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Risk-Focused Examinations: Lessons Learned

The NAIC has recently adopted new risk-focused examination guidance that is intended for implementation in all states by 2010. One of the most fundamental aspects of this new guidance is that examiners understand well the company under examination so that they can better focus examination resources and design examination procedures in response to perceived risk levels involving various areas of the company and its operations. A number of states have begun to use the new approach, and feedback from those experiences is surfacing.

This is the first of a series of articles the objectives of which are to share experiences from some of these early implementation efforts; to consider emerging issues and their implications going forward; and to shed some light on future challenges as an increasing number of examiners from more states take the plunge with the new approach.

The following does not result from a formal survey or study. Rather, it is based largely on the experiences of the author and his firm, and of others – regulators, examiners, and company representatives as well – who graciously shared some of their experiences in early implementation efforts on a non-attribution basis.

This is not a primer on the risk-focused guidance itself. Nonetheless, a short list of the more fundamental changes that have resulted from the new NAIC guidance is helpful as a framework for exchanging experiences about lessons learned in early implementation efforts. That list includes:

- Top-down approach
- Heightened focus on governance, enterprise-wide controls, and risk management strategies
- Broader focus on the audit function and related oversight
- Framework built around “key functional activities”
- Risk assessment process that considers inherent and prospective risks
- Supplemental form of reporting in the form of a “management letter”

However, before we explore these areas, we must start at the beginning of the examination – actually, before the beginning.

Pre-Exam Preparations

The new approach makes it critical that all involved understand and embrace the examination's objectives. In the past, that might simply have been to perform the mission within a specified timeframe. Of course, there often were other objectives as well, for example, to focus on some particular areas of concern such as reinsurance or derivatives. However, going forward, the examination objectives may vary even more from one company to the next. One reason for that is the impact of the NAIC's Risk-Focused Framework.

The NAIC adopted the Risk-Focused Framework and its Risk Assessment Cycle as a model to provide for a continuous cycle of surveillance objectives of which financial examinations and financial analysis are just two key components. Each component of the cycle contributes insight to an evolving risk profile of the company – an Insurer Profile Summary that serves as a living document to capture the most current and best thinking about the unique aspects of the company and the risks that it faces.

With that framework in place, then certain examination objectives will inevitably stem from the insights gained from the resulting Insurer Profile Summary. For example, prior surveillance may have identified unusual asset concentrations; an explicit objective of an upcoming examination therefore could be to delve directly into those areas and to better understand and assess how the company manages risk relative to those subject asset classes. In contrast, the objectives of an examination of another company, even one operating in similar business segments, may be quite different because of its own unique company risk profile.

Other examination objectives might include implementing the new approach with an emphasis on doing so in a manner that develops the risk-focused examination skills and experience of examination team members. In some cases, e.g., where the risk profile suggests lower overall risk levels, an objective might be to complete the examination in less time overall than under the prior examination approach in response to the lower levels of risk at the company. As a consequence, more examination resources would presumably be available for involvement on examinations of other companies whose risk profiles are of greater concern.

Despite that the NAIC's risk-focused examination guidance is less than a year old, the notion of an examination that is responsive to risk dates back to the former "SRA-based" (for "Specific Risk Analysis") examination approach that was adopted by the NAIC in the early 1990s. What is different now is that the universe of risks that is to be considered is much broader, and the deployment and implementation appears to be managed more closely by senior staff at state insurance departments.

Although the risk-focused objectives of the new approach seem like little more than common sense, accomplishing them in the field often presents challenges. As those challenges are encountered valuable lessons are learned including, but by no means limited to, those that follow which relate primarily to pre-examination planning and strategies. In subsequent articles, other lessons related to various other stages of the risk-focused examination methodology will also be explored.

Lesson #1: The Company Needs to be Prepared Too

The various states do, of course, prepare their staff for upcoming examinations. This can include formal training and various examination planning and strategy meetings. However, some states have taken the tact to also prepare the company for what is to come with the new risk-focused approach and to address their objectives up-front with the company that is to be examined.

Preparing the company involves discussions about what is new regarding the new risk-focused examination approach, addressing any obstacles that the company may raise, and establishing communication channels to deal with problems or misunderstandings should they arise down the road as the examination progresses. Some recent experiences have shown this to be an effective strategy, particularly as the implementation of the new approach will not go unnoticed by those who coordinate the examination on behalf of the company.

