

October 24, 2012

2012 Financial Services

Audit Committee Forum

Insurance



Welcome

Mike McColgan

Partner, East Region Assurance Leader, PwC

Agenda

October 24, 2012

Return to growth

2:05-3:15pm

Break

3:15-3:30pm

Risk & capital management panel

3:30-4:30pm

Key trends in internal audit best practices

4:30-5:00pm

Networking cocktail reception

5:00-6:00pm

Return to growth panel

William Chrnelich (Moderator)

Retired Partner, US Insurance Practice, PwC

Phil Bancroft

Chief Financial Officer, ACE Limited

Mike Sproule

Executive Vice President and Chief Financial Officer, New York Life Insurance Company

Keith Walsh

Analyst, Citigroup Equity Research

If current business models do not change, how do you envision the future of the insurance industry?

Polling
question 1

1. Steady growth
2. Limited growth
3. Stagnation
4. Gradual decline
5. Rapid decline

How is your organization primarily seeking to grow?

Polling
question 2

1. New customer acquisition (e.g., underserved markets)
2. More aggressive risk pricing/premium increases
3. Merger or acquisition
4. Organic expansion
5. Expansion into other lines of business (not necessarily insurance)

What does your organization view as the biggest single obstacle to growth?

Polling
question 3

1. Saturated insurance market
2. Competition from other products/services (e.g., mutual funds, equities)
3. Interest rate environment
4. Regulatory requirements
5. Shortage of qualified personnel (in the trenches and/or at senior levels)

What is your organization's view of emerging markets?

Polling
question 4

1. A promising opportunity for growth
2. A nice complement to our traditional business, but not a game changer
3. Undecided
4. Unpromising

Which of the following offers the most promise for improving organizational performance?

Polling
question 5

1. Technological/process improvements (e.g., claims/policy administration/billing systems replacement)
2. Narrower scope of product offerings (i.e., specialization)
3. New techniques to analyze customer data and underwriting risks
4. Business process co- and/or outsourcing (e.g., narrow focus on underwriting, outsourcing of other functions)

Which distribution channel will be most important to your organization's future growth?

Polling
question 6

1. Individual Agents
2. Independent Agencies
3. Direct mail
4. Web-based selling

Risk & capital management panel

Thomas Sullivan (Moderator)

Principal, Financial Services Regulatory Practice, PwC

Richard de Haan

Principal, US Insurance AIMS Practice, PwC

Thomas Leonardi

Insurance Commissioner, State of Connecticut

Stanley Talbi

Executive Vice President and Chief Risk Officer, Global Risk Management, MetLife

Agenda

- International
- Systemic risk
- SMI

How much impact do you think international risk and capital regulatory and standards-setting activity will have on your business?

Polling
question 1

1. A lot
2. Some
3. Not much
4. None

Does your organization support a common, global regulatory framework?

Polling
question 2

1. Yes, ComFrame
2. Yes, but not ComFrame
3. No, the current system works fine
4. No, but the current system needs improvement to reflect the global market

Do you think any insurance companies present a potential threat to national or global financial stability?

Polling question

3

1. Yes
2. Perhaps, depending on their size and risk profile
3. Unlikely, but there is an outside chance
4. No

How far along is your organization in preparing for RMORSA requirements?

Polling question

4

1. We're in good shape
2. We need to step up our game a bit
3. We haven't done much
4. Uh oh

Has your organization been in contact with regulators about the RMORSA?

Polling question

5

1. Yes, regularly
2. Yes, but we need to increase our dialogue
3. No, but we anticipate it will be easy for us to start a dialogue
4. No, and we're not sure where to start

Key trends in internal audit best practices

Richard Reynolds

Partner, Financial Services Internal Audit Services Practice,
PwC

Agenda

- The case for change
- Key trends in internal audit best practices
- Case study

The bar has been raised for internal audit effectiveness

The case for change

According to the OCC's paper on Attributes of a Strong Internal Audit Function:

The challenges facing the internal audit (IA) functions of large banks have increased over the past several years, particularly since the beginning of the financial crisis in 2006. These include:

- The complexity and velocity of risk facing the banking system have increased.
- Bank products and processes have significantly changed. New bank products and markets are more complex. Enterprise and line of business (LOB) risk management have greatly expanded.

Senior Deputy Comptroller Brosnan has stated, “because of the importance of large banks to our economy and the capital markets, we have learned that it is not sufficient to have a ‘satisfactory’ IA function. Today, the expectation is that all large banks need to build and maintain strong IA functions.”

Furthermore, boards and management are expecting internal audit to play a pivotal risk oversight role and be their eyes and ears on the ground.

