



NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

To: Interested Parties

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Subject: Risk-focused Examination Approach

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**Executive Summary**

In 2006, the NAIC adopted revisions to the Financial Condition Examiners Handbook (Handbook) relating to a revised risk-focused examination approach. This new examination approach will be required for accreditation purposes, for all examinations beginning on or after January 1, 2010. In addition, state examiners may choose to begin implementing the revised exam approach in 2007. The revised approach is meant to broaden and enhance the identification of risk inherent in an insurer's operations and utilize that evaluation in formulating the ongoing surveillance of an insurer. The revisions incorporate a seven-phase process which will be required for all full scope examinations following the risk-focused surveillance examination approach.

In accordance with the revisions made to the Handbook, there will be a greater focus placed upon a company's risk management culture, corporate governance structure, risk assessment programs and control environment, which may change some of the information requested from the insurer by the examiner. The changes may include requests for interviews with key members of management and potentially with members of the Board of Directors, requests for additional internal control documentation (including Sarbanes Oxley compliance documentation, if available), and an increased level of importance in coordinating with external and internal auditors. It is anticipated that the new exam approach will increase the overall effectiveness and efficiency of the examination process. Any questions or concerns about the new regulatory examination approach may be addressed to the domestic state of the insurer or to NAIC staff support for the Risk Assessment Working Group.

**History**

In 2002, the Risk Assessment Working Group of the Financial Condition (E) Committee was formed with an overall focus to review and enhance the utilization of risk assessment, including the review of risk management practices employed by insurance companies, in the regulation of financial solvency.

In order to proceed with the initiative towards an enhanced risk-focused surveillance approach, the Risk Assessment Working Group established three subgroups in November 2002. The first subgroup, the Risk Assessment Development Subgroup, developed the Risk Focused Surveillance Framework (adopted June 14, 2004) to describe the NAIC's proposed risk-focused financial surveillance process. Upon adoption of the Framework, the second subgroup, the Handbook Revisions Subgroup, convened to incorporate the concepts from the Framework into the Handbook.

The revisions to incorporate the Risk Focused Surveillance Framework into the Handbook were adopted by the NAIC in 2006. It is anticipated that the risk-focused examination approach, which will be included in the 2007 edition of the Handbook, will be required for accreditation purposes for all exams beginning on or after January 1, 2010. However, as the revised risk-focused approach will be published in the 2007 edition of the Handbook, states may begin implementing the revised approach in 2007.

During the period from January 1, 2007 through December 31, 2009, state examiners may choose to use either a specific risk analysis (included in the 2006 and previous editions of the Handbook) or a revised risk-focused examination approach. This memo has been created to give some background and a brief description of what is involved in the revised examination approach to insurance companies that may be impacted by these recent developments.

### **Description of Risk Focused Surveillance Examination Approach**

The examination approach included within previous editions of the Handbook was considered to reflect a risk-focused examination approach. However, a revised risk-focused approach was considered necessary to better incorporate prospective risk assessment in identifying insurers that have or will encounter solvency issues and bring focus to the broader issue of the ability of management to identify, assess and manage the business risks of the insurer.

The intent of the revised risk-focused process is to broaden and enhance the identification of risk inherent in an insurer's operations and utilize that evaluation in formulating the ongoing surveillance of an insurer. The revised risk-focused approach is designed to provide continuous regulatory oversight and extend the examination process to not only encompass the risks present as of a specific examination date, but to consider risks which extend or commence during the time which the examination was conducted, and risks which are anticipated to arise or extend past the point of completion of the examination. The Handbook has been revised to incorporate a seven-phase process to conduct risk-focused examinations:

Phase 1: Understand the company and identify key functional activities to be reviewed: In this phase, key activities and sub-activities are identified using background information gathered on the company from various sources. The risk-focused surveillance process promotes the use of a 'top-down' approach to identify activities.