In many cases, those company representatives have been through many examinations and know “the drill” as well as many examiners. But when they hear for the first time that the examination is to be launched via a meeting with their CEO and followed quickly by meetings with some of their board members, alarm bells will certainly sound.

This is not intended to suggest that the industry has some inherent dislike for the new examination approach that must be overcome; rather, questions are simply going to arise because examiners will now, in some respects, be asking different questions of different people and requesting access to different information and documents than was typically the case in the past. And in many of those cases, that will also mean examiner access to company insights that are both higher-level and more sensitive. Ergo, the examination, which heretofore may have been relegated to lower levels within the company to contend with, will now have a much higher profile within the company and that will invite questions and challenges by senior management about the examination that might not have been raised in the past.

Preparing the company has the positive effect of helping to assure that the company understands not just the “what” about the new approach, but also the “why.” A well-run company should quickly see that the implications to them of either are not onerous. In fact, under certain circumstances, the approach could enable a company to achieve some return on its investment in risk management and in its development, documentation, testing and reporting of internal controls.

In their efforts to prepare the company, examiners must also consider exactly who at the company should be involved. It has been commonplace for insurers to formally assign responsibility for the coordination of the examination from the company's perspective. Individuals charged with that task often hail from finance and accounting, from internal audit, or in some cases from the general counsel's office. It would be appropriate to start there, but the examination team should be certain that those representing the company in these initial meetings have sufficient experience and authority to understand the implications of the new approach to the examination effort at the company, and to be capable of communicating that effectively to senior management and others.

With the company on board, both it and the examination team can be better assured that each will then be pushing or pulling in the same direction to enable the examination to make better and faster progress. From the company's perspective, better and faster will readily translate as less expensive and less distracting – attributes that should be eagerly welcomed.

Lesson #2: The Importance of Mutual Cooperation is Raised to a Higher Plateau

Some states have begun to see some “roadblocks” erected by companies to certain aspects of the new approach. For example, in one situation a state was mid-way through a risk-focused examination only to have the company raise at that late stage concerns about access to sensitive risk management information and the need to have direct dialogues with directors.

From that experience, the “lesson learned” by that state is to have a face-to-face meeting at the outset of the examination with the company representatives, including the company's legal counsel. The state found from their experience that it was better to encounter obstacles up front and to resolve them before the examination proceeds. Thus, the need to educate the company continues to be paramount under the new approach.

However, this state's experience suggests that that process should go beyond the traditional examination contacts at the company and include higher senior level officers, including counsel. If the company is, or is part of, a publicly-traded stock company or group, and the larger and more high-profile that company/group is, the more likely that the application of this “lesson learned” will reap benefits for the examination team.

The notion of an examiner speaking face-to-face with directors seems to have struck a nerve of senior management at some companies during early exams using the risk-focused approach. Their concerns are multiple and varied:

- Board members may be privy to non-public information
- They may not know themselves exactly what information they possess may be sensitive
- They may not know their legal obligations and responsibilities with respect to specific information, preferring to rely on counsel for advice as to what can and cannot be discussed and with whom outside of the Board room

- Access to board members even by the company itself may be highly structured and limited to certain key individuals
- The company may, in their own way, simply want to show respect for their board members and for their time, recognizing that they often are busy and accomplished individuals of considerable stature from industry, academics, the public sector, or from not-for-profit or other organizations

A company that is governed and managed well will be astutely aware of the risks and potential liabilities associated with divulging sensitive information with others, particularly forward-looking or competitive information. Therefore, it would be ironic if the reluctance by such a company to cause its directors to eagerly jump into dialogues for the first time with examiners without first understanding the circumstances and potential implications or establishing some ground rules were to be interpreted adversely by examiners. It will simply take some time for companies and regulators alike to gain some experience with these dialogues with directors and for mutually-acceptable practices to develop.

Early experience suggests that, in the absence of a plausible reason to do so, some efforts to meet with directors may do more harm than good. In other words, the examiners may not glean significant new insights from what had already been learned from meetings with management and from reviews of key documents. Furthermore, insisting to meet with directors notwithstanding the legitimate concerns of management and in the absence of a compelling case to do so may adversely impact the relationship between the regulator and the regulated entity.

