Proposed Responses to a Comparative Analysis of Existing U.S. Corporate Governance Requirements

Introduction

The NAIC’s Corporate Governance (E) Working Group has been charged with, *inter alia*, outlining high-level corporate governance principles for use in U.S. insurance regulation and developing regulatory guidance, including detailed best practices, for the corporate governance of insurers. In furtherance of these charges, the Working Group reviewed recent insurance regulatory reforms in the corporate governance area and compiled a summary of existing corporate governance requirements impacting U.S. insurers. This review was organized based on the structure of “The United States Insurance Financial Solvency Framework”, which outlines the seven core principles used to regulate financial solvency. Work was finalized in this area on December 22, 2011 resulting in a document entitled “Existing U.S. Corporate Governance Requirements” being adopted by the Working Group.

After summarizing the existing corporate governance standards and practices in place within the U.S. regulatory system, the Working Group performed a comparative analysis between the existing standards and international standards, company best practices and regulatory needs. To complete this effort, the Working Group assigned individual states to perform an analysis of each of the seven core principles within the U.S. framework and to report their results and recommendations back to the Working Group. This occurred through a series of conference calls whereby the individual states recommended that the Working Group consider the implementation of specific corporate governance enhancements as a result of the comparative analysis.

The findings of the comparative analysis and enhancements proposed as a result of this analysis have been summarized within this document to assist the Working Group in reviewing and receiving comments on the proposals in an organized fashion. Commenters are encouraged to organize their thoughts in accordance with the structure of this document and provide specific suggestions for changes to the individual exhibits, if applicable. Upon the conclusion of the exposure period, the Working Group plans to hold conference calls to discuss the comments received and adjust this paper and its proposals, if necessary. The Working Group plans to finalize its response to a comparative analysis of U.S. corporate governance requirements by the NAIC’s December 2012 National Meeting, in accordance with its timeline.

Summary of Proposed Enhancements

**Principle 1: Regulatory Reporting, Disclosure and Transparency**

- Receive more regular and timely information on corporate governance practices of insurers through filing a confidential supplement on insurer governance practices with the domestic state of each insurance legal entity. (See Exhibit A)
- Enhance the existing Supplemental Compensation Exhibit through the addition of disclosures requiring a narrative description of the insurer’s compensation practices similar to those adopted by the SEC for public companies. (See Exhibit B)
- Add a section to the Model Audit Rule requiring insurers above a certain size to maintain an internal audit function. (See Exhibit C)

**Principle 2: Off-site Monitoring and Analysis**

- Send a referral to the Financial Analysis (E) Working Group asking it to clarify the existing procedures in place to review the suitability of officers and directors of insurers on a regular basis; update procedures relating to the review and follow-up on corporate governance issues; and consider adding procedures in these areas for holding company analysis at the group level. (See Exhibit D)
- Develop a common methodology for assessing corporate governance flexible enough to distinguish between governance expectations for large and small insurers. (See Exhibit E)
Principle 3: On-site Risk-focused Examinations

- Send a referral to the Financial Examiners Handbook (E) Technical Group requesting the addition of any necessary procedures and guidance to incorporate elements of ICPs 5, 7 & 8 into the examination process. (See Exhibit F)
- Develop a common methodology for assessing corporate governance flexible enough to distinguish between governance expectations for large and small insurers. Incorporate the results of the assessment into the regulators’ Insurer Profile Summary and/or Supervisory Plan. (See Exhibit E)

Principle 4: Reserves, Capital Adequacy and Solvency

- Send a referral to the Life Actuarial (B) Task Force recommending that the appointed actuary be required to present the full life actuarial report to the board of directors on an annual basis. (See Exhibit G)
- Send a referral to the Casualty Actuarial and Statistical (C) Task Force recommending that changes to the property/casualty actuarial process be considered to allow the commissioner a similar level of authority to deem an appointed actuary unsuitable as provided under Model #822. (See Exhibit H)

