



# Memo

To: Mr. Jim Hattaway (AL), Chair, and members of the Risk-Focused Surveillance (E) Working Group (RFSWG)  
From: Pat Tracy, LeeAnne Creevy and Jan Moenck, Risk & Regulatory Consulting, LLC  
Date: February 8, 2013  
Subject: Feedback About the Impact of the Critical Risk Categories on the Analysis Function

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## **INTRODUCTORY REMARKS:**

We agree with the RFSWG that improvement is needed to effectively coordinate the continuous surveillance process (e.g., input to the exam by the analysts as well as output by the examiners to the analysts). Over the years, working as vendors for various States, we have offered suggestions about using risk summaries (or risk “dashboards”), which have been key outputs from completed risk-focused examinations to communicate effectively at an executive level about risk. Focus on tools such as risk summaries provides a sound basis, grounded in the NAIC Financial Condition Examiners Handbook (“FCEH”), to coordinate efforts between the examiners and analysts.

We also believe that improving the consistency of terminology about risk between examiners and analysts will significantly assist in the process. For example, synching up the inherent risk concepts outlined in the FCEH (i.e., likelihood of occurrence and magnitude of impact) with the NAIC Financial Analysis Handbook (“Analysts’ Handbook”) terminology would help facilitate utilizing common tools to allow for more effective maintenance of up-to-date risk summaries between examinations. We believe that the ability to keep current risk dashboards that capture highlights of both prospective and financial reporting risks would substantially improve the ability of State regulators to conduct discussions about risk on a State-to-State, State-to-Federal and State-to-Foreign (e.g., Supervisory College) basis. These risk dashboards would summarize, in an executive level manner, highlights of the most important risks identified that include the Critical Risk Categories discussed on the January 24<sup>th</sup> RFSWG call, the prospective risk assessment (Exhibit V) and other financial reporting related risk areas. The ability to effectively communicate risk is important to realize the goal of the continuous surveillance process and advance the U.S. State-based system.

As we explain in more detail below, we believe that well maintained risk dashboards that are kept current between examinations provide important highlights from certain aspects of Phases 1 and 2 of the risk-focused approach (e.g., Understand the Company and Assess Inherent Risk). If these risk dashboards can be kept somewhat current between examinations by the analysts, it could significantly increase the examiners’ level of efficiency when starting Phases 1 and 2 of the next risk-focused examination. Current risk dashboards also allow insurance department executives to better address the need for interim targeted examination work on high risk areas as well as effectively incorporate information from ORSA and Form F filings into the continuous surveillance process.

We suggest the following recommendations for improving analyst and examiner coordination on risk-focused exams, each of which is covered in more detail in the sections below:

1. Agree on a communication tool that will be produced on risk-focused examinations and kept current between exams. Similar to best practices in industry, it is important for the regulatory community to effectively identify and communicate risk. We believe this tool needs to be a high-level risk communication tool that allows any reader to understand the inherent risk ranking process and facilitate effective executive level communication.
2. Provide training to the analyst that covers how inherent risk and residual risk are assessed and evaluated using the FCEH guidance.
3. Provide training to the analyst, insurance department executives and possibly some examiners on how to use a risk dashboard as a primary management tool. The foundation for this tool already exists and is major value-added output from a well-executed risk-focused examination.
4. Identify the interim key sources of information, in addition to what the analyst currently reviews, that should provide meaningful input to maintain current risk dashboards.

**STEP 1: AGREE ON A COMMUNICATION/ MANAGEMENT TOOL TO EFFECTIVELY IDENTIFY AND COMMUNICATE RISK:**

We believe that excellent financial reporting and prospective risk summary information is embedded within the TeamMate files on most risk-focused exams. This information may include the company's key risk summaries that are part of an effective enterprise risk management ("ERM") function. For instance, the summarized information may be part of an ERM package that is regularly shared with the company's board of directors, audit committee and/or enterprise risk committee comprised of senior level executives at the company. This type of information also may already be incorporated into the examiners' risk accumulator tool and may be included on the Exhibit V or within certain sections of Exhibit K.

