



**Solvency Modernization Initiative
International Solvency (EX) Working Group**

**Consultation Paper on
Corporate Governance and Risk Management**

The NAIC's Solvency Modernization Initiative (SMI) was announced in June 2008 to encompass projects already under way at the NAIC, including a study of other financial supervisory modernization initiatives and solvency proposals in place or under development in other jurisdictions, including Australia, Canada, Switzerland and the EU. The initiative includes the following:

- Articulation of the U.S. solvency framework and principles.
- Study of other sectors' and other countries' solvency and accounting initiatives and the tools that are used and proposed.
- Creation of a new reinsurance regulatory framework.
- Movement to principle-based reserving for life insurance products.
- Enhancement of group supervision.
- Ultimately, implementation of new ideas to incorporate into the U.S. solvency system.

“Solvency” for purposes of the SMI is defined to mean “financial regulation” as opposed to “market regulation.” The SMI scope includes aspects relative to the financial condition of a company and is not limited to evaluation of insolvency alone.

The mission of the Solvency Modernization Initiative (EX) Task Force is to coordinate all NAIC efforts to successfully accomplish the Solvency Modernization Initiative. At these initial states of the SMI, the Task Force and its working groups are gathering intelligence for eventual dissemination to the NAIC committees and their task force and working group structures, who will be charged to implement the SMI. An SMI roadmap is being developed by the International Solvency (EX) Working Group of the SMI Task Force, which will eventually identify the charges to NAIC committees, task forces and working groups.

Goal of this Exposure Document: Comment Submission

A first working draft of the SMI roadmap was released Sept. 20, 2009. As part of the research needed to make recommendations for implementation of SMI, an exposure document on corporate governance and risk management was requested to be released for comment.

This consultation document concentrates on the consideration of corporate governance and risk management focus within the SMI. Because of the relationship between risk management and internal capital assessment, high-level issues surrounding the implementation of an Own Risk and Solvency Assessment are also explored in this paper. Additionally, two appendixes have been attached to this document outlining International Association of Insurance Supervisors principles and standards in areas relating to corporate governance and risk management that may warrant consideration.

Comments responding to the issues identified within this paper should be submitted by March 1, 2010. All comments received by March 1 will be incorporated into a document for discussion at an interim meeting to be



held prior to the NAIC Spring National Meeting in late March 2010. Please note that comments must be submitted in writing by the deadline for consideration at the interim meeting.

Upon deliberation, the next step in the Solvency Modernization Initiative process will be more extensive development of the SMI Roadmap.

1. Corporate Governance

- 1.1. Corporate Governance can be defined as a framework of rules and practices by which a board of directors ensures accountability, fairness and transparency in an insurer's relationship with all its stakeholders. Historically, regulators have set only basic requirements for insurance companies in this area, as corporate governance has been seen as a company responsibility defined by corporate law. However, due to changes in the economic environment and a move toward principle-based regulation, a greater regulatory focus on corporate governance may be required. The SMI should consider ways to improve the corporate governance of insurers as indicated throughout this section of the document.
 - a) Due to the various ways that insurance company groups are organized, it will be important to consider how corporate governance principles should be applied in a group situation. The SMI should consider whether principles apply at the group level, to individual insurance entities, or to some combination of both.
- 1.2. The primary responsibility for implementing proper corporate governance principles rests with the insurer's Board of Directors. It is important that a fully functional, well-qualified and independent Board of Directors be established to ensure that corporate governance principles are effectively implemented.
 - a) The Board of Directors should be composed of a sufficient number of knowledgeable, independent and active members to properly fulfill its governance and oversight responsibilities. The Board should be composed to ensure that it can act independently of management through a thoughtful and diligent decision-making process. The process to elect members of the Board should be formal and transparent. The SMI should consider how these standards can be effectively implemented.
 - b) The Board of Directors and its committees should be governed by formal bylaws and charters to ensure that duties and responsibilities are effectively documented and communicated.
 - c) Members of the Board of Directors should possess the appropriate professional qualifications, knowledge and experience to enable sound and prudent management. Members of the Board of Directors should be of good repute and integrity in order to properly fulfill their obligations. The SMI should consider how these standards can be effectively implemented.
 - d) Members of the Board should be guided by two basic principles, the duty of care and the duty of loyalty. Board members must have a sense of care and interest in the organization and willingness to place the organization goals above personal interests.
- 1.3. The corporate governance system implemented by the Board should include an adequate transparent organizational structure with a clear allocation and appropriate segregation of responsibilities, as well as an effective system for ensuring the transmission of information. Within this structure the Board of Directors should provide a significant level of strategic oversight in each of the following areas:



- a) Executive Oversight & Remuneration – The Board of Directors should be responsible for the appointment and compensation of the Chief Executive Officer and other key executive officers of the insurer. In addition, the Board should provide oversight to the overall compensation structure of the insurer. The nature and extent of Board oversight to be provided in this area should receive further attention and discussion from the SMI.
- b) Strategic Planning and Risk Management – The Board of Directors should be regularly involved in formulating, reviewing and approving the strategic business plan governing the insurer. The Board should approve the corporate philosophy and mission. In addition, the Board should be directly involved in overseeing the insurer’s process to identify, monitor and manage the risks the insurer faces. The nature and extent of Board oversight to be provided in this area should receive further discussion and attention from the SMI.
- c) Audit Function – The Board of Directors should provide oversight to the insurer’s audit function by establishing an Audit Committee to oversee the accounting and financial reporting processes of the insurer as well as the audits of financial statements of the insurer. Requirements for the Audit Committee have already been established for regulatory purposes in the *Annual Financial Reporting Model Regulation* (Model #205). However, requirements in this area stop short of requiring insurers to establish an internal audit function, which may require additional consideration from the SMI.
- d) Actuarial Function – The Board of Directors should provide oversight to the actuarial function of the insurer by receiving and reviewing reports in this area on a regular basis, including the effectiveness of internal controls with respect to the reserve calculations. In addition, the Board should interact with senior management to resolve questions and collect additional information regarding the actuarial function as needed. Principles for Board oversight of the principle-based reserving function have been adopted for regulatory purposes in Section G of the Valuation Manual. However, the nature and extent of Board oversight of the overall actuarial function and in relation to all product types should receive further discussion and attention from the SMI.
- e) Code of Conduct/Ethics – The Board of Directors is responsible for establishing the “Tone at the Top” of the insurer regarding the importance of ethical conduct throughout the organization. The Board should be actively involved in establishing and enforcing a code of conduct for the organization. Insurers are currently required to disclose whether the organization has a code of ethics that senior managers are subject to, but there are no other specific oversight requirements in this area. The nature and extent of Board oversight to be provided in this area should receive further attention and discussion from the SMI.
- f) Regulatory Compliance – The Board of Directors, or a committee thereof, should be responsible for overseeing the process to ensure compliance with the applicable regulatory standards of the insurer. Currently, there are no specific expectations regarding Board oversight in this area. As such, the nature and extent of Board oversight to be provided in the area of regulatory compliance should receive further attention and discussion from the SMI.
- g) Director Education and Performance Evaluation– Board members should complete an orientation program describing the obligations and responsibilities of Board members and receive continuing education on significant industry developments and risks on a regular basis. To ensure that an insurer’s Board of Directors is properly fulfilling its responsibilities, there should be a formal process to review the



effectiveness of the overall Board as well as individual members. If the Board or an individual member is determined to be ineffective, procedures are in place to correct the situation. The nature and extent of Board education and evaluation requirements should receive further attention and discussion from the SMI.

h) Succession planning – To ensure that qualified Board members and senior management are available to govern the insurer on an ongoing basis, a succession plan should be in place enabling a seamless transition of qualified individuals when vacancies occur. The SMI should consider the extent of Board responsibilities in this area.

1.4. Although the primary responsibility for implementing proper corporate governance principles rests with the insurer's Board of Directors, a critical role is also played by Senior Management in this process. As Senior Management is charged with the day-to-day management and oversight of the insurer, it is important that the individuals charged with this responsibility are capable to meet expectations in this area.

a) Members of Senior Management should possess the appropriate professional qualifications, knowledge and experience to enable sound and prudent management. Senior Managers should be of good repute and integrity in order to properly fulfill their obligations. The SMI should consider how these standards can be effectively implemented.

b) Senior management should assume responsibility in establishing the "Tone at the Top" of the insurer regarding the importance of ethical conduct throughout the organization. Senior Management should be held accountable to meet ethical standards by signing and agreeing to a formal code of conduct that has been adopted by the Board.

1.5. Information regarding the corporate governance of insurers should be shared with the regulator on a regular basis and verified during the financial condition examination process. The SMI should consider what information should be shared in this area and with what frequency. In addition, the SMI should consider developing standards for regulatory review and use of this information in solvency monitoring.

2. Risk Management

2.1. Risk Management can be defined as a process implemented by an entity's board of directors and management that is applied in strategy setting across the enterprise—designed to identify potential events that may affect the entity and to manage risk to be within its risk appetite—to provide reasonable assurance regarding the achievement of entity objectives. An insurer's risk management function should limit the risks acceptable to the entity to ensure that it is able to continue to operate following an extreme loss event.

a) Due to the various ways that insurance company groups are organized, it will be important to consider how risk management principles should be applied in a group situation. The SMI should consider whether principles apply at the group level, to individual insurance entities, or some combination of both.

b) A critical element of any risk management process should be the performance of scenario analysis and stress testing. As risks are identified and analyzed, various scenarios should be considered to determine the potential impact of critical risks. The SMI should consider how and to what extent stress testing and scenario analysis should be included within an insurer's risk management processes.



