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# THE INSURANCE COMPANY EXAMINATION PROCESS – A REPORT CARD

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A regulatory examiner, an independent accountant, and an industry representative will examine and discuss the objectives and quality of today's financial examination process.

- Objectives of each type of examination
- Guiding principles and procedures
- How successful are such examinations in protecting the public's interests?
- Does the process need fixing, and if so, how and what can or should actuaries do?

MR. GLEN M. GAMMILL: Our three panelists are Bob Huff, Leon Hank, and Tom Finnell. Bob Huff, a fellow partner of mine in Peat Marwick Dallas office, is the partner in charge of Peat's Regulatory Insurance Services practice. Bob Huff has spent more than 15 years in state regulation, predominantly in the examination and receivership areas. He has supervised numerous financial examinations for state insurance departments, including zone participation. Bob served as an instructor in various NAIC training programs for state insurance regulators, is a member of the Society of Financial Examiners, and holds a designation of certified financial examiner (CFE). He will be providing the historical perspective of the regulatory examination process.

Leon Hanks is the director of Financial Analysis and Examinations Division of the Michigan Insurance Bureau. Leon manages a 35 person staff of financial analysts and examiners who regulate the more than 1,600 companies licensed in Michigan. Leon is active in regulatory matters on the national level serving on eight different NAIC committees. He currently chairs the NAIC's working group studying the sale of future revenues, securitization, and other capital formation alternatives. He's a Certified Public Accountant (CPA). Leon will cover a broad range of topics that include performance auditing, techniques used in the examinations, the use of consulting actuaries in the examinations, and improving the usefulness of the actuarial opinion in the examination process.

* Mr. Finnell, not a member of the sponsoring organizations, is a Partner of Ernst & Young in Raleigh, North Carolina.

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‡ Mr. Huff, not a member of the sponsoring organizations, is Principal of KPMG Peat Marwick in Dallas, Texas.

Tom Finnell is a partner in the Raleigh, North Carolina office of Ernst & Young. He's the National Director of Insurance Regulatory Services for Ernst & Young. Tom has more than 15 years of experience in serving insurance company clients. He has served state insurance departments in a wide variety of troubled insurance company situations, rehabilitations, and liquidations. Tom has participated in the development of the NAIC's *Troubled Company Handbook* and the *Receivers and Liquidators Handbook*. He is the chairman of an industry subgroup proposing changes to the *NAIC Examiners Handbook*. Tom is a CPA, a member of the American Institute of Certified Public Accountants (AICPA), and a Fellow of the Life Office Management Association. Tom will be highlighting the activities of the industry advisory group that he chairs.

MR. ROBERT E. HUFF: I'm going to provide you with the historical background of the examination process. The examination process is essentially the backbone of insurance regulation. How many of you have been directly involved in a regulatory examination for a regulator? And how many on the other side, on the industry side? I guess almost all of you. As you may know, over the years, there has been a definite a change in the examination process. Some 20 years ago, when I began as a young examiner, all of my peers at that point had been examiners for many years. During that time frame in the examination process, the insurance departments were not hiring young examiners. Consequently, today, when we really need a great many examiners with a lot of expertise, there is a void. In the past there were some very good examiners, but what they were dealing with is not what we are dealing with today. In the past, the examination process was pretty clear cut. Over the past decade, changes in the economy have resulted in changes in the industry resulting in changes in the industry's products and the investment vehicles that support these products. As the industry became more complex, the examiners themselves felt the need to form a group, not unlike the CPAs or the actuarial groups. This group, the Society of Financial Examiners (SOFE), was founded in the early 1970s, and over the years, SOFE has grown to be accepted by the NAIC. One must pass five examinations to become an Associate Financial Examiner (AFE) and an additional four examinations to become a CFE. SOFE has benefited the examination process greatly. No longer do we have people who cannot keep abreast of what is happening in the industry and in regulation. The CFE designation is essentially required to do zone examinations.

In conjunction with the NAIC, SOFE started an examiner's training school that is held twice yearly in Kansas City. Leon and I have been participants and we were talking earlier about how impressed we are with the quality of young professionals that are getting in the field. We now have a very large group of examiners that are highly educated. Many of the states now are requiring that their examiners be CPAs. The examination process is growing in intensity, magnitude, and importance.

