunching a number

EIC takes lead, but actuary takes active role in Communication and Coordination

Periodic status meetings/reports between EIC and Actuary.

Expectations

APPOINTED ACTUARIES

Actuarial Opinions and other reports will be thoroughly reviewed by regulators

Reports to be presented to the BODs or AC for consideration.

Prepare Actuarial Report consistent with ASOP 9, which can provide a foundation for efficient reserve evaluation

COMPANY ACTUARIES

Thinks about risk and how your Company manages risk

Talks with examiners – Possibly be interviewed

Provides documents to state examiners for review

Old vs New Process
as impacts an Examining Actuary

Old Process	New Process
• Independent loss reserve analysis	• Substantive testing limited to moderate or high risk areas
• Evaluate reasonability of carried reserves	• Evaluate internal controls about reserving process
• No consideration of risk mitigation	• Consider risk mitigation strategies
• Minimal interaction with examiner	• More regular interaction with examiner
• Limited view of reserves only	• Broader view of reserves, pricing, liquidity and reinsurance

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

Planning and Risk Identification → Control Identification & Testing → Substantive Procedures & Conclusion

Phase 1
Phase 2

Phase 3
Phase 4

Phase 5
Phase 6
Phase 7

Seven Phases of RFE – one view

Planning and Risk Identification

Control Identification & Testing

Substantive Procedures & Conclusion

Phase 1
Phase 2

Phase 3
Phase 4

Phase 5
Phase 6
Phase 7

Examining Actuary Involved throughout all Phases

RFE – Branded Risk Categories

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

Examiners are responsible for all of these areas

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Examiners are responsible for all of these areas

Examining actuaries may be called upon to assist in areas beyond reserving

Lessons Learned – A Year Later

- RFE Process still evolving
  - The role of the Appointed Actuary
  - Determination of Management's Best Estimate
- RFE Process takes time
- The timing of actuarial work and examiner work does not naturally align
  - Related Timing and Budgeting challenges
- NAIC Training Offered

Lessons Learned
RFE Process Still Evolving

How does management use the Company's Appointed Actuary ("AA") work?

- Management books AA's point estimate
  - AA is an employee
  - AA is a consultant
- Management does not book AA's point estimate
  - Management leverages from the AA analysis
  - Management sets reserves without consideration of AA analysis
    - Has an internal actuarial department to assist
    - No internal actuarial assistance

Lessons Learned
RFE Process Still Evolving

Financial Statement Carried Reserves are based on Management's Best Estimate

- Management books AA's point estimate
  - Outsourcing the actuarial function in and of itself is not a strong control.
  - Management should apply diligence over that work to be a strong control
- Management does not book AA's point estimate
  - How does management set reserves?
  - Is their reserve analysis documented?
  - We see a good number of examined companies where management's best estimate is not well documented.

Lessons Learned
RFE Process Still Evolving

The RFE concepts are <u>designed to apply the same</u> to all companies

- Tailor the approach to the high risk items, which will be different for each company
- Does not necessarily imply that Reserves will always be a high risk area.
- Each insurance organization and management style brings unique challenges, and so the examination approach should uniquely adapt.
- The <u>exam deliverables and results</u> are very <u>different:</u>
  - Exam findings vs management letter comments

Risk Assessment Example

- How would you assess reserving risk for the following insurer profile?
  - Multi-state insurer group writing 100% Workers Compensation
  - Writing business only for last ten years or so
  - Carried loss reserves determined by CFO
  - No in-house credentialed actuary
  - Accident year loss ratios in the 60%-70% range.

- Do you need more information to determine the inherent risk assessment?

Risk Assessment Example: WC Insurer #1 Profile

- Business underwritten directly
- CFO prepares full reserving package on quarterly basis for management.
  - Well documented
  - Uses traditional actuarial techniques
- The audit actuary peer reviews CFO quarterly analysis
  - Audit actuary meets with Audit Committee
- External appointed actuary provides ground up analysis twice a year.
- Company history of reported loss reserve redundancies

Risk Assessment Example: WC Insurer #2 Profile

- Business produced by affiliate MGA
  - MGA commission rate is 23%
- Works with a fronting carrier for A rated paper
- Parent (Life Co.) issued guaranty for collateral to fronting company
- Support for management's reserves is not documented.
- Appointed Actuary support – no break out for fronting/guaranteed business
- Fronting company sets reserves based on LDFs and loss ratios from assuming reinsurer – *no WC expertise on either side.*
- One year reserve development pattern unstable

