



2008 Enterprise Risk Management Symposium

Communication in Risk Focused Examinations





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Readying Companies for Risk Focused Examinations

- Introduce Risk Focused Examinations to Companies
- Explain Benefits of Risk Focused Examinations





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Preparing for the Exam

- CARRMEL and Enterprise Risk Management Questionnaires
- Initial contact with Companies and CPAs





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Communication During the Exam

- Communication with CPAs, Internal Audit, SOX
- Use of SER Log
- Regular Communication with the Company
- Update of ERM and CARRMEL
- Communication within examination team and with State Analysts, Actuaries, and other applicable State personnel



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Continuous Surveillance Process

- Pre-Examination Communication with the State Analyst, Actuary, and other applicable personnel
- Post-Examination Communication with the State Analyst, Actuary, and other applicable personnel





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Importance of Communication

- Communication takes the mystery out of new processes, protocols, methodologies
- Companies can understand where they stand in terms of the examination process at various stages of the exam; no surprises environment
- More informed state regulatory process; ability to better understand the Company's risk management abilities and regulate accordingly





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Benefits of Communication

- Enhanced understanding of the examination process
- Ability to prepare for and manage the examination process for efficiency and effectiveness
- Better information for ongoing solvency monitoring





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How Exam Results are Used

- Field CARRMEL
- Updated Enterprise Risk Management Questionnaire
- Risk Assessment Narrative
- Insurer Profile
- Surveillance/Supervisory Plan
- Ongoing surveillance by the State Analyst





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Questions



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Actuary's Role in a Risk Focused Examination and Enterprise Risk Management.

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NAIC Branded Risk - Reserving Risk

- One of the nine risk classifications is Reserving Risk
 - The following guidance is designed to help examiners think critically about the correlation between the Reserving Risk classification and various areas of the financial statement.
- *Definition:* Actual losses or other contractual payments reflected in reported reserves or other liabilities will be greater than estimated.
 - *Risk areas to consider:*
 - Lines of business that generate significant reserves.
 - Relevance of pooling as well as external third party ceded/assumed reinsurance.
 - Use of internal versus external adjusting staff.
 - Use of current technology and software.





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NAIC Branded Risk - Reserving Risk (cont.)

Evaluating Reserving Risk Management Controls (i.e., Effectiveness):

- Policies established by management and the board reflect a conservative approach toward reserving and reserving practices (management's ability to override the actuary's reserve estimate is limited and reported to the board/responsible committee).
- Historically, reserve levels have developed favorably.
- Staff responsible for recommending financial statement reserve levels is competent and experienced.
- Processes are in place to reliably, accurately, and timely evaluate prior and current period reserve levels (direct and net of reinsurance basis) for adequacy and report findings/recommendations to senior management.

Source: FINANCIAL EXAMINERS HANDBOOK © 1976 – 2007 National Association of Insurance Commissioners - EXHIBIT L – Assessment of controls



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NAIC Branded Risk - Reserving Risk (cont.)

- Reinsurance ceded/assumed is considered as a separate component of the reserve.
- Claims adjudication processes are well-documented, internal controls and limits of authority are clear and present, and there is an active audit function for the detection of errors, overrides, and fraud.
- Reserving actuary obtains relevant insight from pricing actuary, claims, and underwriting staff regarding emerging trends and product dynamics.
- Informational systems are accurate, dependable, and validated.

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Testing and Relying on Risk Mitigation Strategies/Controls

- Objective: To determine whether controls, as designed, are operating effectively to mitigate the inherent risks
- Results of the control testing will impact the examiner's assessment of residual risk in Phase IV and the examination procedures planned and executed in Phase V
- Exhibit L – Assessment of Controls (strong, moderate, weak, preventive and detective controls); specific and monitoring controls





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Testing and Relying on Risk Mitigation Strategies/Controls

- What are Internal Controls?
- Overall cautions on the use of risk mitigation strategies:
 - Risk mitigation strategies (i.e., internal controls) cannot:
 - ensure the occurrence of risk will never manifest
 - ensure the Company's success or continued survival
 - Internal controls can only mitigate or manage the fact that the risk may eventually occur
 - Even with good risk mitigation strategies, risk can still occur if there is collusion or management override





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Testing and Relying on Risk Mitigation Strategies/Controls