That is not to say that it is never appropriate for examiners to have direct contact with board members. In fact, the guidance of the risk-focused approach highlights certain factors that may warrant such a meeting and states that, even in the absence of such factors, a meeting may nonetheless be appropriate to obtain an overview of the board or members' functions and responsibilities.

Examiners considering meeting with directors should be well prepared, which would include the preparation of a detailed agenda and perhaps an interview script. In reviewing that information prior to the meeting, if the topics and questions appear to simply corroborate information that is already well documented and otherwise provided and supported by management, then the need for the meeting should be challenged.

Conversely, if the examination team has conducted an appropriate review of documentation and minutes and interviews of management and still remains unconvinced about the scope or effectiveness of governance in place at the company, then a compelling case would seem to exist to support the examiners' request for meetings with one or more directors.

Lesson #3: It's About Knowledge Management

Knowledge management, or "KM", comprises a "range of practices used by organizations to identify, create, represent, and distribute knowledge for reuse, awareness

and learning.”¹ KM concepts have not been lost on state insurance regulators over the years, but the new examination approach encourages even more knowledge sharing, still within the “firewall” of the department for confidentiality, to provide a robust picture of the company from which examiners can learn and then expand upon through the examination process.

In some respects, the Risk-Focused Framework aims to apply knowledge management techniques to the financial surveillance function by recognizing that there are multiple inputs to insight about the company and its risks – not just those emanating from an on-site examination. In many cases, it is true that examiners are covering matters that others at the state insurance department may have already addressed, and in some cases, in more detail. For example, review by the examiner of:

- Reinsurance agreements that have already been subjected to extensive reviews by departmental staff for prior approval
- Investment transactions or asset classes that may be new to the examiner; analysts at the department have previously encountered such assets elsewhere
- Operational risks related to distribution which may already have given rise to compliance issues that have been previously reviewed by market conduct examiners in one or more states, either at the company under examination or at other companies

While not yet an exact science, part of the “art” of the risk-focused examination approach is for examiners to leverage the knowledge from a broader set of resources for insights about the company that can contribute to the overall examination effort. In the past, the value of intra-departmental communications between examiners and financial analysts was well recognized. However, the Risk Focused Framework and the new examination guidance appear to reinforce that concept and also to embrace the notion that meaningful dialogues and knowledge-sharing about the company between examiners and others within the insurance department may also be fruitful.

Like exams of old, the new approach will provide ample opportunities for specialists, for example in areas such as complex investments, real estate and mortgage loans, derivatives, reserves, reinsurance, information technology, and more. But the new approach seems to have also created a need for other specialists – those who have a working knowledge of risk management, and those who can effectively dialogue with the most senior executives of the largest companies. The larger and more complex the company, the more valuable will be the role for these new specialists.

Insurance departments may already have individuals who are well qualified for these new roles, but they are likely to be more senior individuals who may now be absorbed in departmental management activities. Finding ways to tap their knowledge and to involve them selectively in certain exam-related events such as C-Level interviews and planning

¹ Wikipedia, at http://en.wikipedia.org/wiki/Knowledge_management

discussions may be a challenge, but nonetheless valuable to the risk-focused examination efforts.

Lesson #4: Examination Timing/Scheduling Will Change

Timing and scheduling of the examination is another issue for which several states are in the midst of making some changes. Having started some early risk-focused exams as in the past – that is, shortly after the annual statement has been filed for the year under examination – they are now rethinking that entire dynamic.

Some of these states now believe that the risk-focused examination process should begin not after the Annual Statement has been filed, but 3-6 months prior to the end of the year that will be under exam. In other words, from 6-9 months prior to what would have been the inception date under their past practices. In this way, they aim to have a completed risk assessment and an examination program before the end of the year under examination. They can then lay low for a couple of months while the company closes its books and prepares and files its Annual Statement, and then return to the company to execute the planned procedures. And, if the company is well-managed as supported by the examiners' risk assessment process, the examination procedures should be more concise and narrowly focused than in the past, allowing that phase of the examination to conclude more quickly.

The impetus behind this shift in thinking about the examination calendar has to do with the top-down approach embraced by the new examination guidance. Early experience suggests that a greater proportion of the examination time will be spent on understanding the company, including the nature and effectiveness of enterprise-wide controls and the identification and evaluation of key financial activities.

