Life Insurance Company of Alabama

ERM – Additional Mitigation Work

LICOA is developing formal templates for each of its identified risks. An initial pass of primary risks follow this summary. A wide variety of risks are shown. A risk being included here does not mean that risk norms have been breached.

1. Risk (risk score - 16) – Business Continuity and System Availability

   Mitigation - Currently LICOA does not have a dedicated Disaster Recovery fail over machine for its current administrative system. Mainly due to the cost of the AS400 platform. We are currently in the process of converting off the AS400 platform and going to Windows based system called Inspro. The DR site for InsPro is located at the Sunguard data center in Pennsylvania. In the event of a machine failure or natural disaster, business could continue with access to InsPro DR site once new/temp end user machines and communications are restored. LICOA is also in the final stages of implementing remote backup site located in Atlanta, Georgia. Using Veeam Backup Replication software, daily and weekly backups of virtual and physical servers are pushed to the server in Atlanta through a secure VPN using two SonicWALL firewalls. The Veeam software allows both virtual and physical machines to be restored to new vm environment or new physical server (called bare-bone restore). Tape backups are also done daily and stored locally in a vault and full backups performed on weekends are taken to an off-site location locally.

2. Risk (risk score - 25) - The board of directors (or committee thereof) and management do not effectively monitor or supervise contracted third parties in the implementation of the investment policy/strategy.

   Mitigation – A revised investment policy was drafted by management and approved by the board of directors in 2017. This policy is provided to the contracted investment firm. New England Asset Management was contracted with in 2017 and began work in 2018. Any transaction that is a deviation from the policy must be approved, in writing, by the company, called a waiver, before the investment firm may perform those transactions. The investment firm provides reporting on at least a quarterly basis of the transactions performed as well as any positions that are out of compliance with the policy.

3. Risk (risk score - 24) – The company doesn't have a formal succession plan

   Mitigation – while the company does not have a formal plan in writing, the Company and Board of Directors review the officers and leadership on an annual basis and make any necessary recommendations.

4. Risk (risk score - 16, current RBC is 2431%) – that the company is not monitoring its capital and surplus needs including how changes may impact RBC and financial strength ratings from rating agencies.

   Mitigation – quarterly meetings of senior management and board to review the financial statements including current capital and surplus positions. RBC is discussed at least annually, including a review of the Authorized Control Level, Company Action Level, Regulatory Action Level and Mandatory Control Level event ratios to ensure the company is in excess of these levels. Current ERM strategy also includes analysis of these key features as well as BCAR. New Investment advisors will review the impact on RBC that any change in investment strategy produces.

5. Risk (risk score - 12) – premium transaction are not recorded accurately in the system

   Mitigation - Premiums received via check, cash, or credit/debit card flow through a cash clearing account when deposits are made. This cash clearing account is balanced down to 0 on a daily basis which ensures that these payments have been properly transferred to the policy administrative system to be applied. The Company's deposit ledger account is balanced to the appropriate bank statement on a monthly basis to ensure that all amounts deposited into our ledger match the bank records. Any discrepancies are investigated and corrected. A past due report is reviewed on a quarterly basis and suspense accounts, monies that have been received but not applied to a particular policy, are reviewed at least once a year.

6. Risk (risk score - 12) – The board of directors is not involved in establishing and/or reviewing the insurers overall reserve practices

   Mitigation - The majority of the reserves are calculated based upon Statutory rules. These rules determine the methods and assumptions that can be used in calculating the reserve. To the extent there are reserves that do not have such strict guidance, the board and company guidance has been to establish reserves that are consistent with statutory reserve requirements, industry practices, as well as any additional conservatism that is necessary. These reserves are also reviewed annually during the external audit and a report of these findings is provided to the board Audit Committee, who presents them to the full Board. The Appointed Actuary also prepares for the Board an actuarial opinion regarding reserves and related actuarial items. The Appointed Actuary further provides a report to the board showing the results of the Asset Adequacy Testing which is performed in support of the Actuarial Opinion.

7. Risk (risk score - 14) – inforce data utilized by the actuary to calculate reserves for life, A&H and deposit-type contracts is not complete or accurate nor consistent with accounting records

   Mitigation - Every quarter a file is created by the administrative system that contains the inforce records, according to the admin system definition. This file is then used by the reserve system to determine the reserves for the life, A&H and deposit type contracts. There are some adjustments made to this file by the reserve system such as an adjustment to account for policies that are at duration 0 as well as the creation of some reserve records to deal with benefit issues within a policy. The administrative system produces an inforce report that I then use to compare to the results from the reserve system.

8. Risk (risk score - 16) – The computations for cash flow testing and asset adequacy analysis may not be computed correctly and the assumptions used in cash flow testing and asset adequacy analysis may not be correct (lapse, mortality, morbidity, interest rate, asset maturity, etc.) and the asset adequacy analysis may not properly reflect the risks associated with adverse development in experience.