Key attributes of a high-performing internal audit function

The case for
change

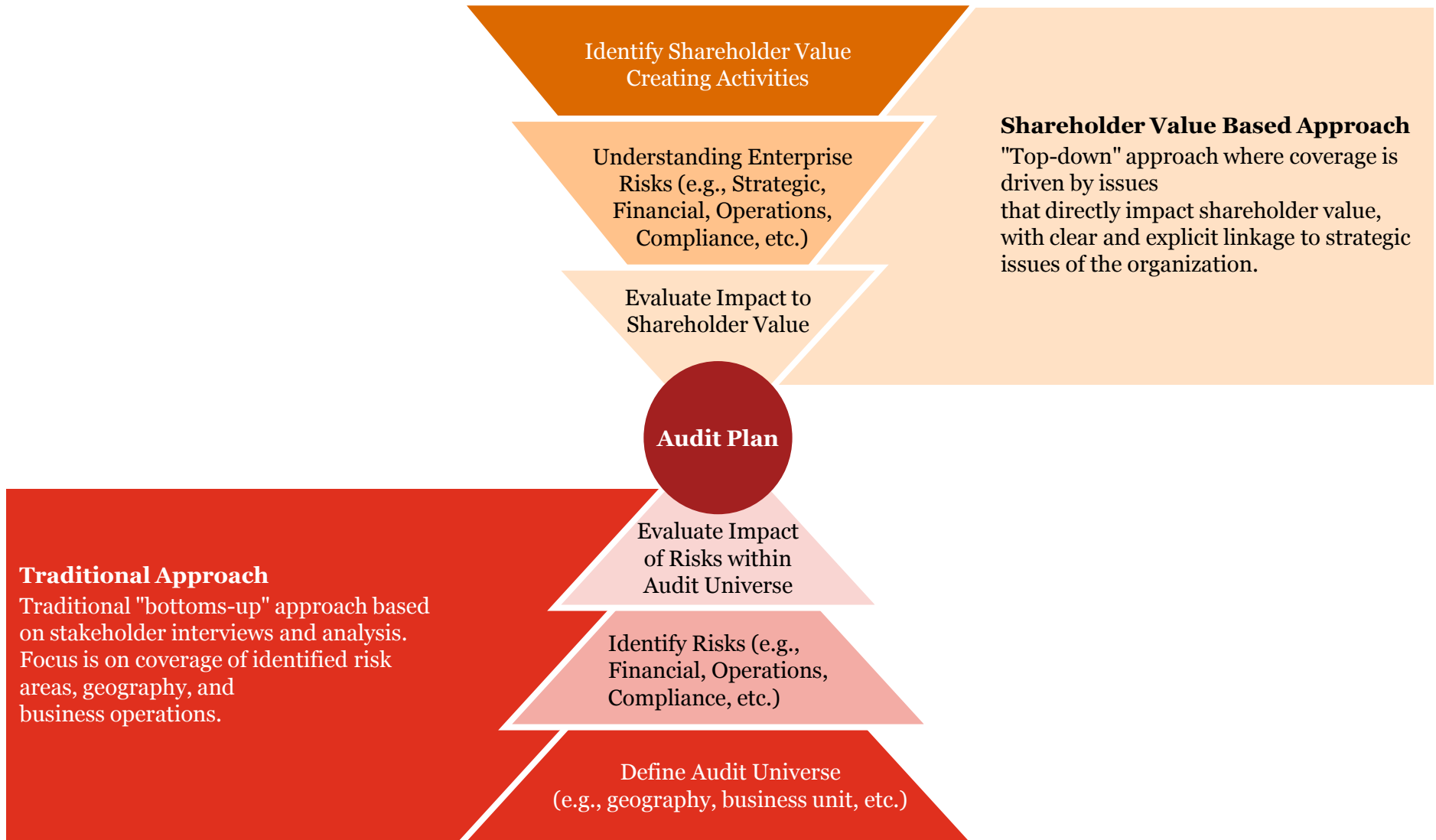
- Expectations for “block and tackle” compliance-based auditing are met with ease
- Internal audit is viewed as an independent, trusted advisor to executive level management and the board on risk and control issues
- Internal Audit is leading the sharing of best practices across the company
- Operating groups regularly call internal audit for perspectives on leading practices
- Internal audit is at the forefront of providing assurance to management regarding the execution of significant company initiatives
- Internal audit is well prepared to pass an External Quality Assessment and targeted regulatory examination
- Communication processes have been streamlined by leveraging technology, reducing overall cycle time
- Compliance testing is more efficient, reducing overall costs

As audit departments address these heightened expectations, a number of common areas for improvement across the industry are emerging

Key trends in
internal audit
best practices

1. Dynamic risk assessment and planning
2. Auditing strategic and business risks
3. Continuous monitoring and emerging risk identification
4. Leveraging data throughout the audit lifecycle
5. Convergence with other risk partners
6. Skills assessment and training
7. Executive and board reporting
8. Audit efficiency

Shareholder value vs. traditional risk assessment approach



Are you focused on the right risks

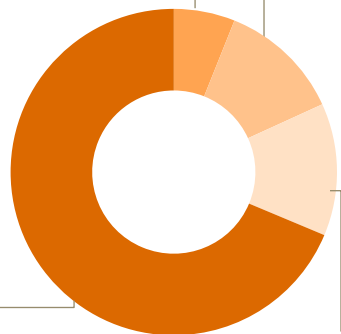
How value is destroyed in companies – reasons for decreases in shareholder value.

