

NAMIC ISSUE ANALYSIS



GETTING VALUE OUT OF YOUR NEXT FINANCIAL EXAMINATION

A CLOSER LOOK AT COST DRIVERS AND POTENTIAL SOLUTIONS TO HIGH EXAM FEES

JONATHAN RODGERS
Director of Financial and Tax Policy
National Association of Mutual Insurance Companies

JONATHAN RODGERS

Jonathan Rodgers serves NAMIC as its director of financial and tax policy. Jon is involved in a number of financial and accounting issues, including statutory accounting, risk-based capital, financial examination and analysis, state, federal, and international tax issues and emerging issues like blockchain and distributed ledger technology. He is part of NAMIC's team covering developments at the National Association of Insurance Commissioners and serves as liaison to national and international accounting organizations.

Prior to joining NAMIC's Government Affairs Department in 2013, Jon served as an accountant in the finance department for more than seven years. Jon is a native of Ann Arbor, Michigan. He graduated from Eastern Michigan University with a bachelor of business administration in accounting. He also has a Master's Degree in finance from Indiana University.

For more information about this NAMIC Issue Analysis please visit www.namic.org/issues/our-positions or contact:

JONATHAN RODGERS
jrodgers@namic.org
317.876.4206

NAMIC membership includes more than 1,400 member companies. The association supports regional and local mutual insurance companies on main streets across America and many of the country's largest national insurers. NAMIC member companies write \$268 billion in annual premiums. Our members account for 59 percent of homeowners, 46 percent of automobile, and 29 percent of the business insurance markets.

TABLE OF CONTENTS

Introduction	2
The Evolution of the Financial Condition Examination	3
A Significant Component of State Solvency Regulation	3
Risk-Focused Financial Examinations Are Born	4
Much Has Changed in Solvency Regulation	6
Exam Fees Continue to Increase at Outsized Pace	7
Redundancy in a Risk-Focused World	7
The Impact of Third-Party Examiners	8
A Way Forward – Solutions on the Horizon	9
Make Your Next Examination a More Valuable Proposition	10
Communication, Communication, Communication...	11
Regularly Discuss the Budget	11
Provide Available Information	11
Propose Ideas to Promote Efficiency	12
Critical Risks	12
Corporate Governance and Enterprise Risk Management Strategy	12
Third-Party/Vendor Management	12
Cybersecurity	13
Conclusion	13

NAMIC ISSUE ANALYSIS

INTRODUCTION

Financial solvency regulation in the insurance industry has undergone monumental change over the last decade, and it is the financial examination that companies undergo every three to five years that has been impacted the most. Since the global financial crisis, state insurance departments have been slashing their budgets and cutting the number of staff dedicated to financial solvency regulation, while the National Association of Insurance Commissioners has been adding more regulations for companies to comply with, which has resulted in additional work for fewer regulatory staff to review and test during the financial examination. On top of additional regulations, a new method of financial surveillance, known as risk-focused surveillance, has been incorporated into the examination approach so financial examiners can conduct more efficient financial examinations. The slashing of state insurance department resources and the new regulations and approach to examinations have forced many states to turn to outside help from third-party vendors in conducting financial examinations and to fill other regulatory needs. This, in part, has led to the continued increase in financial examination costs, increases in some cases of 100 percent or more from one exam to the next.

As regulators and insurers alike seek to find their way in this difficult environment, this paper explores the history of the financial examination, the introduction of the risk-focused approach that ushered in the concept of branded risks, cost drivers such as duplication and outsourced regulation, and some potential solutions to curbing ever-increasing exam costs along with ideas for how to make the financial examination a better value proposition for the company being examined.



GETTING VALUE OUT OF YOUR NEXT FINANCIAL EXAMINATION

THE EVOLUTION OF THE FINANCIAL CONDITION EXAMINATION

A SIGNIFICANT COMPONENT OF STATE SOLVENCY REGULATION

In the United States, insurance regulators monitor insurers through financial analysis and periodic financial condition examinations. The purpose of the financial condition examination is for regulators to review and evaluate an insurer's business processes and controls in order to assess and monitor the current financial condition and prospective solvency of an insurer. Financial analysis – critical to a well-functioning financial examination process – is a continuous process to review the status and condition of a company and typically involves a dedicated insurance department analyst who reviews the company's periodic submissions and documented interactions with the company's management. These functions represent the core of solvency regulation and two of the five major inputs into the overall U.S. solvency regulation risk assessment cycle¹. Regulators have come to rely on this cycle as a means of developing supervisory plans and to better understand the complete profile of the insurer or insurance group.

