WINTER 2014
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THE NEWSLETTER OF THE BDO INSURANCE PRACTICE

INSURANCE ADVISOR

KEY QUESTIONS BOARD MEMBERS SHOULD ASK ABOUT RISK MANAGEMENT

By Richard Bertuglia and John Green

Recently, the audit committee chair of a client inquired, "are we (the board) asking the right questions?" Given the increased scrutiny of regulators and the emphasis on risk management and capital adequacy in the insurance industry, it is imperative that members of boards of directors become familiar with risk management programs and ask appropriate questions to meet their fiduciary obligations. The potential impact of certain events on the company's financial position and the sufficiency of capital are key issues that should be understood by board members.

Insurance regulators have greatly increased their focus on the quality and sufficiency of capital in the insurance industry in the wake of the financial crisis and the occurrence of several major catastrophes throughout the world. Under Dodd-Frank, several insurance companies (Prudential and AIG to name two) have been designated as Systemically Important Financial Institutions (SIFI) and now face both state and federal regulation. In 2015, all insurance companies with written premiums greater than $500 million will be required to prepare an Own Risk and Stability Assessment (ORSA) that must be submitted to the domiciliary regulator.

These increased regulatory initiatives have raised the bar on risk management practices in the industry. The existing governance structure and board communications may need to be adjusted to meet the increased

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According to ***Accenture***, nearly 90 percent of North American insurers will invest in their underwriting function over the next three years.

A ***CEB TowerGroup Insurance*** survey found that most customers prefer to use and research insurance products online, but opt for more traditional channels like phone calls and in-person meetings for purchases and customer support.

According to a ***Guy Carpenter*** survey of executives at the 2013 PCI Annual Meeting, one third of respondents believe that the biggest opportunity to grow their business in 2014 will be through geographic expansion, followed by new products (24 percent) and new distribution channels (23 percent).

Trade association ***TVB*** reports that health insurers are slated to spend more than $500 million on local television ads in 2014, up from $216 million in 2012.

According to ***Moody's 2014 Global P&C Insurance Outlook***, property/casualty insurance premiums will grow at low- to mid-single-digit rates in North America and Europe and high-single-digit or double-digit rates in Asia and Latin America in the coming year.

According to ***A.M. Best***, the primary cause for insolvencies of P&C insurance companies continues to be inadequate loss reserves.

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RISK MANAGEMENT

demands of the regulators and protect the interests of stockholders and policyholders. In response to this new environment, insurance companies have developed, or enhanced, Enterprise Risk Management (ERM) programs. Members of boards of directors need to be aware of the implications of ERM programs and be prepared to ask relevant and probing questions of management.

▶RISK MANAGEMENT BASICS

There are five major categories of risk that companies must address as follows:

- **Credit Risk** – counterparty credit exposure from all potential creditors including agents, reinsurers and bondholders
- **Market Risk** – financial exposure to volatility of markets, interest rates, foreign exchange rates, commodity prices and mismatches of assets and liabilities
- **Underwriting Risk** – pricing, product development, reserving and claims management, actuarial, mortality and morbidity, lapse rates, renewal rates, persistency, loss trends and legal rulings
- **Operational Risks** – competency of management, management changes, fraud, data capture, security and integrity, employee retention and reputation
- **Strategic Risk** – adverse business decisions, lack of execution of business plan, failure to respond to industry changes, competitive disadvantage

The standard responses to risk, whether real or perceived, are to:

- Avoid or eliminate the risk
- Transfer the risk through insurance, reinsurance or other means
- Reduce or mitigate the potential impact of risk
- Accept the risk

▶ERM BASICS

ERM is an ongoing process that should identify all risks that apply to the organization; quantify the risk in dollar terms; monitor risk in relation to financial position, results of operations and cash flows; and implement policies and procedures to manage risk. Often, ERM is assigned to a particular member of management such as the chief actuary, chief financial officer or risk officer. Some companies have established a risk committee. Ideally, ERM should be incorporated into a company's core operations with risk/return metrics embedded into the business processes such as financial planning, budgeting, strategic initiatives, operating results, and backup and disaster recovery planning. The most effective ERM would incorporate a top-down approach whereby employees at every level are responsible for risk management.