In addition, the examiners utilize a variety of other sources to identify critical risks as part of Phases 1 and 2 (e.g., conducting C-level management interviews, reviewing key documentation, considering past examination issues and findings, reviewing and incorporating the analysts' input, etc.). As such, this risk information contains inherent risk rankings per the FCEH and also contains the examination team's residual risk assessment. States may refer to this critical information as "risk summaries", "risk dashboards", "top risk listings" or other similar name. Regardless of what the risk information is called, or the format in which key risk information is captured, it is important to note that this exam work product also is very similar to how most ERM processes work at companies, and during the exam the company's information was reviewed by the exam team as noted above.

We believe that it is productive and extremely helpful to many interested parties in the financial examination process to consider the use of a separate prospective risk summary and a separate financial reporting risk summary for several reasons. First, the prospective risk summary includes many holding company type risks that are managed and mitigated at the holding company level but may apply to the legal entity or entities under examination. The nature of risk mitigation also may be significantly different for prospective risk versus financial reporting risk areas. Additionally, the outside CPA firm's work and Sarbanes-Oxley ("SOX") / Model Audit Rule ("MAR") requirements do not necessarily involve testing prospective risks. Having a separate prospective risk summary also shows the "windows" look required by the recent Holding Company Act, one objective of which is to increase transparency. A separate financial reporting risk summary allows a more direct focus on the legal entity's risks (the "walls"), which most likely already have been identified and tested by the outside CPA firm and are probably scoped into SOX/MAR efforts in companies subject to those compliance requirements.

The above explanation of risk summaries would include significant information that examiners would gather as part of evaluating the newly proposed Critical Risk Categories. The risk categories themselves, as well as the

underlying sub-components to each risk, can be identified and explained within the risk summaries. The nature of the risk categories, specific considerations driving the level of risk, and other important information (such as the inherent risk assessment) can be included on the risk summary document at an executive level. The Exhibit K risk assessment matrices will naturally include more details at a granular level, showing how the risks were assessed, and related internal controls were validated and tested, etc.

As explained in the “Introductory Remarks” section of this memo, the ability for the financial examiners to capture this type of risk information and summarize it into useful summaries about risk will pave the way for a tool that can be updated and kept current between examinations by financial analysts. We strongly suggest that the hand-off of these summaries from the examination team to the analysts take place in person, whenever possible. Face to face discussion of the risks will facilitate a more efficient and effective transition of the ownership of the risk summaries as the phases of the examination wrap up. This meeting could coincide with the sharing of the Supervisory Plan between the examiner and analysts, which is also best done in person whenever possible.

As noted earlier, working in conjunction with one of our State regulatory customers, we previously shared with the NAIC examples of risk dashboards (prospective and financial reporting related risks) for Life, P&C and Health entities (Please refer to Appendix A). These examples represent blended content from actual risk-focused examinations and only required an executive level upgrade from information in the TeamMate files. Note these risk summaries are fully supported by Exhibit K risk assessment matrices and other specific information contained within the TeamMate files, but they have been designed to facilitate executive level communication and allow for adding, deleting or modifying the inherent risk between examinations.

## **STEP 2: PROVIDE TRAINING TO THE ANALYST ON HOW THE EXAMINER RANKS INHERENT RISK AND RESIDUAL RISK:**

The FCEH contains excellent inherent risk guidance that also parallels what most companies have in place to execute and maintain an effective risk culture. We understand that the current Analysts’ Handbook guidance does not include an inherent risk approach. We believe if financial examiners and analysts are speaking the same language it would help tremendously in terms of facilitating coordination, communication and maintenance of key risk information as part of the broader risk surveillance process.

We suggest that training provided to the analysts covers the concept that identifying, and then later ranking, inherent risks does not include any type of testing or verification at that point. Identifying and ranking inherent risk can in fact be done by analysts who are tracking the company. It is a subjective process that is very similar to what the companies perform regularly to effectively identify and rank risk as part of their ERM programs.

With effective and sufficient levels of training, we believe analysts could get comfortable with inherent risk and therefore play a key role in maintaining these critical risk documents between examinations.

