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Additional Comments on Risk Assessment Working Group's Proposed Revisions to the  
Examiners Handbook

Ms. Geel and Ms. Knief:

Inasmuch as the Risk Assessment Working Group has extended the deadline for comments, I would like to take this opportunity to provide the following comments as a supplement to my earlier letter of January 18, 2005. I hope that you will find these comments constructive and helpful as you strive to improve upon the handbook.

Sincerely,



A. Thomas Finnell, Jr.

Supplemental Comments to the Risk Assessment Working Group

My letter of January 18, 2005 included, among others, the following recommendations:

- Construct the framework using an outside-in vs. inside out approach. Start with the 9 risk categories to “box in” or frame the project, identify if significant inherent risks appear to exist in each category, and for those, identify only the key business processes that mitigate that risk.
- Provide a means to capture key conclusions from the detailed analytical review in the Risk Assessment Matrix.

I thought it would be worthwhile to amplify those comments and to consider their impact together.

As described in the RAWG’s proposal, the examination framework appears to be a “bottom up” approach, starting with “key functional activities,” e.g., business activities, risks, cycles, and/or processes. In the context of COSO’s Integrated Framework for Enterprise Risk Management, that appears similar to performing event identification at the process flow level. While that is certainly possible, hopefully the company under exam has already performed some analysis at that level. It would be more efficient and practical, I believe, for examiners to avoid entering the risk assessment process at such a granular level of detail and instead to take a higher road. They should begin by assessing risk assessment at the entity level, asking question such as:

- Has the company established a risk assessment process? At what levels (entity/ process/ application)?
- What is in place that assures that the company will react adequately to dramatic changes in risks?
- What is in place to assure that the accounting function is aware of such changes, and in changes in business processes, and regulatory requirements?

While a process flow analysis is certainly one way to approach risk identification, COSO’s ERM Framework also notes that “event inventories” are helpful. As defined by COSO, these are “detailed listings of potential events common to companies within a particular industry, or to a particular process or activity common across industries.....” In that regard, you may be aware of the Audit Risk Alerts that have been published by the AICPA. These reports highlight key risks that auditors should be aware of as they begin their year-end audit season. And, because risks change over time, the AICPA updates these reports annually. Some of the CPA firms also produce similar reports for their own staff, customizing them for application in specific industries.

I believe that an “Exam Risk Alert” could be a very useful tool that should be incorporated into the RAWG’s proposed examination framework. In addition, it would be a very appropriate role for the NAIC to include a periodic update of the Exam Risk Alert as an ongoing charge for the RAWG. These reports could leverage much of the

information that is available from other sources such as the AICPA, but could also include other insurance regulatory-specific information that can be channeled to the RAWG by NAIC researchers, other NAIC working groups and committees (such as the group that earlier compared insurance risk categories to those utilized by the Federal Reserve), state insurance departments, and individual examiners. Most importantly, exam teams then would not have to “reinvent the wheel” to determine the common risks to be considered as part of the exam process.

Once gathered into a concise “Exam Risk Alert,” exam teams can then jumpstart their risk assessment process by using that document as a tickler to identify the possible existence of a wide variety of risks at the company, supplementing that with additional inquiry to better understand:

- How risks that are so identified cross lines of business, business units, or legal entities within a group
- How such risks are addressed and managed at the entity level
- What business processes drive those risks, and control them

At this stage, analytical review becomes key to the exam process. Under the present Examiners Handbook guidance, analytical review is used on an overall level in the initial planning stage, at the account level in preparing individual SRAs, and in some cases as a direct test of balances, i.e., as an exam procedure resulting from the SRA. However, it is significant to understand that the current exam framework itself stands alone; the cycles and control objectives are common to all insurers, and analytical review is only used to evaluate the extent of risk within that framework.

Under a more contemporary examination process such as that under consideration by the RAWG (and as would be amended if my earlier recommendations are adopted), analytical review takes on a much more fundamental role. Industry segment analyses, peer company analyses, and entity-specific analyses are key to better understanding and developing the exam framework itself, that being the key risks that are pertinent to each specific company. Thus, I believe the role of analytical review is more strategic under the proposed approach than under the current SRA approach. While carrying forward language from the existing Examiners Handbook about analytical review may be helpful, that alone is not sufficient. Additional guidance describing this more strategic role, and the efficiencies that can be gained there from is recommended.

For example, if investment credit impairment risk is suggested by the Exam Risk Alert as a potential concern, analytical review can help to confirm that by considering:

- What is the composition of the investment portfolio by asset class?
- Which asset classes are most prone to that risk?
- Are there asset classes for which the company has an unusual investment concentration relative to industry norms?
- What measures (e.g., account balances) can shed light on potential impact?

- What qualitative information helps to put those measures into better context for purposes of better understanding inherent and residual risk?

Just as important, analytical review can identify significant risks that may be unique to a company and which may not otherwise be suggested by a tool such as the Exam Risk Alert.

Once the foregoing information has been obtained, the examiner will be much better prepared to start the Risk Matrix. However, I remain concerned that the identification of risk itself may be a seemingly endless process. As you well know, the assumption and management of risks are what the business of insurance is all about. Examiners will have to recognize that, and assemble a manageable list of the key risks for analysis, and review of key controls. Otherwise, it is relatively easy to foresee how the exam process as currently proposed will take more time, not less, even on well-managed, well-controlled, and well-capitalized companies. The anomalous situation that should be avoided is where more time is spent on exams of such companies because, well-managed as they are, they simply have more and better information available for examiners to review.

In summary, I hope that the foregoing comments help to amplify remarks made in my January 18, 2005 letter, emphasizing:

- Focus on risk first: The exam process should take a higher level approach to risk assessment by understanding the company's risk assessment process and results, challenging that information as needed leveraging the Exam Risk Alert and overall analytical review as tools.
- Then focus on "key functional activities": For risks that are significant based on probability/impact, consider the business processes that drive those risks and the key controls that the company has in place.