Risk-Focused Examinations

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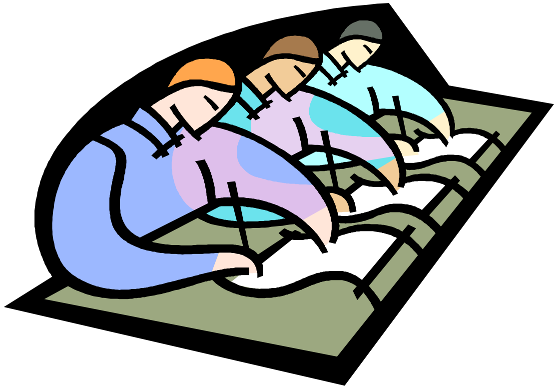


Why Conduct Financial Exams?

- **Detect** insurers with potential financial trouble;
- Determine **compliance** with state statutes and regulations;
- Compile information needed for timely, appropriate **regulatory action**;

Why Conduct Financial Exams?

- To provide a clear methodology for **assessing residual risk** and how it translates into examination procedures;
- To allow the **assessment of risk-management processes** in addition to those which relate to financial statement line items; and
- To utilize examination findings to establish, verify or revise company's **priority score**.

Conducting Examinations

- The NAIC *Financial Condition Examiners Handbook* provides guidance to assist state insurance departments to effectively plan, conduct, and report on the financial condition of insurers.
- Approach changed to a Risk-Focused Surveillance approach in 2007

Model Law on Examinations

- The NAIC Model Law and Accreditation guidelines specifically require state departments to conduct examinations in accordance with policies and procedures included in the NAIC *Financial Condition Examiners Handbook*. Variations to the methods and scope of exams are permitted to the extent that the variations reflect the financial strength and position of the insurer.
  - Exams required through model every 5 years
  - Some states statutes require exams every 3 years

Risk Assessment Cycle

Supervisory Plan

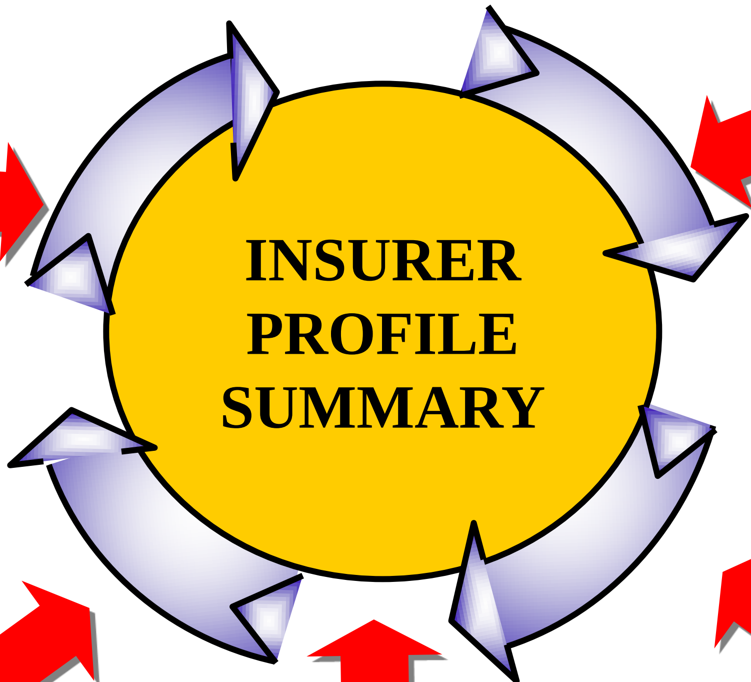
Develop Ongoing Supervision That Includes:

- 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

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

Internal/External Changes

Consider Changes to:

- NRSRO Ratings
- Ownership/Management/ Corporate Structure
- Business Strategy/Plan
- CPA Report or Auditor
- Legal or Regulatory Status

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Risk Assessment Matrix

1a	Key Activity	

1b – Overall Risk	

1c – Analytical	

Phase 1	Phase 2					Phase 3			Phase 4			Phase 5	Phase 6	Phase7
1d	2a	2b	2c	2d	2e	3a	3b	3c	4a	4b	4c	5	6	7
	Risk Identificatio		Inherent Risk Assessment			Risk Mitigation Strategy/Control			Residual Risk Assessment					
Sub-activities	Identified Risks	Branded Risk	Likelihood	Impact	Overall Inherent Risk Assessment	Risk Mitigation Strategy/Control	Evidence & Document Testing Controls	Overall Risk Mitigation Strategy/Control Assessment	Calculated Residual Risk	Judgmental Residual Risk	Overall Residual Risk Assessment	Examination Procedures / Findings	Prioritization Results Supervisory Plan	Report Findings & Management Letter Comments
Risks Other than Financial Reporting														
Financial Reporting Risks														

Seven Phase Examination Process

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Phase 1	Understand the Company and Identify Key Functional Activities to be Reviewed	Planning
Phase 2	Identify and Assess Inherent Risks in Activities	
Phase 3	Identify and Evaluate Risk Mitigation Strategies/Controls	
Phase 4	Determine Residual Risk	
Phase 5	Establish/Conduct Exam Procedures	
Phase 6	Update Prioritization and Supervisory Plan	
Phase 7	Draft Exam Report and Management Letter Based on Findings	

Steps to Phase 1, Part 1

1 Understanding the Company

- **Step 1** – Gather necessary planning information
- **Step 2** – Review the gathered information
- **Step 3** – Perform Analytical and Operational Reviews
- **Step 4** – Consider Information Technology Risk
- **Step 5** – Update the Insurer Profile Summary

Note: Portfolio Analysis would be completed in conjunction with Phase 1, Part 1.