Principle 5: Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities

- Add a question to the Annual Statement General Interrogatories regarding the Board of Directors’ role in overseeing a company’s reinsurance strategy. (See Exhibit I)
- Send a referral to the Reinsurance (E) Task Force inquiring of the domestic supervisor regarding the reinsurer's corporate governance practices during a review of collateral reduction applications. (See Exhibit J)
- Add questions to the Annual Statement General Interrogatories regarding the Board of Directors' role in overseeing risk management and compliance. (See Exhibit K)

Principle 6: Preventive and Corrective Measures, Including Enforcement

- Send a referral to the Financial Regulation Standards and Accreditation (F) Committee requesting that section 4B(10) of Model #385 be considered a critical element for accreditation purposes. (See Exhibit L)
- Incorporate consideration of the authority provided under Model #385 as part of the common assessment methodology developed under Principle 2. (See Exhibit E)

Principle 7: Exiting the Market and Receivership

- Send a referral to the Group Solvency Issues (E) Working Group to consider insurers' corporate governance best practices in developing and approving resolution/contingency plans. (See Exhibit M)

Other Related Processes

- Add a question to the Annual Statement General Interrogatories regarding the Board of Directors’ role in overseeing compliance as developed under Principle 5. (See Exhibit K)

Body of the Report

**Principle 1: Regulatory Reporting, Disclosure and Transparency**

Insurers are required to file standardized annual and quarterly financial reports that are used to assess the insurer’s risk and financial condition. These reports contain both qualitative and quantitative information and are updated, as necessary, to incorporate significant common insurer risks.

In reviewing Principle 1 and performing a comparative analysis with international standards and U.S. regulatory needs, the Working Group identified three primary areas for further consideration. These areas include annual reporting of corporate governance practices, annual reporting of remuneration practices and internal control over...
statutory financial reporting. Regulator discussions relating to each of these topics, including proposed enhancements to existing processes in these areas, are outlined within this section of the paper.

**Annual Reporting of Corporate Governance Practices**

In performing a comparative analysis of Principle 1, Working Group members noted that some information on an insurer’s corporate governance practices is reported and disclosed through the annual regulatory reporting processes. However, this information is generally limited to a description of the insurer’s organizational structure (including a listing of the officers and board members), reporting on whether a code of ethics is in place and reporting on an insurer’s most highly compensated executives through the Supplemental Compensation Exhibit. In addition, companies that exceed a premium threshold are required to report on the effectiveness of their internal controls over statutory financial reporting, and insurers that are a part of a holding company group are required to submit a filing outlining general information regarding the holding company structure.

Although this information provides regulators with a general understanding of an insurer’s organizational structure, it does not provide much insight into an insurer’s corporate governance framework and practices. Typically, detailed information in this area is gathered and reviewed during on-site examinations, which occur every 3-5 years. However, through its comparative analysis process, the Working Group has identified a need to receive more regular and timely information on corporate governance practices of insurers. The gathering of additional information in this area would assist regulators in fulfilling their regulatory responsibilities both domestically and internationally. On the domestic front, this information would allow for a more timely and extensive review of corporate governance practices during the annual statement analysis process, rather than relying on information from the last on-site examination. The collection of additional information regarding corporate governance on an annual basis would also assist U.S. regulators in complying with international standards and sharing information on the governance practices of internationally active insurance groups with other supervisors.

In reviewing the international standards developed in this area, the Working Group notes that the eighth standard of Insurance Core Principle (ICP) 7 of the International Association of Insurance Supervisors (IAIS) states the following:

> The supervisor requires the insurer’s Board to have systems and controls to ensure the promotion of appropriate, timely and effective communications with the supervisor and relevant stakeholders on the governance of the insurer.

The guidance underlying this standard makes it clear that supervisors are expected to receive information from the insurer describing its governance practices on a regular (at least annually) and timely basis. The information to be provided is described in the ICP as addressing the following items:

- the insurer’s overall strategic objectives, covering existing or prospective lines of business and how they are being or will be achieved;
- the insurer’s governance structures, such as allocation of oversight and management responsibilities between the Board and the Senior Management, and organizational structures, including reporting lines;
- members of the Board and any Board committees, including their respective expertise, qualifications, track-record, other positions held by such members, and whether such members are regarded as independent;
- processes in place for the Board to evaluate its own performance and any measures taken to improve the Board’s performance; and
- the general design, implementation and operation of the remuneration policy as well as information to enable stakeholders to evaluate how the remuneration system relates to risk and whether it is operating as intended.

