



PROSPECTIVE RISKS: HOW TO ADDRESS IN A RISK FOCUSED EXAMINATION

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risk®ulatory

CONSULTING

KEY OBJECTIVES

- rrc NAIC Peer review – lessons learned
- rrc Methods of identifying prospective risks
- rrc Effective testing of prospective risks
- rrc Documenting prospective risks
- rrc Communicating with the Analyst
- rrc Specific prospective risk examples



NAIC PEER REVIEW – LESSONS LEARNED

- Understand the risk, root causes and drivers
- Ensure identified risks are addressed on Exhibit V or appropriate Key Activity Matrix
- Ensure a robust level of testing related to the identified risks/and or risk mitigation strategies

NAIC PEER REVIEW – LESSONS LEARNED

- Regulators: Be concise with recommendations to Financial Analysts
- Financial Analysts: Document follow-up, which may include corroborating evidence.
- Prospective Risk Sound Practice:
http://www.naic.org/documents/financial_exam_sound_practices_exhibit_v.pdf

IDENTIFICATION OF PROSPECTIVE RISKS

Sources of Prospective Risks

- rrc C-level interviews
- rrc MD&A
- rrc ORSA
- rrc Financial Analyst reports
- rrc NAIC Risk Alerts
- rrc Rating Agency Reports
- rrc ERM documentation
- rrc Company announcements and press releases

IDENTIFICATION OF PROSPECTIVE RISKS

Considerations When Identifying Risks

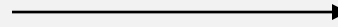
- Evaluation of Risk at an Enterprise Level
 - Aggregation of risk
 - “Big picture” assessment
 - Equate the risk into achievement of corporate strategies, goals and objectives
 - Tie into corporate governance assessment in Phase 2

IDENTIFICATION OF PROSPECTIVE RISKS

Problems

Questions to Consider

Are there prior or current period problems that indicate current period or prospective risks?

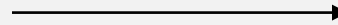


Risk Indicators

Prior period errors or control deficiencies

Changes

Are there changes in the current period that indicate current period or prospective risks?



- Changes in business conditions, transactions or operations
- significant unusual/one-off transactions
- significant new products
- significant M&A activity

Complexities

Are there process related risks that require a controls-based approach?

Subject Matter Expert (SME) Input

Are there issues identified based on knowledge of the industry & Firm experts that indicate risks?

SOME COMMON PROSPECTIVE RISKS – LIFE

1. Mergers and Acquisitions
2. New Product Development
3. Low Interest Rate Environment
4. Data Integrity
5. New Strategies
6. Legal and Regulatory
7. Dependency on Holding Company
8. Asset Liability Matching
9. Anti Money Laundering
10. Long Term Care
11. People Risks
12. Cyber Risks
13. Risks Associated with Legacy Systems

SOME COMMON PROSPECTIVE RISKS – P&C

1. Pricing/Underwriting
2. Data Integrity
3. Dependency on Holding Co.
4. Capital Adequacy and Financial Strength
5. Catastrophe Risk
6. Legal and Regulatory
7. Cyclicity of Markets
8. Dependence on Independent Agents
9. People Risks
10. New Product Development
11. New Strategies
12. Self Driving Cars
13. Global Climate Change
14. Cyber Risks
15. Risks Associated with Legacy Systems

SOME COMMON PROSPECTIVE RISKS – HEALTH

1. Administrative Cost Ratio
2. Medical Cost Ratio Trending
3. Data Integrity/IT Risk
4. Scale (Lack of Provider Networks Out-of-State)
5. HR Risks (Recruiting and Retaining Talent)
6. Federal/State Government Programs and Mandates
7. Vendor Reliance
8. Market Conduct and Claims Handling Issues
9. Erosion of Network Discounts
9. Cyber Risks
10. Risks Associated with Legacy Systems

EFFECTIVE TESTING OF PROSPECTIVE RISKS

- Critical nature of prospective risks
- No other parties are testing
- Challenging aspect of Risk-Focused Exams

EFFECTIVE TESTING OF PROSPECTIVE RISKS

- Obtain a clear understanding of the risk
- Document the root cause and the drivers
- Assess the “likelihood of occurrence” and “magnitude of impact”
- Focus exam procedures on those prospective risks deemed to have “high” inherent risk

EFFECTIVE TESTING OF PROSPECTIVE RISKS

- Consider conducting follow-up meetings with members of management
- Gain an understanding of the entire process in place to mitigate the risk
 - Could be multiple controls in place

