AMERICAN ACADEMY
of ACTUARIES

Comments on the Corporate Governance for Risk Management Act

**From the American Academy of Actuaries' Life Governance Team
Presented to the National Association of Insurance Commissioners' Capital
Adequacy Task Force November 7, 2007**

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The Life Governance Team of the American Academy of Actuaries appreciates this opportunity to comment on the draft Corporate Governance for Risk Management Act ("Act") that was re-exposed for comment by the National Association of Insurance Commissioners' (NAIC) Capital Adequacy Task Force (CADTF). We provided comments on the previous version of the Act and Corporate Governance for Risk Management Model Regulation (Regulation) on December 10, 2006. In that comment, we expressed several concerns about those drafts.

Most of our concerns about the documents that were exposed last year relate to requirements in the draft Regulation. Therefore, it is difficult for us to comment only on the current exposure document without knowing more about what is planned for the supporting Regulation. We continue to be concerned about the supporting Regulation based on Section 5A of the current exposure document, which describes the scope of anticipated additional requirements. The NAIC recently established a Corporate Governance Subgroup of the Principles-Based Reserving (EX) Working Group. We understand that the subgroup will consider the provisions in the latest exposure draft and the next steps that should be taken.

It appears that many of the changes from the previous version were intended to improve alignment with governance-related issues in the Solvency II directive ("Solvency II") that was released by the European Commission in July. We think that it is worthwhile to attempt such alignment to the extent that it makes sense for the US environment, especially since the Solvency II requirements may become a standard used by other parties, and because many US insurers are subsidiaries or affiliates of companies that will be subject to Solvency II.

That said, many companies will be subject to corporate governance requirements or standards issued by multiple regulators and other bodies (e.g., rating agencies, stock exchanges). Governance will be most effective and efficient if these requirements are in harmony. They should not result in requirements for companies to maintain different (and potentially costly and inefficient) structures and reports to meet requirements that multiple external parties impose. Therefore, we believe that companies should have the flexibility to meet external requirements for governance using processes that the companies also use to make business decisions.

For these various governance requirements to be in harmony, we believe that the external requirements should be based on principles and outcomes rather than on detailed implementation rules, and that there should be a consistent framework for the levels at which these external requirements are imposed. Such principles for insurance regulation should acknowledge that there will be differences between the information and decision parameters used for statutory reporting, which may include a significant degree of conservatism, and information and decision parameters used to make other kinds of business decisions, which are often based on estimates of expected outcomes together with an analysis of risks and variations around those estimates.

In addition, we note that the health insurance and health care industries in the United States are very different from the health care financing systems of most European countries. For that reason, many of the governance issues that arise in the U.S. industry may not have been encountered or contemplated in development of Solvency II. Accordingly, additional consideration should be given as to how these governance standards would be applied in the context of health insurance, most especially group medical coverages.

In the provided comparison, it is noted that Solvency II addresses governance more broadly than in the draft Act, which is restricted to corporate governance for risk management. We suggest that the NAIC consider requirements based on governance principles that would encompass all company activities, including board responsibilities, membership, and committee structure; as well as company governance issues, such as policies regarding ethics and conflicts of interest. Assuming that such an overall framework is developed, we believe that regulatory oversight of corporate governance for risk management could largely be built into the Risk-Focused Surveillance (RFS) framework, perhaps with some additional guidance regarding governance principles.

Such a structure for regulatory oversight of corporate governance is used by the Office of the Superintendent of Financial Institutions in Canada, and it appears to be working well. We suggest that particular consideration be given as to how the RFS framework may be used in monitoring corporate governance.

While we believe that corporate governance requirements will be more effective and efficient if they are principles-based and at a high level, we understand that effective corporate governance is critical to successful implementation of principles-based approaches (PBA) for determining insurance reserves and capital, because PBA allows greater flexibility for determining such amounts than life insurers had in the past. The various constituencies of insurance companies, including policyholders and regulators, rely on the boards of directors and managements to ensure that the obligations of the companies are met when they come due and that the companies maintain reserves and capital as required by statute to provide an adequate margin of safety. However, we believe that corporate governance of risk management can be implemented most effectively by considering the risks of the company in general, independent of whether the business is subject to PBA.

At least initially and for many years into the future, PBA will not be used to determine all components of capital. PBA will be used in determining reserves only for some insurance products and lines of business and most life insurance companies will have products and lines of business for which reserves will continue to be determined by traditional formula methods. If particular regulatory guidance is appropriate for how companies govern their processes for using PBA to determine certain specific reserve and capital amounts, we suggest that the appropriate place for such guidance should be in the Valuation Manual (VM) that is currently under development. Such guidance in the VM could address how governance requirements for PBA relate to governance of other products that are not subject to PBA, and could have the force of regulation. In addition, by putting such guidance in the VM, there should be sufficient flexibility to make changes as needs and typical practices for governance evolve and improve.

