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INSURANCE ADVISOR

WHAT IS ENTERPRISE RISK MANAGEMENT?

By Vadim Alayev

Since the credit crunch and financial crisis of 2008, a renewed interest in risk management for companies has emerged. Prior to 2008, safety nets were bluntly ignored as companies took on more risk to increase upside profit potential, which coincided with the booming economy. Times have changed, however. Today, few would question the value of Enterprise Risk Management (ERM) – its idea is essential for the survival of every business. But in order to have an effective ERM system, it is important to understand both what it represents and what it involves.

What is "Enterprise Risk Management?"

ERM has been a buzz phrase throughout the past decade, but what is often misunderstood is how it is distinct from the narrower term "risk management." The term "enterprise," for instance, does not merely refer to the "entity," but rather represents something that is "collective" or "integrated." "Risk management" encompasses "pure" risks with only downside potential; often these are insurable risks, such as risks of loss from a catastrophe or a liability exposure. Risk management essentially means the formulation of strategy to address a limited set of pure risks. Insurance companies play a fundamental role in insuring these risks.

It is recognized that risk can be transferred via insurance, retained, reduced or avoided. Insurance provides one source of financing to pay for possible losses, but losses can also be paid from an entity's existing resources, by borrowing or from additional equity issuance. In other words, uninsured, potential losses can be financed via internal funding mechanisms.

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▶DID YOU KNOW...

Big data is becoming increasingly important to property & casualty (P&C) insurers. This year, twice as many large P&C insurers are planning to pilot big data technology tools compared to last year, according to ***Novarica***.

BDO was recently named among the top P&C, life and health audit firms by ***Best's Review***.

According to the ***Census Bureau***, in 2012 54.9 percent of Americans received health insurance under an employee-sponsored plan.

According to ***Moody's Investor Service***, U.S. commercial P&C rates should continue to increase for the remainder of the year, marking the third consecutive year of higher rates for commercial insurers.

Health insurance exchanges are expected to enroll 7 million Americans in the first year, according to ***The Wall Street Journal***.

Sixty-two percent of all people in the United States were covered by some type of life insurance in 2013, according to ***LIMRA's 2013 Insurance Barometer Study***.

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ENTERPRISE RISK MANAGEMENT

These risks are in control of the entity, where management can set up appropriate measures of internal control and can influence the probability of its occurrence. By investing in safety and internal quality control, including disaster recovery programs to back up operational and financial information, the entity can reduce the expected value and volatility of its losses.

There is little recognition that the tools of corporate finance can be used as a framework to expand risk management strategy beyond coverage of a pure risk. Yet, any company with investors must show both stable financial results and a proven potential for long-term growth, so it is imperative to identify and evaluate all of the potential risks that could be faced – including operational, financial, insurable and business risks.

Where risk comes from is of secondary importance. Rather, what must be recognized is that the contributions of each source of risk cannot be isolated. Risk does not simply "add up." One risk can be negated by the results of another, or can be amplified by external events to double the impact. Much like in a modern portfolio theory, some of the risks can be naturally reduced or diversified away if two risks are uncorrelated or negatively correlated but considered jointly. As long as units of risk are not perfectly correlated, there will always be some risk reduction. Thus, when all the exposure units of risk are considered collectively, diversification effectively reduces the total risk faced by the entity. Therefore, the job of the entity management and its risk management department is to identify all risks and measure them *collectively*. This is ERM.

Committee of Sponsoring Organizations of the Treadway Commission (COSO)

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) recognized a need for a robust framework to effectively identify, assess and manage risk for each enterprise. In 2004, COSO, through its *Enterprise Risk Management – Integrated Framework*, defined ERM as: "a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives."

Then, in May 2013, COSO issued an updated *Internal Control – Integrated Framework*, which is meant not to supersede, but to complement, its *ERM Framework*. The update expands on internal control, providing a more robust and extensive focus on the broader subject of enterprise risk management. COSO's *ERM Framework* remains viable and suitable for designing, implementing, conducting and assessing ERM.