WC Insurer Conclusions

WC Insurer #1	WC Insurer #2
• Residual Risk Assessment low to moderate • Phase 5 testing limited to a review of Appointed Actuary Report • No reserve adjustments • Several process improvement observations • No additional monitoring directed to analysis	• Residual Risk Assessment high for reserving • Ground up reserve review required in Phase 5 • Significant reserve adjustments required • Non-credible underlying data • Company placed into runoff and receivership by Department • Poor Governance was primary contributing factor – Fronting and Reinsurer • Claims settlement practices likely to impact ultimate losses

Lessons Learned
RFE Exam Process Takes Time

- Involvement of an actuarial specialist in all seven phases
  - From beginning to the end
  - Used to only be involved at a kickoff meeting and then to provide loss reserve estimation
  - *An actuary should expend to spend significant time on risk identification and risk mitigation and controls*
- Involvement of actuarial specialist in more than just reserving activities
  - Assistance with Pricing & Underwriting
  - Advice on Reinsurance risk
  - Liquidity can also be a risk in some insurers

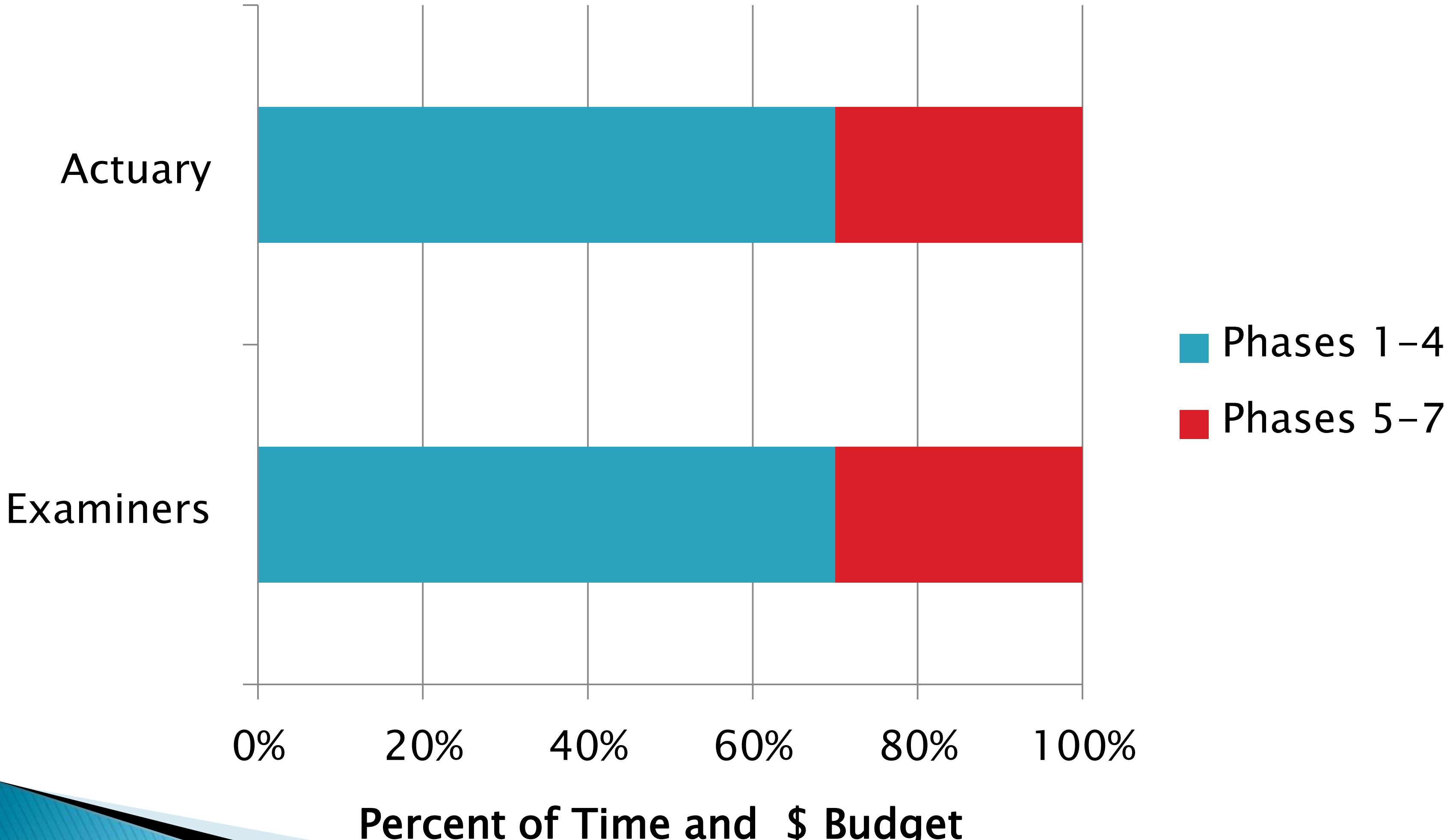
Lessons Learned
RFE Exam Process Takes Time

