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This is the second of a series of articles, the objectives of which are to share experiences from some of the early implementation efforts by state insurance departments with the NAIC's risk-focused examination approach; 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.

Risk-Focused Examinations: Lessons Learned, Part 2

The current ominous economic environment that has resulted from easy credit and the proliferation of subprime debt provides a unique opportunity for financial examiners to learn new lessons about risk-focused examinations even as an increasing number of states are ramping up their implementation of the NAIC's new examination approach.

On October 24, 2007, Merrill Lynch & Co. reported write-downs of \$8.4 billion relating to Collateralized Debt Obligations ("CDOs") and U.S. subprime mortgages. In a conference call with investors, Merrill's CEO Stan O'Neal acknowledged missteps saying, "The bottom line is we got it wrong by being overexposed to subprime."¹ Within the week, Mr. O'Neal announced his retirement from Merrill Lynch, a fall from grace indeed, but one that was at least made somewhat easier for him to bear through a termination package valued at more than \$160 million.

The bad news for financial institutions did not stop there. On November 4, 2007, Citigroup announced declines since September 30, 2007 in the fair value of the approximately \$55 billion in U.S. subprime related direct exposures in its Securities and Banking business. The reduction in value attributable to those declines was reported to range from approximately \$8 billion to \$11 billion. Citi's announcement was accompanied that very day by the retirement of its Chairman and CEO, Charles Prince, whose fall was also cushioned – in this case, by \$40 million of termination benefits.

The list of casualties continued – Bear Stearns, Lehman Brothers, Wachovia, Morgan Stanley, Countrywide Financial, Freddie Mac and more. Analysts estimate that from \$60 billion to \$75 billion of write-downs will occur in the second half of 2007. And as bad as the third quarter of 2007 was, credit quality continues to deteriorate. Moreover, the direct

¹ Wall Street Journal, October 25, 2007, p.1, *Merrill Takes \$8.4 Billion Credit Hit*

impact of the losses is only part of the story. The negative impact on stock prices and market capitalization has eroded value to shareholders who already have filed lawsuits against a number of these companies. The prospective impacts of legal costs and settlements as well as the impact of reputational damage – not to mention all those termination benefits – will dribble in over years to come. Certain of these once-proud financial juggernauts are looking to jettison non-core operations and may even be merger candidates themselves as their stock values spiral downward.

The subprime debt situation has tentacles that have woven a complex web throughout the entire financial services industry. The involvement of hedge funds and other non-traditional players in the market has resulted in a degree of transparency that is much less than ideal. Despite the proliferation of easy credit over the past years and the well-publicized fears that ensued, it is taking much longer than many had expected for the impact of credit losses to fully emerge now that the party is over.

Insurers are Exposed to a New Wave of Emerging Risks

The insurance sector is by no means immune from contagion caused by the subprime mess and the related upheaval in the credit markets. Mortgage guaranty insurers, credit insurers and title insurers are bearing the brunt for the insurance sector at the moment:

- AIG subsidiary United Guaranty Corp., a mortgage insurer, reported a \$215 million loss for the third quarter of 2007, and anticipates additional losses of \$500 million through the end of 2007 and into 2008.
- AM Best reported that Ambac Financial Group, MBIA Inc., ACA Capital Holding, Radian Group Inc., MGIC Investment Corp. and PMI Group Inc. posted a combined \$2.5 billion third quarter net loss.²
- Mortgage insurers Radian and MGIC called off their proposed merger, disclosing that, “Current market conditions have made combining the companies significantly more challenging.” Analysts also cited material losses emerging from their joint venture investments in subprime mortgage investor C-Bass LLC.

It appears for now that the traditional life/health and property/casualty sectors have much more modest exposures to subprime debt, at least as a percentage of their respective invested assets and of surplus. However, if credit losses continue to mount, if the willingness of banks to lend money is significantly impacted, if the economy stalls and if the stock markets turn bearish, then all insurers (as well as many commercial companies) will be impacted, at least to some degree. That may be a lot of “ifs,” but the situation described is not completely implausible at the moment. A potential vicious cycle is shaping up that would involve the downgrades by rating agencies of bond insurers which could then trigger downgrades of securities guaranteed by those insurers.³

² BestWeek U.S./Canada, November 12, 2007

³ Washington Post, November 24, 2007, *Crunch May Hit Insurers of Bonds*

With this ominous scenario as a backdrop, it is an apt moment to pose some probing questions, the discussion of which should be of some interest to the financial examiner community:

