Randi Reichel
Reichel Consulting, Ltd.

Risk Assessment and Financial Examinations
What Company Management Needs to Know

In late 2006, the National Association of Insurance Commissioners (NAIC) adopted significant and far-reaching changes to the way financial examinations can be conducted. These changes, which currently are voluntary at the option of the state, will require the personal involvement of senior management in areas where historically they have not been active participants. It is important to understand that senior management may now be required to personally participate in examinations and be subject to interviews by state financial examiners. Regulators will expect those managers, as well as senior board members, to be conversant with the risk profile and risk tolerance of the company, and to be capable of discussing those areas as well as the corporate governance structure of the company, relationships, management and auditor independence, among other things, in detail with the financial examiners.

Among the rationale for the changes to the examination protocol is the desire to move from a static balance-sheet examination to one focused more on the overall risk profile of the company. There is a national trend toward adopting a flexible regulatory scheme to oversee carriers based upon each company's own unique business mix and operations, rather than relying solely on benchmarking to an inflexible set of financial ratios. This is illustrated not only by the changes to examination protocol but also in the changes to the Model Audit Rule adopted in 2006, the pending amendments to the *Standard Valuation Law*, and the proposed changes to the way life insurance reserves will be regulated that are being discussed in the context of principles-based reserves and corporate governance.

The *Financial Condition Examiner's Handbook*, which is published and sold by the NAIC, outlines the types of questions that senior management should be prepared to answer, including but not limited to: descriptions of the "tone at the top" of the company, management philosophy and operating style and how those impact enterprise risk management, anticipated or proposed changed to the company operations, membership criteria for board members, board independence, and finally, management competence.

It is important that senior management, and company personnel who are responsible for interfacing with financial examination teams, be aware of these examination changes. Management must be responsive to examiner questions, must be able to discuss the company's enterprise risk program if one exists, the future operational plans of the company, the interface between board, management, auditors and company personnel, and the corporate governance structure of the company in general.

The National Association of Insurance Commissioners is in the process of training financial examiners in the new risk-surveillance program. At present, the use of this new examination protocol is optional at state's choice. Carriers should be aware that while some states will embrace the risk-surveillance paradigm completely, others will not, or will be further behind in their training and implementation than others. It is likely that over the course of the next few years carriers within a holding company system will have distinctly different examinations. Flexibility – and preparation – will be the key to ensuring that the results of those examinations are successful, and it is critical that all those involved in the examination process be aware of the upcoming changes to the protocols.