- Manual vs. Automated
- Manual controls are people-based. They carry the risk of human error.
- Automated controls are system-based. They carry less risk if working properly.
- Automated controls are generally preferable to manual controls, all things being equal





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Testing and Relying on Risk Mitigation Strategies/Controls

Preventive vs. Detective Controls

Controls can be classified as preventive or detective:

- Preventive Controls – Designed to prevent the risk from occurring in the process. An example may be an automated payment system will not release payment unless authorized by two separate employees. Preventive controls generally are stronger than detective controls and this should be taken into consideration when assessing controls.
- Detective Controls – Designed to detect the anomaly after it has occurred. An example would be a reconciliation. Most reconciliations are performed after a transaction has taken place and will detect a problem after it has occurred. Detective controls are generally weaker than preventive controls and this should be taken into consideration when assessing controls.

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Testing and Relying on Risk Mitigation Strategies/Controls

- Preventive vs. Detective Controls – Summary
- Preventive controls, if designed and operating effectively, are up-front controls designed to keep a problem from happening before it occurs.
 - Example: Passwords
- Detective controls are back-end controls that are designed to catch a problem after it has already occurred.
 - Example: Reconciliations



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Testing and Relying on Risk Mitigation Strategies/Controls

- Control vs. Key Control for SOX Purposes

What is a key control? Here are a couple thoughts:

- A key control is a primary (or significant) control relied upon to provide reasonable assurance as to the achievement of the financial reporting control objectives of a company.
- A key control is a process which reduces a significant risk (one which affects the solvency/existence of a company, or could seriously affect profitability) to a level below a company's risk appetite (that is to a level of impact and likelihood that the company can live with).





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Evaluate Risk Controls by Design

High

RELIABLE

System-based
detective
control

System-based
preventive
control

People-based
detective
control

People-based
preventive
control

Low

DESIRABLE

High



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Determine Residual Risk

- Residual risk is assessed by determining how well the company's risk mitigation strategies/controls mitigate the level of inherent risk in the insurer's activities.
- Residual risk may be expressed as:
$$\text{Inherent Risk} - \text{Controls} = \text{Residual Risk}$$
- To determine the overall residual risk for each of the insurer's sub-activities, the examiner should consider the assessments made regarding inherent risk in Phase 2 and the risk mitigation strategies/controls in Phase 3.



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Determine Residual Risk (cont.)

Determination of residual risk is driven by the following steps:

- i. Identification of key functional activities
- ii. Identification of primary risk classifications and assessment of inherent risks
- iii. Identification and evaluation of risk mitigation strategies/controls
- iv. Determination of residual risk

Financial reporting residual risk is the risk remaining after taking into account the controls established to achieve certain objectives in the financial reporting function or process.



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Determine Residual Risk (cont.)

- Financial reporting residual risk may be the result of:
 - A control deficiency, which exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
 - A significant deficiency, which is a control deficiency, or a combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, or report external financial data reliably such that there is more than a remote likelihood that a misstatement of the company's financial statements that is more than inconsequential will not be prevented or detected.
 - A material weakness that is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the company's financial statements will not be prevented or detected.



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Residual Risk Assessment Ratings

- **High Residual Risk**
- **Moderate Residual Risk**
- **Low Residual Risk**

Although the determination of the residual risk assessment is primarily a calculated component of the examiner's assessment of inherent risks and controls, it is expected that the examiner will judgmentally assess whether the calculated risk is reflective of the examiner's anticipated residual risk assessment.

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Residual Risk Assessment Ratings (cont.)

- **High Residual Risk** – generally would be assigned to an activity where the risk management process does not significantly mitigate the high inherent risk of the activity. Thus, the activity could potentially result in a financial loss that would have a significant adverse impact on the organization's overall condition, even in some cases where the processes are considered strong. For financial reporting risk, the existence of control deficiencies and/or material weaknesses could indicate a high residual risk. However, the lack of control deficiencies and/or material weaknesses does not exclude a residual risk determination of high. In cases where management appears to have an insufficient understanding of the risk and/or capacity (lack of timely and accurate information or analysis) to anticipate and respond to changing conditions, the examiner may need to re-evaluate their determination of the inherent risk and the residual risk.

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Residual Risk Assessment Ratings (cont.)