- Should these and/or other emerging risks impact an insurance company at some point in the future, will the risk-focused examination approach be effective at pinpointing them, and on a timely basis?
- Are state insurance examiners comfortable with their ability to assess such risks and evaluate the potential implications to insurers under examination?
- Putting the specifics of subprime debt problems aside for the moment, what is the ability of the risk-focused examination approach itself and of the examiners who will implement it to come to grips with any future risk du jour, no matter its novelty, complexity, or magnitude? For example, some analysts and economists predict that the subprime mess may worsen as interest rates on over \$350 billion of adjustable rate mortgages reset in 2008.

Admittedly, these are unfair questions to ask. After all, it is the company's management – not the regulator or his/her examiners – who are directly responsible for the company's affairs, the risks that it takes on and their management and of the resulting financial consequences. Nonetheless, insurance regulators and examiners have a significant role to play, periodically inquiring into the affairs of the company at critical points in time through analysis and examinations to understand these same matters. It is in that context that these questions are posed.

A Rating Agency Perspective of the Company's Risk Assessment Process can be Illuminating

To consider these questions further, it is instructive to focus on another comment cited by Mr. O'Neal, now an alumnus of Merrill Lynch: "It turned out that both our *assessment of the potential risk and mitigation strategies* were inadequate."⁴ (emphasis added) Indeed, he cites what should by now be familiar terms to any insurance examiner who has been trained in the NAIC's risk-focused approach, critical aspects of which include:

- *Inherent risk* assessment, i.e., an evaluation of underlying risk without consideration of risk mitigation strategies or controls
- Identification and evaluation of *risk mitigation strategies and controls*
- Assessment of *residual risk* which considers the application and effectiveness of the risk management strategies and controls that are in place
- A focus on *prospective risk*, i.e., that risks may emerge in the future

Such assessments by examiners are best made after careful consideration of the insurer's own risk assessment. The risk-focused examination guidance suggests gaining an understanding of the company from a top-down perspective, which includes determining the nature of and support behind the risk assessment process in place at the insurer.

⁴ Wall Street Journal, October 25, 2007, p.1, *Merrill Takes \$8.4 Billion Credit Hit*

One means toward the accomplishment of that task is to ask management to share with the examination team the same kind of presentation that is provided to rating agencies – not just the document itself, but also the opportunity to hear management’s oral comments and engage in a substantive dialogue with management directly about key points covered in their presentation.

For many examiners, participation in such a rating agency-like meeting may be a new experience. In the case of well-managed and resourceful insurers, examiners will likely be duly impressed with the information provided. Management’s presentation often details the company’s strategy, the nature of the its business and its key markets, market share information, financial and non-financial performance measures, a description of key risk management measures in place, corresponding metrics or key risk indicators, and much more. For SEC registrants, the rating agency presentation can also provide examiners with the opportunity to supplement their understanding from reading the required “risk factors” disclosures in 10-K and 10-Q filings and registration statements.

After all, such presentations to rating agencies matter greatly to the insurer’s management; a notch up on the ratings scale can translate into millions of dollars of additional business (the converse is also true). Thus, considerable time and attention is devoted annually by the most senior managers of the company in their efforts to convey to the rating agencies the very essence of the company – its structure, businesses, governance and management resources, but also its strategy and key indicators that show that the strategy is effective and that progress is being made toward key goals. In short, this is a presentation that is typically prepared, rehearsed and delivered by management with great care.

Examiners Have to Understand What Supports the PowerPoint Presentations

Generally, information provided by senior management to rating agencies is in the form of PowerPoint documents accompanied by graphs and charts. The entire package, together with supporting documentation and oral comments of senior management is carefully assembled and packaged so as to communicate an abundance of complex information in a relatively simple and coherent manner. A more subtle goal is to convince the rating agency that the lens through which management views the company provides clear optics for the rating agency as a foundation for its own analysis.

Although their processes are different, the key for insurance examiners is similar to that for the rating agencies themselves – to be able to separate the wheat from the chaff, to understand what lies behind the PowerPoint documents with their color schemes and fancy fonts, charts and graphs and to fundamentally assess the risk and the risk mitigation strategies in place. In short, the goal is simply to understand the very concepts that Messieurs O’Neal and Prince, once of Merrill and Citi fame, somehow missed. Examiners also have to relate what is learned from rating agency presentations focused

primarily on an entity-wide and GAAP perspective to the specific legal entity and statutory considerations that is the primary focus of the exam team.