Parts to Phase 1

2

Understanding the Corporate Governance Structure

3

Assessing the Adequacy of the Audit Function

4

Indentifying Key Functional Activities

5

Consideration of Prospective Risk

Phase 2 – Identify and Assess Inherent Risk

- Inherent risk – Risk of economic loss or inaccurate financial reporting before considering internal controls

Phase 2 – Identify and Assess Inherent Risk

Write risk statements

- Ask “What can go wrong?” for each activity/ sub-activity
  - e.g. The insurer’s bonds, stocks and short-term investments are incorrectly valued.

Examination Repositories

- Can be used as a reference tool to identify risks
- Only <u>Most Common</u> risks included
- For each risk, the following are included:
  - Control Best Practices
  - Tests of Controls
  - Examples of detail tests

Examination Repositories

- Repositories <u>not</u> intended to:
  - Establish a minimum level of documentation and testing to be performed; nor,
  - Be an all-inclusive list of risks for an examination
- Repositories <u>are</u> intended to:
  - Act as a guide or double check for examiners

Phase 2 – Identify and Assess Inherent Risk

- Identify inherent risk
  - Other than financial reporting inherent risk
    - Items not directly related to a current f/s line item
    - Generally related monitoring, policies, BOD interaction, strategic type risk, etc.
  - Financial reporting inherent risk
    - Typically directly related to a current f/s line item

Phase 2 – Identify and Assess Inherent Risk

- Assess inherent risk based on:
  - Likelihood of Occurrence
  - Magnitude of Impact
- To reach overall inherent risk levels of:
  - High
  - Moderate
  - Low

Phase 2 – Identify and Assess Inherent Risk

- Likelihood of Occurrence
  - Probability the risk will occur or would prevent a process or activity from attaining its objectives.
- Magnitude of Impact
  - Potential impact or potential materiality effect of a risk

CALCULATED OVERALL INHERENT RISK

	Magnitude of Impact			
Likelihood of Occurrence	**Threatening**	**Severe**	**Moderate**	**Immaterial**
High	High	High	High	Moderate
Moderate-high	High	High	Moderate	Moderate
Moderate-low	High	Moderate	Moderate	Low
Low	Moderate	Moderate	Low	Low

Phase 3 - Control Identification & Evaluation

1. Identify and understand internal controls that the insurer has in place for each risk
   – Document Understanding
2. Consider whether the controls appear to be designed appropriately to mitigate each risk
   – If not, no need to test controls
3. If so, test the controls for operating effectiveness
   – Not required if testing will be inefficient
4. Conclude whether the internal controls effectively mitigate each inherent risk
   – Strong, Moderate or Weak

Phase 3 – Risk Mitigation Strategies

Assessment of Controls

The Overall Risk Mitigation Strategy/Control Assessment ratings to be indicated in the Risk Assessment Matrix are:

- Strong risk management
- Moderate risk management
- Weak risk management

Phase 3 – Risk Mitigation Strategies

Control Testing → Intended to provide assurance that control procedures are operating as prescribed

Control testing is generally performed using one of the following methods

- Walkthrough
- Corroborative inquiry
- Observation
- Re-performance
- Examination of Documents

Phase 3 - Utilization of Existing Work

- Existing Control Documentation
  - SOX Workpapers
  - Internal Audit Workpapers
  - External Audit Workpapers
- Utilize where relevant to exam

Phase 4 – Determine Residual Risk

- Residual risk is determined by how well the risk mitigation strategies/controls mitigate the inherent risk.

Phase 4 – Residual Risk Grid

INHERENT RISK	STRONG RISK CONTROLS	MODERATE RISK CONTROLS	WEAK RISK CONTROLS
HIGH	Mod or High	Mod or High	High
MODERATE	Low or Mod	Mod	Mod
LOW	Low	Low	Low

Phase 5 – Establish/Conduct Exam Procedures

Phase 5 Handbook Guidance:

- Detail examination procedures should be selected to correspond with the level of residual risk determined for each identified risk.

High Residual Risk	Detail procedures required.
Moderate Residual Risk	Fewer detail procedures performed (i.e. tests of details of transactions), including more utilization of analytical procedures.
Low Residual Risk	Limited or no detail procedures performed, which may be limited to analytical procedures.

Phase 6 – Update Prioritization & Supervisory Plan

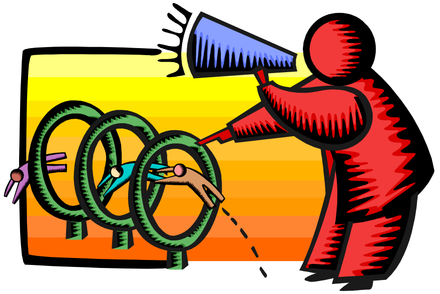
- Supervisory Plan
  - Created/updated at least yearly by domiciliary state
  - Based on recent exams and analysts’ reports
  - Lead state concept with multi-state companies
  - Outline type of surveillance planned, resources, and how coordination planned
  - Part of Insurer Profile Summary

Phase 7 – Draft Examination Report & Management Letter

- Examination Report
  - Contains findings related to scope
  - Include other findings discovered during exam

Phase 7 – Draft Examination Report & Management Letter

- Management Letter
  - Part of exam workpapers
  - Used for results or observations that are not material to public report
  - Optional



Phase 7 – Draft Examination Report & Management Letter

Examination Report- Common Findings

- Additional Reserves Needed
- Asset Valuation- OTTI
- Items not recorded in accordance with SAP

Management Report- Common Findings

- Proprietary Company Issues
- Prospective Risk Discussions
- Internal Control Deficiencies

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Questions