To: The Financial Regulation Standards and Accreditation (F) Committee

From: Al Bottalico, Chair
Financial Examiners Handbook Technical Group

Date: February 14, 2014

Subject: Consideration for Financial Accreditation Standards
2014 Financial Condition Examiners Handbook

At the Winter 2007 National Meeting, the Financial Regulation Standards and Accreditation Committee (FRSAC) adopted the Review Team Guidelines to be used for financial examinations performed using the risk-focused surveillance approach that is found in the NAIC Financial Condition Examiners Handbook (the Handbook). This memorandum is to update the FRSAC on changes that the Financial Examiners Handbook Technical Group (FEHTG) has made to the Handbook during 2013.

Modifications are made to the Handbook each year, and a new edition is printed annually. This process allows for an efficient way to update the Handbook and ensures that users have the latest version. The FEHTG made several changes to the Handbook in 2013. It is the FEHTG’s opinion that several of these changes should be considered “significant” for accreditation purposes. FEHTG defined “significant” as a change that may immediately warrant a change to at least one accreditation standard or the Review Team Guideline(s) for said standard. These changes are segregated in the list below.

Although some changes have been categorized as “significant” by the FEHTG, this is not meant to suggest the modifications are synonymous with the term “significant” within the FRSAC context. During 2013, the FEHTG made the following changes:

**Significant Changes to the Handbook:**

- The concept of critical risk categories was developed and incorporated into the Handbook to encourage examiners to focus examination resources on the most critical areas of an examination. While this change represents a significant theoretical change, actual changes to Handbook guidance are minimal. This change is applicable to examinations as of December 31, 2013 and later. The specific changes include the following elements:
  - The requirement to perform a minimum level of testing for all annual statement line items above tolerable error was eliminated. Examiners are now required to perform a minimum level of testing for each critical risk category by identifying at least one risk statement on a key activity matrix or Exhibit V – Prospective Risk Assessment. In some circumstances, one or more of the critical risk categories may not be applicable to the insurer under examination; in this case, the examiner may bypass testing for that critical risk category and document the rationale for that decision in the examination planning memorandum.
  - Newly created Exhibit DD – Critical Risk Categories was developed to assist the examiner in demonstrating that each critical risk category has been appropriately addressed by the examination. This is shown by referencing either the applicable risk statement(s) pertaining to the
critical risk category or the examination planning memorandum in situations in which the critical risk category does not apply.

- Other minor changes were incorporated into the Handbook relating to reliance on work performed by auditors, as well as other references to ensure consistency of these new concepts.

As a result of these revisions, FEHTG would advise accreditation to consider revising the guidelines pertaining to Accreditation Standard F: Performance and Documentation of Risk-Focused Examinations with regard to the required minimum level of testing to be performed on a financial examination and the use of Exhibit DD. FEHTG would suggest the following revisions be made to the Review Team Guidelines to reflect this change:

f. Performance and Documentation of Risk-Focused Examinations

Guidelines

1) For examinations with an as of date prior to December 31, 2013: For any particular activity that has one or more annual statement account balances that are greater than tolerable error, the examiner should choose it as a key activity or sub-activity, or develop risk statement(s) associated with the account, and walk it through the seven phase process. The examiner should carefully consider the risk of understatement when reviewing the materiality of liability accounts. If the examiner does not include any risk statements related to a specific account balance that is greater than tolerable error, the rationale for such should be adequately documented in the examination planning memo.

For examinations as of December 31, 2013 and later: Each critical risk category should be addressed by at least one risk in the risk matrices or Exhibit V. The examiners should utilize Exhibit DD – Critical Risk Categories, or something similar, to demonstrate that all critical risk categories have been addressed. In situations in which a particular risk category is not addressed by at least one risk statement, the rationale for this should be adequately documented in the examination planning memo.

- As a result of a referral from the Risk-Focused Surveillance Working Group to the IT Examination Working Group, revisions were made to Handbook guidance regarding several aspects of the IT general controls review. These revisions included the following:
  - Defining Information Technology General Controls (ITGCs) and describing how they are different from application controls;
  - Guidance regarding when it may be appropriate to utilize existing work and how to document the examiner’s reliance on that work;
  - Expectations for concluding on the IT review and communicating the results to the EIC, including how they may impact the financial examination.

