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BULLETIN NO.: 02-25

TO: ALL INSURERS AUTHORIZED OR ADMITTED IN NEW JERSEY
FROM: HOLLY C. BAKKE, COMMISSIONER
RE: CORPORATE GOVERNANCE AND EXTERNAL AUDIT OVERSIGHT

Recent events surrounding the bankruptcies of several large corporations have focused attention on issues involving internal corporate governance and the independent or "external" auditing of the condition of corporations. Insurers transacting business in New Jersey have been, and continue to be, subject to numerous requirements and ongoing oversight in these areas. The purpose of this Bulletin is to highlight and remind insurers of their continuing responsibilities.

CORPORATE GOVERNANCE

The evaluation of the corporate governance framework of an insurer is a critical element of the solvency surveillance function performed by the Department of Banking and Insurance ("Department") Office of Solvency Regulation. The evaluation is integral to the overall assessment of the operations and financial soundness of the organization and assists the Department in the determination of the level of regulatory supervision to be applied to the entities.

These evaluations focus primarily on the following areas of corporate governance:

- Board of Directors and senior management responsibilities, especially in the area of establishing and maintaining policies and procedures for internal controls and risk management.
- Integrity of the members of the Board of Directors and senior management and the possession of the necessary skills and experience.
- Appropriate independence of the Board of Directors.

- Financial oversight function of the Board of Directors, including external and internal audits.

The primary review of the corporate governance framework of a particular insurance company is performed during the on-site financial condition examination of the entity, conducted at least every five years pursuant to N.J.S.A. 17:23-20 et seq. The examination is comprehensive in nature and is performed in accordance with the procedures outlined in the Financial Condition Examiners' Handbook adopted by the National Association of Insurance Commissioners ("NAIC"). As part of the initial phase of an examination, an evaluation is made of the activities of Board of Directors and senior management, and an assessment is made of the overall management environment by the examiner.

The examiner also must verify compliance with the various insurance statutes which govern the Board of Directors and senior management practices. The examination process culminates in a report which sets forth findings and recommendations which must be addressed by the insurer. It should be noted that a limited scope examination also may be conducted if an area of concern is identified in the intervening years between the full scope examinations, including any concerns regarding the performance of the Board of Directors and/or senior management.

In addition to on-site financial examinations, the Department monitors the financial condition and operations of an insurer on a continuous basis, primarily through the review and analysis of information and data submitted to the Department as mandated by law, including annual and quarterly financial statements pursuant to N.J.S.A. 17:22-1, 17:46B-55 and 17B:21-1, and risk based capital reports pursuant to N.J.A.C. 11:2-39. Correspondence and periodic meetings with company personnel also take place. The evaluation of the corporate governance framework of an insurer is monitored and amended as necessary, based on the findings and results of these analyses. Where necessary, Departmental actions would be initiated.

New Jersey insurance statutes and rules also address various areas of corporate governance, which especially impact the focus of the Department's evaluation as set forth above. These include:

- Fit and proper requirements. State insurance laws authorize the Commissioner of Banking and Insurance ("Commissioner") to take appropriate action if it is found that an officer or director is not a person of good character or integrity. Statutes governing formation, acquisitions of control and mergers, provide that the Commissioner may take applicable action if she finds that the competence, experience and integrity of those persons who control the operations of the insurer are such that it would not be in the best interests of the policyholders and public in this State. As part of the review process, biographical affidavits must be submitted by all directors and senior officers to the Commissioner.
- Board independence. The Insurance Holding Company Systems Act, N.J.S.A. 17:27A-1 et seq., requires that at least one-third of the members of a Board of Directors of a domestic insurer, or entity controlling the insurer, be independent. One-third of any

committee of the Board must also be independent. Independent members are defined as persons who are not officers or employees of that insurer or of any entity controlling, controlled by, or under common control with, that insurer and who are not beneficial owners of a controlling interest in the voting securities of that insurer or any such entity. This statute also requires that at least one independent member be included in a quorum for the transaction of business. Moreover, this statute requires that a committee(s) be established by the Board comprised of all independent members, to be responsible for the following activities:

- Recommending the selection of independent certified public accountants;
- Reviewing the insurer's financial condition;
- Reviewing the scope and results of the independent audit and any internal audit;
- Nominating candidates for Director for election by shareholders or policyholders;
- Evaluating the performance of principal officers of the insurer; and
- Recommending the selection and compensation, including bonuses or other special payments, of the principal officers.