## **STEP 3: START USING THE RISK DASHBOARDS OR SUMMARIES AS A REGULATORY MANAGEMENT AND COMMUNICATION TOOL:**

Similar to how industry has evolved, we believe it will improve productivity if regulators consistently use risk dashboards or similar tools to identify and rank inherent risks. The process of discussing high inherent risk areas will increase everyone’s comfort level with the process. We are not sure if any States have elevated the risk management information out of the TeamMate details and have begun to use it as a regulatory tool to communicate both internally and externally; however, if this process has not yet happened, it certainly represents an opportunity for continued emphasis to increase important communication in this area.

We see clear benefits in the Supervisory College area if U.S. regulators can articulate key risk areas tested on a financial examination as well as communicate an effective on-going monitoring process that includes updating risks following the FCEH inherent risk methodology between exams. For example, if a new emerging high risk is identified between exams (e.g., low interest rates) it provides a solid basis to perform targeted examination work and test the company's risk mitigation efforts/internal controls and then update the level of residual risk. Working with one of our State regulatory customers, we also have shared with the NAIC examples of updates to the risk dashboards (refer to Appendix A). These examples show how new risks (and performing targeted work around these risks, where needed) can be addressed effectively using the approach we are suggesting.

*We understand and recognize the challenges associated with incorporating this type of information into the normal State reporting process, but we see a major opportunity for the U.S. State-based system to lead the way in effective regulation on a global basis.*

#### **STEP 4: IDENTIFY INTERIM SOURCES OF RISK INFORMATION**

With a common approach to ranking inherent risk, we believe information from sources like ORSA submissions, Form F ERM filings, rating agencies and other information from the company all represent outstanding sources of risk information to maintain and update a risk summary document. The prospective risk summaries, in particular, represent opportunities for the analysts to think more about the key prospective solvency risks that relate to other areas outside of the financial statements, financial ratios, etc. As noted above, training is a critical aspect. Conducting in-depth training for analysts should help them become more comfortable with identifying, documenting, and assessing the inherent risks relating to areas identified through the ORSA and Form F filings.

Our understanding is that the current activity by the analysts consumes all their time and leaves little to no additional resources/time to tackle the above suggested areas. If necessary, we suggest reviewing the current level of activity and assessing the lists of on-going tasks completed regularly to assure it is all valuable to the solvency monitoring and risk surveillance process at a macro level. Reprioritizing the list of on-going tasks performed may result in dropping certain requirements/tasks if appropriate.

In closing, we applaud the RFSWG's continued efforts to improve the efficiency and effectiveness of the risk-focused examination process, and we are willing to assist in any way we can. Please contact us with any questions or if you wish to discuss our suggestions further.

# Top Risk Summaries (“Dashboard”) Examples Previously Shared with the NAIC

“ABC” Life, Health and P&C Companies  
Financial Reporting & Prospective Risks

# Life Company Examples

Top Risk “Dashboards” –  
Communication Tools

# ABC Life Co. Financial Reporting Risks Dashboard

Top Financial Statement Risk Areas	Financial Statement Assertions	Likelihood of Occurrence	Magnitude of Impact	Overall Inherent Risk
Derivatives/Hedging	Accuracy, Valuation, Obligation and Ownership	Moderate-High	Threatening	High
Impairments	Valuation	Moderate-High	Severe	High
Claims	Obligation, Accuracy	Moderate-Low	Moderate	Moderate
Premiums	Accuracy	Moderate-Low	Moderate	Moderate
Separate Accounts	Accuracy, Valuation	Moderate-Low	Moderate	Moderate
Bonds	Existence, Ownership, Valuation	Moderate-Low	Moderate	Moderate
Mortgage Loans	Existence, Ownership, Valuation	Moderate-Low	Moderate	Moderate
Reserves	Valuation, Obligation	Moderate-High	Severe	High
Real Estate	Ownership, Valuation	Moderate-Low	Severe	Moderate
General Ledger and Financial Reporting	Accuracy	Moderate-Low	Severe	Moderate
Suspense Accounts	Completeness, Accuracy, Valuation	Moderate-High	Severe	High