Just as the nature and scope of the examination has changed over time, so has the examination report. In the past, most reports issued were long form reports. Such reports dealt with every item in the annual statement, and commented on each item at great length, whether or not there was anything found to be wrong. Over time, many states adopted a short form examination report that only commented on those items that had exceptions. Now we seem to be going back to the long form. Today, it's a different ball game. Right now it's an exciting field; it's exciting for all of us who work in it. Even though I am not a regulator now, I still work with many of the states doing examination work.

MR. LEON E. HANK: Bob did a good job on talking about what we've been through in the past. I will simply say that insurance examinations cost the insurance industry too much money, take too long to complete, are too inefficient, and I would question some of their effectiveness.

I'd like to focus on three key points. The first is the role of the actuary in the regulatory examination. It is critical that we have a very comprehensive actuarial review of an insurance company during the examination process. Second, I'd like to talk about what I call performance auditing techniques and how we are attempting to integrate those into the examination process. Third, I'd like to talk about a regulatory view on the actuarial opinions that we see now. I'd like to be very candid with you and tell you what people in the regulatory community say about the opinions that actuaries issue today. In the past, I have been a critic of the actuarial community. Over the last few years, I have seen a big improvement in some of the actuarial work done. Although I have been a critic of the actuarial community, I've also been a very big promotor of the profession.

In our state, we insist on hiring an independent actuary to participate in any examination that we perform. We don't care how many actuaries have looked at the reserves on an insurance company's balance sheet, we want to have our own actuary look at that work and tell us that the judgments made were appropriate and that the reserves are fairly set. We spend about a $.5 million a year in contracting out these services to actuarial firms on the 50-60 examinations that we do, and that's solely in the life area alone. We also contract extensively on the casualty side. We're very big promoters of trying to get all states to take this same approach. One of the weaknesses we see in state regulation is that some states have no actuaries on their staff, do not contract out with other actuaries, and simply rely on their examiners to perform a review of the actuarial items during the course of an examination. We believe that's very inappropriate and that such an approach detracts from the integrity of the examination. Particularly on the casualty side, we think it's appropriate to always have an independent actuary participate on behalf of the state during the regulatory examination.

When we contract with actuaries, we try to get them to do five things for us. First and foremost is that we want a clean opinion. We want to be able to demonstrate that we have hired an outside expert in what we think is a highly specialized and technical area and we do not want our examiners taking responsibility for that particular function. Second, we want our actuaries to do a comprehensive systems review of the company. We want our actuaries to look at the data and the systems that develop those data that go into making the projections and determining the reserves of the company. When we have our actuaries do this type of systems review, we found in a number of cases they often can come up with very practical suggestions. We're very big on having our actuaries come into the company, look at those systems, work with the actuarial people within the company, and develop a good feel for where the underlying numbers come from. The third thing that we're big on is actually auditing the underlying data that go into the actuarial certification. What we try to do in our contractual relationships with the actuaries is to have them identify for us what are the critical data elements. What are those elements that are most critical to determining the right reserve numbers? We, in turn, take responsibility for auditing that data, working in conjunction with the actuary. The fourth thing we like our actuaries to perform is an analysis of reinsurance. This is a very sophisticated part of the business and we need a good actuarial analysis of it. We like our actuary to work with us and to make sure that there's reasonable chance that the reinsurance has been properly accounted for. The fifth and final thing that we rely on our actuaries for is to provide general support to our examination staff. Bob talked about education and how education is improving. We know that we need more sophisticated examiners. Our business is much more complex than it was 10 or 15 years ago, and we have very complex products out there today, very complex investment vehicles, very creative accounting treatment, etc. We want an actuary around to provide general support to our examination staff during the conduct of the field work. We've found that the actuaries that we hire do contribute very directly toward upgrading the quality and education of our examination staff. If you get an actuary to work closely with your staff during the course of an examination, it's only natural that some of that actuary's knowledge is going to rub off on your examination staff. That makes our examiners much better, much more capable to take on these very sophisticated issues that we see today.