EFFECTIVE TESTING OF PROSPECTIVE RISKS

- Validate what was communicated by Management
- Request documentation as follow-ups to the meetings
 - Verify documentation is as described
- Assess the overall processes and controls in place to mitigate the risk

EFFECTIVE TESTING OF PROSPECTIVE RISKS

Phases 1 & 2 Considerations

- rrc Make Risk Statements Very Specific
- rrc Understand What Management Considers as “Critical Risks”
- rrc Risk Assess ALL Identified PRs At Once
 - Versus KFA or Exhibit V

EFFECTIVE TESTING OF PROSPECTIVE RISKS

Phases 3 & 5 Considerations

- Start testing Prospective Risks as early as possible
 - DO NOT wait until the end of the exam
 - PRs should be the focus and NOT an Afterthought
- Develop a plan to validate management's key assertions
 - Very critical to test/validate their process
 - Select a sample of “key items” to validate

EFFECTIVE TESTING OF PROSPECTIVE RISKS

- Who is responsible for Prospective Risk Testing?
- Summary Review Memo (“SRM”) and Insurer Profile Summary (“IPS”)
 - Only recommend follow up for significant residual risks
 - Follow up suggestions should be detailed and specific, including the frequency of follow-up

DOCUMENTING PROSPECTIVE RISKS

Exhibit V

- rrc Identify overarching prospective risk
- rrc Link identified risk to a branded risk category
- rrc Document the risk mitigation strategies
- rrc Document the testing performed and corroborating evidence obtained
- rrc Document assessment of the risk and the mitigation strategies in place
- rrc Document any ongoing examination procedures and/or follow-up to be performed

DOCUMENTING PROSPECTIVE RISKS

PART ONE – OVERARCHING PROSPECTIVE RISK TESTING TEMPLATE

Overarching Prospective Risk Identified	Branded Risk	Risk Mitigation Strategies	Corroborating Evidence and Documentation	Prospective Risk Assessment	Ongoing Examination Procedures and Follow-Up
<p>Example Prospective Risk 1:</p> <p>The company's executive compensation practices encourage and/or reward excessive risk-taking and may induce fraudulent behavior.</p>	OP	<p>The board of directors maintains an independent compensation committee that meets at least annually to update the strategy and approve executive compensation.</p> <p>Variable compensation is limited to a percentage of salary and is based on qualitative and quantitative performance over a rolling 5-year period.</p>	<p>Reviewed minutes of the 20XX compensation committee meeting (see A.1.1), noting that actions were taken as described by the company.</p> <p>Obtained and reviewed variable compensation plan (see A.1.2), noting cap as a percentage of salary.</p> <p>Reviewed schedule calculating 20XX variable compensation for executives (see A.1.3), noting the calculation is based on five-year results and ties to GL.</p>	<p>Although the company carries a high expense ratio and the department had identified concerns with compensation in the past, it appears that the company has put additional controls in place to mitigate risks relating to executive compensation. As such, a Moderate prospective risk rating is deemed appropriate.</p>	<p>Based on the moderate prospective risk rating, total compensation awarded to the top five executives in the company was benchmarked to competitors and industry averages (see A.1.4). Although the company appears to be on the high end of the range, compensation did not appear unreasonable. Analyst will be asked to closely monitor changes in the expense ratio and executive compensation to determine if additional action is necessary.</p>
<p>Example Prospective Risk 2:</p> <p>The company may experience rating agency downgrades, causing the company to be unable to sell its products.</p>	ST RP	<p>The company has processes in place to monitor and manage its financial performance in accordance with metrics considered significant by rating agencies.</p> <p>The company utilizes modeling to determine its economic and rating agency capital needs.</p>	<p>Reviewed financial reports for evidence of monitoring of rating agency performance measures and management review, noting that the company appears to be meeting its benchmarks w/o/e (see A.1.4).</p> <p>Obtained and reviewed the economic capital calculation at 12/31/XX, noting that rating agency considerations are included in the process</p>	<p>The company has product lines sensitive to a ratings decrease; however, it appears that the company has appropriate controls and strategies in place to maintain strong ratings. As such, a Low prospective risk is deemed appropriate.</p>	<p>Based on the low prospective risk, no additional work is necessary at this time. However, we request that the analyst notify the examination unit if a future rating downgrade occurs so that the units can collaborate regarding actions to be taken (e.g., limited scope exam) at that time.</p>

COMMUNICATING WITH THE ANALYST

- “Ongoing Exam Procedures & Follow-up”
- Adequately document everything on the Supervisory Plan
- There will likely be residual risk that the Analysts should be aware of and consider
- Make clear recommendations for the analysts for follow-up