But that, of course, is no easy task. For example, it is most concerning to consider that mistakes were made not just in the executive penthouse suites of Merrill, Citi and others, but throughout those companies. Over the years, they and other large financial institutions have made material investments in risk management resources – people, research, knowledge, methodologies and technology enablement. Nonetheless, risk emergence related to subprime debt occurred with a degree of suddenness and in magnitudes either unforeseen – or, if foreseen, then ignored – by all.

Thus, errors were made not just by these two former kings of industry – O’Neal and Prince – but by all the kings’ horses and all the kings’ men, as well. And if the collective risk management and executive talent of firms such as Merrill and Citi can’t make them impervious from such a fall, is it realistic to expect that insurance examiners will fare better in their own efforts to ferret out undue risk of insurers?

Again, that is not a fair question, and there is no easy answer. It likely depends on the relationship and degree of confluence at any point of time of many dynamic factors, including:

Factors that relate to the company:

- External factors such as macro-economic developments, competitive issues, and capital markets trends
- Internal factors such as the adequacy and competency of managerial resources, the strength of independent governance, the independence and competency of the audit function, the company’s risk appetite and tolerance, and the extent and effectiveness both of enterprise-wide controls and risk management strategies as well as underlying controls at the activity level
- The nature and magnitude of various risks, as well as the timing of their eventual emergence

Factors that relate to regulatory oversight:

- The degree to which the variety and totality of regulatory resources – analysts, examiners, specialists, and senior regulatory staff of the domestic state and other interested states – actively and substantively participate and contribute to a current and thorough understanding of the company’s risk profile
- Timing – of examination field work, of departmental analysis, and of other regulatory inquiries into the company’s operations, risks, and financial affairs

The foregoing factors are, in certain ways, addressed by the NAIC’s risk-focused examination guidance. Successful execution of those exam-related processes will vary based on the skills, experience and training of each examiner as well as their respective abilities to work in a manner such that the whole of the team is greater than the sum of its parts.

For example, an emerging risk issue related to a reserving risk might be adequately addressed by an examiner with sufficient expertise or by departmental actuarial resources that could provide competent assistance in the evaluation. However, there probably is a much lower likelihood that any given insurance department will have ready access to affordable technical specialists who are qualified to evaluate the newest and most complex capital market transactions in an exam setting. So, the first line of defense – to engage a qualified expert – may be easier said than done, depending on the nature of the risks involved.

The Examiners' Focus on Governance Can Provide Additional Insights

But there is another tactic that examiners can also consider: to evaluate the role of governance in stemming the tide of undue risk. Boards themselves face the very same limitations of technical know-how as do examiners. Despite the financial and business acumen of even the best boards of directors, most companies would be very fortunate indeed to have a single individual on the board who is a qualified expert at a particular new and unique emerging risk. So how do boards of directors govern in a situation where they themselves lack the necessary knowledge and experience?

The response of many directors is to fall back on their own experience, which often suggests that plain talk, common sense and a prudent approach is the best match for any obstacle. A good board will demand, and good managers will know that they will have to provide, an explanation in clear, understandable and simple terms of the nature and extent of risks undertaken, the strategies to mitigate or manage them, and any potential weaknesses or limitations of those strategies. Only then can the board truly exercise its unique ability to interject business savvy, prudent-man principles and good common sense to the equation.

Likewise, the examiner can approach such complex topics in a similar manner. They should see what kind of information is being presented to the board about potential business ventures, products, transactions or investment vehicles and whether they are described by management in clear, understandable and simple terms. Technically-complex risks and issues presented at a company should be no reason for examiners to shy away from an engaging dialogue of the topic with management. Indeed, examiners should attempt to determine if there are signs that the board itself may be overwhelmed, if not even intimidated by overly technical presentations by management.

During the course of the examination, examiners can request and should expect to receive a clear and understandable explanation of seemingly complex matters. The inability of examiners to obtain such an explanation or to be able to decipher whatever explanation is provided can be an indication of the quality of information that is being provided to the board by management. If management is unable to explain these same issues to the examination team in understandable terms, then the team may rightfully assess risk at the company – all things being equal – to be some degree higher than otherwise.