Figure 1: Risk-Focused Surveillance Cycle

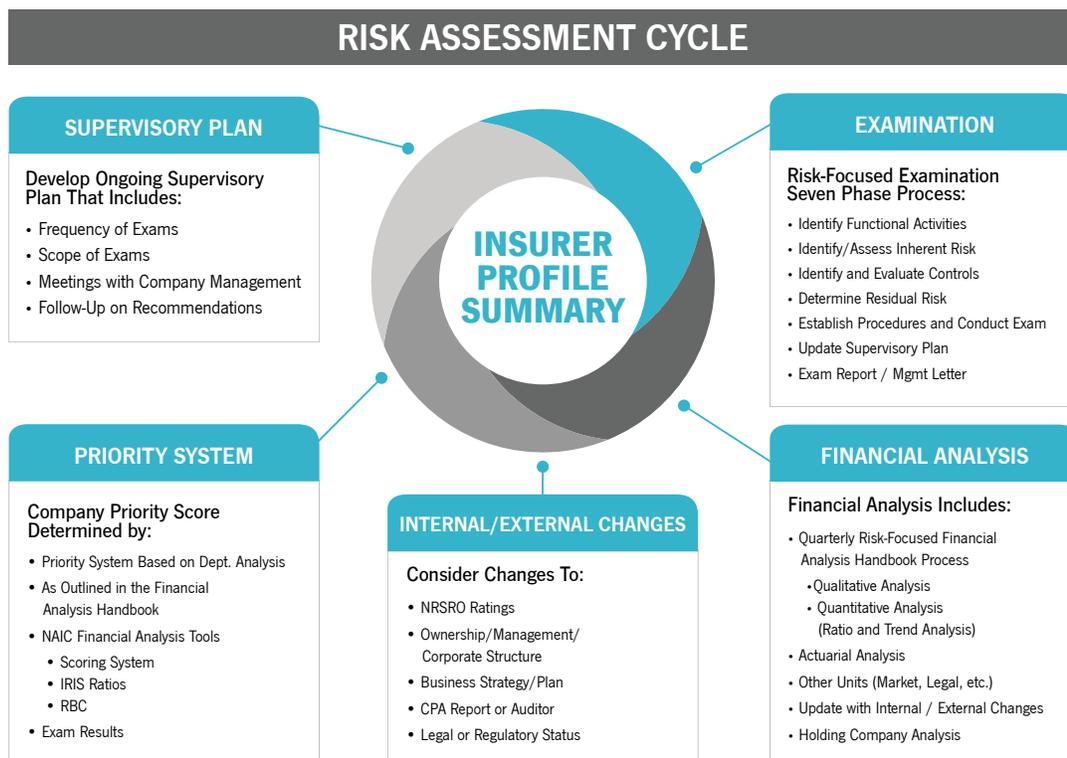


Figure 1: Financial analysis and periodic financial condition examinations represent the core of solvency regulation and two of the five major inputs into the overall U.S. solvency regulation risk assessment cycle.

¹ Supervision, Examination, Financial Analysis, Internal/External Changes, and Priority System make up the complete regulatory cycle – NAIC 2019 Financial Conditional Examiners Handbook – [See Figure 1].

NAMIC ISSUE ANALYSIS

Financial examinations are performed every three to five years and are supported by ongoing oversight conducted by the department analyst in-between exam cycles. The financial examination is a more in-depth look at the company's financial condition and involves on-site testing of company controls and interviews with key members of the management team. As part of the process, the examiner keeps an eye toward identifying and evaluating risks that could cause an insurer's surplus to be materially misstated, both currently and prospectively.

RISK-FOCUSED FINANCIAL EXAMINATIONS ARE BORN

Risk-focused financial surveillance, including on-site examinations, is a critical task for state insurance departments and a key pillar to the NAIC accreditation program². Part of the accreditation program requirements is a model law on examinations³ that has been adopted in all 50 states. The model requires the insurance commissioner to observe the processes and procedures set forth in the Financial Condition Examiners Handbook⁴, a guide subject to annual changes by various NAIC working groups that are incorporated by reference into state law each year. The handbook has undergone major revisions since the model was first adopted by the NAIC in 1991, including adopting a risk-focused approach to conducting examinations. This newer approach was formally adopted by the NAIC in 2010 and incorporated into the Financial Condition Examiners Handbook⁵.

Risk-focused examinations were welcomed by the industry, as it represented a new approach that would identify and categorize risks into different critical risk categories and tailor the examination to the nature and scale of the company being examined. Historically the examination process was more of a quantitative approach, with the use of checklists to ensure correct amounts were reported. In contrast, the new risk-focused approach is a qualitative approach that takes a more comprehensive view of the current and ongoing operation of the business enterprise. For details about the step-by-step process to the risk-focused examination approach, see Exhibit 1.