   Mitigation - The computations for the reserves in cash flow testing, which is an accepted method for of asset adequacy analysis, are the same as those that are used for quarterly reserve calculations, as the same modeling software, inforce records and models are used. The liability assumptions (expenses, mortality/morbidity, terminations etc) are based upon company experience. The model results are reviewed to see that they are consistent with recent actual experience. The assets are based upon our existing assets, as shown in Schedule D of the annual statement and initial model values are reviewed for consistency with reported values. The asset adequacy analysis looks at more than just the impact of various interest scenarios. There are also sensitivity tests of various critical components such as mortality/morbidity, terminations, expenses as well as obtaining rate increases on the unlimited cancer block of business. The final actuarial opinion, the reason for performing the asset adequacy analysis, is based upon all of these results.

9. Risk (risk score - 11) – The reinsurance program will not provide adequate protection for catastrophic losses

   Mitigation - LICOA carries reinsurance on its life products. The term products are 50% reinsured on a first dollar basis up to the company retention of $100,000, after that it is 100% reinsured. The whole life products are reinsured on a YRT basis for amounts in excess of the retention limit. The retention limit is also a per insured retention meaning that we only retain a total of $100,000 on all policies covering a given individual, anything in excess of that is reinsured. The company has a block of unlimited cancer policies that has continued to shrink over the years, currently less than 10% of the total health premium. These policies have been authorized to be paid based upon the negotiated amounts from the major medical carrier instead of the amount billed by the provider. These policies continue to be reviewed annually for necessary rate increases as well to account for any worsening experience.

10. Risk (risk score - 10) - The assumptions and methodologies used for life, A&H and deposit-type reserves and liabilities are not accurate or appropriate.

    Mitigation - The reserve assumptions are prescribed by statute. When a new product is initially reserved there are checks to make sure that the assumptions and results are as they should be.

After this they become part of the quarterly validation to make sure the results are changing in a reasonable manner.

11. Risk (risk score - 16) - The life, health and deposit-type reserves and IBNR claim liability computations are not performed correctly or the selected estimates are unreasonable.

    Mitigation - A premium and claims file is produced by the administrative system and is used to calculate the health claim liabilities. The health claim liability calculations are based upon a completion factor approach combined with a loss ratio adjustment for recently incurred claims, those in the last 6 months. As part of the process of establishing the A&H claim liability an analysis is performed comparing the general ledger results, the information provided by the administrative system, to the information provided by the reserving system. A further analysis regarding the adequacy of the reserve established is the Schedule H test, which is reviewed quarterly. The life IBNR calculation is based upon the results of a study of life claims. This study produced a factor to use to estimate the life IBNR each quarter. This IBNR is then reviewed at the end of each year to determine the adequacy and adjustments for future IBNR calculations are made based upon these results.

12. Risk (risk score -15) - The assumptions used in pricing may not reflect LICOA's experience or comparable industry experience (expenses, mortality, morbidity, lapses, interest rates, etc.).

    Mitigation - When a product is priced we begin with industry data for mortality, morbidity and interest rates. I perform expense, lapse, and mortality studies periodically. The results of these studies are then incorporated into the pricing. Occasionally a product is brought to us that is already priced and ready to file, usually a reinsurer. We will run a model of this product, using our assumptions for expenses, mortality/morbidity and lapses to see if the profitability is satisfactory before we will file the product.

13. Risk (risk score -15) - The underwriting guidelines may not reflect the risks that the pricing actuary assumed.

    Mitigation - The underwriting guidelines are discussed with the pricing actuary(ies) before any work is performed. In the case where a product is provided, as discussed above, we provide a copy of our anticipated application to them to ensure that the underlying assumptions are reflective of the anticipated underwriting. Periodically a study of experience by duration is performed that would indicate potential issues regarding underwriting.

14. Risk (risk score -15) - LICOA does not effectively monitor experience on key pricing assumptions which may lead to unknown losses or unrecognized premium deficiency reserves.

    Mitigation - The key pricing assumptions would be mortality/morbidity, expenses and lapses. When preparing the annual budget there is analysis by line of business to determine if there are expected gains or losses in each line, and this analysis includes a full allocation of all expenses and the recognition of actual mortality/morbidity and termination experience. Morbidity experience is reviewed quarterly and rate increases are requested as necessary. There is a risk, regardless of how much we monitor the experience, a state will not approve the necessary rate increases. Mortality and lapse studies are performed periodically, usually every 2 years, to see if it is as assumed in pricing. The results of these studies are then reflected in any future models used such as those in pricing, asset adequacy analysis and budget analysis. Expenses are reviewed quarterly but we do not track expenses by product, they are allocated to a line of business based upon budgeted results. The results of actual lines of business are compared to the budgeted results each quarter. Asset adequacy analysis is performed annually to determine any premium deficiency, which includes a gross premium valuation for the A&H lines, although this allows one products excess to offset another products deficiency.

