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The Small Company Actuary and Risk-Focused Financial Examinations

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Remember those fellowship exam questions that always started off: "You are the actuary for a life insurance company …"? Well, you are that actuary today and you just found out that your company is going to go through its financial examination conducted by the state insurance department. Do you cringe at the thought or welcome the opportunity to show what you do? How can you as the company's actuary be better prepared to handle the requests, questions and follow-up that will be needed to ensure the examination process concludes successfully? You have also heard from fellow actuaries that your time commitment will be greater and it will be more costly for your company since the insurance department has implemented this new risk-focused examination approach.

In years past you would provide to the examining actuary your workpapers, answer a few questions, and ensure the workpapers reconciled to the reserve amounts in the financial statements. This was when the examination process focused on the company balance sheet and tried to ensure that all the key line entries for assets and liabilities were determined and set correctly. This new examination process is more holistic in nature. The process is designed to assist the examiner in understanding what the company mission and goals are, what processes are used to achieve those goals, and what risks the company faces that would prevent it from reaching those stated goals. An analysis of those risks is then performed and a determination is made as to whether or not a control or strategy is in place that is effective in mitigating that risk.

Risk-Focused Examination Process

Beginning for all new examinations that started after Jan. 1, 2010, the risk-focused examination approach is becoming more refined and ingrained. However, there seems to be a low rumble—if not a roar—that this new approach is more time-consuming for the actuary and has been more costly to the company. Obviously, that was not the intent when this format was devised. One possible reason for this widespread view is the shift from the old paradigm to this new format has not been applied consistently. If one were to think of this shift along a continuum with the prior balance sheet approach on the left of the continuum and the new risk-focused

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approach on the right, what is apparent is that each state insurance department is at a different point along that continuum in trying to implement the new approach. Even examiners-in-charge (EICs) for the same state could be placed along this continuum at different points. Just like all change that affects people, some can accept totally and jump in with both feet while others are more moderate and methodical in their approach to accepting of the change. They may take longer to embrace the changes that the new process requires.

For those who may be unfamiliar with the NAIC risk-focused examination approach, a brief synopsis is provided. For additional background on the risk-focused examination process, I would refer the reader to an article, "The Risk-Focused Examination," written by Frank Clapper in the June 2014 issue of *The Financial Reporter*. Frank discusses the background of the risk-focused examination process and provides detail on the various phases of the process.

There are seven phases of this approach, which can be summarized as follows:

Phase 1 Understanding the Company and Identifying Key Functional Activities

Phase 2 Identify and Assess the Inherent Risk Found in the Activities

Phase 3 Identify and Evaluate the Risk Mitigation Strategies or Controls

Phase 4 Determine Residual Risk

Phase 5 Conduct Detail Examination Procedures

Phase 6 Update Prioritization and Supervisory Plan

Phase 7 Draft Examination Report and Management Letter

The actuary is primarily going to be involved in Phases 1, 3, 5 and 7. The amount of time and effort needed by the actuary will vary for each phase.

Phase 1

In Phase 1 the examination team is working to understand the company, determine what the material risks the company may be facing are, and how the governance structure of the company works to mitigate those risks. A key element of this process is the interview. The senior officers are all interviewed, and that includes the chief actuary and generally the appointed actuary if that is a different individual. This may be the first encounter the actuary has with the examination process.

Actuarial Interview

There are a number of key areas that are targeted during the actuarial interview. Some areas may be emphasized more than others given the circumstances, but generally these are the areas the actuary should think about when notified of the interview.

Background and Experience

The interview begins with the actuary discussing his or her background and experience. This information is important if the actuary is new to the position. The actuary's information found in the SOA directory may be checked to determine whether the actuary is compliant to sign the actuarial opinion. Documentation of the continuing education that gives rise to the compliant status may be requested. A copy of the letter naming the actuary as the appointed actuary that is sent to the insurance commissioner may also be requested.

Operations

The actuary would then be asked about the organization: Who reports to the actuary? To whom does the actuary report? What kind of experience does the actuarial staff have? How long has the staff been in place? How often and what kind of interaction takes place? These are some of the items that may be explored. The examiners will want to know how much contact the actuary may have with senior management and/or the board of directors.