Exhibit 1 - A Seven-Step Approach to the Risk-Focused Financial Examination Process

The risk-focused financial examination can be broken down into seven distinct phases. The first two phases can be categorized as planning work that consists of understanding the company and identifying key functional activities to be reviewed and identifying and assessing inherent risk in activities. In Phase 1, key functional activities that are significant business processes or business units within a company are identified and key sub-activities within these units are also identified. The work during this phase continues until the examiner has obtained a level of detail necessary for understanding an activity within a company. In Phase 2, the examiner leverages the work completed by the analysis staff and classifies inherent risks into different categories, known as branded risks. From there the examiner assesses the inherent risks by determining the likelihood of occurrence and magnitude of impact to obtain the overall inherent risk assessment. These early phases in the exam cycle are key to understanding how an examiner plans for the examination and how they prioritize and plan to focus on key risks.

² The NAIC accreditation program relies on state certification by other regulators, requires on-site examinations, and requires solvency-related model laws, rules, and guidelines. Accredited insurance departments are required to undergo an independent review every five years to ensure the department is meeting baseline financial solvency oversight standards. [NAIC Financial Regulation Standards and Accreditation Program – April 2019, https://www.naic.org/documents/cmte_f_frsa_pamphlet.pdf].

³ NAIC Model Law on Examinations – <https://www.naic.org/store/free/MDL-390.pdf>.

⁴ NAIC 2019 Financial Condition Examiners Handbook.

⁵ Risk-Focused Financial Analysis was adopted into the Financial Analysis Handbook in 2017.

GETTING VALUE OUT OF YOUR NEXT FINANCIAL EXAMINATION

The next two phases of the examination are the mitigation and control review part of the overall process. This is where examiners identify and evaluate risk mitigation strategies and controls in Phase 3 and determine any residual risk posed to the company, which is Phase 4. The third phase requires the examiner to identify and evaluate controls in place to mitigate inherent risk. Examiners will test internal controls for how well they mitigate identified inherent risks. Under the NAIC's Model Audit Rule, another accreditation standard, it is required that corporate management be responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting. Therefore, information prepared to comply with these requirements is used to assist the examiner in identifying and assessing risk mitigation strategies and controls. To determine residual risk, examiners assess how effectively controls reduce the level of inherent risk for each risk identified. Based on the identification of riskier activities, the examiner can determine where to focus examiner or analyst resources and how to most effectively test for the risk in the insurer's business.

The next phase of the examination process is the most consequential part of the exam, as it includes substantive testing of the risks identified and requires the examiner to conduct testing based on the exam handbook procedures. Examiners prioritize testing based on the level of residual risk, which decreases with the strength of the controls for the risk. The risk-focused nature of the exam comes into play during Phase 5. This is illustrated in that there isn't as much substantive testing where the controls are strong or the residual risk is low, but there is increased testing for risks that are backed by weak controls or if residual risk is moderate or high.

The final two phases of the exam include updating the supervisory plan and summarizing the findings. Phase 6 includes an assessment of how the department would prioritize the insurer going forward as it relates to solvency risk. This phase also includes an update to the supervisory plan based on the material findings from the risk assessment exercise. Finally, Phase 7 is to draft an examination report and management letter based upon the findings. The examination report is required for each full-scope examination and only includes significant findings of fact and general information about the insurer and its financial condition. The management letter is more like examination work papers and includes significant results and observations that are not appropriate or necessary for inclusion in the public examination report but should be communicated to the board and/or management.

While the model law on examinations has been adopted in all 50 states, the risk-focused approach to the examination has been slow to catch on. As a result, a bifurcation between the new approach and the old approach has emerged, where some states have become very good at the new method while others have maintained the old quantitative checklist approach. Much of the divide can be attributed to whether state examiners are regularly attending the NAIC peer-review sessions and obtaining proper training on the new approach⁶. The NAIC understands that some states don't have adequate resources to send their examiners to its headquarters in Kansas City, Mo., to attend peer-review sessions; therefore, they have proposed other ways to address this problem that will be discussed later in this paper. Because the NAIC has adopted several new solvency regulations in recent years, it has invested significant resources to come up with new ways to support the states.⁷ This is

⁶ The NAIC peer-review program is a program whereby states submit exam files to be reviewed and critiqued by other participating state regulators and NAIC staff. The focus of the review and discussion is on reviewing testing performed in Phase 3-5 areas of the risk-focused examination. [NAIC Peer File Review Project – https://www.naic.org/documents/financial_exam_prp_exam_summary_agenda.pdf].

⁷ In 2018 and 2019 the NAIC invested in a project to update the Financial Analysis Handbook to assist state regulators in performing enhanced solvency oversight. The new design allows regulators to quickly identify issues and trends. Also, part of the project included a redesign of the Financial Profile Report, an automated analysis tool. In addition, investments in the NAIC State Ahead Initiative include providing service and support to state insurance departments through the expansion of training for regulators at all levels of state insurance departments.

