

# COMMONWEALTH OF VIRGINIA

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## STATE CORPORATION COMMISSION BUREAU OF INSURANCE

October 2, 2009

### **Administrative Letter 2009 - 09**

**To:** All Domestic Insurers Licensed in Virginia

**Re:** Risk-Focused Examination Approach

The purpose of this administrative letter is to inform all Virginia domestic insurance companies that a new risk-focused examination approach will be used beginning with the 2010 financial examinations.

#### **Background**

In 2006, the National Association of Insurance Commissioners ("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 the NAIC Financial Regulation Standards and Accreditation Program for all financial examinations beginning on or after January 1, 2010. 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 the Board of Directors, requests for additional internal control documentation (including any applicable compliance documentation), 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.

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

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 in 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 the following 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: Phase 2 requires the examiner, with the assistance of the analysis staff to 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 overall assessment reflects the examiner's determination on how well the internal 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 insurer's internal and external audit work already performed.

It should be noted that the examinations associated with the revised risk-focused approach have enough flexibility to allow procedures to be added, modified, supplemented or reduced, in accordance with the overall risk assessment of the insurer. Therefore, it is anticipated that the scope of the examination and the procedures associated with such an examination will be modified for small to medium sized insurance companies. In some instances, companies may only note minor changes to the procedures that have been utilized in previous financial examinations.

We appreciate your cooperation in the transition to the new risk-focused examination approach. We believe that the risk-focused approach will be beneficial to both regulators and industry partners in the years to come.

Any questions or concerns about the new regulatory examination approach may be directed to:

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Cordially,



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