National Association of Insurance Commissioners

To: Financial Examiners

From: NAIC Examination Unit Staff

Date: February 10, 2015

Re: Sound Practices in Utilizing Exhibit DD – Critical Risk Categories

Background

The NAIC's *Financial Condition Examiners Handbook* includes a requirement for each Critical Risk Category (CRC) listed on Exhibit DD to be addressed by at least one risk statement on a key activity matrix (or on Exhibit V). The CRCs are intended to address some of the most common and significant solvency risks (current and prospective) impacting a majority of insurers. However, if the exam team determines that a particular CRC is not applicable to the company being examined, which is not expected to be overly common, the guidance allows the examiner to pass testing by explaining the rationale for this decision in the examination planning memorandum. In these situations, the examiner should provide rationale explaining why the CRC is not applicable or why it does not represent a significant risk to the company under exam. This description is required to be included in the exam planning memo for review and approval by the Chief Examiner (or designee).

Rationale for Not Reviewing a CRC

The primary reason for not addressing a CRC during a full-scope examination should generally be based on an insurer's exposure to a particular category. If the insurer's business operations do not result in a significant exposure (currently and prospectively) to a particular CRC, then the category should not be subject to review and testing. However, such a decision should be adequately documented through use of Exhibit DD and the Exam Planning Memo. An example of such documentation is provided below:

Documentation on Exhibit DD

Risk Category	Description	Where Addressed
Valuation/ Impairment of Complex or Subjectively Valued Invested Assets	This category encompasses the valuation of particularly complex or subjectively valued investment holdings significant to the insurer, including assets that are hard-to-value, high-risk and/or subject to significant price variation, with a focus on current valuation. The likelihood of security impairment and determination of whether those impairments are other than temporary would also be an area to consider.	*Not considered applicable to this company.* *Refer to planning memo at (wp.A.1)*

Documentation in Planning Memorandum

The insurer does not hold a significant amount of assets that are considered complex or subjectively valued investment holdings. According to the Summary Investment Schedule, the insurer holds approximately 90% of its assets in U.S. Government Bonds and the remaining 10% of investments in cash, cash equivalents and short-term investments. In addition, there have been no significant changes in the composition of the portfolio during the examination period (see planning analytics at A.3.15 and input from analyst at A.2.1). Therefore, the Critical Risk Category for Valuation/Impairment of Complex or Subjectively Valued Investments is not considered applicable based on the types of investments held at this company.

Issues to Avoid in Utilizing Exhibit DD

Through recent sessions of the NAIC Exam Peer Review Project, some best practices regarding issues to avoid in utilizing Exhibit DD have been identified. These best practices are discussed below:

1. **Inappropriate Rationale for Not Reviewing a CRC** – As discussed above, the primary rationale for not reviewing risks within a critical risk category during a full-scope examination is expected to be based on the insurer's lack of exposure to that particular category of risks. Other reasons for not identifying and testing risks within a particular critical risk category would not typically be appropriate. For example, the following are inappropriate reasons to avoid addressing a particular critical risk category, if the insurer is exposed to significant risks in that area:

    a. **Risks Are Addressed Through the Audit Processes –** Certain CRCs may often be covered by external/internal audit testing (e.g. Valuation of Invested Assets, Reinsurance Reporting, Reserve Data, and Reserve Adequacy). While testing and documentation from audit sources may be useful in addressing risks associated with CRCs, the existence of such work is not appropriate rationale to explain why a particular CRC will not be reviewed. In these situations, risks relating to a CRC should be place on the appropriate matrix (or Exhibit V) and CPA work brought into the file to support testing procedures performed in Phases 3 and 5.

    b. **Specific Controls/Mitigation Strategies are in Place to Address Risks –** Certain CRCs may often be largely mitigated by specific controls an insurer has put in place to address risks in that area. For example, an insurer may outsource the valuation and reporting of its investments to a third-party whose services are covered by a SOC 1 Report. However, the existence of specific controls is not seen as appropriate rationale for not reviewing a particular CRC. In these situations, risks relating to the CRC should be placed on the appropriate risk matrix (or Exhibit V) and mitigating controls should be identified, tested and assessed through the existing exam processes (i.e. Phase 3) to address the risks identified.

2. **Failure to Consider the Prospective Nature of Certain CRCs** – While several of the CRCs are primarily related to current financial reporting risks, several of the CRCs have a significant prospective element that requires consideration (e.g. Investment Strategy, Adequacy of Reinsurance, Underwriting and Pricing Strategy, etc.). In general, it is less likely for insurers to avoid exposure to these CRCs as the risks often extend beyond current holdings or transactions. For example, although a company's current investment portfolio may be very conservative, the company could still be exposed to significant long-term risks relating to its investment practices. Therefore, addressing risks related to this CRC would allow the exam team to determine if the company has a solid investment strategy/policy and controls in place to address prospective risks in this area.

3. **Failure to Document Rationale in the Exam Planning Memo** – As the decision of whether to identify and address risks related to a particular CRC is deemed significant, Handbook guidance requires such a decision to be subject to supervisor and Chief Examiner (or designee) review. Therefore, a general explanation of why certain CRCs will not be reviewed during the exam is required to be included in the Exam Planning Memo (EPM). If the documented rationale is only included on Exhibit DD and not reflected in the EPM, the exam team would not be meeting expectations in this area. In certain situations, it may be appropriate to present a brief explanation in the EPM, with a link to Exhibit DD for further explanation and rationale.