As much of this information is not currently provided to U.S. regulators outside of the examination process, the Working Group has discussed the need for such information to be reported by the insurer to regulators on an annual basis. Regulators recognize that some of the information that could be reported in this area may be proprietary and/or confidential in nature. Therefore, the Working Group proposes that governance information should be required to be reported directly to the states through a confidential supplemental filing, similar to the existing Supplemental Compensation Exhibit.
The Working Group developed a list of proposed disclosure questions in this area relating to insurer corporate governance practices after reviewing the ICPs, disclosures required by the Securities Exchange Commission (SEC), disclosures required by other regulatory bodies (domestic and international) and considering the needs of U.S. regulators in reviewing this information on an annual basis. As a result, it is proposed that the discussion questions included in Exhibit A be considered for inclusion in the Annual Statement Blanks as a Supplemental Exhibit on Corporate Governance to be filed confidentially with the domestic state of each insurance legal entity.
Exhibit A

Corporate Governance Disclosure Topics

1. Describe your organization’s governance structure, including a description of the Board and various committees ultimately responsible for governing the organization.
   a. Discuss the rationale for the current Board size and structure, explaining why the organization believes it to be appropriate;
   b. Discuss the duties of the Board of Directors and each of its committees and whether they are governed by formal charters;
   c. Discuss how oversight and management responsibilities are delegated between the Board, its committees and Senior Management, and how reporting responsibilities are organized;
   d. Discuss why the organization has chosen its leadership structure, including a discussion of why the roles of Chief Executive Officer and Chairman of the Board are separate or combined;
   e. Provide the number and dates of meetings held by the Board and its committees over the preceding 12-month period.

2. Describe the membership of the Board of Directors and any Board committees of the organization;
   a. Discuss the respective expertise and qualifications, length of service, other positions held within the organization, and independence status of each Board and committee member serving the organization;
   b. Discuss whether the reporting entity has a lead independent director, as well as the specific role the lead independent director plays in the leadership of the reporting entity;
   c. Provide information on individual member attendance at Board and committee meetings over the preceding 12-month period.

3. Describe the organization’s process to identify, nominate and elect members to the Board and its committees;
   a. Discuss whether a nomination committee is in place and why or why not. If a nomination committee is in place, describe the process it follows in identifying and selecting individuals for nomination;
   b. Discuss whether term limits are placed on members and describe the process for re-election.
   c. Discuss whether a Board diversity policy is in place. If so, describe the implementation of the policy as well as the board’s assessment of the policy’s effectiveness.

4. Describe the processes in place for the Board to evaluate its performance and the performance of its committees, as well as any measures recently taken to improve performance;
   a. Discuss whether a Board training program is in place and, if so, describe its contents/requirements.

5. Describe the Board of Directors’ involvement in the organization’s risk management process and the Board’s relationship with senior management in managing the material risks facing the reporting entity;
   a. Discuss whether the Board of Directors is involved in the risk oversight process directly, or through a committee(s).

6. Describe the Board of Directors’ involvement in reviewing the effectiveness of the organization’s system of internal controls;
   a. Discuss whether the organization maintains an internal audit function and, if not, discuss the reasons for the absence of such a function.
   b. Discuss whether the organization maintains a compliance function and, if not, discuss the reasons for the absence of such a function.

7. Describe the suitability standards that have been developed to assist your organization in determining whether officers and key persons in control functions have the appropriate background, experience and integrity to fulfill their prospective roles.
   a. Discuss which positions the organization has developed suitability standards for and provide a description of the standards employed;
   b. Discuss the organization’s process for performing background checks on individuals as a prerequisite for employment;
   c. Discuss the organization’s process for performance evaluations and corrective action;
   d. Provide information on any changes in an officer’s or key person’s suitability status as outlined by the organization’s standards.
Exhibit A

8. Describe the organization’s overall strategic objectives, covering existing or prospective lines of business and how they are being or will be achieved;
   a. Discuss how the organization’s strategic plan is updated and at what frequency.
Annual Reporting of Remuneration Practices

Another topic discussed by the Working Group was the amount of information reported to regulators regarding an insurer’s remuneration practices. As previously noted, the existing Supplemental Compensation Exhibit requires certain compensation information to be reported to regulators on an annual basis, including salary and bonus information for the top ten highest compensated individuals associated with each insurance entity. However, this information is not currently provided on an aggregate (company) level and does not describe or address the entity’s compensation practices and policies.