In summary, when you do those five things, we believe you end up with a much higher-quality examination than if you just simply let your examiners do it themselves. I believe strongly that we need someone to represent the interests of the state and that it's a mistake to rely on an actuary hired by the company. Our resources are strained at the state level in terms of examiners and we look to the CPA firms for help. I think you'll see us come under very intense pressure to upgrade the quality of our examinations and to improve examination integrity. We're going to have to look more and more to the actuarial community and we'll need more and more services from you. In addition, I see us using more and more services in specialized areas, for example, in demutualizations.

Next, I'd like to talk a little bit about what I call performance auditing. Historically, we have concentrated on determining the true financial condition of a company at a point in time. For example, if we were to start the examination now, we would focus virtually all of our resources on the financial side. Tom Finnell has very graciously agreed to chair a committee that's trying to steer us in another direction to make us much more effective and efficient in how we use our limited resources.

Right now, in your typical examination report, there are very few clues on how well the company is managed and what it needs to improve. We give very little feedback on what are the real operational problems in the company. Receiverships and liquidations are increasing and we've got to do something about them. We know one thing: insolvencies happen because of mismanagement in almost all cases. So it makes sense that we should be addressing certain management issues when we conduct the financial examination. Fraud is also certainly a factor in some cases, but in many cases it's mismanagement. So it makes sense to us that we should be focusing on how well a company is managed in the examination.

Let me give you some examples. Historically, when we would do a review of bonds, for example, we'd look for a few very simple things. We'd make sure that the bonds really exist and that the company really owns them. We'd ascertain that bonds are properly valued and that they are being amortized properly, and we'd verify that the proper investment income is being receipted into the company. We would really concentrate on those hard-core accounting type issues and those issues would be the focus of all our resources in the examination. The difference between that historical approach and implementing some performance auditing techniques is to take a broader view of what we look at in the area of bonds. Under the performance perspective, we would start by asking ourselves some other questions such as is there good maturity diversification among the bonds. Some companies will have all their bonds in very long-term bonds, and if we go through another period of disintermediation, certainly a company like that is taking some enormous risks by investing long. We think examiners can look at those kinds of issues and make constructive comments in the examination reports to force management to look at those issues and to respond.

A second thing we have looked at in the performance auditing area has to do with the cash flow studies. There are certainly some companies that have potential problems with the asset-liability matching. When we see companies that are heavy into junk bonds and potentially have some mismatched assets, we're making recommendations now. If the company is performing cash flow studies, we're looking at the quality of those studies. I think states will get a lot more aggressive in demanding that the companies do more performance oriented studies.

Another example would be the quality of a company's portfolio. In the past, you'll see very few comments in our reports that address the quality of a company's portfolio. I think you'll begin to see us start making more comments on the quality of investment portfolios. We'll start suggesting that the company may have too many affiliated transactions, or that there may be too many nonincome producing bonds in the portfolio, or too many junk bonds. Some of our reports are already filled with comments like that and I think you'll see more of those comments as we progress. Well, those are simple examples of some types of performance auditing where we're going beyond the numbers and we're making more management-oriented comments. We're forcing the management of insurance companies to start looking at how well they are performing.

My third point is to discuss the actuarial opinion and to concentrate on what I call plugging the holes in the current opinion. I think an important point is that it's the perception of a lot of regulators that the current actuarial opinions are so filled with qualifications that they don't have the usefulness that they could or should have. There is a perception that actuaries are not stepping forward and taking a responsibility for the setting and certification of reserves. To many of us in the regulatory community, it makes no sense at all to get an opinion from someone who works for the insurance company being examined. (Regrettably, in our first round of NAIC actions, we've allowed this.) Second, one of the things on which I've been a real critic of the actuarial community is the use of wide ranges. It happens more on the casualty side. If a purpose of the actuarial opinion is to supplement a statutory insurance company filing, it only makes sense that such an opinion would have a little conservatism built into it. We don't always see that, and here's a real-life example. On the 50 or 60 actuarial opinions that I work on myself, I reviewed one the other day from our actuary and the opinion was clean. It said reserves were adequately set. I had looked at the reserves of this casualty company previously and I had told our actuary that their reserves were deficient. Even though we had that discussion, the actuary cranked out an opinion stating that the reserves were adequate. I called the actuary and we talked about her opinion. She said the she could construct one scenario where the reserves were adequate. I asked her, what is the probability that that scenario will happen? She said almost none. I said how could you possibly give this company a clean opinion? After a long discussion, I convinced her to change her opinion but again I think that's the type of thing that really frustrates us as regulators in working with the actuarial community. The fact that something like that could happen scares us. Third, is the qualification for data accuracy, and we've spoken on that already so I just want to mention this briefly. We think it's in all our interests that we try to minimize this qualification in the opinions, and we think the solution is having the accounting profession take responsibility for auditing the data. We understand the concerns of the actuarial community where you're not auditors and you don't want to take responsibility for those data, but in our view, somebody should.