NAMIC ISSUE ANALYSIS

especially important to the risk-focused approach given the recent changes adopted to the NAIC accreditation program, where independent accreditation review teams are now charged with evaluating how well insurance departments conduct financial examinations to ensure they are using the risk-focused approach.

MUCH HAS CHANGED IN SOLVENCY REGULATION

The risk-focused approach was designed to respond to a new regulatory paradigm, where the regulators' focus shifted from checking for errors in reporting to corporate governance, enterprise-wide risk management, and critical risks known to cause insolvencies. The new approach came at a time when the NAIC was undergoing a critical self-examination of the U.S. solvency framework, known as the Solvency Modernization Initiative⁸. Born out of SMI were key financial solvency model laws and regulations that ultimately became part of the NAIC accreditation program requiring states to adopt the new laws and regulations or something substantially similar to maintain their accreditation with the NAIC, which the states do not want to lose. The new solvency regulations adopted by the NAIC over the last decade and now applicable in nearly all the states include the Own Risk and Solvency Assessment Model Act, the Corporate Governance Annual Disclosure Model Act and Regulation, changes to the Model Holding Company Act to require an enterprise risk report and to facilitate group supervision, and new capital requirement assessments such as operational risk and catastrophe risk⁹.

One of the key changes to the financial analysis and examination process was the introduction of the concept of branded risks as part of the risk-focused paradigm. This was done to provide the framework for an examiner to tailor the examination to the key solvency risks of the company being examined. Another benefit to the concept of branded risks was the notion of a common language that could help improve communication between analysts and examiners. The branded-risk concept has been incorporated into the U.S. solvency framework in other ways, including as the basis for assessment of section 2 of the ORSA and in the Summary Review Memorandum as Exhibit AA in Financial Condition Examiners Handbook¹⁰.

Part of the risk-focused process is for financial analysts to include an assessment of each of the nine branded-risk classifications: credit, reserving, legal, market, liquidity, strategic, pricing/underwriting, operational, and reputational. These categories represent the top causes of an insurer becoming impaired or insolvent. For example, according to an AM Best report that looked at property/casualty insurer impairments from 1969-2014, pricing/underwriting or insufficient financial reserves were the leading cause of an insurer becoming impaired, not misreported financial statements, which are something the old examination method would have identified¹¹. See Figure 2 for a list of the leading causes for impairment. The on-site examiners provide input and feedback on the branded-risk assessments. These inputs are then incorporated into the Insurer Profile Summary or Group Profile Summary. The purpose of the IPS and GPS is for the regulator to build a profile of the insurer to be used as a reference point throughout the solvency cycle, including the financial examination.

⁸ NAIC Announces Solvency Modernization Initiative in June 2008 – https://www.naic.org/documents/smi_overview.pdf.

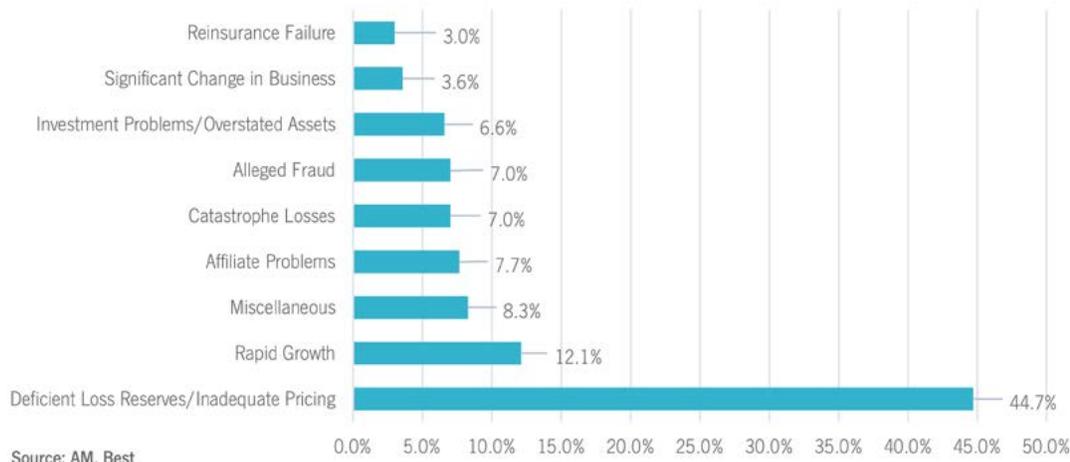
⁹ Recent changes to the Financial Condition Examiners Handbook and Financial Analysis Handbook include the addition of: holding company analysis, supervisory colleges, ORSA reporting and review, Form F reporting and review, Corporate Governance reporting and review, Principle-Based Reserving, Cybersecurity controls, Group Supervision, Insurer Profile Summary and Group Profile Summary. In addition to these changes, the NAIC adopted changes to the Annual Financial Reporting Model Regulation in 2006 (effective 2010) to require reporting on internal controls around financial reporting. As of this writing, Corporate Governance and Group Supervision have not been implemented in all U.S. states, and additional changes to the Model Holding Company Act may be considered as the NAIC implements the new Group Capital Calculation.