~6% Legal and compliance risks

- Regulatory conflicts
- Civil lawsuits/litigation settlements

~68% Strategic risks

- Decline in core product demand
- Poor acquisition/ Merger integration
- Competitor infringement on core market
- Failure to identify asset price bubbles
- Destructive price war
- Undiversified partnership risk
- Margin pressure
- Investor loss of confidence
- Senior management turnover
- Failure to expand alternative revenue sources



~12% Financial risks

- Accounting irregularities and/or financial fraud
- Poor financial hedging
- Financial restatements
- Excessive financial leverage

~13% Operational risks

- Corporate restructuring/ Operational setbacks
- Poor demand forecasting
- Commodity price decline
- Poor IT integration

The financial markets crisis

Yale University economics professor Robert J. Shiller wrote in his aptly titled article, *Infectious Exuberance*, “*Speculative bubbles are fuelled by the social contagion of boom thinking.*”¹ He points out that in an environment characterised by rampant optimism, “*skeptics have a hard time of it.*”²

Risk management functions are an organization’s sceptics but few were heard arguing for shareholder value protection during the boom years.

Strategy that may have strained risk boundaries in other circumstances seemed comfortable at the time because everyone was doing it.

The best organizations reacted fast to risks associated with the crisis in the financial markets, others were less nimble and were consumed.

Could a shareholder value centric Internal Audit function have helped assess these kinds of risks before it was too late? Perhaps at least from a governance and risk management perspective. But there is undoubtedly a need to focus on the organization’s SDMP.

¹ Shiller, Robert J., “Infectious Exuberance,” July-August, 2008. *The Atlantic, Ideas Issue.* ² Ibid.

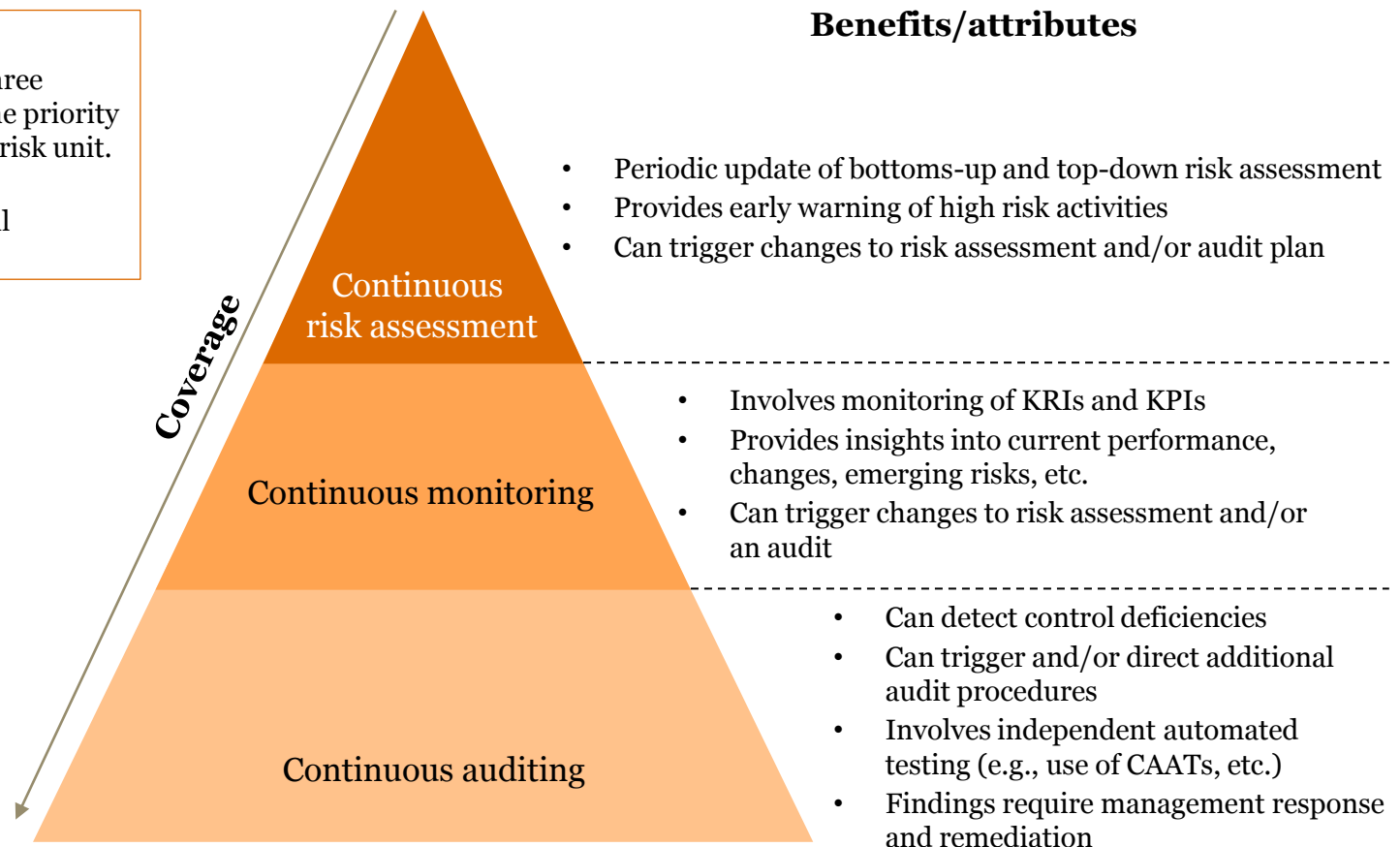
Source: *The Future of Internal Audit*, Corporate Executive Board, 2010