A reasonable approach for examiners is to put on their “director hat” and ask themselves the following questions:

- Has management clearly and candidly articulated the risk in simple and understandable terms?
- Does management’s assessment of the risk, as well as the effectiveness of the risk mitigation strategy or controls, sound plausible?
- What evidence of potential variability and severity and of the operational effectiveness of strategies and controls has been presented? Has management performed sensitivity analyses on key assumptions and inputs to its risk models?
- Has the environment changed? What is the range of possible changes that could occur, and what might the impact be of risk under those alternative scenarios? Has management demonstrated those potential impacts?
- What resources has management involved to confirm their assessments? What internal experts? Any external consultants? What have they recommended? Have they provided any formal reports or opinions and, if so, what do those reports and opinions say? What caveats are included?
- Is the transaction or item so complex that it introduces other risks such as key-person dependencies because only one or a few technical people at the company understand (or think that they understand) the subject matter?

It is in asking questions such as these that the examiner can begin to see the story “behind the PowerPoint.” Ideally, these and other questions would be explored in a joint effort by those on the field examination team along with a qualified expert. But even in the absence of such an expert, much can be learned by assessing both the willingness and the ability of the company to “dummy down” the issue into understandable and digestible nuggets of meaningful information that the board can grasp and react to consistent with their governance responsibilities. In a similar manner the examiner can achieve a double-benefit: a better understanding of the risks on both an inherent and a residual basis and of the effectiveness of governance over the company in practical operation.

The irony is that the best demonstration of management’s ability to handle complex risks and business matters is best evidenced by its ability to break them down into more simple component parts that can be understood by mere mortals: the staff who have to implement the transaction or operate the business, those who perform the accounting and financial reporting, board members, and yes, even examiners.

So the onus may very well be less on the examiners to be able to step up to complexity, and more on management to demonstrate that they aren’t simply using complexity to obscure the truth about the risks involved and to unduly push the envelope with new products or investment vehicles.

In the words of Blaise Pascal, a French mathematician, physicist, and religious philosopher from the 1600s, “I would have written a shorter letter, but I did not have the

time.”⁵ Likewise, if managers devoted an adequate amount of time, they would be able to clearly explain complex concepts in a succinct and coherent fashion. In the absence of such clarity, board members can’t be expected to make rationale decisions. In the absence of such clarity, examiners should be more skeptical.

What this suggests is the following:

- In a mature industry, sophisticated players will continue to seek competitive advantage through solutions that are increasingly innovative and complex
- As a result, the parade of novel investment and capital market vehicles and their use within the industry to drive product solutions will continue
- As always, it will take time to truly understand the operational effectiveness and limitations of any new product/vehicle in the real world and across a wide band-width of potential economic and interdependent scenarios
- In the meantime, the ability of any “expert” to reliably predict the outcome of potential risk scenarios is subject to many practical limitations
- Insurance examination teams will likely remain one or two steps behind the industry in terms of the availability of a sufficient number of affordable technical resources who can reliably evaluate such unique and complex issues in the field
- As a consequence, the use of “specialists” or “experts” by examination teams, while recommended, may never provide absolute assurance that unforeseen problems won’t somehow materialize down the road, i.e., that significant prospective risks will not emerge
- A governance-based review of how management and the board interact in exploring the use of complex instruments and evaluating their risk may provide a more balanced approach than pure reliance on technical specialists.

Enterprise-Wide Controls are Key, but Evidence of Their Effectiveness Can be Elusive

What that suggests, in turn, is the fundamental importance of enterprise-wide controls. In other words, before examiners dive into key financial activities and plow through a lot of risk matrices, the most important task they can probably do as part of the risk-focused examination approach is to fully understand the enterprise-wide controls that are in place at the company – such as governance itself – and evidence supporting their effectiveness.

Enterprise-wide controls exist in various forms at insurance companies. For example, the role of the board and of the committee structure is to exercise governance over the company and its management. A key committee from the standpoint of financial reporting is the Audit Committee, which oversees the combined and integrated plans of the company’s internal audit department as well as of the external audit function. In addition, the Audit Committee often has the most direct involvement in overseeing the risk management function. Other examples of enterprise-wide controls include:

⁵ Wikipedia – see Blaise Pascal

- Enterprise-wide risk management (ERM) office under the direction of a Chief Risk Officer
- Other initiatives that focus on specific risk categories across business units and/or geographical locations: i.e., initiatives related to operational risk, credit risk, market risk, reserving risk, etc.
- Internal control analysis, documentation, testing and reporting pursuant to SOX§404 or other internal control framework and performed under the oversight and direction of an enterprise-wide Project Management Office, or “PMO.”
- Any function that deserves the appointment of a corporate “Czar” to oversee the development, communication, deployment and monitoring of a risk-related initiative. Examples include privacy of consumer information, anti-money laundering initiatives, corporate-wide ethics programs, various HR initiatives, and others.