FEHTG would advise accreditation to consider revising the guidelines pertaining to Accreditation Standard C: Use of Specialists: Computer Audit Expertise Guidelines to clarify the supporting documentation necessary for the IT Review. Previously, changes were made to this standard for updates to the 2013 Handbook specifically for small companies; however, the current changes broaden the scope for certain guidance to include all companies. FEHTG would suggest the following revisions be made to the Review Team Guidelines to reflect this change:
c. Use of Specialists

Computer Audit Expertise Guidelines

4) The IT Review should be supported by proper documentation including, at a minimum, a completed Information Technology Planning Questionnaire (Exhibit C – Part One), an IT Review Work Program (Exhibit C – Part Two), and a summary of findings or something similar. As discussed in the Examiners Handbook, there are certain situations in which the use of Exhibit C – Part Two may be limited or the Exhibit may not be completed. These situations include reliance on internal or external audit work and for small companies or insurers with a non-complex IT environment. When the examiner limits or eliminates the use of Exhibit C – Part Two, the examiner should document the rationale for such in the IT planning memo and/or summary memo. In all cases, the six-step process should be adhered to. For examinations of small companies or companies with a non-complex IT environment, test procedures may be limited, as long as the six-step process is adhered to. In limited circumstances discussed in the Examiners Handbook, the examiners may bypass the use of Exhibit C – Part 2 and document their assessment of each of the four domains of the IT framework in memo format.

Other Changes to the Handbook:

- As a result of a referral from the FRSAC, revisions were made to clarify and expand existing guidance regarding required elements to be included in exam status reports. This change may help the review and enforcement of Accreditation Standard B: Communication of Relevant Information to/from Examination Staff. The required content is as follows:
  - A clear explanation of the examination’s progress broken down by phase/key activity;
  - A summary of time incurred by examiners including budget, actual and time remaining to complete;
  - A summary of unusual problems, any significant issues identified throughout the examination and the examiner-in-charge’s proposed resolution; and,
  - Proposed changes to the approved budget.

- Revisions to incorporate consideration of risks that may be identified through a review of Form F.

- Revisions to clarify that work performed by non-independent individuals may be utilized during an examination, and what additional measures are necessary when relying on such work.

- Revisions to the Coordination Framework to align the coordinating state and lead state concepts. Revisions include replacing the term “coordinating” with “lead,” defining how the Lead State is selected, and how Exhibit Z, Part 1 – Examination Coordination should be used.

- Revisions to several examination repositories to consider procedures for validating catastrophe modeling and data that is used in determining the catastrophe risk charge in the Property & Casualty RBC formula.

- A new section was added to the Handbook regarding special considerations when examining insurers with separate accounts. This section includes background information and a repository of risks specific to insurers with separate accounts.
• Revisions to clarify the certain elements of the examination are required, including:
  
  o Completion of Exhibit AA – Summary Review Memorandum, or a similar document;
  o Completion of Exhibit P – Review of Events Subsequent to the Balance Sheet Date, or a similar document;
  o C-Level Interviews; and,
  o Completion of Management Letters, or a similar process for communicating examination issues/findings.

• Revisions to expand Exhibit A – Examination Planning Procedures Checklist and Exhibit M – Understanding the Corporate Governance Structure to include certain governance principles highlighted in the International Association of Insurance Supervisors Insurance Core Principles.

• Revisions to several examination repositories to consider procedures for reviewing the company’s preparation for implementation of principle-based reserving.

• Revisions to narrative guidance in phases 3 – 5 to highlight the importance of reviewing mitigation strategies for Other Than Financial Reporting risks, and the possible follow-up procedures or communication that may be necessary if a residual risk exists.

• Revisions to reinsurance narrative guidance to incorporate changes made to the Credit for Reinsurance Model Law and the Credit for Reinsurance Model Regulation regarding the concept of certified reinsurers.

• Revisions to Exhibit C – IT Work Program to update for changes made to the COBIT Framework.

The FEHTG sincerely requests that the FRSAC consider the items listed above as insignificant changes to the Handbook. We will continue to notify the FRSAC of any changes to the Handbook and also advise if, in our opinion, those changes are “significant” by accreditation expectations.

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