3) Continuous monitoring and emerging risk identification

A sample framework for monitoring emerging risks

Key attributes:

- Frequency and focus of all three processes will be based on the priority and risks identified for each risk unit.
- Formal process for elevating and reporting output from all three processes.



Linkage to audit plan: Business/risk monitoring, as required in the audit frequency and intensity matrix, ideally entails a well-developed continuous risk assessment and monitoring process for each risk unit

Drivers and value of analytics for internal audit

Drivers	Value	
What is creating demand for analytics?	Why is it so important for organizations to get it right?	
<ul style="list-style-type: none"> Regulatory expectations to monitor business activities are increasing. Data is growing exponentially, while the skill sets to use tools beyond access and excel is decreasing. Organizations are being forced to do more with less. Competitive pressures are forcing organizations to innovate. Key technology, business and data hybrid skills are in high demand. 	<ul style="list-style-type: none"> Deeper business understanding & focus on risk 	<p><i>Analytics allows specialists to link data to business processes allowing us develop a better understand of the business and associated risks.</i></p>
	<ul style="list-style-type: none"> Lower existing and future costs 	<p><i>Advanced analytical techniques are more cost efficient than traditional methods. A recent study indicated that an analytical procedure costing \$0.01 could cost as much as \$4 to perform similar procedures using traditional testing.</i></p>
	<ul style="list-style-type: none"> End-to-end testing 	<p><i>Analytics can track data across functions and units allowing us to identify issues missed by traditional (more focused) testing.</i></p>
	<ul style="list-style-type: none"> Increased population and control coverage 	<p><i>Analytics allows for 100% population testing as compared to traditional sample testing. In addition, analytics allows us to reverse engineer issues identified during testing.</i></p>
	<ul style="list-style-type: none"> Real-time evaluation of controls and data integrity - facilitates “what-if” analysis 	<p><i>Clients can view actual mistakes in logic or processing errors rather than focus on hypothetical risks – this can accelerate root cause analysis and assist in the implementation of new controls.</i></p>

The three lines of defense outline the institution's internal risk management posture

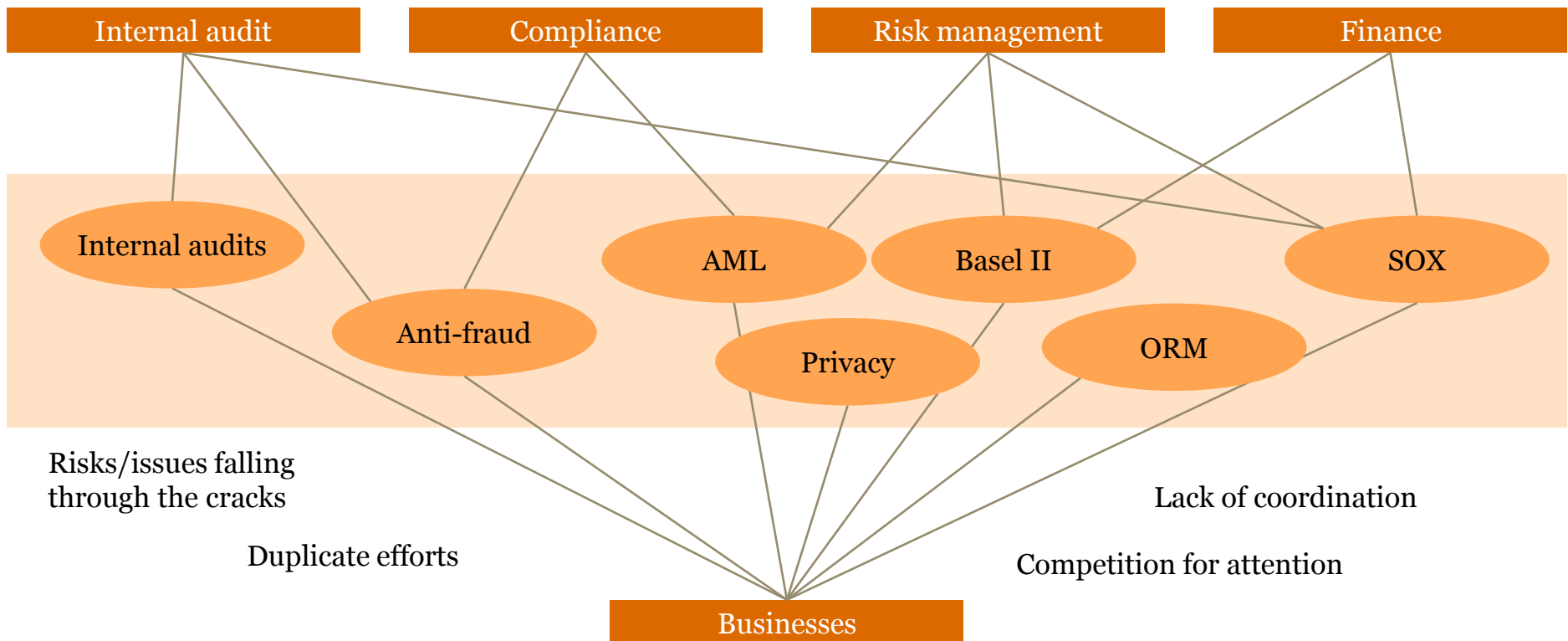
Each line has specific responsibilities with respect to risk identification, assessment, management, oversight, compliance and control.