In each of these situations, there are a number of common elements and best practices, which can include the following:

- A call for action from the very top of the organization, i.e., the CEO
- The appointment of an existing or new member of senior management to take personal responsibility for the initiative
- A committee that includes membership across business units and geographical locations who are responsible for activities at those levels which further embrace the initiative
- Procedures that are communicated and deployed
- The determination of metrics or other indicators and the reporting of same to senior management and on to the board to monitor and evaluate the effectiveness of the initiative
- Feedback by senior management and by the board with additional or remedial actions to be adopted down the line
- A continual and robust cycle of the above activities.

Among the larger and better companies, numerous enterprise-wide controls may exist. The \$64,000 question is, are they effective? And, if so, to what degree may they be relied upon to detect and cure problems across a wide variety of detail functional areas and in the ordinary course of events?

The fact that enterprise-wide controls exist are evidenced by charters and minutes, various internal communications and memorandum, and in communications to external audiences such as shareholders reports and rating agency presentations. But does the existence of those documents alone suggest effectiveness? And if not, how many of what other documents would provide sufficient assurance? Do well-written and lengthy minutes exemplify an effective operational risk initiative, whereas brief hand-written notes do not? Further, if an examiner is able to interview an audit committee member who, through oral representations, simply reinforces the same understanding that was

gained by a review of the Audit Committee minutes, does that alone mean that the audit function is effective? In short, what evidence is sufficiently compelling to suggest that such controls are really effective? What's an examiner to believe?

The answer to those questions cannot be derived simply by examination of the enterprise-wide controls themselves. The proof is in the pudding. In other words, a review of at least some key functional areas is also necessary. Such is the conundrum about enterprise-wide controls; the fact that they exist in some form is rarely disputed, but the direct evidence that they offer themselves of their own effectiveness is rarely sufficient to an outsider – such as an examiner – to draw any meaningful conclusions.

Rather, it is the indirect evidence – the demonstrated impact that enterprise-wide controls have over key functional activities – that is most conclusive. Indeed, at least some review of risks and controls at the activity level must be performed to gauge the effectiveness of enterprise-wide controls. If examiners see a consistently high-quality and level of robust controls that are thoughtfully documented and tested by well-qualified personnel across a number of functional activities, it is the result of no mere coincidence. Such is only the result of highly-effective enterprise-wide controls. And that should be important for the examiner to know, and for these reasons:

- Risk may be assessed as lower
- Examiners can place more reliance on the work of others, e.g., the company's independent auditor firm and its internal audit department
- Whether examiners test a key functional activity or not, prospective risk is lower; there is assurance that, long after the examiners have come and gone, that management has the “right stuff” in place to keep controls in-place, tested and effective across the enterprise.

Insurance Examinations are at the Dawn of a New Era

Which brings us back to the case in hand – Merrill Lynch and Citigroup, et al – with respect to the subprime debt debacle. Had these entities been insurers, would examiners have come up with findings or recommendations that, if acted on, would somehow have ameliorated the situation, at least to some degree?

The truth is, we may never know. But there is some comfort in knowing that, with the risk-focused approach working in tandem with the overall Risk-Focused Surveillance Framework, examiners can be more pro-active in ferreting out such risks and assessing their potential impacts – currently, and prospectively. We are at the cusp of a new era where risk-focused examination techniques will be the norm rather than the exception. Nonetheless, those techniques will have to contend with a new era of significant and complex emerging risks, as well.

No examination handbook, no matter how well-written, will be sufficient to provide the guidance necessary to deal with all emerging risks in the current or future environments. Examiners, like management and boards themselves, will have to be vigilant in

monitoring current developments, in breaking through complex issues to understand the underlying fundamentals, in seeking the counsel of others and in carefully assessing the risks and resulting mitigation strategies.

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*The author plans to continue sharing lessons learned about the risk-focused examination approach in subsequent editions of *The Examiner*, and welcomes SOFE members to submit other lessons learned 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.*