EXTERNAL AUDIT OVERSIGHT

To assist in the Department's ongoing solvency surveillance function, N.J.A.C. 11:2-26 requires that all insurers have an annual audit by an independent certified public accountant, which must be submitted to the Commissioner by June 1 for the year ended December 31 immediately preceding. The contents of the report are prescribed by the rules, which are based on model rule adopted by the NAIC, and include the requirement that the report and opinion reflect the financial position of the insurer in conformity with Statutory Accounting Principles ("SAP") rather than Generally Accepted Accounting Principles ("GAAP"). SAP are the principles or practices prescribed or permitted by an insurer's state of domicile, and are designed to address the concerns of the regulators. The statutory accounting principles as set forth in the Accounting Practices and Procedures Manual adopted by the NAIC provide a comprehensive framework by which insurers report their financial condition. Insurers are required to comply with the requirements of the Accounting Practices and Procedures Manual in completing financial statements pursuant to N.J.S.A. 17:23-1, 17:46B-55 and 17B:21-1. SAP reporting provides the Department with a basis on which to determine an insurer's ability to satisfy its obligations to its policyholders and creditors as of the financial statement date.

N.J.A.C. 11:2-26 also sets forth the qualifications of independent certified public accountants and requires that the accountant be registered with the Commissioner. Qualifications include the following:

- The accountant is in good standing with the American Institute of Certified Public Accountants;
- The accountant conforms to standards contained in the Code of Professional Ethics of the American Institute of Certified Public Accountants and Rules and Regulations or similar code;
- The accountant has not been convicted of fraud, bribery or any dishonest conduct or practice;
- The accountant has not violated the insurance laws of this State with respect to previous reports submitted; and
- The accountant has not demonstrated a pattern or practice of failing to detect or disclose material information in previous reports filed.

The Department will accept reports prepared only by a qualified independent certified public accountant.

In addition, there are “rotation” requirements in that no partner of an accounting firm may render a report for more than seven consecutive years. Moreover, if an accountant is dismissed or resigns, the Commissioner must be notified and informed whether there was any disagreement on any matter of accounting principles or practices, financial statement disclosure, or auditing scope.

Further, the external auditor must report immediately to the insurer in writing any adverse financial condition; that the insurer has materially misstated its financial condition as reported to the Commissioner; or that the insurer does not meet the minimum capital and surplus requirements. The external auditor must also report any significant deficiencies in the insurer’s internal control structure. Copies of these reports must be filed with the Department. In addition, the external auditor must provide a reconciliation of differences, if any, between the audited financial statements and the Annual Financial Statement filed with the Commissioner.

The Annual Audited Financial Reports filed with the Department are analyzed in conjunction with the ongoing financial monitoring function of the Office of Solvency Regulation. Meetings with the insurer’s external auditor are held when deemed necessary. Any workpapers prepared by the external auditor relating to the audit are required to be maintained for review until the Department has filed its examination report covering the period of the audit. An essential element of the planning of an on-site examination is the review of the workpapers prepared by the external auditor. Any concerns or issues identified are discussed directly with the external auditor.

The procedures and requirements set forth above provide a general outline of existing requirements and Department procedures with respect to the review and analysis of corporate governance and external audits of insurers. Insurers should continue to be familiar with all applicable requirements pursuant to law.

10/29/02
Date

/s/ Holly C. Bakke
Holly C. Bakke
Commissioner