¹⁰ Section II of ORSA is the risk-exposure assessment of the ORSA, and insurers assessment includes a pre- and post-mitigation assessment of the nine branded risks. The Summary Review Memorandum (Exhibit AA in Financial Condition Examiners Handbook) is a document used by the financial examiner to communicate information to the financial analyst at the conclusion of an examination.

¹¹ See Figure 2 – AM Best 2014 report, Property/Casualty Impairments Continue Downward Trend [U.S. P/C Primary Cause of Financial Impairment, 1969-2014].

GETTING VALUE OUT OF YOUR NEXT FINANCIAL EXAMINATION

Figure 2: Primary Causes of Financial Impairment [1969 – 2014]



Moving to a risk-focused approach, developing a common language around branded risks and the new regulations gained from the SMI included significant changes regulators and insurers would have to adapt to. The regulatory community was rightly focused on the drivers and causes of insolvencies and would need to increase its training, not only on the risk-focused method, but also on all the new regulations that were being adopted in the states. To aid the analyst and examiner in reviewing and analyzing the new information to be gathered, the NAIC made several amendments over the years to both handbooks and continued to stress the importance of tailoring the examination to the nature and scale of the insurer.

EXAM FEES CONTINUE TO INCREASE AT OUTSIZED PACE

REDUNDANCY IN A RISK-FOCUSED WORLD

Notwithstanding a new streamlined method to focus on key solvency risks, many state insurance regulators were overwhelmed by all the new regulations needing to be reviewed, analyzed, prioritized, and possibly tested. The guidance in the handbooks, despite being amended dozens of times over the years, was not clear as to which functionary, analyst, or examiner would perform the work. Adding to the increased workload was a growing frustration among insurance companies that the on-site examination is often full of redundant and duplicative procedures. It is common to hear stories from insurers about examiners doing work that was already performed by the department analyst in-between exam cycles. It became evident that the Financial Condition Examiners Handbook and the Financial Analysis Handbook included considerable overlap that resulted in a very inefficient, duplicative examination and analysis process.

By 2016, the chorus of complaints from the industry regarding redundant and duplicative examination experiences could no longer be ignored. Not only was the exam experience frustrating for insurers, the costs of the examinations were increasing both in dollars spent and in the amount of time and resources dedicated to the overall process. It was clear that the risk-focused process was not leading to reduced time and money spent on the exam, something it was designed to address. It was at this time that the NAIC agreed to work with the industry on a solution to address duplicative and redundant handbook guidance. As part of the work performed to overhaul the analysis and examination function, industry stakeholders proposed dozens of changes to each of the handbooks, including that the Financial Analysis Handbook adopt a risk-focused approach.

NAMIC ISSUE ANALYSIS

These changes also called for taking a closer look at how information was gathered and how it was processed by each function, as well as reviewing the handbooks to eliminate any overlap between the two. Much of the duplication was related to the examiner asking for information already in the possession of the department analyst and reprocessing or retesting it without consulting the analyst or reviewing their assessment. It became evident that in certain cases the exam teams were not leveraging the work completed by the department analyst, or that the work of the analyst did not necessarily provide enough benefit for the exam teams to use.

Many of the industry-proposed changes to address the overlap between the two handbooks were accepted by the NAIC, including a risk-focused approach to financial analysis. There still existed a breakdown in communication between analyst and examiner, however, and because of the long cycle time between examinations, certain changes would need time to be implemented and incorporated before any real impact could be realized. If nothing improved over time, the poor communication between functions was going to continue to contribute to higher exam costs and a frustrating experience for insurers. The risk-focused approach to surveillance was supposed to usher in a more efficient and tailored approach to financial analysis and examination and, yet, in certain cases it was having an opposite effect. In addition to the continued problems with communication, other issues were starting to emerge as they related to regulators ability to manage all the new solvency regulations being adopted by the NAIC and the states.

THE IMPACT OF THIRD-PARTY EXAMINERS

A growing phenomenon in the insurance regulatory space is the outsourcing of regulation to third-party vendors, particularly in the area of financial examinations. This trend has taken state insurance departments by storm. Since the global financial crisis, state insurance departments have been slashing their budgets and reducing the amount of staff dedicated to insurance regulation. The number of financial examiners employed at the various departments of insurance fell 32 percent from 2006 to 2018¹². The annual budgets for state insurance departments dropped precipitously in the years immediately following the financial crisis and have not since returned to pre-crisis levels¹³. In response to having to work with fewer resources, departments of insurance have turned to outside vendors for help. In years past, insurance departments utilized third-party vendors as specialists to supplement the examination teams in areas that required unique expertise, such as a reserving actuary to perform reserve analysis. Now, entire examinations are being outsourced to third-party vendors, producing a new set of problems.