# ABC Life Co. Prospective Risks Dashboard

Top Prospective Risks	Likelihood	Magnitude	Overall Inherent Risk
M&A Activity	Moderate-High	Threatening	High
New Product Development	Moderate-High	Severe	High
Dependency on Holding Company for Capital Transactions, incl. Reinsurance	Moderate-High	Threatening	High
Data Integrity	Moderate-High	Threatening	High
Legal & Regulatory	Moderate-Low	Threatening	High
New Strategies	Moderate-High	Severe	High
Asset Liability Matching	Moderate-Low	Threatening	High
Money Laundering (AML)	Moderate-High	Severe	High
People Risks	Moderate-High	Severe	High
Sub-prime Exposure	Moderate-High	Threatening	High
Securities Lending	Moderate-High	Threatening	High
2008 Market Crisis (Effect on Liquidity)	High	Threatening	High



# Health Company Examples

Top Risk “Dashboards” –  
Communication Tools

# ABC Health Co. Financial Reporting Risks Dashboard

Top Financial Statement Risk Areas	Financial Statement Assertions	Likelihood of Occurrence	Magnitude of Impact	Overall Inherent Risk
Investments	Valuation, Existence, Ownership	Moderate-High	Severe	High
Cash/Treasury Management	Existence, Ownership	Moderate-High	Moderate	Moderate
Premiums/UW	Existence, Accuracy	Moderate-High	Severe	High
Federal & State Taxes	Accuracy, Completeness	Moderate-Low	Moderate	Moderate
Intercompany	Valuation, Existence, Ownership	Moderate-High	Moderate	Moderate
Claims	Valuation, Accuracy, Completeness	Moderate-High	Severe	High
Reserves	Valuation, Accuracy, Completeness	Moderate-High	Threatening	High

# ABC Health Co. Prospective Risks Dashboard

Top Prospective Risks	Likelihood	Magnitude	Overall Inherent Risk
Non-competitive ACR	High	Severe	High
Unfavorable MCR trending	High	Severe	High
Data integrity/IT risk	High	Threatening	High
Small scale	High	Moderate	High
HR Risk	Mod-Low	Threatening	High
Government programs	High	Threatening	High
Vendor reliance	High	Moderate	High
Claims handling	High	Moderate	High
ICD10	High	Severe	High
Network discount erosion	Mod-High	Severe	High

# Property & Casualty Company Examples

Top Risk “Dashboards” –  
Communication Tools

## ABC P&C Co. Financial Reporting Risks Dashboard

Top Financial Statement Risk Areas	Financial Statement Assertions	Likelihood of Occurrence	Magnitude of Impact	Overall Inherent Risk
Reserves	Valuation, Obligation	Moderate-High	Threatening	High
Bonds	Existence, Ownership, Valuation	Moderate-Low	Severe	Moderate
Claims	Obligation, Accuracy	Moderate-High	Severe	High
Premiums	Accuracy	Moderate-High	Severe	High
Schedule BA (Hard-to-Value Assets)	Existence, Ownership, Valuation	Moderate-High	Moderate	Moderate
Common Stocks	Existence, Ownership, Valuation	Moderate	Moderate	Moderate
Reinsurance	Valuation, Obligation	Moderate-High	Threatening	Moderate
Related Party Transactions	Existence, Ownership, Valuation	Moderate-Low	Moderate	Moderate

# ABC P&C Co. Prospective Risks Dashboard

Top Prospective Risks	Likelihood	Magnitude	Overall Inherent Risk
Pricing / Underwriting	High	Threatening	High
Data Integrity	High	Threatening	High
Capital Adequacy/Dependency on holding company for capital transactions	High	Threatening	High
Maintaining Favorable Rating with A.M. Best	High	Threatening	High
Catastrophe Risk	Moderate-Low	Threatening	High
Legal and Regulatory Risk	Moderate-Low	Threatening	High
Cyclicality of Markets	High	Threatening	High
Dependence on Independent Agents	Moderate-Low	Severe	Moderate
People Risks	Moderate-High	Severe	High
New Product Development	Moderate-Low	Severe	Moderate