Reserves

The reserving process is then probed. What are the procedures used to set the reserves? What systems are used (have they changed since the last exam)? What steps does the appointed actuary take to get comfortable with the reserves, especially if they are actually generated by someone else? These are just a few of the types of questions one may get. Generally, the questions regarding reserves are more about the processes that are in place to ensure they are properly being computed. This is especially key for those reserves that allow the actuary to use some judgment in determining the amount. For example, in determining unpaid health liabilities, questions as to what influence does senior management have on the level of reserves may be explored.

Pricing and Underwriting

While the actuary may have been accustomed to responding solely about valuation issues, the risks of pricing and underwriting have become more significant and are usually explored. What kinds of risk these areas pose for the appointed actuary and how the actuary works to understand and if necessary mitigate those risks is the key element of this line of questioning.

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ERM and ORSA
A line of questioning regarding enterprise risk management (ERM) and Own Risk and Solvency Assessment (ORSA) (if subject to) is also discussed, trying to determine at least from the actuary's point of view the material and relevant risks the company is facing and what the response is to deal with those risks.

Reinsurance
The reinsurance program is also explored, including how it is used to mitigate risk.

Ethics
Finally, ethics is an area that is explored—personal ethics and corporate ethics. Questions that are generally asked include: What kinds of ethics training are used by the company? Does the actuary know of any instances of fraud against the company?

The actuary may be requested to provide follow-up documentation of anything significant that comes out of the interview. Also, depending upon the organizational structure, other actuaries may be interviewed, i.e., pricing or modeling actuaries if it is determined they can shed light on the company. The results of the interviews are summarized, and the summaries become a part of the examination record.

Phase 2

Once all of the interviews have been completed and summaries created, along with the other planning that has been performed, the process moves to Phase 2. Key risks have now been identified, and in this phase those risks are assessed. This is completed by the examining staff. Risks are evaluated using a metric where magnitude of impact on surplus versus likelihood of occurrence is measured with resulting risks being labeled as high, moderate or low. A risk with significant impact on surplus with high frequency of occurrence would probably dictate a high level of inherent risk.

Phase 3

In this phase the identification and evaluation of the risk mitigation strategies or controls occur. This is the next phase where the company actuary will be asked to provide information or answer additional questions. In this phase the examiner is not looking at the ending reserve numbers that are posted to the financial statement that is under examination. Rather, the examiner is trying to determine whether the company has in place the types of controls that will assure the examiner whether those risks that could have a significant impact on a company's surplus do in fact have a very low chance of occurring.

Risk Matrices
The risk matrix is essentially a score or tally sheet. The prior information gathered in Phase 1 and the risks assessed in Phase 2 are used to develop a risk matrix. This document outlines the risks that have been identified and whether they result in a high, moderate or low risk category. Obviously, those risks identified as high require the most time to review. The Phase 3 step is to review company controls that have been set up to mitigate the identified risk. Once the controls have been identified then the question is whether the controls have been designed appropriately to mitigate the risk. Some of the matrices developed where the actuary may be called upon to provide information include those for the reserving risk, pricing risk, underwriting risk, premiums, investments and claims. Generally, the risk matrix is created in an Excel spreadsheet. Risks are listed down the sheet while the different phases are shown across the top. Risks are identified in the Phase 1 column; the Phase 2 column will show the determination of whether the identified risk is in the low, moderate or high categories. Phase 3 generally takes two columns: The first column describes the control strategy that has been identified to mitigate that particular risk. The second Phase 3 column is completed when the control is evaluated. The results of the testing are shown. There are identifying codes that direct the examiner to the location of the documents that have been used to support their conclusions.

SOX & MAR Controls
If a company is subject to the Sarbanes-Oxley Act of 2002 (SOX) or the Model Audit Rule (MAR—NAIC Model Regulation #205), there should be substantial documentation of the controls that have been designed for each identified risk. If that is the case, the examiner will want to review the documentation supporting the implementation of that control, i.e., a sign-off document by the appropriate individual. The evaluation also consists of a qualitative aspect to try to determine whether the identified control really does reduce the risk from occurring. If a company is not subject to either the SOX or MAR regulations, the effort necessary for the examiner increases substantially. This could significantly impact the amount of time the actuary will need to devote to the examination process. The actuary will be asked to document the reserving process and steps the actuary goes through to ensure the calculated reserve amounts are appropriate, for example.

