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SOX Controls and Risk Focused Examinations

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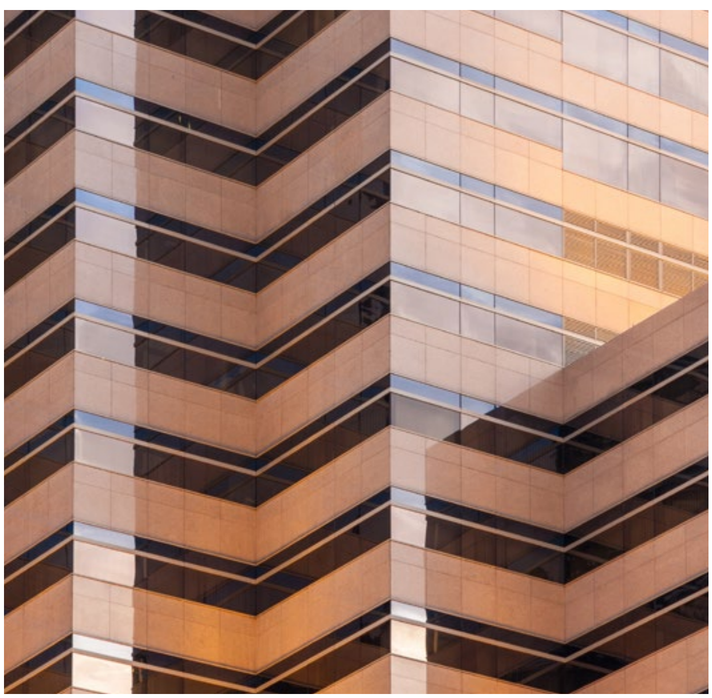
As the NAIC and state insurance departments continue to refine and gain experience in using the risk focused examination methodology in the financial examinations of insurance companies, the importance of sound risk controls in all aspects of insurance company operations continues to gain importance. As can be expected with a relatively new process, the rigor in the application of this risk focused methodology can vary widely from state to state. It can also vary from examiner-in-charge to examiner-in-charge within a particular state. As such the degree to which the following analysis is applied will also vary.

As a quick review, the risk focused examination process is divided into seven phases. In the first phase the examiner is to understand the company and determine what areas should be included in the examination. In phase 2 the examination team identifies and assesses the inherent risks of the company. Phase 3 identifies and evaluates the controls the company has in place to manage its risks. In phase 4 a determination of the residual risk is made. This is the risk that remains even after the controls used to mitigate risk are analyzed. Phase 5 again is what can be considered the traditional examination methodology where, for example, detailed testing of reserves may take place. Phases 6 and 7 involve developing any recommended supervisory plan and the drafting and finalization of the exam report and project. In this article, the prime focus is with phase 3: identify and evaluate risk mitigation strategies.

For an actuary working in a publicly traded company this generally means the risk focused examination is focusing on SOX controls. SOX controls are those documented processes and procedures which are required by the Sarbanes-Oxley Act of 2002 and are used to mitigate risk. For those companies not subject to SOX, the NAIC Annual Financial Reporting Model Regulation, aka Model Audit Rule (MAR #205) and adopted by almost all of the states, contains many of the same ideas found in the SOX legislation.



These risk mitigation strategies are generally based on the following principles:[1]

- Active board and management oversight;
- Management information systems which have adequate risk management and monitoring mechanisms;
- Clear policies, procedures and stated limits;
- Comprehensive internal controls; and
- Processes to ensure compliance with laws and regulations.

The first two items above are usually detailed in phases 1 and 2 of the examination. In phase 3 the last three items are analyzed. Generally, the examination team will have identified the key risks to the company and more specifically to the actuarial function (phases 1 and 2). These risks may include those related to pricing & underwriting, reserving, liquidity and operational functions.

For example, when evaluating reserving risk controls some of the issues the examiner may review could include: Do the reserving methodologies established by management reflect a conservative approach? Is the valuation staff responsible for developing the reserves capable and experienced? Are the processes used to evaluate current and prior reserves and reserve trends reliable, accurate and produced on a timely basis? Are the electronic systems from which the valuation information is extracted accurate, dependable and can it be validated? Does the appointed actuary seek out insight from the pricing actuary, claims or underwriting staff regarding product trends and dynamics? If applicable, is reinsurance considered appropriately? In the determination of claim liabilities, is the claim paying function well-documented, validated, and audited? Has the company developed a plan for implementing principle based reserving (PBR)?

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If your company is working under the aegis of SOX or MAR, there should exist extensive documentation of the controls that serve to mitigate reserving risks. This documentation may include narrative descriptions of the processes, checklists, flowcharts, videos, or any other type of documentation that may be pertinent to the specifically identified risk. The examination team will review those controls and determine whether they are functioning as anticipated. The team can rely on the work of the company's external or even internal auditors if they have recently completed testing. The examination team can also perform again control tests to ensure the SOX or MAR controls are functioning appropriately. As an example of a control test ensuring the adequacy of the monthly reserve calculation, consider the following: The SOX control says the valuation actuary reviews the monthly reserve calculation and signs off each month that the review has been made and the amount approved. In practice, monthly reserves are developed by a member of your staff. When the work is completed, the results are presented to you as valuation actuary. A document is signed, stating the reserves have been reviewed, discussed and agreed with the amounts shown. The control test may be to verify a document exists that has been appropriately signed each month. If the document is verified, there may not be any additional testing of the reserves for that particular block.

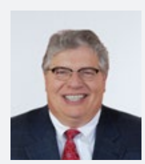
How are controls examined for a smaller insurance company where segregation of duties is not possible or SOX or MAR documentation is not required? The answer is not clear cut and will depend on the size, complexity and sophistication of the company. The actuary may decide to develop his or her own documentation of the valuation or pricing procedures even if not compelled to do so. Obviously, this takes precious time, but having some documentation of the methodology or processes, however rudimentary, may greatly assist the company should something occur where the actuary becomes unavailable to perform his or her duties. The documentation would also assist the examiner in completing phase 3 of a financial examination by minimizing the amount of time the actuary would need in responding to an examiner's requests.

In summary, if there are SOX or MAR controls, they will be reviewed and tested to determine whether they are functioning as described and anticipated. If such documentation does not exist it becomes more difficult for the examiner to determine whether sufficient controls exist to mitigate the risk. If the determination of weak controls is made, much more substantive testing will occur in phase 5 thereby increasing the time and expense of the examination. Therefore, documentation of policies and procedures is always a plus. Good documentation is even better. Not surprising as that has always been the case.

For more information on risk-focused exams see the cover article by the same author in the September, 2014 edition of *Small Talk*. ■

ENDNOTE

[1] *NAIC Financial Condition Examiners Handbook*



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