- 2.2. Each insurer should adopt a formal risk management framework/function to ensure that the insurer is properly identifying, monitoring and managing the risks it faces. This risk management function should be sufficiently independent in order to avoid conflicts of interest and to objectively monitor risk origination. The SMI should consider what should be included within a risk management framework/function, how such a function may be independently maintained, as well as how proportionality may be appropriately reflected.
 - a) The day-to-day management and oversight of the risk management function should be provided by Senior Management. However, the Board of Directors should be involved in regular oversight of the insurer's risk management function. The SMI should consider how and when oversight should be provided by the Board of Directors in the risk management function.
- 2.3. In establishing a risk management function, 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. The risk management policy should be transparent to various levels of management with a clear articulation and internal communication of the risk strategy. The policy should describe the linkage with the insurer's tolerance limits, regulatory capital requirements, economic capital, and the processes and methods for monitoring risk. The SMI should consider what should be included within a risk management policy as well as how often the policy should be updated and who should approve it.
- 2.4. In addition to establishing a risk management policy, an insurer should establish its own risk tolerances through the adoption of a formal risk tolerance statement. The statement should set out the insurer's overall quantitative and qualitative tolerance levels and define tolerance limits for each relevant and material category of risk, taking into account the relationships between risk categories. The insurer should then embed the risk tolerances into its ongoing risk management efforts to assist in making appropriate risk management decisions. The SMI should consider what tolerances should be defined within a risk tolerance statement and how the statement should be incorporated into the insurer's risk management practices.
- 2.5. For a risk management function to be adequate for solvency purposes, it should include provisions for the quantification of risk for a sufficiently wide range of outcomes and be responsive to change using appropriate techniques. This measurement of risk should be supported by accurate documentation providing appropriately detailed descriptions and explanations of risks. The SMI should consider which categories of risks should be documented and what level of detail should be included within the documentation.
 - a) Some of the typical categories of risk to be considered and documented within a risk management function should include underwriting risks, market risks, credit risks, operational risks (including disaster recovery/business continuity risks), liquidity risks (including asset-liability matching), legal risks, reinsurance risks and reserving risks.
 - b) Another risk that may need to be considered is reputational risk, which is the risk that negative publicity—whether true or not—causes a decline in the customer base, costly litigation, revenue reductions, or other negative impact on insurer solvency.
 - c) Another risk that may need to be considered is business contagion risk, which is the risk that problems arising from other affiliated businesses within the group could have a negative impact on the insurer's financial solvency.



- 2.6. The risk management function should be utilized by the insurer to determine the level of internal economic capital that should be held for solvency purposes. The quantification of risks as well as the scenario analysis and stress testing performed should be utilized by the insurer in making these decisions. To assist in this process, the insurer should perform an Own Risk and Solvency Assessment (ORSA). An ORSA is a tool that companies use to properly assess their own short and long term risks and the amount of own funds necessary to cover them.
- a) The ORSA should be performed on a regular basis, and the results of the assessment should be shared with Senior Management and the Board of Directors. The SMI should consider how often an ORSA should be performed, updated and the results reported to the Board of Directors.
 - b) The ORSA should encompass all reasonably foreseeable and relevant material risks, including—at a minimum—underwriting, credit, market, operational and liquidity risks. The assessment should identify the relationship between risk management and the level and quality of financial resources needed and available. The SMI should consider which risks should be addressed within the ORSA and at what level of detail.
 - c) As part of its ORSA, an insurer should analyze its ability to continue in business and the risk management and financial resources required to do so over a long time horizon. This continuity analysis should address a combination of quantitative and qualitative elements in the long-term business strategy of the insurer and include projections of the insurer's future financial position and analysis of the insurer's ability to meet future regulatory capital requirements. The SMI should determine what the time horizon may be and what specifically should be included within such a continuity analysis.
- 2.7. The risk management function should require that strategic decisions be made that are consistent with established risk management policies and tolerances after giving due consideration to the risks quantified and the amount of capital maintained for risk management purposes. Individuals responsible for strategic decisions should be subject to the oversight of and held accountable by the Board of Directors.
- 2.8. Information regarding the risk management function of insurers should be shared with the regulator on a regular basis and verified during the financial condition examination process. In addition, the results of the ORSA should be shared with regulators and considered as a valuable input in the solvency assessment process. The SMI should consider what information should be shared with the regulator and how often, and standards should be developed for the regulatory review of risk management and ORSA information. In addition, the SMI should determine how risk management and ORSA information should be used within the solvency monitoring framework.

W:\Dec09\TF\SMI\ISWG\CG and RM Consultation Paper.doc