Because of the level of complexity associated with the insurance industry, quantifying risk is largely driven by models which apply various assumptions to a company's financial operations. ERM can be driven by the balance sheet or various other metrics such as Value at Risk (VAR). As evidenced in the aftermath of Superstorm Sandy, even the most detailed models can often yield results that differ greatly from actual events.

▶THE ROLE OF BOARD MEMBERS IN RISK MANAGEMENT

The approach to ERM will vary from company to company depending on individual circumstances. A newly formed insurance company may be willing to accept more risk in order to achieve more rapid growth, enabling faster returns to stockholders. Conversely, established companies, especially mutual companies, will likely take a more conservative approach to ERM in order to preserve capital and protect the interests of stockholders and policyholders.

Boards of directors have a dual mandate to serve the company in an advisory and oversight capacity and represent the interests of the stockholders and policyholders. The oversight of risk management practices clearly falls into the responsibility of the board of directors as there could be material consequences to the company if risk management practices prove to be insufficient. Boards of directors need to incorporate the review and oversight of the company's ERM into the regular board agenda and require regular and detailed reports from management. Some best practices for boards of directors include:

- **Tone at the top** – boards must ensure that senior management takes ERM seriously and has instituted the desired approach and behaviors to risk management throughout the organization.
- **Alignment** – ensure that the company's compensation system is aligned with sound risk management policies and procedures.
- **Risk appetite and risk tolerance** – review the ways in which risk is measured on an aggregate, companywide basis, the setting of aggregate and individual risk limits.
- **Risk transfer and mitigation** – review the company's plans including reinsurance, hedging and risk limits.
- **Review with management the categories** of risk the company faces, including any risk concentrations and related party risk or other interrelationships.
- **Review with management the assumptions and analysis** that support the company's risk models and whether adequate procedures are in place to ensure that new or materially changed risks are properly and promptly identified, understood and properly incorporated into the models.
- **Review with committees and management the board's expectations** as to each group's respective responsibilities for risk oversight and management of specific risks to ensure a shared understanding as to accountabilities and roles.
- **Review the risk policies and procedures adopted by management**, including procedures for reporting matters to the board and appropriate committees and providing timely updates.

Once a company establishes an ERM framework, including the appropriate communications between management and the board of directors, there should be ongoing dialogue between the board and management. In order to ensure that ERM is functioning as intended, the board should be prepared to ask appropriate questions. Examples of some of the questions are as follows:

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- **Has/have the model(s) been stressed sufficiently?**
  – For example, what happens if interest rates double in the next two years?
  – What impact could be expected if unemployment spikes to 12 percent?
  – How will the company cope with an extended power outage at one or more locations?

- **Is management reasonably comfortable with the range of possible outcomes?**
  – Are there any risk factors not addressed?
  – Is there a succession in the event one or more key members of management unexpectedly pass away, become ill or leave the company?
  – Have all members of management weighed in on the risk plan? Were there any differences of opinion? If so, how were the issues addressed?

- **Does the company have sufficient capital to remain in business after a particular event has occurred?**
  – How large a loss can the company withstand before regulatory oversight?
  – Is there sufficient reinsurance in place?
  – Should capital be required immediately; are there contingent plans in place?
  – Is there sufficient liquidity to pay claims if there is a sudden natural disaster or other catastrophe?

In some cases, board members may not feel they have sufficient expertise to assess whether the company's risk management practices are sufficient or whether management's responses to board inquiries are appropriate. In these circumstances, the board should consider hiring outside experts to review the risk management plan and provide guidance on the proper advisory and oversight practices of the board, including the appropriate board inquiries.

For more information, please contact Richard Bertuglia, Assurance Partner at rbertuglia@bdo.com or John Green, Assurance Partner at jgreen@bdo.com.

UNDERSTANDING LOSS RESERVE DEFICIENCIES

By Corwin Zass, Principal & Consulting Actuary at ARM, and Dale Ogden, Principal & Consulting Actuary at DFO

At the macro level across the insurance spectrum, all insurance companies, from life to health to casualty, face a similar dilemma: they must learn from their past, they must assess their impact in today's environment and, finally, they must be able to predict their effects well into the future (which, depending on products and guarantees might be two months to 50 years). While no one person can predict the future, understanding the "what-ifs," underpinned by a solid risk management regimen, can go a long way in preventing an insurance company from insolvency.