Outside Auditors
Information from a company's outside auditors is used. If the auditors have completed detailed testing of a reserve or reserve process and the examiners believe the testing was sufficient and reliable for their purposes, they will rely on

that information and waive additional control testing. Or they may supplement the testing with additional tests of their own.

Example

As an example, a key risk for health insurers is the determination of incurred but not reported (IBNR) reserves. The impact of setting wrong reserves can be significant on surplus, and there is a high frequency of occurrence of wrong reserves being calculated especially when setting reserves every month. So what does Phase 3 testing look like? First, as part of the Phase 1 discussions you know the company uses lag triangles to set determine reserves. There is a reconciliation performed of the data in the triangles to that data that goes into the general ledger. Next, once the reserve estimate has been determined, there might be a meeting of the senior management, claims and pricing/UW personnel to discuss the level or change in the level of reserves. Once everyone agrees to the amount, the reserves are posted to the financial statement. The controls on this risk of misstatement of reserves have several pieces. First there is the reconciliation of lag data to the general ledger; second there is a meeting to discuss the level of reserves; and finally there is sign-off that management agrees with the amounts determined. So the Phase 3 analysis will look to find the reconciliation and the documentation that supports it. Next, since there is to be a meeting, the examiners will check to make sure the meeting actually took place, look for meeting notices and who received the notices, and get that documentation. Finally, if there is a sign-off by management as to the reserves, that documentation will also be added into the examination work record. There should be a document with signatures that support that control that is the document that goes into the examination file.

Documentation

In short, the key word for the Phase 3 testing is documentation. Good documentation of the processes and procedures you use when setting reserves, pricing or paying claims is more important than ever. Good documentation may allow the examiner to pass on a lot of the Phase 5 testing discussed below.

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If you are the appointed actuary for a company not subject to SOX or MAR, you should develop documentation that describes the approach and process used to develop the IBNR or any reserve that may have a significant impact on surplus if not determined correctly. The testing in this phase did not check whether the amounts were calculated correctly but rather were the established processes used to ensure the appropriate determination of reserves followed and are those processes applicable to that, ensuring the risk is mitigated.

Critical Risk Areas

When the NAIC began this risk-focused approach, potential risks were identified and placed in a database the examiners could access and use in their work. These risks were such that almost all companies would be subject to them. It was pretty much a given that these were the risks that needed to be reviewed—in certain instances, no more and no less, even if they were not necessarily applicable to the company. That thinking has evolved as people have become more familiar with this process.

The NAIC is now producing what are described as critical risk areas, things like credit, market, pricing/underwriting, liquidity, operational, reserving, legal and a few others. The examiner is to determine the specific risks a company may be exposed to that are in these broad categories rather than rely on specific risks populated in the database. It will be an evolutionary process as to how quickly the critical risk areas will be incorporated into the examination process. As examiners become more confident in identifying the risks that are specific to the particular company, the reliance on predetermined risks will subside.

Phase 4

In this phase the examiner reviews the information and documentation obtained in Phase 3 and then makes a determination as to the amount of residual risk that still remains of the original defined risk, i.e., how well did the controls reviewed actually mitigate the risk. Again a table is used to quantify this residual risk. Beginning with the

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Phase 2 inherent risk assessment of high, moderate and low, cross-referenced with how well the controls mitigated the risk, provides the amount of residual risk that remains. This residual risk is measured on high, moderate or low basis. Once each of the risks has been analyzed, the process moves to Phase 5.

Phase 5

From an actuarial standpoint at least, this is the phase where the traditional actuarial examination testing would be performed. If the residual risk is rated high, substantive detail testing would be performed. As an example, if the determination of life reserves was indicated as having a high inherent risk, the misstatement of the reserves could have a material effect on the level of surplus. Controls were reviewed and determined that for the most part they were sufficient, appropriate, and being applied correctly. However, the company embarked on marketing a new line of business since the last examination. While the control assessment may have been strong for the existing business, for this new business there may have been moderate or low control assessment. This scenario would require what can be deemed traditional examination testing of reserves. A request to receive the seriatim in-force listings and actuarial statements of basis as the components to begin review would be made, then a recalculation of the reserves for a sample of contracts to assure the examiners that the calculations were correct. This testing constitutes the substantive or detail testing. In theory, if the controls are strong this should greatly reduce the amount of detail testing that needs to be completed.