Business (1st Line)	Risk management (2nd Line)	Internal audit (3rd Line)
<ul style="list-style-type: none"> Identify, assess, manage and control the risks it takes or is exposed to while conducting its activities <p>This principle:</p> <ul style="list-style-type: none"> Applies across risk types Places ultimate accountability for the management of risk with the CEO/chairman and the business heads Implies that the business must absorb losses resulting from risk events May prompt line of business leaders to appoint staff within the business units to assist them in discharging their responsibilities with respect to risk management 	<ul style="list-style-type: none"> Provide risk oversight to the business <p>Key responsibilities:</p> <ul style="list-style-type: none"> Risk management policies, standards, tools, methodologies, and programs Clear understanding of strategy, business architecture, and risk profile of the business Independent guidance and advice to the business in implementing risk policies and programs Oversight of all risks across all businesses Independent risk monitoring and reporting Independent escalation of risk management gaps, issues, and concerns Risk aggregation and a portfolio view of risks 	<ul style="list-style-type: none"> Provide an independent, periodic assessment of the risk management and internal control systems to the board <p>Scope includes:</p> <ul style="list-style-type: none"> Compliance with policies and standards Effectiveness of the independent risk management function Completeness and accuracy of information

5) Convergence with other risk partners

The current state of risk partner convergence in most banks

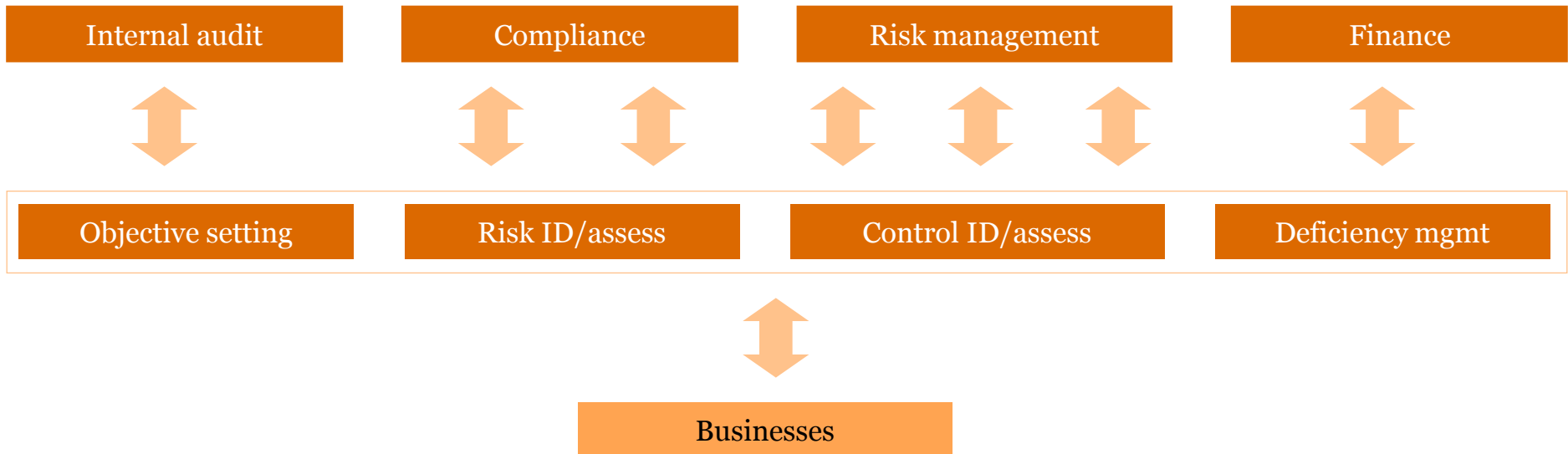
The business and regulatory environments have become increasingly complex, raising corporate risk profiles. Strategic consequences exist if companies are unable to systemically manage governance, risk and compliance requirements effectively. Most attempts to date have been ad-hoc and produced limited results.