We also note that the definition of "Principles-based valuation" (defined to mean "any valuation in a statutory financial statement or RBC report based in whole or in part on assumptions determined by the insurer" in Section 3D of the exposure document) is very broad. By necessity, the determination of liabilities for unreported claims under medical policies and similar coverages makes use of insurer-determined assumptions. Industry-wide valuation bases do not exist; and they would not be relevant to any individual company even if they did exist. Therefore, estimates of such incurred but not reported (IBNR) claim liabilities would be "principles-based" according to the definition in the exposure document. It is unclear how useful it would be to include, for example, the valuation of dental IBNR within provisions related to principles-based valuations.

We believe that the provisions of Section 4 of the draft Act could be included in the VM. However, we suggest that the NAIC further examine the consequences of establishing specific regulatory limits on risk amounts as percentages of capital and surplus, as described in Section 4F. We agree that it is appropriate for each company to have specified limits on the risks it retains. However, we believe that the appropriate limits depend on company-specific factors. For example, other factors being equal, a company with risks that exhibit high frequencies but low severities of claim amounts could reasonably retain higher risk limits (as percentages of capital and surplus or relative to other standards) than could reasonably be retained by a company that has risks that exhibit higher severities but lower claim frequencies. Imposing a rules-based set of limits departs from the principles-based approaches that the NAIC is developing.

As noted above, many companies are subject to a variety of governance requirements, including those imposed by non-regulatory bodies in addition to multiple domestic and perhaps foreign regulators. We are concerned that particular numeric limitations on risk could be imposed in different ways by different bodies, and it would be unnecessarily complex for companies to try to meet all of these standards simultaneously. One set of requirements might be based on percentages of statutory capital and surplus, using a "once in a hundred year standard" (as in the current exposure draft). Another set might be based on capital and surplus determined according to a different accounting framework (e.g., US GAAP), but using a "once in two hundred year standard." A third set of requirements might base the limits on more complex stress testing of extreme scenarios. Each set of requirements could include different definitions of the range of risks to be considered (e.g., whether and to what extent operating type risks should be considered). And a particular company may have done independent research to demonstrate that a totally different structure for risk limits is appropriate for its particular circumstances.

The application of such quantitative standards to health insurance, medical insurance in particular, would be especially challenging. Would insurers have to include complying maximum benefit limitations in every medical insurance policy? Would such limitations be applied annually, or on a "lifetime" basis? How could they be adjusted to reflect changes in the company's capital and surplus and its volume of business? How would the "related events" limitation apply to something like an influenza epidemic? Could insurance policy terms possibly be set to impose such a limitation?

The preceding three paragraphs illustrate our serious concerns. We suggest that the limits each company sets could be evaluated more effectively based on principles, as part of the RFS framework, than by rules-based legislation or regulation. According to the provided comparison, Solvency II does not contain such specific numerical limits on the risks that companies may retain, even though Solvency II is intended to be a comprehensive framework for company solvency.

We believe that additional requirements that may be introduced by regulation, such as those referenced in Section 5 of the Act, also could be included more effectively and efficiently in the VM. On this basis, the additional requirements could be changed more frequently than applicable laws and regulations would change, and such evolution would be beneficial in accommodating environmental changes and emerging actuarial practices. As noted above, we believe that the requirements should be principles-based, to accommodate varying circumstances and needs of the different companies; to facilitate integration with governance requirements issued by other regulators and other entities; and to facilitate integration with other business and decision-making processes within a company. In particular, we believe that the requirements covered by Section 5A(1) of the Act (i.e., requirements for risk exposure limitations, risk tolerances, risk measurement and support of financial reporting and solvency assessment including principles-based valuations) would be most effective if they are expressed in terms of core principles, generally qualitatively rather than quantitatively.

The enforcement requirements for these provisions could be the same as the requirements that would apply to other sections of the VM, which may include enforcement requirements in the VM itself and in other applicable regulations and laws. We are not aware of reasons that different enforcement requirements should apply to corporate governance. If there are different enforcement provisions for governance, we think they should be harmonized with the overall regulatory enforcement structure and should specify due process consistently. For example, in the current exposure draft, due process procedures for circumstances in which the commissioner finds that the company's risk management system does not meet the applicable requirements are listed in Section 6D. It is not clear to us whether the authority that would be given to the commissioner in Sections 6C and 6F would be subject to the due process steps listed in Section 6D and, if not, we do not know what the due process in these circumstances would be.

We would be happy to provide additional information to the CADTF, or to other NAIC groups that will be addressing governance issues, such as the new Corporate Governance Subgroup. We would be particularly interested in receiving updated information on the intended next steps for the most recent exposure document and any plans regarding additional requirements such as those described in the previous Regulation that the CADTF exposed for comment last year and in Section 5A of the current exposure document.