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Theoretically, the type of testing being done at the Phase 5 level should be less than what has traditionally been done under the prior examination approach. There are states that just require the examining actuaries to assist in the examination, complete the assessment of the actuarial controls, and do any detail testing as may be required as a result of the control assessment. The examining actuaries then summarize their work and complete their assignment. Other states, however, because of how their laws and/or regulations are written, require the examining actuaries to provide an Actuarial Opinion on the level of reserves shown in the financial statement as of the examination date (year-end). In this case, despite what the risk matrix may say is necessary for work that needs to be completed in Phase 5, the actuaries still need to comply with the appropriate ASOPs and do enough testing, calculations, etc. that they can provide a signed actuarial opinion. Thus, in those states, more detailed testing will probably be required than might be necessary otherwise.

The NAIC and the state insurance departments are endeavoring to work more closely together and get many of a company's affiliates to be examined at the same time. In many instances this involves coordinating with more than one insurance department. These multistate coordinated exams also can mean more testing is performed than what might actually be required if strictly following the risk matrix. Generally, what happens in these multistate coordinated exams is that a lead state is designated, primarily because the main or most important company is domiciled in that particular state. That state then begins the examination process and moves through the various phases as has been discussed. It may be entirely probable the controls and processes used at the main company are the same as those used by many or all of the other affiliated companies. The risk-focused process is to recognize this and hopefully shorten or abbreviate the need to re-perform the procedures on all the affiliated companies. However, state law may dictate the examiners and the examining actuary to conduct additional testing on the particular affiliate because it cannot rely on the testing solely performed by the lead state on the main company. This is especially true if business from that particular state was not included in the testing conducted by the lead state examination team. Thus, even though the process as designed is an attempt to streamline and make the process more efficient, there are instances where current state law or regulation may not allow that to happen to the fullest extent.

Phase 6

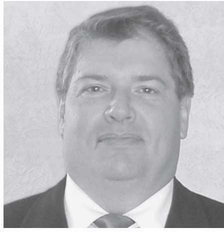
Once all of the detail testing has been completed, the examiners will use all of the information that has been developed and update the company's priority and/or supervisory plan. At least once a year the domestic state insurance department updates its supervisory plan for each domestic insurer. This plan is based on information the state gathers from the quarterly financial analysis that it does and then supplements that information with the results of the examination. The plan should be concise and outline the type of surveillance planned, the resources dedicated to the oversight and coordination with other states. For a well-managed, well-capitalized company, the plan will not be extensive.

Phase 7

The last phase encompasses the final completion of the examination report and management letter. For the company actuary this will be where any recommendations that are made will be found. The actuary should review these items and can either implement the recommendations or may find that the recommendation may be impossible or impractical to implement. If the latter, the actuary should provide clear, sound documentation and provide that to the examiner or the in-company contact so that when the examination reoccurs in the next three to five years and the examining actuary is reviewing the prior recommendations to see whether they have been implemented or not, reasons for not following up will be readily available and the issues can be dealt with early rather than later in the examination process.

One may be able to think of this risk-focused examination process as an extension of a company's ERM process. A company with a strong ERM plan should find the examination process simply an evaluation of that work. A company with strong ERM will have identified its risks, will have developed strategies to manage the risks, will have documented what those strategies are, and will be able to show that the processes are working. These companies should find the examination process to be a verification of all of that ERM work that should be beneficial to all concerned.

In summary, while this whole risk-focused approach may seem to be time-consuming and expensive, the intent is that with experience, the process can be streamlined and made more relevant and efficient. It is certainly not a perfect process and there is room for improvement. The company actuary is a key component for ensuring a successful completion of the examination process. If the reserving process is well-documented, if the controls that have been devised are designed well, and if those controls are effective in ensuring the risk is minimized, then the amount of time the actuary is needed to work with the examination team can be minimized.



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