According to *AM Best*, the primary (recurring) cause for insolvencies of p&c insurance companies continues to be inadequate loss reserves. While it is not always easy to understand what causes these types of failures, the question remains as to whether we should expect a company to act differently if its management knew these failures typically occur in the following scenarios: when the company consistently takes an aggressive reserve development stance; when the company uses an internal actuary versus enlisting a consultant to compute its reserves; or following significant changes in the company's underwriting philosophy or claims management process.

It helps for a company to engrain, from the board level down, a proactive philosophy with respect to the complete underwriting-claims cycle. While a focus on only the claims does not necessarily cover all major risk exposures, it does provide the biggest "bang for the buck." Companies that exhibit more stable reserves tend to be those that delve deeper into claim causes to see if there are any hidden trends (e.g., effects of tort issues, legal reforms, health cost increases and changing social attitudes).

Additionally, supplemental external reviews can inject a dose of healthy skepticism. Receiving external feedback through a peer review that the underlying methods, assumptions and approaches taken by a company *make sense*, appear defendable and rational (versus the industry) can be very valuable for insurers. If the last several years have shown us anything, it is that complacency is like the plague and events that may have appeared as anomalies are in reality the new norm.

The adage of "keep your friends close, but your enemies closer" also proves true for the insurance market. One area that influences a company's claims experience is how it stacks up against its competitors. With the technology gains of the last decade, it is relatively easy to access a plethora of information from the industry, including competitive intelligence. One can analyze others in the marketplace by reviewing

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LOSS RESERVE DEFICIENCIES

public financial results or listening in on management discussions during earnings calls, any of which might identify clues that help a company manage its own business.

Insurance companies should also assess its reinsurance levels to determine whether these safety nets adequately reflect existing liabilities within the organization and more importantly whether these treaties protect against ruin. Tangentially, tremendous insight is found by reviewing reserves from a random scenario view. Such stochastic views will soon become the new norm so a prudent first step has companies considering these techniques now. These forms of analytics simply enhance a company's ability to mitigate reserve deficiencies by identifying, as an example, a systemic methodology problem that shows reserve deficiencies occurred even though management picked within an actuary's range of estimates.

While somewhat cynical, companies might also consider the existence of implicit bias in the derivation of the reserves since neither an external consultant nor an internal actuary really wants to deliver to management news that liabilities must be higher. For companies struggling with volatile earnings and that are trying to stay under the regulator's radar and the like, obtaining an independent "second set of eyes" certainly is a value-add and should pay off in the near future.

In closing, while the above methods of proactive claims and loss reserving management may not enable you to predict the winning numbers of tomorrow's lottery, as stewards of global risks, the best offense sometimes is a better defense.

Learn more by contacting the BDO Alliance actuarial firm, Actuarial Risk Management, at info@actrisk.com

This article's views and comments are those of Corwin Zass, Principal & Consulting Actuary, ARM, and Dale Ogden, Principal & Consulting Actuary of DFO, who currently is the Chair of the American Academy of Actuaries' Committee on Property Liability Financial Reporting ("COPLFR").

SIGNIFICANT ACCOUNTING AND REPORTING HIGHLIGHTS FROM THE NAIC FALL 2013 NATIONAL MEETING

By Barb Woltjer

Affordable Care Act Section 9010 Assessment: The question of appropriate timing for recognition of a liability with respect to the fee payable under Section 9010 of the Federal Affordable Care Act (ACA) was the center of controversy during the Accounting Practices and Procedures Task Force (Task Force) session at the National Association of Insurance Commissioners (NAIC) Fall 2013 meeting, which took place Dec. 15-18 in Washington, D.C. Under the ACA, health insurance entities will be required to pay a health insurance assessment. The assessment will be due in September 2014 (fee year) but will be based upon 2013 written premium data (data year). During the NAIC meeting, Task Force members argued that the liability and expense should be reflected in the data year rather than when the assessment is due, and requested that NAIC staff redraft revisions to the *Statement of Statutory Accounting Principles (SSAP) No. 35R—Guaranty Fund and Other Assessments and Issue Paper No. 148, Affordable Care Act Section 9010 Assessment.* Ultimately, the Financial Condition Committee rejected the argument and adopted the revisions to the guidance as previously accepted by the Statutory Accounting Working Group. The adopted revisions to SSAP No. 35R include guidance to recognize the liability and expense on Jan. 1 of the fee year. The adopted Issue Paper No. 148 included an analysis of the adopted guidance under the Statutory Accounting Statement of Concepts, as well as dissenting opinions.