5) Convergence with other risk partners

How have organizations made it work

- Utilize a standard framework
- Consider structure across/within functions, businesses and regulatory requirements
- Align with regulatory expectations
- Choose the right place to start: new and developing functions, union of similar silos, areas ripe with duplication, integrated/related environments



If internal audit is to evolve, skill sets must adapt accordingly

Skill sets that will be more important:*

1. Critical thinking & analysis	68%
2. Knowledge of risk management approaches	67%
3. Communication	64%
4. Understanding of organization's strategy and business model	61%
5. Specific technology experience	60%
6. Experience in the business outside of internal audit	53%

* Survey respondents indicating that the need for the above capabilities and depth of knowledge will increase over the next three years.

Source: PwC's 2010 State of the Profession Survey

“The ability to conduct data analysis is essential.”
- Chief Audit Executive, Healthcare Industry

“Integrating technology and the finance skill set is becoming more and more important.”
- Chief Audit Executive, Technology Industry

“Sarbanes-Oxley has developed an Internal Audit culture of staff believing they could ‘stop thinking.’ Internal Audit needs to get back to having business conversations, be better prepared, and have an understanding of what is going on in the business.”
- Chief Audit Executive, Consumer Products Industry

A sample framework for internal audit skills assessment – Loan servicing

Core	Technical	Leadership
<ul style="list-style-type: none"> • Teamwork • Client Service Focus • Continuous Improvement Mindset • Ownership and Accountability • Flexibility/Adaptability • Act as a Change Agent • Oral Communications • Independence and Objectivity 	<ul style="list-style-type: none"> • Mortgage Business Acumen • Specialized Loan Servicing Knowledge • General Information Technology • Applications/End-User Computing • Data Analysis • Modeling • Analytical Skills • Flowcharts, Documentation and Quality Review • Knowledge of Audit Standards 	<ul style="list-style-type: none"> • Sets Vision and Direction • Develops Others and Self • Inspires and Motivates • Drives Execution

Rating scale definitions

1 No experience	2 Limited awareness	3 Basic proficiency	4 Full proficiency	5 Expert proficiency
Has not had exposure to the stated competency; demonstrates none of the behaviors.	Demonstrates knowledge in some of the behaviors. However, requires close supervision and guidance in applying the behaviors to both routine and non-routine situations or conditions.	Demonstrates knowledge in most of the behaviors. Needs guidance in applying the behaviors to non-routine situations or conditions. Gives some knowledge-based guidance to others.	Demonstrates in-depth specialist knowledge in all of the behaviors. Acts independently in applying and modifying the stated competency and gives guidance and advice to others, often at a high level.	Demonstrates all behaviors at an expert level of proficiency. Acts as one of the highest sources of expertise within the institution or externally and/or is recognized as an expert in the area and called upon to advise on topic.

Many institutions are moving to regular reporting of residual risk by business unit