Own Risk and Solvency Assessment (ORSA)

In addition to having robust internal controls, an insurance company must also ensure and be able to demonstrate to the public that it has proper liquidity and capitalization to pay the claims when they come due. Recognizing the need for a standardized and transparent enterprise risk reporting process, U.S. insurance regulators began to modify their supervisory framework. In 2008, the National Association of Insurance Commissioners (NAIC) launched the Solvency Modernization Initiative (SMI). SMI focuses on key issues such as capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting, and reinsurance. As part of the SMI, the NAIC re-evaluated risk-based capital (RBC) in the United States and determined that RBC will continue to form the backstop function for insurer solvency. However, it was decided that additional assessments would be necessary to complement RBC and, promoted by the International Association of Insurance Supervisors (IAIS), NAIC adopted a version of Solvency II directive of Own Risk and Solvency Assessment (ORSA). Thus, in September of 2012, NAIC enacted its own version of ORSA titled, "Risk Management and Own Risk and Solvency Assessment."

The purpose of the Risk Management and Own Risk and Solvency Assessment Model Act is to provide the requirements for maintaining a risk management framework, to complete an Own Risk and Solvency Assessment, and to provide guidance and instructions for filling out an ORSA Summary Report with the insurance commissioner of each state. A risk management framework assists the insurer with identifying, assessing, monitoring, managing and reporting its material and relevant risks. This requirement may be satisfied if the insurer's insurance group maintains a risk management framework applicable to its operations.

In general, ORSA is an internal process undertaken by an insurer to assess the adequacy of its risk management and solvency positions. ORSA will require insurers to analyze all reasonably foreseeable and relevant material risks (i.e., underwriting, credit, market, operational, liquidity risks, etc.) that could have an impact on an insurer's ability to meet its policyholder obligations. This framework was adopted in order to ensure insurance entities' solvency by setting minimum capital and surplus requirements to operate and write a particular coverage for a premium. It is expected that ORSA will apply to any individual U.S. insurer that writes more than $500 million of annual direct written and assumed premiums, and/or insurance groups that collectively write more than $1 billion of annual direct written and assumed premiums. It's also anticipated that each state will adopt risk-management and ORSA requirements into state law prior to 2015.

Use of Derivatives

Insurance, risk avoidance and reduction are not the only risk management strategies. With the rapid financial innovation and growth of financial derivatives, a host of other hedging strategies are available to an entity's management. For example, an insurer's exposure to interest risk could be hedged with a range of interest rate derivative instruments such as forwards, futures, swaps and caps. For a life insurance company, an asset-liability duration mismatch can be managed by swaps and options. A counterparty risk in a transaction can be managed by credit default swaps. The consideration of all available insurance and finance tools ensures that a company's risk management is truly integrated.

Risk Management Costs

Strategies for ERM can cost little or nothing; setting up adequate internal controls can be

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accomplished along with the routine setup of the process flows. For example, entering into a forward or futures contract to lock in the future price volatility for disposition of an asset or sale of a product will not require any investment. But other strategies can be more complex, requiring extensive modeling, and as such are likely to be more costly.

Likewise, as the demand for risk management tools increases, additional investment by companies is expected. According to CFO.com, for example, average corporate expenses for insurance rose by 5 percent in 2012, fueling a jump in the overall cost of risk. The 5 percent hike in risk management costs in 2012 came on top of a 1.7 percent uptick in 2011, the first increase after a few years of decreasing risk management costs. Nonetheless, the benefit of having a comprehensive risk management program outweighs the cost of exposure to the myriad number of risks faced by companies every day. It is prudent for an enterprise to concentrate on its core products and what it does best, insulating itself from the unnecessary distractions in the form of price volatility, credit risk, litigation, etc. But, depending on the risk tolerance of the entity, some residual risk can augment the financial results from operations. These retained risks need to be identified, measured and monitored.

Without a doubt, risk awareness has been one of the hottest topics over the past few years. While perceptions range from ERM as a complex exercise in high-level economic capital modeling to tactical in nature, ERM at its core is a process that allows businesses and executives the ability to strategically manage their operation and the allocation of capital. Through this process, internal and external risks can be appreciated and understood in the context of the drivers of those risks, while demonstrating resilience to external factors. After all, stability and guaranteed long-term viability of an insurance company are what drive us all to trust the industry to manage our own risk.

For more information, please contact Vadim Alayev, Audit Senior Manager, at valayev@bdo.com.