SSAP No. 104R—Share-Based Payments: The Task Force adopted revisions, with modification, to the generally accepted accounting principles (GAAP) guidance, as reflected in Accounting Standards Codification 505-50–Equity Payments to Non-Employees, with a Dec. 31, 2014 effective date.

SSAP No. 105—Working Capital Finance Investments: The Task Force adopted a new SSAP, SSAP No. 105—Working Capital Finance Investments, with an effective date of Jan. 1, 2014. SSAP No. 105 allows working capital finance investments to be admitted assets if certain criteria are met. This action also included adoption of Issue Paper No. 147, Working Capital Finance Investments.

Other Significant Highlights

- The Executive Committee and Plenary (Committee) adopted model law development requests for amendments to the *Actuarial Opinion and Memorandum Regulation* and will consider making it a requirement for an appointed actuary to present the Actuarial Opinion and Memorandum to the board of directors annually. Additionally, the Committee will consider modifications to enhance the Actuarial Opinion and Memorandum's usefulness as a regulatory tool by making its information more accessible.

- The Committee adopted the *U.S. National State-Based System of Insurance Financial Regulation and the Solvency Modernization Initiative* white paper.

- The Committee adopted a one-year exposure period for the *Risk Management and Own Risk Solvency Assessment Model Act* (#505) for accreditation purposes.

- The Committee adopted the approval of four international supervisory authorities as Conditional Qualified Jurisdictions under the *Process for Developing and Maintaining the NAIC List of Qualified Jurisdictions.* The four jurisdictions are the Bermuda Monetary Authority (BMA); the German Federal Financial Supervisory Authority (BaFin); the Swiss Financial Market Supervisory Authority (FINMA); and the United Kingdom's Prudential Regulation Authority of the Bank of England (PRA)

For more information, please contact Barb Woltjer, Assurance Partner at bwoltjer@bdo.com.

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PErspective in Insurance

With steady cash flow and low capital expenditure, the insurance sector continues to be an attractive area for private equity investment. Recently, private equity firms are taking a particular interest in the automotive insurance industry. According to Pitchbook, since the beginning of 2012, 15 auto insurance companies have received private equity investment, nearly doubling the amount of capital invested in this sector from 2008 to 2011.

Specifically within the automotive insurance sector, private equity is narrowing in on a niche market: the automobile claims software market. These companies provide automobile-claims processing solutions to the insurance and collision repair sectors.

Private equity's interest in this sector comes at a time when these companies face a somewhat uncertain future given the fact that the auto collision repair market is consolidating. With fewer motorists on the roads, accident-avoidance technology such as backup cameras increasingly being installed in new vehicles and higher deductibles on auto policies -- the industry is noting a decrease in the number of reported claims. These firms may be looking to develop new strategies, expand geographically and into other areas of software insurance.

Additionally, there are only a few companies inhabiting this space, so the leaders in this market have dominant market positions with few competitors. And, these companies typically report predictable earnings, making it relatively easy for private equity to leverage up its investment.

Finally, private equity's interest in this sector is not surprising given that it has a hold on the insurance software market as a whole - an industry that has been growing in recent years due to advances in technology that permit significant electronic management and communication with customers, agents, underwriters and others.

PErspective in Insurance is a feature examining the role of private equity in the insurance industry.

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JANUARY

January 21-23
The 4th Annual Forum on AML & OFAC Compliance for the Insurance Industry
The Carlton Hotel
New York, N.Y.

FEBRUARY

February 2-5
ABA Insurance Risk Management Annual Forum
Hilton La Jolla Torrey Pines
San Diego, Calif.

February 24-26
2014 NAHU Capitol Conference
Hyatt Regency on Capitol Hill
Washington, D.C.

February 27
Insurance Summit 2014, Presented by The Economist
The Dorchester
London, United Kingdom

MARCH

March 5-6
2014 AHIP National Policy Forum
Ritz-Carlton Washington
Washington, D.C.

March 16-19
Claims Conference & Insurance Expo
Indiana Convention Center
Indianapolis, Ind.

March 17-21
The 3rd Annual RiskMinds Insurance
Hotel Okura
Amsterdam, Netherlands

March 26-28
2014 LIMRA Regulatory Compliance Exchange
Hotel Monteleone
New Orleans, La.

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