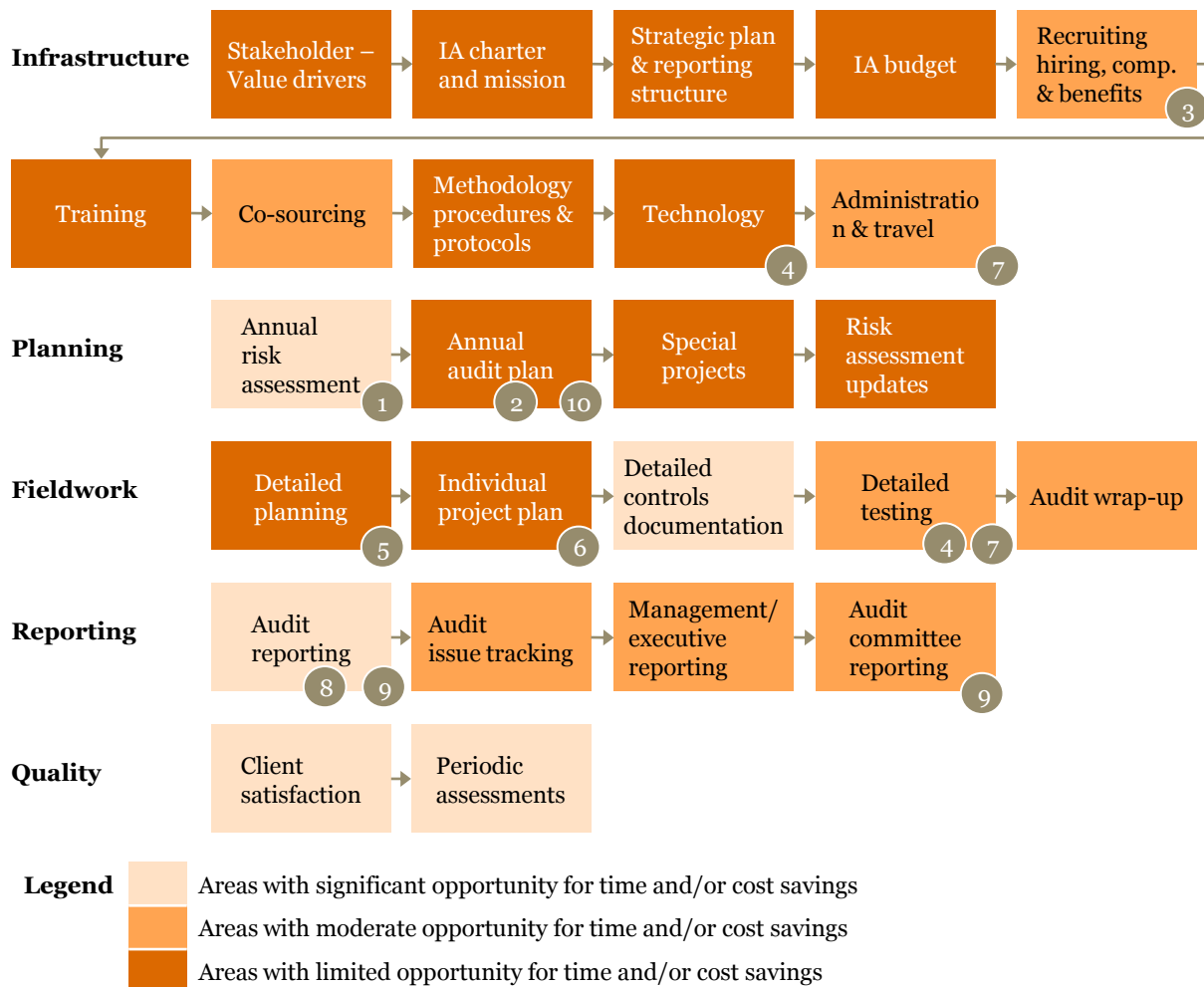
Illustrative

Sales and Trading	Open Findings	Open Actions	Current Quarter					Prior Quarters			
			L	M	H	C	▲	Q4'10	Q3'10	Q2'10	
Institutional Equities Division (incl. PDT)	16 (+2)	28 (+3)		★				-	M	M	M
Fixed Income	26 (+14)	42 (-)		★				-	M	M	M
Non-Core ¹	25 (+12)	61 (+40)			★			→	M	M	M
Commodities	6 (-5)	12 (-4)		★				-	M	M	M
Bank Resource Management ²	6 (+4)	12 (+4)		★				-	M	M	H
Institutional Banks	4 (+4)	- (-)		★				-	M	-	-
Sales and Trading Risk Management	6 (-)	14 (-2)			★			-	H	-	-

- **IED's main risk-reduction and processing projects**, equity swaps and derivatives renovation, are on track, resulting in less high-risk manual adjustments. The trend should continue if the projects stay on target.
- **Fixed Income:**
 - **Interest Rate Derivatives** is experiencing technology application and infrastructure constraints in the timely processing of risk data, booking of structured notes and valuation of some complex products. Project Pioneer, which was the planned solution aimed at improving straight-through processing and reducing manual workarounds, is under review. If the constraints go unaddressed, these infrastructure issues could increase operational risk in light of management's plans to increase market share and volumes.
 - **Fixed Income Strategists, Controllers and Technology** revisited the aged action plans for Securitized Products P&L attribution and deprioritized derivatives attribution, while targeting attribution for sold positions by early May.

Internal audit processes may be inefficient and due for a top-to-bottom review

Internal audit process overview



Top 10 gaps common to many internal audit functions

- 1 Risk assessment typically not aligned with drivers of shareholders value
- 2 Internal audit activities focus on low value activities and controls, or replicates external audit procedures
- 3 Financial and human resource limitations and constraints
- 4 Use of technology tools is limited and they are not integrated
- 5 Audits are planned with overly broad objectives and scope
- 6 Routine audits do not fully leverage available data analytical tools
- 7 Assignment process and travel requirements create significant process inefficiencies
- 8 Communications (e.g., reports, etc.) and ratings consume significant resources
- 9 Recommendations are not impactful
- 10 Process is weighted toward repetition vs. relevance