Another point I'd like to discuss is cash flow testing. Glen and I had a good discussion before this session on the need to accelerate the work we do in the cash flow testing area. We're sort in a middle ground right now; we're continuing to evolve. The industry needs to accelerate the process.

MR. A. THOMAS FINNELL JR.: This is sort of an unusual presentation for me because instead of having to talk about something I've done, I get to talk about something I have yet to do. It's sort of like airing your "to do list" in public. Not something I wish to do very often. As Leon and Glen mentioned, I head up an NAIC industry subgroup whose mission it is to try to rewrite the *NAIC Examiners Handbook*. This is going to be a very lengthy process, it's already something that's covered a year or so or more of development just to get to where we are right now, which is essentially an outline of what we want to do. I thought I would give you a feel of what I think is in the works, what direction the examinations are going to take, and what impact that may have on actuaries, accountants, and regulators.

I think a good starting point is back with Earl Pomeroy's solvency policing agenda. Earl was the president of the NAIC and completed his term in 1990. Part of that agenda included an examination processes assessment. That assessment included holding hearings in selected parts of the country to obtain broad input and views on the examination process. During the hearings, testimony was given by the actuarial and accounting professions as well as regulators and other parties in various states. The NAIC wanted to determine if the current focus of financial examinations was appropriate. The NAIC also wanted to review the recommendations of the NAIC's report from the Special Joint Committee on Examinations, the so-called Bill Bud report; they wanted to review the GAO report on insurance regulation, and review the NAIC's recommendations for improving solvency regulation, and all of that review was assigned to the NAIC's Committee on Examinations. As a result of their work, the Committee on Examinations developed a list of recommendations, a handful of which related directly to the *NAIC Examiners Handbook.* First among those recommendations is the aspect of targeted examinations. They wanted to include some beefed up language in the *Handbook* as to targeted examinations and to base those examinations on specific criteria that would include in-house financial analysis, discussions with the insurer's management, Insurance Regulatory Information System (IRIS) results, CPA audits, etc. They recommended strengthening some of the interim reporting within the examining department as to the status of the examination. They also asked that some additional postexamination follow-up procedures be incorporated into the *Handbook.* One particular area requiring a great deal of strengthening is the examination planning techniques. Currently, if you look at the *Handbook*, there's only a slight reference to examination planning. By examination planning, I'm referring to some newer concepts in auditing that get into materiality, risk analysis, and planning, which targets audit procedures toward areas that are most likely to have a likelihood of material error and to focus examination resources on those areas. There was also an expressed need to include some minimum standards for examination administration, including the budgeting and monitoring of time. More importantly, the Examination Committee recommended that the examiners make use of the reports and working papers of both independent accountants and consulting actuaries. The Committee's recommendations were turned over to the Committee on the *Handbook,* to get these revisions and recommendations implemented. In turn, a subgroup was then identified composed principally of industry members. Three of the Big-6 firms were also represented, Ernst & Young, Peat Marwick, and Arthur Andersen, and working together we're trying to incorporate language that will accomplish all of those recommendations. One subgroup issued a report to the NAIC committee in Charleston last month that effectively was approved. That report was an outline of the suggested changes that needed to be made. The NAIC Committee has now asked us to get to work and come back to Indianapolis with some verbiage to be reviewed and approved. The first and perhaps most important recommendation, I believe, is this aspect of targeted examinations. Currently, there's not a lot of guidance in the *Handbook* as to what a targeted examination is. Currently, there are comprehensive examinations and targeted examinations. It's not readily understood what the objectives of those two examination types are and how they differ. We think perhaps better terminology might be to call comprehensive examinations "full scope examinations." The purpose of such examinations is to opine on the financial position of the company taken as a whole. Then there could be so-called limited scope examinations, and by definition those would be anything that's not full scope.