In reviewing the information that regulators currently receive in this area, the Working Group has concluded that regulators could benefit by receiving more information in the period between examinations on how companies manage their compensation practices. In considering what additional information would be appropriate to receive in this area, the Working Group reviewed a referral it received in 2010 from the NAIC/AICPA (E) Working Group recommending a number of changes to the Supplemental Compensation Exhibit including the development of a new list of disclosures relating to compensation and board risk management. The majority of these proposed changes were based on new disclosure requirements adopted by the SEC for public companies.

In addition, the Working Group reviewed international standards in this area included in ICP 7 as discussed in the previous section. The international standards stress the importance of reviewing insurer compensation practices as a means to ensure that they do not induce excessive or unnecessary risk taking. After reviewing this information, regulators determined that changes to the Supplemental Compensation Exhibit would be appropriate to gather additional information in this area. However, some of the changes previously proposed by the NAIC/AICPA (E) Working Group may not be necessary to allow the regulator to get an understanding of insurer practices in these areas. Therefore, the Working Group simplified the proposed changes to the existing Supplemental Compensation Exhibit to focus on those items most significant for regulator review on an annual basis. As a result, the newly proposed version shown as Exhibit B includes a section for the insurer to describe its compensation practices in narrative form, in addition to completing the tables on executive compensation. Gathering and reviewing this information should be beneficial to both financial analysts in the period between examinations and to examiners in preparing for an upcoming examination related to insurer compensation practices.
## Exhibit B

### ANNUAL STATEMENT BLANK – LIFE, HEALTH, PROPERTY, FRATERNAL & TITLE

**SUPPLEMENTAL COMPENSATION EXHIBIT**

For the Year Ended December 31, 2011

(To Be Filed by March 1)

### PART 1 – INTERROGATORIES

1. The reporting insurer is a member of a group of insurers or other holding company system: [ ] yes [ ] no. If yes, do the amounts below represent 1) total gross compensation paid to each individual by or on behalf of all companies that are part of the group: [ ] Yes [ ] No.

2. Did any person while an officer, director, or trustee of the reporting entity, receive directly or indirectly, during the period covered by this statement any commission on the business transactions of the reporting entity? [ ] Yes [ ] No.

3. Except for retirement plans generally applicable to its staff employees, has the reporting entity any agreement with any person, other than contracts with its agents for the payment of commissions whereby it agrees that for any service rendered or to be rendered, that he/she shall receive directly or indirectly, any salary, compensation or emolument that will extend beyond a period of 12 months from the date of the agreement? [ ] Yes [ ] No.

### PART 2—OFFICERS AND EMPLOYEES COMPENSATION

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Exhibit B
PART 3 – DIRECTOR COMPENSATION

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PART 5 – NARRATIVE DESCRIPTION OF COMPENSATION POLICIES

1. Use the table provided below to describe the general design, implementation and operation of your organization’s compensation policies:
   a. Discuss the general objectives of the organization’s compensation programs and what the programs are designed to reward;
   b. Discuss each element of compensation awarded in the programs and why the organization chooses to pay each element;
   c. Discuss how the organization determines/calculates the amount of each element of compensation paid within the programs;
   d. Discuss how compensation programs are related to both company and individual performance over time;
   e. Discuss whether compensation programs include risk adjustments and how those adjustments are incorporated into the programs for employees at different levels;
   f. Discuss the organization’s policies and decisions regarding the adjustment or recovery of awards or payments if the relevant performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of an award or payment;
   g. Discuss the Board’s role in overseeing compensation practices;
   h. Discuss whether compensation consultants are utilized by the organization and, if so, what role they play in the organization’s remuneration policies;
   i. Discuss any other factors relevant in understanding how the organization monitors its compensation policies to determine whether its risk management objectives are being met with respect to incentivizing its employees.
Internal Control over Statutory Financial Reporting