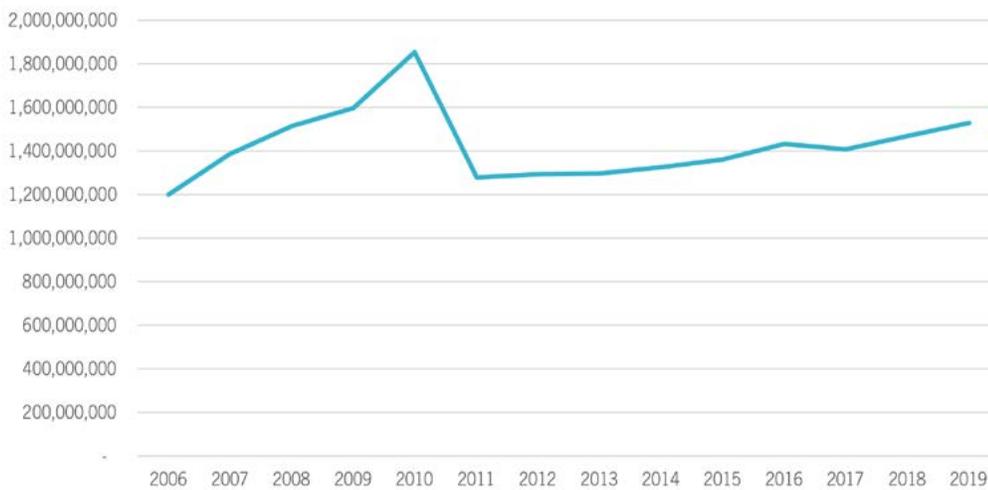


¹² There were 841 financial examiners on staff at state insurance departments in 2008 and only 575 on staff in 2018. [NAIC Insurance Department Resources Report – 2008 and 2018 versions].

¹³ See Figure 3: Insurance Department Budgets 2006 – 2018. [NAIC Insurance Department Resources Report – 2009, 2012, 2014, 2017, and 2018 versions].

GETTING VALUE OUT OF YOUR NEXT FINANCIAL EXAMINATION

Figure 3: State Insurance Department Budgets [2006 – 2019]



Given the issues already present with the lack of communication between department analyst and financial examiner, the problem is exacerbated in states where outside vendors perform on-site financial examinations. Often-times third-party examiners are located in a different state than the department with which they are contracted, which contributes to a breakdown in communication between contractor and insurance department, not to mention an increase in travel and lodging expenses that are ultimately billed to the company being examined.

Adding to the problems around communication is a lack of oversight by insurance departments over the vendors they hire to perform on-site examinations. Because the contractor typically works directly with the insurer on budgeting and billing for the time and work performed, the insurance department doesn't have a sense of the overall costs of financial examinations in their state. This dynamic produces an environment where the insurance department is one step removed from a critical function of their role as state regulators. State insurance commissioners need to increase their oversight capabilities because there is no incentive for third-party vendors to be efficient with their time, nor is there good reason for them to rely on the work performed by the department analyst. Without proper oversight of these vendors the issue of ever-increasing exam costs will be difficult to resolve.

A WAY FORWARD – SOLUTIONS ON THE HORIZON

The new approach to financial analysis and examination, the numerous new laws and regulations insurers need to comply with, the trend of outsourcing the financial examination function, and the existing breakdown in communication between analyst and examiner, all combine to create many obstacles in insurers' path to tackle the problem of ever-increasing financial examination costs. But there are potential solutions on the horizon and a hope that the risk-focused process can be better incorporated into state methods and communication improved.

While the challenge of dwindling state insurance department resources may not be overcome, department oversight of outside examiners they contract with can be enhanced. In 2018, Pennsylvania passed Act 41, which amended the Insurance Department Act of 1921 requiring the state insurance department to produce an annual examination and analysis report detailing the total amount of money billed to companies by the department and its contractors for purposes of the financial

NAMIC ISSUE ANALYSIS

examination¹⁴. In addition, the act requires scheduling conferences between the department and the company being examined to establish a budget and discuss what vendors will be used for the examination. This presents a great opportunity to improve vendor oversight and will provide useful information for the public to better understand how much regulation is being outsourced and why. In addition, there is an opportunity for the company being examined to be more involved in the budget process from the outset of the exam.

Other insurance departments around the country could benefit from a similar law, as it would bring to light the costs of outsourcing the financial examinations in their states. It could also signal to state governments just how dependent the insurance departments have become on third-party regulation. Whether that leads to insurance departments having a better reason to retain more of the funds they already raise through premium taxes or other methods is a question to be considered. The dynamic of having to outsource this function may not go away, so it will be important for insurance departments to maintain some degree of oversight and control of the process.