Compliance vs. risk-based auditing

Case study

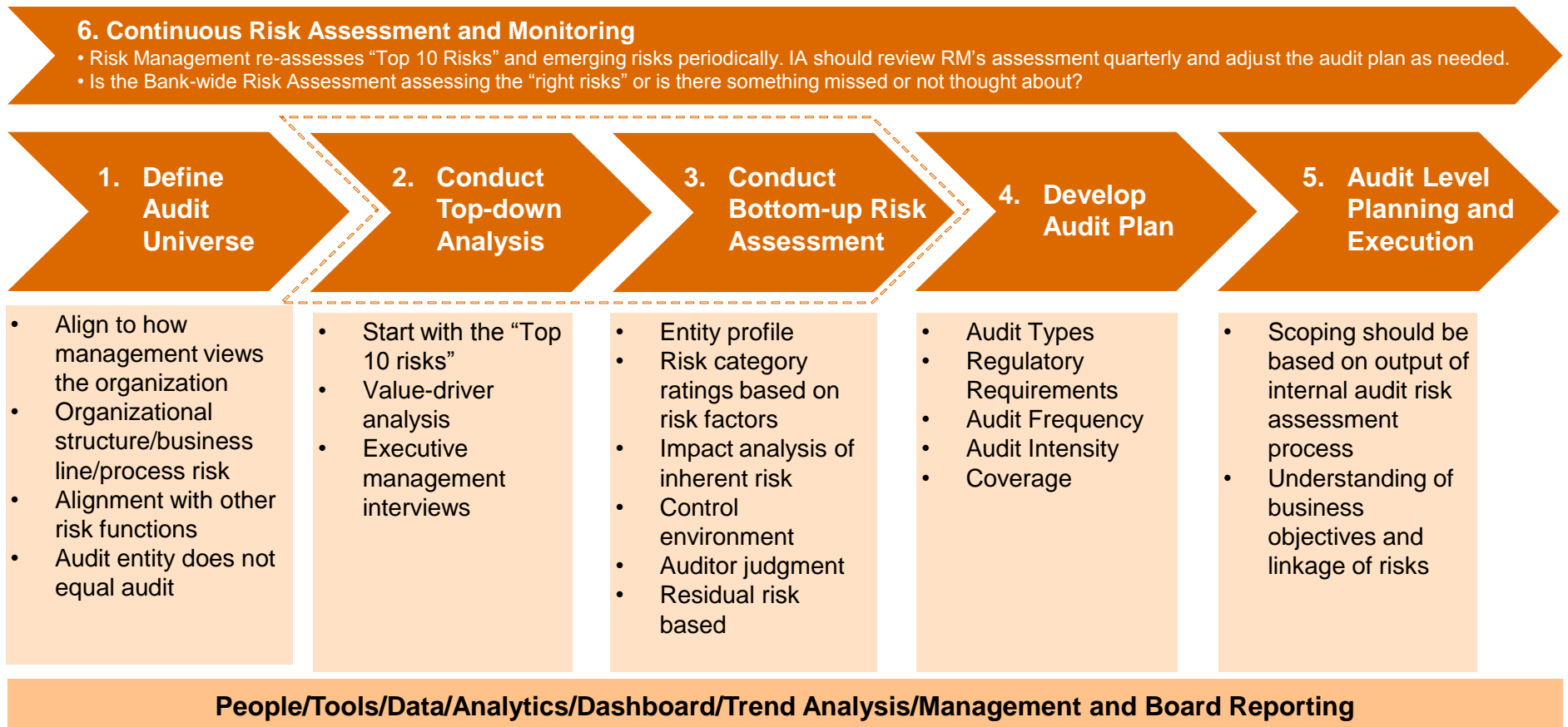
PwC was engaged by a mid-sized US regional bank to assess the value it was deriving from its internal audit function in response to regulatory criticism. During this assessment, PwC determined that the bank would benefit by moving from a more traditional controls compliance-based approach to a more dynamic and risk-based approach. The key elements of this risk-based approach included:

- A plan that prioritizes the allocation of audit resources to those areas that pose the greatest risk to the organization's ability to meet its objectives.
- An audit execution methodology that drives audit teams to understand the business strategy and objectives of the area being audited, identify the risks to achieving those objectives, and assess and test the management policies, processes and controls in place to mitigate those risks within approved risk tolerances.
- A business and risk monitoring program that enables the audit department to stay abreast of changes in the business strategy, objectives, and risks and dynamically adjust the department level plan accordingly.

Suggested risk-based audit framework

As part of this engagement, PwC proposed the following framework for implementing a risk-based audit approach including key attributes for each framework component. The first 4 steps encompass Risk-based Planning and steps 5 and 6 cover Risk-based Audit Execution and Continuous Risk Assessment and Monitoring, respectively. PwC's final report provided detailed and actionable recommendations for each component of the framework.

Case study



www.pwc.com/us/insurance