

MEMORANDUM

To: Financial Examiners
From: NAIC Examination Unit Staff
Date: April 30, 2020
Re: Sound Practices in Testing Overarching Prospective Risks

Exhibit V - OVERARCHING PROSPECTIVE RISK ASSESSMENT: Background

Exhibit V was created to give regulators a means of testing prospective risk during a financial exam. The testing template is similar to Exhibit K - RISK ASSESSMENT MATRIX, with simplifications to the Exhibit V testing template in recognition of the complexity of testing prospective risks.

Exhibit V Sound Practices

The sound practices presented in this document attempt to outline helpful hints and effective practices to **Apply**, as well as problematic practices to **Avoid** when testing risks on Exhibit V. These practices have been accumulated as a result of NAIC Peer Review findings and are presented in accordance with the relevant sections of the Exhibit V template.

Overarching Prospective Risk Identified

This column of Exhibit V is used for documenting overarching prospective risks that the examiner identified as a result of the knowledge and understanding of the company gained during planning.

Apply	<ul style="list-style-type: none"> • Identify risks using a brief, concise risk statement that draws attention to the underlying concern of the regulator. For example: <ul style="list-style-type: none"> ○ The company may experience rating agency downgrades, causing the company to be unable to sell its products.
Avoid	<ul style="list-style-type: none"> • Identifying risks as overly generic concerns which may lead to testing that is ineffective or nonresponsive to the underlying concerns. For example: <ul style="list-style-type: none"> ○ AM Best Rating • Burying risks within lengthy, excessive narratives. For example: <ul style="list-style-type: none"> ○ In 2013, the company’s AM Best rating was downgraded to B+ following the company’s rapid expansion of products and states of operations. In 2014... ○ It may be appropriate for regulators to provide context for the identified risk, but the context should be broken out as to not obscure the risk statement. • Testing risks on both Exhibit V and a Key Activity Matrix <ul style="list-style-type: none"> ○ It is generally expected that risks will originate on Exhibit CC and thereafter, be tested either on Exhibit V or a Key Activity Matrix (Exhibit K) and not both. Therefore, regulators should avoid the practice of placing a risk on one testing template (Exhibit V or K) and later transferring it to another testing template.

Overarching Prospective Risk Identified cont.

General observations:

- Ultimately, the main concern of an examiner is that a risk be tested. However, an ineffective risk statement may lead to confusion on the matter to be tested and is therefore an important first step towards a successful investigation.
- There may be situations in which an examiner wants both a specific concern investigated (i.e. succession planning for CEO, etc.) and a broader issue investigated as well (i.e. succession planning in general). It may be appropriate to test both issues within one underlying risk statement. However, supervising regulators should take steps to ensure that the examiner responsible for testing understands the complexity of the concerns. In other words, in the situation laid out, testing should address both how the company will find a suitable replacement for the CEO and what the company is doing to develop its succession planning in a more holistic manner.

Risk Mitigation Strategies

This column of Exhibit V is used for documenting the identified risk mitigation strategies in place at the insurer (if any) to address the prospective risk.

Apply	<ul style="list-style-type: none"> • Leverage company information to assist in identifying key risk mitigation strategies • Break up documentation into unique testable items by using numbering, paragraphs, etc.
Avoid	<ul style="list-style-type: none"> • Copying and pasting company responses without highlighting testable risk mitigation strategies or scrutinizing company responses for appropriateness <ul style="list-style-type: none"> ○ It may be appropriate to follow up if the initial responses do not directly address the identified risks

Investigate Risk Exposure

This column of Exhibit V is used for documenting the examiner’s investigation of the risk exposure. This includes testing of the mitigation strategies identified by management and, when necessary, additional independent testing to further understand or address the risk.

Apply	<ul style="list-style-type: none"> • Consider both the design and operating effectiveness of the mitigation strategies as part of the procedures performed. • Obtain corroborating evidence and documentation to
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	<p>support the procedures performed and review additional information when possible (i.e. management’s timelines, key reports, projections, business plans, etc.).</p> <ul style="list-style-type: none"> ○ Consider back testing (i.e. reviewing against past performance) if necessary ● Ensure documentation includes the regulator’s assessment of information reviewed ● Consider performing independent test procedures, such as reviewing and evaluating the company’s historical trends, stress testing of company exposures or other procedures determined necessary based on the company’s risk exposure. ● Corroborate, substantiate, and validate!
Avoid	<ul style="list-style-type: none"> ● Undertesting and/or limiting testing procedures to inquiry alone <ul style="list-style-type: none"> ○ If a risk was identified via a C-Level interview, that same interview, without added information, is unlikely to be sufficient evidence to demonstrate adequate investigation of the risk ○ If an examiner is pressed to rely on inquiry, reasonable attempts should be made to corroborate the information provided via an inquiry with another company employee

Communicate Findings to Financial Analysis

This column of Exhibit V is used for documentation of specific information to be communicated to the department analyst. Information should include specific procedures for continual monitoring, specific documents to obtain from the company, expected timelines for follow-up, and contact information.

Apply	<ul style="list-style-type: none"> ● Communicate new information obtained as a result of the examination’s investigation (i.e. management’s timelines, key reports, projections, business plans, etc.). <ul style="list-style-type: none"> ○ The examiner is generally expected to be able to share new information as a result of on moderate/significant risks.
Avoid	<ul style="list-style-type: none"> ● Providing overly simplistic recommendations to the analyst (i.e. continue monitoring underwriting results) ● Providing overly burdensome recommendations to the analyst (i.e. monitor US 10-year treasury rate changes on a daily basis)