However, much of this work is focused on risks, controls, and risk mitigation strategies, concepts for which the relevance to financial statement numbers is pervasive over time and not limited to any particular evaluation date, calendar year-end or otherwise. Thus, the opportunity presents itself for this very significant phase of the examination to be shifted much earlier on the calendar. Nonetheless, it may not make sense to do so in the absence of a reasonable expectation that enterprise-wide controls are effective; indeed, they comprise the framework that maintains risk management and financial reporting on an even keel over time.

Some examiners might resist this way of rethinking the dynamics of examination scheduling especially, for example, if a key part of the examination strategy is to rely on external audit working papers. But in the “post-SOX” (Sarbanes-Oxley Act of 2002) world, examiners will likely find themselves relying much more on company-prepared internal control documentation and testing which is readily available at the company and subject to ongoing updating and testing on a rotational basis. The same scenario could also apply to non-public companies that are not subject to SOX that have developed a satisfactory internal control framework pursuant to anticipated enactment of recent changes to the NAIC's Model Audit Regulation, or other voluntary initiatives.

Where documentation at the company is less than satisfactory and the examiner seeks to use or rely on the work of the external auditor, the necessary working papers of the external auditor won't typically be available until 5-6 months after the end of the calendar year under examination. But states are finding ways of working around that. One state performs much of its work in September-October of the year under examination, a time-frame when the company's external auditors are also in the field doing their process and internal control walk-throughs. Their examiners participate in those meetings with the external auditors, and write up their own notes. Thus, the examination team has the information they need currently and don't need to wait until the audit is completed 8-9 months later to gain access to the CPA's working papers.

Another approach is to first review the external auditor's working papers for the prior year. This can be helpful if the examiner has some assurance that the changes in the auditor's approach are fairly minor from year to year. If so, and if the company's internal processes and controls have been fairly stable, much of the work on internal controls should still be quite relevant. Using prior year working papers may be very helpful in getting a head start on the examiner's risk assessment. Of course, there still may be some specific areas for which the examiner may want to see current year testing results once the current year working papers and audit are complete, and examiners will want to see the current year reports from the auditor when they are available.

Lesson #5: The Risk Assessment Cycle Does Not Begin With the Examination

An evolving issue with the risk-focused approach is the confluence of issues related to the prior two "lessons learned" described above: the *integration* of insights from other departmental resources, and the *timing* of their involvement and sharing of their insights. Old habits die hard. After all, those other departmental resources have other duties to tend to aside from being a resource to examiners. Therefore, they are likely to stick with their past routines, reasonably expecting that any need to contribute insight to an examination team will eventually be provoked by that team itself. In that sense, they are reactive rather than proactive, at least with respect to the examination of a specific company.

By operating in a reactive mode, a valuable opportunity may be missed to optimize the benefits of the expertise of these departmental resources. Risk-focused exams operate under a top-down approach, and generally begin with high-level dialogues with senior management about the complexities of the business, the markets, and the competition. What examiners need is insight at the very outset of the examination to develop targeted areas for questioning – not just generic questions, but well-reasoned and thought-provoking questions that specifically probe about the company, its management and governance, its risks, and the nature and effectiveness of enterprise-wide controls.

Ideally, that kind of input should be ready on "Day One" when the examination commences. Without it, examiners will derive their own meeting agendas, but in doing so they will inherently redo much of the same research that the analysts may have already covered, and possibly miss some key points in doing so.

In that vein, one must consider the now infamous one-slide graphic of the NAIC's Risk Assessment Working Group and which summarizes the Risk Assessment Cycle. That single illustration captures the essence of financial surveillance by the states, and its key components: the risk-focused examination, off-site risk-focused financial analysis, internal/external changes, a priority system, and a supervisory plan, all interacting with and contributing to the insurer profile summary.

The Risk Assessment Working Group's members have made the point that the components of the risk assessment cycle do not operate sequentially; rather, the intent is that they operate simultaneously or even independently. Nonetheless, early experience in some states suggests that it is the examination team that is leading the charge with their risk-focused examinations. But if the other elements haven't already contributed their insights to the insurer profile summary, the examination experience will be sub-optimized.

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It is indeed about knowledge sharing, and these and other "lessons learned" are intended to contribute to that objective. The author aims to continue sharing lessons learned about the risk-focused examination approach in subsequent editions of The Examiner. The author welcomes submission of other lessons learned from SOFE members for consideration for discussion in further articles on a no-attribution basis.. You can submit your "lessons learned" in an e-mail to the author, at tfinnell@invotexgroup.com.