KEY CHANGES TO FASB'S PROPOSED ACCOUNTING STANDARDS UPDATE FOR INSURANCE CONTRACTS

By Barb Woltjer

In an effort to improve the financial reporting guidance for insurance contracts, on June 27, 2013, the Financial Accounting Standards Board (FASB) released for public comment a proposed Accounting Standards Update (ASU), *Insurance Contracts (Topic 834)*. The proposed guidance would apply to all contracts that meet the definition of an insurance contract, not just those written by insurance companies.

The proposed standard is a result of an ongoing joint project with the International Accounting Standards Board (IASB), with the goal of developing converged comprehensive guidance addressing recognition, measurement, presentation and disclosure for insurance contracts. The IASB recently released a revised exposure draft of international proposed standards and, although the standards are not yet in full convergence, the gap between U.S. and international standards appears to be narrowing. Public comments on both proposals are due Oct. 25.

Key changes proposed by the FASB include:

▶SCOPE

The guidance would require that all contracts that transfer significant insurance risk be accounted for in a similar manner, regardless of the type of entity issuing the contracts.

▶TWO MEASUREMENT MODELS

The proposed ASU would require an entity to apply one of two measurement models based on the characteristics of the insurance contracts at the date of inception of the contract. The premium allocation approach would be applied if the coverage period of an insurance contract is one year or less, or at contract inception if it is unlikely that during the period before a claim is incurred there will be significant variability in the expected value of the net cash flows required to fulfill the contract. This approach would apply to most property, liability and short-term health contracts, as well as some guarantee and service contracts. The building block approach would be applied to all other contracts, which would primarily consist of life, annuity, and long-term health and disability contracts.

▶DISCOUNTING CASH FLOWS

The guidance would require an entity to measure the present value of expected cash flows that arise from insurance contracts (the net of all cash inflows and outflows) and to update assumptions each reporting period to reflect all available information for contracts that will be measured using the building block approach. The measurement would also include a margin that initially reflects the expected profitability of the contract. Current guidance results in "locked-in" assumptions that may not appropriately reflect the current estimation of an entity's rights and obligations that relate to the fulfillment of insurance contracts.

▶LIABILITY FOR INCURRED CLAIMS

For contracts measured using the premium allocation approach, the proposed guidance would require an entity to measure the liability for incurred claims as the probability-weighted expected amount of cash outflows and to reflect the time value of money (discounting). It is the view of the FASB that requiring discounting of the liability for incurred claims, where material, would more accurately reflect the value of the insurance liability, especially in circumstances in which the expected claims settlement (payment) period extends for many years. In addition, a probability-weighted expected value for the liability for incurred claims would eliminate estimation bias that currently exists in the "best estimate" methodology.

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NAIC SUMMER MEETING UPDATES

By Richard Bertuglia

THE NATIONAL ASSOCIATION OF INSURANCE COMPANIES (NAIC) HELD ITS 2013 SUMMER NATIONAL MEETING THIS AUGUST IN INDIANAPOLIS.

While there was no adoption of statutory accounting principles during this meeting, most discussion was centered on several exposed revisions concerning the accounting of fees paid to the federal government.

We have highlighted the adopted non-substantive and exposed substantive statutory accounting revisions below:

Fees Payable to the Federal Government by Health Insurers:

The Statutory Accounting Principles Working Group (SAPWG), which is responsible for developing and proposing new Statements of Statutory Accounting Principles (SSAPs), exposed substantive revisions to SSAP No. 35R-Revised-Guaranty Fund and Other Assessments (SSAP No. 35R). The revisions proposed to adopt, with modification, the Accounting Standards Update (ASU) No. 2011-06-Fees Paid to the Federal Government by Health Insurers (ASU 2011-06), and to recognize the liability the year the fee is paid.

The Patient Protection and Affordability Act will impose an annual fee on health insurers for each calendar year beginning on or after Jan. 1, 2014. A health insurer's portion of the annual fee is payable no later than Sept. 30 of the applicable calendar year and is not tax- deductible. The annual fee for the health insurance industry will be allocated to individual health insurers based on the ratio of the amount of an entity's net premiums written during the preceding calendar year (the data year) to the amount of health insurance for any U.S. health risk that is written during the preceding calendar year. A health insurance entity's portion of the annual fee becomes payable to the U.S. Treasury once the entity provides health insurance for any U.S. health risk for each calendar year beginning on or after Jan. 1, 2014.