- Actuarial deliverables prepared at various points throughout the examination:
  - Planning memo / Inherent Risk Assessment memo
  - Control identification and controls testing results
  - Phase 5 substantive test plan (when needed)
  - Final Actuarial Report and all Phase 5 support
- Review of examiner deliverables:
  - Exam Report
  - Management Letter Comments
  - Supervisory Plan
- Expect more time spent in Phases 1-4, than in Phases 5-7

Lessons Learned
Actuarial and Examiner Timing

- Phases 1-2
  - Examiners responsible for ALL key activities
  - Actuaries support examiners in 1-2 key activities
- Phases 3-4
  - Actuaries may help with control identification
  - Examiners may actually perform the control testing at the direction and/or suggestion from actuary
- Phase 5
  - Substantive test work may be mitigated for many activities, EXCEPT reserving, so actuaries spending more time here.

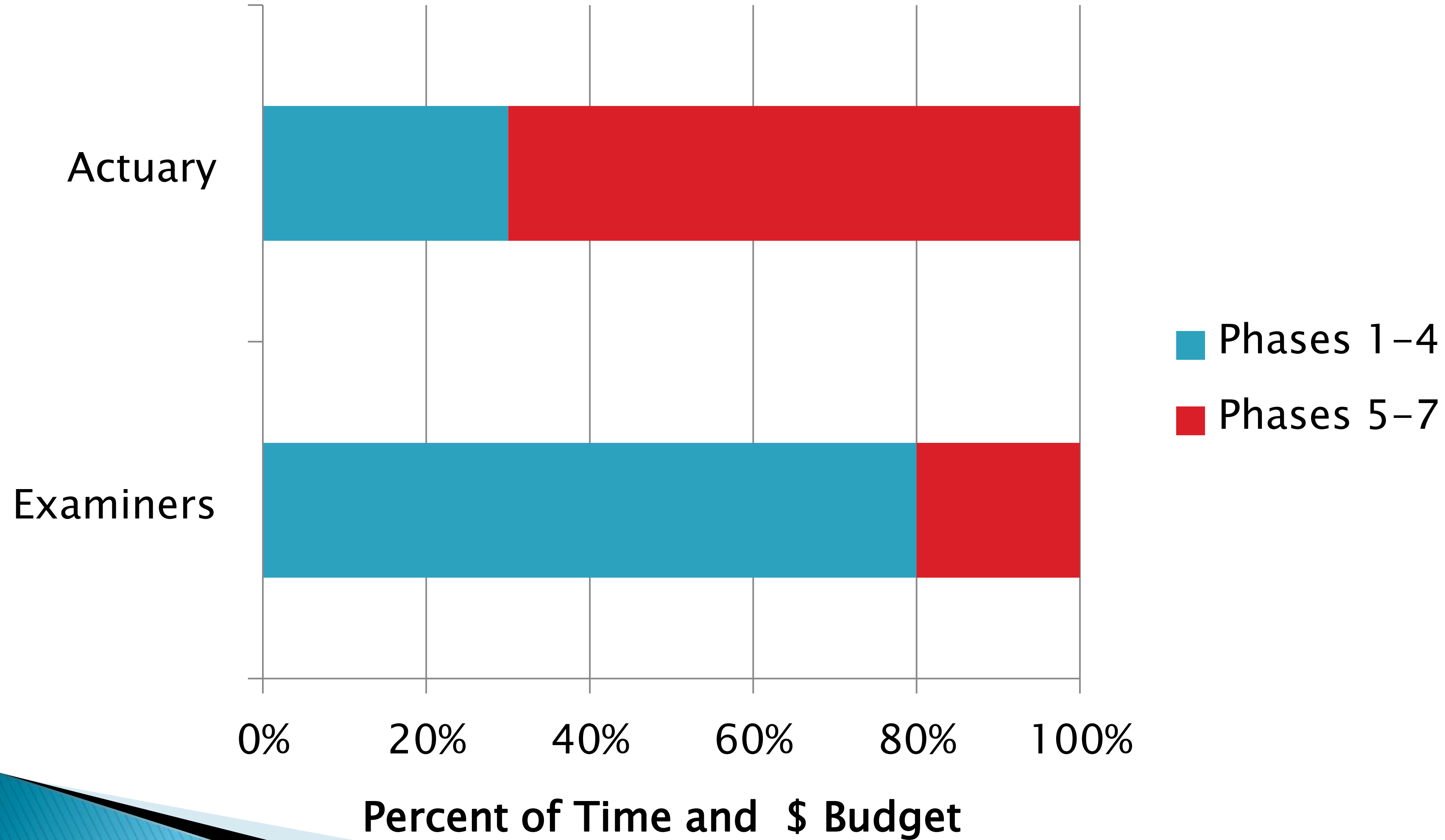
Actuarial and Examiner Timing ABC Insurer