- **Moderate Residual Risk** – generally would be assigned to an activity having moderate inherent risk where the risk management processes do not appropriately mitigate the risk. However, a strong risk management process may reduce the risks of an inherently high-risk activity so that any potential financial loss from the activity would have only a moderate, short-term, adverse impact on the financial condition of the organization. For financial reporting risk, this could be evidenced, in part, by the existence of control deficiencies, which are typically not considered to be significant or material weaknesses. In cases where management appears to have an insufficient understanding of the risk and/or capacity (lack of timely and accurate information or analysis) to anticipate and respond to changing conditions, the examiner may need to re-evaluate their determination of the inherent risk and the residual risk.

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Residual Risk Assessment Ratings (cont.)

- **Low Residual Risk** – generally would be assigned to an activity that has low inherent risks. An activity with moderate inherent risk may be assessed as low residual risk where internal controls and risk management processes are strong and effectively mitigate much of the risk. After considering risk management controls, any potential financial loss from the activity would have minimal impact on the financial strength of the organization. For financial reporting, this could be evidenced, in part, by few or no control deficiencies.

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Determine Residual Risk-Assessment of Controls

- A change in the assessment of controls will affect the residual risk and thus the overall risk assessment.

- Mitigation Strategy/Control Rating:

- Strong Controls – Mitigate or reduce the risk and are functioning as intended.

- Moderate Controls – Largely effective (i.e., acceptable) in mitigating or reducing the risk, but are lacking in a modest degree.

- Weak Controls – Do not mitigate or reduce the risk and/or are not functioning as intended.

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Examination Team’s Residual Risk Assessment for Reserves

High Level Inherent Risk Assessment		Exam Phase 2			
Financial Reporting Primary Risk Area		Overall Inherent Risk	Controls Assessment	Calculated Residual Risk	Overall Residual Risk
Reserves		High	Strong	Moderate or High	Moderate
Inherent Risk Assessments by Sub-Area		Exam Phase 3			
Reserves Sub-Areas Converted to Profit Centers		Overall Inherent Risk	Controls Assessment	Calculated Residual Risk	Overall Residual Risk
Individual Life		High	Strong	Moderate or High	Moderate
Individual A&H		Low	Strong	Low	Low
Individual Annuity		High	Strong	Moderate or High	Moderate
Group		Moderate	Strong	Low or Moderate	Low
Retirement		High	Strong	Moderate or High	Moderate
International		Low	Strong	Low	Low

Note: The Judgmental Residual Risk Assessments were based primarily on strong risk controls in place and world class corporate governance assessed at the Company. Therefore, the Examination Team did not believe a higher Residual Risk Assessments were warranted.

Inherent Risk Assessment for Reserves by Profit Center

Inherent Risk Assessments at the Product Level	<u>Actuarial Phase 3</u>		
	Reserves Profit Centers	Number of Products with <u>High</u> Inherent Risk	Number of Products with <u>Moderate</u> Inherent Risk
Individual Life	2	6	9
Individual A&H	0	0	4
Individual Annuity	10	6	10
Group	2	5	8
Retirement	3	9	23
International	0	2	1
Totals	17	28	55

Residual Risk Grid

Inherent Risk	Strong Risk Controls	Moderate Risk Controls	Weak Risk Controls
High	Moderate or High	Moderate or High	High
Moderate	Low or Moderate	Moderate	Moderate
Low	Low	Low	Low



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NAIC Branded Risk - Reserving Risk

QUESTIONS?????????





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ERM and State Regulation

- Mary D Miller FCAS, MAAA
- Assistant Director
- Product Regulation and Actuarial Services
- Ohio Department of Insurance





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ERM 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





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Change is the Air

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





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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





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CARRMEL

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





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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





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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





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Corporate Governance

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

Self-Regulation is the goal





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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





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Assessment of Risk Management Framework & Practices

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





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Inherent Risks

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





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Application of these Risks to Key Business Activities

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





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Risk Assessment Steps

- Identification of Inherent Risk

Plus

- Assessment of Risk Management Processes

Equates to

- Residual Risk Determination





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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



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International Activity

- NAIC process – very compatible with IAA’s “A Global Framework for Insurer Solvency Assessment” and IAIS “Cornerstones for the Formulation of Regulatory Financial Requirements”
- ‘Compatible with’ does not mean ‘in total agreement with’