In addition to potential state law changes, the recent amendments to the handbooks have not been fully appreciated for how they could improve communication between the analyst and examiner. One change that regulators and industry should be aware of is related to the new Exhibit D in the exam handbook. This is a required planning meeting between the financial analyst and financial examiner at the outset of the examination with the purpose of gaining an understanding of the company operations and risks and identifying work already performed by the analyst along with the documents that have already been obtained. This one change alone will go a long way to alleviating many of the headaches companies have been experiencing around redundant processes. It is important for companies that are about to undergo an exam to ask about whether this meeting has occurred, regardless of whether an outside examiner is being used.

Finally, ensuring that state regulators are receiving adequate training is directly related to the amount of resources available at each department of insurance. Many of the states that have become well versed with the risk-focused approach regularly attend NAIC peer-review sessions and go through NAIC training courses; however, those states tend to have more resources available to them. The NAIC knows it has a responsibility to provide as much support to the states as it can; therefore, it has increased the amount of training opportunities through the development of webinars and other online training resources. In addition, through the State Ahead Initiative¹⁵, the NAIC has expanded its programs to target different regulatory work experience levels and will continue to develop new training programs and methods. Further, the NAIC has invested a lot of money in numerous systems upgrades and programs to directly benefit the states. These programs are designed to help state regulators perform their job and give them better ability to leverage the latest technological tools and should benefit both the analyst and examiner.

MAKE YOUR NEXT EXAMINATION A MORE VALUABLE PROPOSITION

There are many actions companies can take, and information they should be aware of, that can contribute to a more valuable financial examination experience for their next exam. Some of those include effective and timely communication, more involvement in the budget process, providing available information to exam teams, and proposing ways to save time. These activities are important in controlling the overall cost of the examination. In addition, there are some other opportunities to add

¹⁴ PA 2018 Act 41 – Insurance Department Act of 1921 - Omnibus Amendments – <https://www.legis.state.pa.us/cfdocs/legis/li/uconsCheck.cfm?yr=2018&sessInd=0&act=41>

¹⁵ Some programs included in the NAIC State Ahead Initiative that will directly benefit the states include: develop the Insure U website and update the tools for state insurance departments, continue outreach to the states to identify training needs, improve the user experience of NAIC technology services, address talent and state resource needs, expand ongoing training for regulators at all levels of state insurance departments, and ensure state regulators have access to secure, reliable, and flexible technical services.

GETTING VALUE OUT OF YOUR NEXT FINANCIAL EXAMINATION

to the value proposition of future examinations through the development of a strategy that identifies trends that the regulatory community is following. Today, those trends include having a good grasp of a companies' critical risks, corporate governance and enterprise risk management strategy, third-party/vendor management, and cybersecurity policy. These potential cost-savings opportunities and industry best practices are key to having a successful and valuable exam.

COMMUNICATION, COMMUNICATION, COMMUNICATION...

As in all good relationships, communication is key. This paper has already explored some of the communication breakdowns, including between financial analysts and financial examiners, and has also provided a discussion on potential solutions to those problems, but there is something the company being examined can do to improve communication as well. Having good communication with the exam team can help reduce overall exam fees. Nobody knows a company better than management, and anything management can do to help the examiner benefits the overall product that is ultimately produced. In the case of financial examinations, the product is the examination report and the management letter. Having an open line of communication with the exam team, starting with the initial exam kickoff meeting through the production of the exam report is very beneficial. Knowing that the exam team is open to discussing the most efficient way of completing exam tasks and understanding what is being tested and why is helpful to both examiner and examinee.

REGULARLY DISCUSS THE BUDGET

Another way to keep a close eye on exam fees is for companies to meet with the exam team early on to discuss the budget. Companies should understand how the department came up with its estimates and see if there are opportunities for cost savings. Much of the budget may include travel and lodging fees, particularly if a third-party vendor is used. Companies should see if any work can be done at the department or the vendor's home office – in an ever-increasing mobile/remote world much of the work does not need to occur on site. In cases where third-party vendors will be used, companies should understand where they are traveling from. If it is out-of-state, they should ask why the department is using out-of-state vendors and if there are local options.

In addition to meeting early in the exam process, companies should set up periodic meetings to discuss how the work is proceeding and to track the budget. They should understand that the exam handbook guidance requires a meeting between examiner and examinee when it is likely that total fees will exceed the budget by more than 10 percent. If the company is meeting regularly with the exam team and having discussions about the budget, they should be better informed about what the overall costs will be in the end. Furthermore, if the exam is being conducted by third-party vendors, companies should check in with the state insurance department to ensure they are monitoring the amount of time being spent on the exam and how that corresponds with budget estimates.