ASU 2011-06 specifies that the liability for the fee should be estimated and recorded in full once the entity provides qualifying health insurance in the applicable calendar year in which the fee is payable (the fee year). This includes a corresponding deferred cost that is amortized to expense using a straight-line method of allocation, unless another method better allocates the fee over the calendar year that it is payable. Additionally, the fee would not meet the definition of an acquisition cost. The proposed statutory modifications also include the fact that they do not admit the deferred expense, and they segregate surplus in the data year for the amount payable in the fee year.

The proposed revisions to SSAP No. 35R will come into effect on Jan. 1, 2014, a day after the fee's effective date. A subsequent event disclosure regarding fees payable in 2014 will be required for the year ending Dec. 31, 2013. The public comment period for the exposure draft ends Oct. 10, 2013.

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FASB'S PROPOSED ACCOUNTING STANDARDS UPDATE

▶REVENUE RECOGNITION

Revenue will be allocated to periods in proportion to the value of coverage provided and other services performed in fulfilling the insurance obligation. For contracts accounted for under the premium allocation approach, a liability for unearned premium would be established and accreted into earnings on the basis of the expected timing of incurred claims and benefits (similar to the current approach). For contracts that are accounted for under the building block approach, revenue will be attributable to future periods based on an expected margin over the coverage and settlement period as the entity is released from exposure to risk. This may result in significant variation from the current practice of recognizing revenue based on the contractual due date for long-duration contracts.

▶UNDERWRITING PROFIT PRESENTATION

Under both approaches, changes in an insurer's estimate of expected cash flows would be recorded to net income, except for the effect of changes in the discount rates on the expected cash flows which would be recorded as other comprehensive income. Claims and contract-related expenses would be recognized when incurred. Any cash flows received that are expected to be returned to the policyholder or the policyholder's beneficiary, regardless of whether an insured event occurs, would be excluded from revenue and expenses (similar to the current deposit accounting concept).

Under the guidance in this proposed ASU, an explicit margin for contracts accounted for under the building block approach would be presented in the financial statements. That is in contrast to current practice, in which the margin is implicitly included as part of the insurance contract liabilities for contracts accounted for under the long-duration model. It is expected that this disaggregation of estimated future net cash flows and the remaining deferred profit should provide further transparency into the liability measurement and an entity's expected profit.

▶EFFECTIVE DATE

Anticipated to be no earlier than 2018, the FASB will establish the effective date of the requirements when it issues the final amendments. The effective date for nonpublic entities would likely be a minimum of one year after the effective date for public entities.

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

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NAIC SUMMER MEETING

Adopted Non-Substantive Revisions to Statutory Accounting:

a. ***Statement of Statutory Accounting Principles (SSAP) No. 40—Real Estate Investments:*** Revisions clarify the definition of "encumbrances."

b. ***SSAP No. 43R—Loan-Backed and Structured Securities:*** Revisions incorporate guidance for interim financial statements for residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) acquired subsequent to year-end.

c. ***SSAP No. 62R—Property and Casualty Reinsurance:*** Revisions included changing the Schedule F reporting and the provision for reinsurance calculation for certain retroactive reinsurance contracts on asbestos and environmental risks with a 2014 effective date. The SAPWG also directed staff to prepare the blanks proposal for Working Group review.

d. ***SSAP No. 64—Offsetting and Netting of Assets and Liabilities, SSAP No. 86—Accounting for Derivatives and Hedging Activities, SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities:*** Revisions reject ***ASU 2013-01: Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities***, and incorporate guidance clarifying derivatives, repurchase and reverse repurchase agreements. Securities borrowing and lending transactions can be reported net on the balance sheet when a valid right to offset exists, and adds disclosures to illustrate the netting impact. The revisions do not change the gross reporting requirements for specific schedules (e.g., Schedule DB). This action includes a referral to the Blanks (E) Working Group for annual statement instruction revisions and recommends development of additional schedules to reconcile the amount reported gross on Schedule DB to the amount reported net on the balance sheet.

e. ***SSAP No. 92—Accounting for Postretirement Benefits Other than Pension, A Replacement of SSAP No. 14:*** Revisions adopt with modification ***EITF 06-04, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements***, which specifies that endorsement split-dollar life insurance contracts do not settle the liability for post-retirement benefit obligations.

f. ***SSAP No. 100—Fair Value Measurements:*** Revisions reject A***SU 2013-03, Financial Instruments: Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities*** for statutory accounting.

g. ***Issue Paper No. 99—Nonapplicable GAAP Pronouncements (Issue Paper No. 99):*** Revisions identify ***ASU 2013-02, Comprehensive Income – Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*** as not applicable for statutory accounting.

