



AMERICAN ACADEMY of ACTUARIES

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Group Solvency Issues (EX) Working Group
Solvency Modernization Initiatives (EX) Task Force
National Association of Insurance Commissioners (NAIC)
Via email: dvacca@naic.org

On behalf of the American Academy of Actuaries' ¹ ERM Subcommittee, I am pleased to provide its comments on the NAIC's Solvency Modernization Initiative (EX) Task Force's *Consultation Paper on Corporate Governance and Risk Management*.

Our understanding is that the purpose of this paper is to explore corporate governance and risk management "as part of the research needed to make recommendations for implementation" of the Solvency Modernization Initiative (SMI.) We also understand that the "SMI scope includes aspects relative to the financial condition of a company and is not limited to evaluation of insolvency alone."

In general, we agree that regulators could benefit by a greater understanding of corporate governance and risk management practices. We also agree that the introduction of an Own Risk and Solvency Assessment (ORSA) into the US solvency framework could provide regulators with significant insight into a company's risk management and risk governance practices. That stated, there will be challenges associated with introducing an ORSA into the US insurance solvency regulatory process, one of which relates to whether these assessments would need to be performed on an individual insurance entity basis or on a group basis.

In addition, we strongly encourage the NAIC to consider the existing environment for the US insurance sector before any new insurance regulations over corporate governance and risk management are added. Specifically, the NAIC's Risk Focused Surveillance framework includes substantial review of company risk management processes. In addition, rating agencies have significantly enhanced their assessment of companies' risk management programs, thus encouraging continued improvement in this area. We would hope that any new regulations would be enhancements to, rather than replacements of, existing frameworks.

We offer the following specific comments on the Consultation Paper:

Section 1: Corporate Governance

1. Paragraph 1.1 a): To the extent that the NAIC increases its regulatory focus on corporate governance, we agree that the SMI needs to explore the application of corporate governance principles at a group level since this is the level at which they are most often

¹ The American Academy of Actuaries ("Academy") is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

adopted by and communicated within large organizations. Of course, this is not to imply that individual company level principles are to be subordinated but only that group level principles merit consideration as well.

2. Paragraph 1.3 b): Board oversight of strategic planning and risk management is essential to strong corporate governance. While we agree that the "nature and extent of Board oversight" should receive additional attention from the SMI, we encourage the NAIC to consider the increased focus that other external stakeholders have placed on board oversight of risk management (e.g., Securities and Exchange Commission in a draft rule amendment requiring disclosures around board oversight of risk management.)
3. Paragraph 1.3 d): "Actuarial function" should be more clearly defined. Actuaries serve in many roles within and across insurance organizations, from the more traditional roles in reserving and pricing to less traditional roles in claims, underwriting, strategic planning, and enterprise risk management. To the extent that the "actuarial function" in this context is intended to mean pricing and/or reserving, these functions should be specifically stated.

Section 2: Risk Management

1. Paragraph 2.1 a): We agree that the "SMI should consider whether principles apply at the group level, to individual insurance entities, or some combination of both." In general, risk management programs are implemented at the group level and then applied across the organization. These programs are more likely to focus on business segments rather than on individual insurance entities, unless they are directly aligned. Therefore, the SMI will need to consider the implications of the legal entity structure of US insurance groups to the extent a process for regulatory reviews of risk management programs is adopted by the NAIC.
2. Paragraph 2.1 b): Stress testing and scenario analysis are vital to strong risk management practices, and many companies currently have processes in place to perform these analyses. Rating agencies expect to see evidence that stress testing and scenario analysis are performed by companies, and this expectation will continue to provide companies with strong motivation to perform these tests. To the extent that NAIC elects to increase the use of stress testing and/or scenario analyses for regulatory purposes, we acknowledge the challenge associated with producing standardized tests that can be both applied uniformly across all companies and provide meaningful information for regulators. However, we recommend more guidance be provided by suggesting that there should be stress testing on any significant risks to an organization/line of business by defining a threshold (e.g., could impact surplus by 20%). In addition, the specific stress/scenario tests performed should change over time as the environment changes and as new risks emerge. To the extent that the NAIC chooses to increase the use of stress testing and scenario analysis for regulatory purposes, the Academy could assist in this area.
3. Paragraph 2.3: While we agree that "an insurer should have a risk management policy that outlines the way in which the insurer manages each relevant and material category of risk, both strategically and operationally", risk management policies will likely vary significantly by company based upon their size and complexity. For example, it is

unlikely that small insurers would quantify economic capital, even if their risk management programs include sound risk management practices including the use of stress and scenario testing. Therefore, while we do agree that it would be useful for the SMI to "consider what should be included within a risk management policy", we recommend that the focus be on the core elements of a risk management policy, not on prescribing specific elements. As with our discussion in paragraph 2 of this section, a company should identify the meaningful categories and provide sufficient documentation for their inclusion as well as why some categories of risk have been excluded.

4. Paragraph 2.4: The risk appetite statement and risk tolerances defined by any individual company reflect their individual corporate culture and strategic objectives. We therefore believe that the SMI should consider what tolerances *might* be defined in a risk tolerance statement rather than what *should* be defined.
5. Paragraph 2.6: It is not currently clear whether the US will adopt the use of internal economic capital models to determine required capital for solvency purposes. Therefore the reference to "the level of internal economic capital held for solvency purposes" is not appropriate and an alternative wording should be considered such as "internal economic capital" or an alternative such as a "rating agency standard." Companies with strong risk management functions have developed and utilize internal economic capital models along with scenario analysis and stress testing. However, these risk management tools are most often used for the purpose of supporting strategic decisions rather than solvency monitoring.
6. Paragraph 2.7: We are concerned with the statement that strategic decisions should be required to be consistent with established risk management policies. We certainly agree that risk management policies should guide the board and senior management. However as worded here, the effect would be to remove decision-making from senior management. Even a well-crafted risk management policy can give vague or conflicting advice. And, given the financial collapse of 2008, it is not difficult to envision a set of circumstances that a well-crafted risk management policy fails to completely address. We believe this paragraph should be amended so that risk management policies are considered when strategic decisions are made and that any significant deviations from the risk management policy be documented, with the reasons for the deviation stated.
7. Paragraph 2.8: As previously stated, we agree that the introduction of ORSA into the US solvency framework could provide regulators with significant insight into a company's risk management and risk governance practices. To the extent it is adopted as a regulatory requirement, we encourage the NAIC to carefully consider and clearly define how often these assessments should be performed, at what level in an insurance group they are to be performed, what they should include, and how they will be used to enhance the existing solvency monitoring framework.

Thank you for this opportunity to comment. If you have any questions, please contact Tina Getachew, senior policy analyst, Risk Management and Financial Reporting Council, via email (getachew@actuary.org) or phone (202/223-8196).

Sincerely,

A handwritten signature in black ink, appearing to read "Maryellen Coggins", with a long horizontal flourish extending to the right.

Maryellen Coggins
Chairperson, ERM Subcommittee
Risk Management & Financial Reporting Council
American Academy of Actuaries