PROVIDE AVAILABLE INFORMATION

Understanding the scope of the exam is critical to knowing what information a company should provide to the exam team. Having those early conversations as the exam team is doing the planning work offers the opportunity to learn what will be in scope and what may be tested. Having this information is helpful to the company being examined, as it is likely they have available information that would aid the exam team in the work they need to perform. Internal audit reports, CPA review documents and workpapers, board of directors meeting agendas and memos, or any other pertinent information that would help the exam team, are always welcomed. Anything that helps along the process of the examination will likely reduce the amount of time needed to perform any given task and in turn lower exam fees.

NAMIC ISSUE ANALYSIS

PROPOSE IDEAS TO PROMOTE EFFICIENCY

Management is in the best position to talk about the company and the risks posed to the company and should be involved in the discussions with the exam team about what risks will be tested and how. Management also has the benefit of knowing what was tested during the previous examination and if any inefficiencies could be overcome the next time around. It may be a good idea to purchase a copy of the latest Financial Condition Examiners Handbook from the NAIC to familiarize yourself with the processes and procedures used by exam teams. The exam team is open to discussing ideas with the company about more efficient ways to approach any given testing process. To reduce exam fees, it may benefit the company to involve themselves in the minutia of the exam procedures via the handbook and demonstrate a way to reduce the number of hours it may take to conduct a test or procedure.

CRITICAL RISKS

That state financial examiners will be focused on critical risks throughout the exam process is something to be aware of. In preparation for this, companies should have a “map” ready to share that examines the company’s critical risks mitigation strategies. Exam teams will be able to leverage the work performed by the company and review the risks identified, leading to efficiencies and potentially reduced costs. Having this information is also a good exercise that could help to prepare executives for the interviews conducted by the examination team.

CORPORATE GOVERNANCE AND ENTERPRISE RISK MANAGEMENT STRATEGY

Insurers are already expected to provide more detailed information to their regulators related to their corporate governance structures and enterprise risk management practices with the introduction of the Corporate Governance Annual Disclosure Model Act and Regulation and the ORSA. As it regards the examination, the exam team conducts interviews of senior management so team members can assess certain qualities about the company’s corporate governance and ERM strategy. Exam teams want to know more about the company’s board size and structure as well as senior management policies and practices. In addition to the filings under CGAD and ORSA, examiners are interested in assessing how well informed the company board is on critical risk areas. Exam teams expect formal documentation of risks and risk mitigation strategies and are interested in learning about a company’s ERM processes and what support there is behind the risk mitigation strategies in place.

THIRD-PARTY/VENDOR MANAGEMENT

A component of the financial examination that has been at the forefront of regulators’ minds in recent years is the information technology portion of the exam, and within that component resides the role of identifying and assessing risks associated with companies doing business with third-party vendors. Exam teams are interested in learning more about how companies manage and monitor their relationships with these vendors. Expected as part of the IT examination is a review of the service providers, including those that affect financial reporting, since those service organizations are required to comply with certain standards reports around internal controls¹⁶. As part of this review, examiners are checking to see if the third-party vendor reports are reviewed and if user-control considerations are addressed and documented.

¹⁶ Statement on Standards for Attestation Engagements (SSAE) No. 18 includes a Service Organization Controls (SOC 1) report that is a report on controls at a service organization that may be relevant to user entities’ internal control over financial reporting.

GETTING VALUE OUT OF YOUR NEXT FINANCIAL EXAMINATION

CYBERSECURITY

Also included as part of the IT examination is an assessment of the company's exposure to cybersecurity risks. The exam team is interested in learning more about the types of sensitive information maintained or accessed by the company. The team is also interested in what and how much information can be accessed by outside vendors. Among the key interviews is a member from the IT senior management team during which examiners will be interested to learn about the interaction between the board of directors and their understanding of the IT control framework. Other areas of interest include how well employees are trained on company cybersecurity policy and whether network activity is adequately monitored.

There are many things companies can do to get more involved in their financial examination process and those things can lead to lower exam fees and a better value proposition for the company.

CONCLUSION

So much has changed in the last decade around solvency regulation in the insurance industry, including a dwindling of state insurance department resources leading to the trend of outsourcing regulation. With all the additional regulations that have been adopted by the states, the financial examination is impacted the most. While it may appear to be an uphill battle for insurers to address the environment of rising exam fees, there are a lot of things that insurers can do to make their next exam a more valuable experience. In addition, there may be potential solutions worth pursuing that would go a long way to address issues around communication and third-party vendor oversight that may contribute to a halt on ever-increasing exam fees.

NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

3601 Vincennes Road | Indianapolis, IN 46268 | 317.875.5250
20 F Street, NW, Suite 510 | Washington, D.C. 20001 | 202.628.1558



NAMIC
NATIONAL ASSOCIATION OF
MUTUAL INSURANCE COMPANIES