Exposed Substantive Revisions to Statutory Accounting:

a. ***SSAP No. 35R—Guaranty Fund and Other Assessments:*** Revisions propose guidance to prescribe the process for recognizing a liability and corresponding expense for the Section 9010 assessment under the Federal Affordable Care Act (ACA) for years 2014 and after. This guidance proposes to adopt, with modification, ***ASU 2011-06, Fees Paid to the Federal Government by Health Insurers***. ASU 2011-06 recognizes the liability in the year the fee is paid. The modifications propose to: 1) nonadmit the deferred expense; and 2) segregate surplus in the data year for the amount payable in the fee year. The Working Group directed NAIC staff to prepare and release for discussion, as soon as possible, an analysis of how the exposed SSAP No. 35R aligns

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PErspective in Insurance

Private equity deal activity in the insurance industry faced a number of hurdles this summer as the New York Department of Financial Services (DFS) sought to constrict the ability for private equity funds to invest in the insurance sector, instigating a national debate on the issue.

In the last year, numerous private equity funds have been buyers of annuities businesses that insurance companies have been enthusiastic to sell in order to manage the underlying assets. According to *Insurance News Net*, as of July 2013, private equity-controlled insurers accounted for nearly 30 percent of the indexed annuity market, up from 7 percent the prior year.

Over the summer, the DFS launched a review of such transactions, voicing concern as to whether private equity firms are too short-term focused, at the risk of the consumer who holds the annuity. Private equity firms contest the DFS' concerns noting their deep experience in the insurance space, having operated insurance companies for decades; the quality performance of many PE-sponsored insurance companies; and the overall operational and financial enhancements funds can bring to the companies in which they invest.

To avoid further delays, private equity firms have agreed to new protections, comparable to private equity ownership of New York banking businesses, in order to secure the regulator's approval. Safeguards include holding higher risk-based capital levels, enhanced scrutiny of investments and operations, and extensive disclosure and transparency requirements.

New York's investigation has moved beyond state lines. Following the DFS's probe, the NAIC created a new working group to examine the trend of alternative asset managers investing in the annuity sector. The working group will continue to provide guidance to additional state insurance regulators monitoring these types of transactions.

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

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NAIC SUMMER MEETING

with the Statutory Accounting Principles Statement of Concepts, and then to proceed with an issue paper to document discussion of the proposed guidance, with supportive and alternative views. The issue paper will subsequently include an analysis of the exposed guidance to the Statutory Accounting Principles Statement of Concepts.

b. ***SSAP No. 104—Share-Based Payments:*** Exposed I***ssue Paper No. 146—Share-Based Payments with Non- Employees***, proposes to substantively revise SSAP No. 104 and adopt, with modification, guidance reflected in ***Accounting Standards Codification 505-50 – Equity, Equity Payments to Non-employees***.

c. ***New SSAP—Working Capital Finance Investments:*** Exposed a proposed SSAP to allow working capital finance investments to be admitted assets if specific criteria are met. This item was exposed with a shortened comment deadline ending Sept. 13.

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

MARK YOUR CALENDAR...

The following is a list of upcoming conferences and seminars of interest for insurance industry executives:

OCTOBER

Oct. 20-23
PCI Annual Meeting
Marriott Copley Place
Boston, Mass.

Oct.26-29
CPCU Society Annual Meeting
Hilton New Orleans Riverside
New Orleans, La.

Oct. 27-29
ACLI Annual Conference
New Orleans Marriott
New Orleans, La.

NOVEMBER

Nov. 18-20
AHIP Operations and Technology Forum
Hyatt Regency Chicago
Chicago, Ill.

DECEMBER

Dec. 15-18
NAIC Fall National Meeting
Washington Marriott Wardman Park
Washington, D.C.

Dec. 17-18
Annual Insurance Executive Conference
Crowne Plaza Times Square Manhattan
New York, NY.

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