

To: Director John M. Huff (MO), Chair of Financial Regulation Standards and Accreditation (F) Committee

From: Commissioner Susan Donegan (VT), Chair of Corporate Governance (E) Working Group

Date: Nov. 17, 2014

Re: Recommendation for Part A Accreditation Standards and Guidelines for revisions to the Annual Financial Reporting Model Regulation (#205)

Executive Summary

On August 19, 2014, the NAIC Executive Committee and Plenary adopted revisions to the *Annual Financial Reporting Model Regulation* (Model #205) to incorporate an internal audit function requirement for large insurers into the regulation. The revisions require individual insurers writing more than \$500 million or insurance groups writing more than \$1 billion in annual premium to maintain an internal audit function providing independent, objective and reasonable assurance to the audit committee and insurer management regarding the insurer's governance, risk management and internal controls. The function is required to be organizationally independent from management and required to report at least annually to the audit committee on the results of internal audit activities.

A statement and explanation of how the potential standard is directly related to solvency surveillance and why the proposal should be included in the standards:

An internal audit function is generally considered to be a key component of an effective internal control framework. International standards recognize the importance of an internal audit function within ICP 8 – Risk Management and Internal Controls. After studying the need for an internal audit function requirement within U.S. insurance regulation, the Corporate Governance (E) Working Group determined that the best way to implement an internal audit requirement would be to place the requirement within the NAIC's existing Model #205. This model already includes a requirement for insurers to receive an annual financial statement audit, as well as requirements related to audit committees and internal controls over financial reporting. In addition, Model #205 is already recognized as critical to solvency surveillance and required for accreditation through the existing Part A standards.

A statement as to why ultimate adoption by every jurisdiction may be desirable:

As Model #205 is already part of the Part A accreditation requirements and has been adopted in some form by every jurisdiction, the internal audit revisions should also be adopted by every jurisdiction to ensure uniformity and consistency in requirements for U.S. insurers. In addition, uniform adoption across jurisdictions will assist the U.S. in meeting international standards and ensure a standard level of protection to policyholders of large insurers across the U.S.

A statement as to the number of jurisdictions that have adopted and implemented the proposal or a similar proposal and their experience to date:

While all states have adopted Model #205 in some format, the Working Group is not yet aware of any states that have adopted the internal audit function revisions. As these revisions were only recently adopted by the NAIC, the Working Group expects jurisdictions to begin taking action to incorporate the revisions beginning in 2015.

A statement as to the provisions needed to meet the minimum requirements of the standard. That is, whether a state would be required to have “substantially similar” language or rather a regulatory framework. If it is being proposed that “substantially similar” language be required, the referring committee, task force or working group shall recommend those items that should be considered significant elements:

The Working Group recommends that the provisions be modified as follows (see tracked changes) to require incorporation of the internal audit function requirement into the existing significant elements:

11. CPA Audits

State statute or regulation should contain a requirement for annual audits of domestic insurance companies by independent certified accountants that is substantially similar to the NAIC’s *Annual Financial Reporting Model Regulation* (#205).

[No changes proposed to existing elements a – n]

- o. Includes requirements for conduct of the insurer in connection with the preparation of certain reports and documents similar to Section 156.
- p. Includes requirements related to management’s report of internal control over financial reporting similar to Section 167.
- q. Includes requirements related to the establishment and maintenance of an internal audit function similar to Section 15.

An estimate of the cost for insurance companies to comply with the proposal and the impact on state insurance departments to enforce it, if reasonably quantifiable:

The Working Group notes that all publicly-held insurers are already required to maintain an internal audit function through stock exchange listing requirements. In addition, it is a standard industry best practice for large insurers to maintain internal audit functions of their own volition. Therefore, the Working Group has concluded that the costs for companies to meet the new requirements are nominal, given existing practices in this area. As far as the impact on state departments to enforce this requirement, the internal audit functions of insurers are already reviewed as part of each full-scope financial condition examination. Therefore, enforcement of the new requirement would be a simple addition to the existing work plan in this area.

Additional information:

None deemed necessary.