Risk Assessment

- Admittedly risk assessment involves the use of professional judgment by the staff member
- Actuaries and examiners wear different hats, so may have a different view of risk.
- The complexity of the insurer will dictate the risk assessment – thus leading to how much time and expense is required for exam support and actuarial specialists support.

Actuarial and Examiner Timing XYZ Insurer



Budgeting Challenges

- Examination firms in some states now budget by phase
  - Amount of work done in one phase is dependent upon findings in the prior phase
- State bidding processes may lock you into a fee structure that does not allow RFE procedures to work.
- Balancing act between efficiency and effectiveness – not necessarily a bad thing
  - Examination Risk – Risk that a problem goes undetected in an examination
  - Professional judgment on **high<u>est</u>** risks

Lessons Learned
NAIC Training Offered

- Insurance Department actuaries and examiners worked with NAIC staff to develop a 3-hour online training course.
- *Risk Focused Examinations – The Role of the Examining Actuary* was offered April 2013, including a live webinar
  - 304 total enrollees
- Training re-packaged as a standalone offering
  - About 60 taken since original offering
  - Should be offered by NAIC for all time
- "Actual experience will be the ultimate teacher"

Prospective Risk

- NAIC recognizes that prospective risk identification occurs throughout the exam.
- Some prospective risks are overarching and relate to more than one specific key activity.
  - Prospective Risks do not have to be captured in a “key activity” matrix
  - Exhibit V (“vee”, not five) used by exam staff to document
- Prospective risks – “aka killer risks” – examiners and actuaries should be gravitating toward heavier emphasis
  - think CRCs

Financial Reporting vs Prospective Risk

Financial Reporting Risk	Prospective Risk
• Identified in Phase 1 • Likely tested by auditors • Tied to balance sheet risk • Usually associated with single key activity	• Identified throughout examination • NOT likely identified by auditors • Off balance sheet risk • Overarching and could apply across multiple activities.

Prospective Risk Examples

- Company management decides to discontinue existing lines of business and transition into complex new business lines.
- One of the states the Company is writing significant business in has threatened a cease and desist order on writing new business.
- The Company is seeking to sell a large life insurance subsidiary in order to eliminate an expense and liquidate an asset.

What else can you think of?

Pricing and Underwriting Risk

- Not so easy for examiners to evaluate
  - Accounting or Auditing deals with “real numbers”
  - These risks will not be considered, let alone tested by, the CPAs.
- Much easier concept for actuaries to grasp
- Impacts to company solvency not so direct, as impacts may be felt years down the road.
- Could be prospective or could be captured in a separate matrix, and categorized as “Other than Financial Reporting”

Pricing and Underwriting Risks

- Let's talk about some examples and where they might fit.
  - Policies are not priced in accordance with insurer guidelines
  - The insurer has not established appropriate pricing guidelines, resulting in inadequate or excessive base premium rates
  - The insurer has not changed filed base premium rates in more than ten years
  - Agents are known in the marketplace to give out large discretionary discounts

Coordination / Communication Best Practices – Consulting 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 – Consulting Actuary

- Familiarity with risk focused concepts
  - Take NAIC training
  - Understand the Handbook and Risk Repositories
- Common to spend more time on planning and risk assessment than actuarial re-calculations.
- Specify expectations of 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 over actuarial risks, i.e., internal controls

Coordination / Communication Best Practices – Appointed Actuary

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