Second, there's a need, we believe, to put in some guidance on when targeted examinations would be more appropriate and how they fit in into the context of these so-called full scope examinations. In past years, many states relied heavily on the triennial full scope examination. Today, there is a push to rely more on the work of independent accountants and to focus the examiner on regulatory issues that are determined to be really critical. The *Handbook* needs some examples of when a targeted examination is appropriate. Some of the examples that have been kicked around in the group include items that were noted during a triennial that perhaps need some sort of follow-up.

We also think that the whole examination process needs to be more current. Frankly, some of the guidance that's out there right now for the insurance industry in public accounting has just come out within this past year. The AICPA, for example, annually comes out with a document called an audit risk alert. We think that's a good example of the type of document that should be used in the process of state examinations as well. There are also criteria currently in the *Handbook* as to when to audit a company. We don't know if there's any real basis for those criteria today.

Something that is not directly related to the *Handbook*, but is certainly a corollary aspect, has to do with continuing education. The types of changes that we're making are very dramatic. Again, the *Handbook* has been in place for quite some time, changes to it have been made over the years, but unfortunately the industry (and the environment), has far out paced some of the language that is in the *Handbook.* A significant amount of continuing education should focus on examination planning, risk and materiality, and trying to determine what is important: Do I audit every account that's more than $1,000 or every account that's more than $1 million? If I pick an account that's more than $1 million, do I have to beat it to death, or just analyze it? All these questions relate to how you allocate your resources to focus on what's important. We need to think carefully about the education required to enable the examiner to use the *Handbook* better once it written. Right now there's no quantification of what's material. We don't have any concepts in the *Handbook* on planning materiality, tolerable error, etc. There's too much reliance, we think, on the IRIS tests. The IRIS tests, like any other analytical tool, are useful to identify a troubled company or to measure one company against another, but once you begin the examination, you can't just take those ratios at face value, you have to go behind them and understand what makes those ratios behave the way they do. I made mention earlier of the use of independent accounting and actuarial working papers by the examiners. As I mentioned, the NAIC has passed a rule that will go into effect in 1991 requiring all insurance companies to be audited. That will have a different impact in different companies. Some companies may have had a consolidated GAAP audit; now we may be requiring a statutory audit. Some states, like Minnesota, go a step further and require separate company audits. One of the routine procedures in some states (and I think the procedure will be put in the *Handbook*) is that one of the first examination steps should be to read those reports and review the independent accountant's working papers.

We are probably going to put some guidance in the *Handbook* about the use of GAAP financial statements. There's some thought that GAAP basis financial statements might be useful in doing comparisons from year to year. So there may be some guidance in the *Handbook* to consider the GAAP financial statements if they're available. All we're saying is if GAAP statements are already done, just look at them and see what they tell you. The GAAP financial statements may suggest that there are some possible areas or transactions that should be looked at on a statutory basis.

Where does the process go from here? The NAIC meets again in Indianapolis. Hopefully, if all goes according to plan, we will have some revised verbiage on a couple of sections of the *Handbook* out and ready for review at that meeting. I think we're going to emphasize this whole area of planning. Because if you plan properly, you can focus the work where it needs to be spent wisely and get that done quickly. We hope to have that verbiage done and submitted to the full committee in Indianapolis. I think that submission will start a long process of having that input evaluated and final verbiage negotiated with the hopes of having some final language for the *Handbook* by the December NAIC meeting. It won't be over at that point because there are some other areas that will carry over and that will probably be a separate agenda for 1992.

MR. ALBERT L. PERUZZO: This question is to Mr. Hank, who spoke on inefficient audits. Pooling arrangements in which two affiliates agree to split the predetermined percentage of their combined business are relatively new on the life side but have been around on the casualty side for decades. Why would states insist on separate audits at separate times requiring rooms full of data that duplicate each other?

MR. HANK: It makes no sense at all to review different companies in groups at different times. You should do all the examinations and all companies at the same time to save the companies a lot of money in examination costs and more efficiently use our examination resources.