15. Risk (risk score -17) - The insurer does not review its liquidity position to determine if adjustments are necessary to meet its potential near-term cash flow needs.

    Mitigation - The VP of Accounting monitors the available cash balance in the operations bank account along with the amount of checks issued on a daily basis to make sure there is enough cash to cover daily cash flow needs. The Company's investment manager has been asked to maintain a healthy cash equivalents balance so that LICOA can have cash wired to the operations bank account at any time. The cash equivalents balance maintained in the investment accounts are reviewed at least a couple of times a month. Other officers/managers also make Katrina aware of any large upcoming cash needs so that she can make sure there is a proper amount of cash available to cover these needs.

16. Risk (risk score -13) - The insurer's bonds and stocks are incorrectly valued.

    Mitigation - LICOA uses FIS/Sungard to maintain investment accounting and investment schedules for the Quarterly and Annual Statement. Katrina Hulsey reconciles all investment information on a monthly basis. The investment database has pre-set valuation conditions in place in order to follow proper accounting guidelines such as making sure book/adjusted carrying value for common stock is carried at FMV while making sure bonds book/adjusted carrying value is reported at amortized cost using the scientific method of amortization. Market values for most stocks and bonds are derived from FT Interactive Data. Money market fund market values are derived from the bank they are held in. This information is generated electronically and imported into LICOA's investment accounting database by FIS/Sungard. Furthermore, FIS/Sungard reconciles the par value of bonds in the accounting system to par values reported on the investment bank statement while the number of shares of stock for equity securities is reconciled from the accounting system to shares reported on the investment bank statement. A copy of the reconciliation is sent to Katrina monthly for review.

17. Risk (risk score -12) - The insurer may not properly write down the value of securities that are other than temporarily impaired.

    Mitigation - Katrina reviews NAIC designations and fair market values compared to book/adjusted carrying values on a quarterly basis. A bond watch list is generated and provided to the executive/senior officers along with the board of directors on a quarterly basis which opens the discussion as to if any bonds need an other than temporary impairment write-down. It is also discussed with the investment manager and advisors as to if an other than temporary write-down is required. Katrina also reviews accounting guidelines in the NAIC Accounting Practices and Procedures to make sure that bonds are written down properly and that the accounting for write-downs are reported properly.

18. Risk (risk score -12) - The insurer's bonds, common stocks, and cash are incorrectly reported in its Annual Statement.

    Mitigation - LICOA uses FIS/Sungard to maintain the investment accounting on a monthly basis. Katrina Hulsey balances LICOA's investment ledger accounts to the investment bank statements on a monthly basis. Katrina also makes sure that all investment schedules generated by the FIS/Sungard system balance to the investment bank statements and the investment general ledger accounts. Furthermore, LICOA's internal auditor reviews all investment bank statements, investment GL accounts, investment schedules, and investments reconciliations to ensure that all investment items are in balance. This is done on a quarterly basis, but all months are reviewed.

19. Risk (risk score - 11) - The insurer's interest maintenance reserve (IMR) and asset valuation reserve (AVR) are incorrectly calculated.

    Mitigation - The Company's investment accounting provider maintains an automated calculation of the AVR and IMR amounts based upon inputs that have been set within the system to comply with the NAIC regulations.

    Various calculations are reviewed internally by Katrina Hulsey including:

    a. Proper categorization of gains/losses as IMR or AVR
    b. Tax rate for determining tax portion of realized gain/loss and unrealized gain/loss
    c. Beginning figures equal prior year ending figures
    d. Total realized gain/loss matches gain/loss recorded on trial balance
    e. Total unrealized gain/loss matches gain/loss recorded on trial balance
    f. Reserve objective and maximum reserve factors for common stock are set to .20.
    g. Katrina calculates real estate book/adjusted carrying value. This is compared to amount carried on trial balance and on depreciation schedule to make sure it matches.

20. Risk (risk score - 19) – Cash inflow/outflow relationship due to interest rate risk is not optimized

    Mitigation – Currently working with our investment advisors (NEAM) to develop an EBAA (Equity Based Asset Adequacy) to ensure relationship is optimized and monitored.

21. Risk (risk score - 25) – LICOA doesn't maintain sufficient internal controls

    Mitigation – LICOA uses an outside audit firm to perform internal audits to review controls and make recommendations where issues may exist. These recommendations are reviewed by the audit committee, company and board, and procedures are implemented where necessary. These items are further reviewed by the company external auditors as well as the state examiners.

22. Risk (risk score - 25) – Investments will not follow policy

    Mitigation – new investment policy and have hired a new investment firm that works within the guidelines of the policy and produces monthly reporting to ensure the company is following policy.