SPECIFIC PROSPECTIVE RISK EXAMPLES

1. Reinsurance
2. Affordable Care Act (ACA)
3. Managing TPA/MGA Risk

IN-DEPTH LOOK – REINSURANCE

Root Cause of Risk/Risk Drivers:

- Inadequate coverage
- Heavily concentrated with a single re-insurer
- Lack of oversight of the reinsurance program
- Reinsurer could be illiquid or insolvent

IN-DEPTH LOOK – REINSURANCE

Specific Causes of Risk:

- Inappropriate strategy
- Reinsurance company is poorly rated
- Lack of risk transfer
- Inequitable contract terms

IN-DEPTH LOOK – REINSURANCE

Sample Controls You Might See in This Area:

- rrc Licensed reinsurance intermediaries
- rrc Policies and procedures, for example:
 - Only highly rated reinsurance companies
 - Concentration limits
- rrc Board oversight of reinsurance programs
- rrc Documented reinsurance strategy
- rrc Ongoing monitoring

IN-DEPTH LOOK – REINSURANCE

Sample Test Plan to Validate Controls:

- Obtain and review the Reinsurance Strategy
- Review evidence of risk transfer analysis
- Review Board minutes to confirm oversight of the reinsurance program
- Confirm the insurer is not too heavily concentrated with a single reinsurer
- Review the AM Best ratings of all reinsurers

IN-DEPTH LOOK – AFFORDABLE CARE ACT

Root Cause of Risk/Risk Drivers:

- New federal requirements that all health insurers will have to comply with
- Evolution to the exchanges

IN-DEPTH LOOK – AFFORDABLE CARE ACT

Specific Causes of Risk:

- Significant changes in the essential benefits
- Elimination of pre-existing conditions
- Consumers' reaction

IN-DEPTH LOOK – AFFORDABLE CARE ACT

Sample Controls You Might See in This Area:

- Strategic plans in place to address and mitigate new issues
- Detailed plans regarding plans to comply
- Board involvement (e.g. is the Board inquiring with management regarding compliance efforts?)

IN-DEPTH LOOK – AFFORDABLE CARE ACT

Sample Test Plan to Validate Controls:

- rrc Review Board minutes
- rrc Review of strategic plans
- rrc Interviews with management to inquire regarding efforts to prepare

IN-DEPTH LOOK – MANAGING TPAs/MGAs

Root Cause of Risk/Risk Drivers:

- The risk exists that the TPA may not have appropriate systems, processes, policies, procedures and internal controls in place to mitigate the Company's exposure to financial solvency and market conduct risks. This risk is not transferred by the use of a TPA/MGA and therefore must be appropriately managed by Company personnel to ensure its effective mitigation.

IN-DEPTH LOOK – MANAGING TPAs/MGAs

Sample Controls You Might See in This Area:

- Robust due diligence before acceptance of a TPA/MGA
- Protectionary clauses in TPA/MGA contract
- Audits of TPA/MGA results

IN-DEPTH LOOK – MANAGING TPAs/MGAs

Sample Controls You Might See in This Area (cont'd):

- Critical reviews of TPA SOC 1 report
- Monitoring of the TPA's policies, procedures and internal controls
- Review of underwriting and claims handling processes

IN-DEPTH LOOK – MANAGING TPAs/MGAs

Sample Controls You Might See in This Area (cont'd):

- rrc Review of the TPA/MGAs audited financial statements
- rrc Insurer reconciles receivables from TPA/MGA
- rrc Insurer tracks TPA/MGA performance

IN-DEPTH LOOK – MANAGING TPAs/MGAs

Sample Controls You Might See in This Area (cont'd):

- rrc TPA/MGA notifies insurer immediately of large claims and threatened litigation
- rrc Insurer handles complex and/or large underwriting and claims cases directly

IN-DEPTH LOOK – MANAGING TPAs/MGAs

Sample Test Plan to Validate Controls:

- rrc Review the insurer's due diligence program for evaluating new TPA/MGAs
- rrc Review contracts with TPA/MGAs
- rrc Review evidence of the Insurer's monitoring of the TPA/MGA

IN-DEPTH LOOK – MANAGING TPAs/MGAs

Sample Test Plan to Validate Controls (cont'd):

- Determine the Insurer is reconciling receivables from the TPA/MGA
- Validate that the TPA is not co-mingling the Company's funds
- Determine the Insurer is tracking complaints associated with the TPA/MGA
- Evaluate compliance with State TPA/MGA statutes

QUESTIONS?



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