Phase 2: Identify and assess inherent risk in activities: In Phase 2, the examiner, with the assistance of the analysis staff, would identify and document the inherent risks of the insurer being examined. The examiner may identify risks from the insurer's own risk assessment, internal and external audit risk assessments, filing requirements of the Securities and Exchange Commission (SEC) and the Sarbanes-Oxley Act of 2002, interviews with management, and any other source. Nine risk classifications have been identified to assist regulators in classifying the inherent risks: Credit, Market, Pricing/Underwriting, Reserving, Liquidity, Operational, Legal, Strategic and Reputational. Once the primary risks are identified within the key business units, the examiner utilizes professional judgment to assess the inherent risk by determining the probability of occurrence and magnitude of impact to obtain the overall inherent risk assessment.

Phase 3: Identify and evaluate risk mitigation strategies/controls: Phase 3 requires the

examiner to identify and evaluate controls in place to mitigate inherent risk. The internal controls should be assessed by how well they mitigate identified inherent risks. The overall assessment reflects the examiner's determination on how well the controls mitigate inherent risk.

Phase 4: Determine residual risk: Phase 4 requires the examiner to determine the residual risk for identified sub-activities to arrive at an overall residual risk by key activity. The assessment is made by determining how well controls reduce the level of inherent risk of the sub-activity using probability, impact and professional judgment. Assessing residual risk is the key to determining where the risks exist in the insurer's business. Once the riskier activities are identified the examiner may use these results to determine where to focus examiner or analyst resources most efficiently and to determine the nature and extent of testing.

Phase 5: Establish/conduct examination procedures: After completion of the risk assessment for an activity, the nature and extent of examination procedures can be determined.

Phase 6: Update prioritization and supervisory plan: Phase 6 requires relevant material findings from the risk assessment effort and any other examination activities to be utilized and incorporated into determining or validating the assessed prioritization of the insurer as well as establishing the going-forward supervisory plan.

Phase 7: Draft examination report and management letter based upon findings: In this phase an examination report should be developed. A Management Letter may also be developed to convey results and observations noted during the examination that should not be contained in a public examination report.

This seven phase approach will be required for all full scope examinations following the risk-focused examination approach. This revised approach differs from the previous examination approach in that the examiner will assess risk throughout the organization on a prospective basis. In accordance with this assessment, not every financial statement account may need to be tested. However, the examiner will be required to provide assurance on the company's financial statements. Overall, the use of the revised risk-focused approach will lead examiners to focus on the areas of greatest risk at the insurer and to limit the testing of areas with less risk. In addition, there will be an increased importance in utilizing the work of an insurer's internal and external audit work already performed.

### **Impact on Insurer**

In accordance with the revisions made to the Handbook, there will be a greater focus placed upon a company's risk management culture, corporate governance structure, risk assessment programs and control environment under the risk-focused surveillance approach. This focus is expected to change some of the information requested from the insurer by the examiner under the new approach.

In order to obtain an understanding of the company, the examiner may elect to conduct interviews with management. Therefore, it is critical to have active participation from the insurer to facilitate the interview process. In addition, the examiner may request information relating to internal controls and risk management to a greater extent than what has been requested in the past. However, the revised examination approach does not

require insurers to create internal control or risk management documentation solely for the purpose of completing an examination. Instead, the examiner is encouraged to request as much information on internal controls and risk management as is currently available from the insurer to assist with the examination effort. These requests may include documentation created by the insurer to comply with the Sarbanes Oxley Act of 2002 and the Annual Financial Statement Model Regulation.

Finally, under the new examination approach, the utilization of internal and external audit workpapers will be very important. Therefore, it is critical to have active participation from the insurer in coordinating access to external and internal audit workpapers as well as in assisting the examiner in understanding how the workpapers relate to the specific legal entity under examination.

The NAIC appreciates your cooperation in the transition to the new examination approach. We believe that the risk-focused approach will be beneficial to both regulators and industry partners in the years to come. It is anticipated that the new approach will increase the overall effectiveness and efficiency of the examination process as both regulators and industry become more familiar with the approach. Any questions or concerns about the new regulatory examination approach may be addressed to the domestic state of the insurer or to NAIC staff support for the RAWG ([http://www.naic.org/committees\\_e\\_rawg.htm](http://www.naic.org/committees_e_rawg.htm)).