The final topic related to Principle 1 reviewed and discussed by the Working Group focused on an insurer’s internal control over statutory financial reporting. The Working Group noted that 2006 revisions to the NAIC’s Annual Financial Reporting Model Regulation (#205) — commonly referred to as the Model Audit Rule — require insurers with more than $500 million in annual premium to file Management’s Report of Internal Control over Financial Reporting. This report attests to the effectiveness of controls put in place to ensure accurate financial reporting. The report is required to be signed by the entity’s chief executive officer (CEO) and chief financial officer (CFO) and to be supported by diligent inquiry in reviewing, documenting and testing the internal controls in place to ensure accurate financial reporting.

In addition, the revisions reduced the existing audit partner rotation requirements from every seven years, with a two-year cooling off period, to every five years, with a five-year cooling off period. While this change in rotation requirements was meant to increase the level of independence amongst external auditors in issuing an opinion on the statutory financial statements, it is difficult to measure whether that goal has been achieved. Members of the Working Group have noted that the European Commission has recently adopted a proposal to mandate audit firm rotation, which is also being considered by the Public Company Accounting Oversight Board (PCAOB). However, as insurance regulators have not identified significant problems in external audit firm independence and the PCAOB has not finalized its position on this matter, the Working Group feels that consideration of audit firm rotation is not necessary at this juncture.

Members of the Working Group have also noted that the Model Audit Rule does not currently include a requirement for insurer’s to maintain an effective internal audit function to assist in ensuring complete and accurate financial reporting. However, it is a standard practice for larger U.S. insurers to maintain such a function and the effectiveness of internal audit functions are extensively reviewed during on-site examinations. In addition, public companies listed on the New York Stock Exchange (NYSE) are required to comply with listing requirements that require each company to maintain an internal audit function.

In reviewing international standards in this area, the Working Group noted that the sixth standard of ICP 8 states the following:

The supervisor requires the insurer to have an effective internal audit function capable of providing the Board with independent assurance in respect of the insurer’s governance, including its risk management and internal controls.

The guidance underlying this standard makes it clear that supervisors are expected to require insurer’s to maintain an independent internal audit function that investigates matters related to financial reporting, IT systems and internal controls. Such a function should be independent from company management and report regularly to the Audit Committee and/or Board of Directors. This issue was also raised by the assessors that conducted the 2009 Financial Sector Assessment Program on the U.S. and the following recommendation was received in this area:

The NAIC and/or departments should make it a formal requirement for insurers to have an internal audit function. Such a function is now widely considered as an important part of a good control framework—similarly to audit committees, where there are now extensive requirements of all but the smaller insurers.

In considering this recommendation, reviewing the international standards in place and considering regulatory needs, the Working Group is proposing that explicit standards be adopted requiring insurers above a certain size to maintain an effective internal audit function. Therefore, the Working Group has proposed that the elements outlined within Exhibit C be considered for inclusion in the Model Audit Rule to require all large insurers to maintain an effective internal audit function.
Exhibit C

Proposed Internal Audit Function Requirements

1. Insurers exceeding premium threshold requirements\(^1\) must maintain effective internal audit functions capable of providing the Audit Committee independent assurance in respect of the insurer’s governance, risk management, and internal controls.

1.1 The internal audit function should provide independent assurance to the Audit Committee through general and specific audits, reviews, testing and other techniques in respect of matters such as asset protection, financial reporting, IT systems and the overall effectiveness of internal controls. Other areas subject to review should include corporate governance practices, risk management processes, compliance with regulations and adherence to compensation policies.

1.2 To help ensure objectivity, the internal audit function is independent from management and is not involved operationally in the business. The internal audit function’s ultimate responsibility should be to the Board of Directors, not management.

1.3 The head of the internal audit function reports to the Audit Committee on a regular basis (at least quarterly) on such matters as the function’s periodic audit plan, factors that may adversely impact the internal audit function’s independence or effectiveness, material findings from completed audits and the appropriateness of corrective actions implemented by management as a result of audit findings.

\(^1\) It is proposed that the premium threshold be established in line with the threshold included in the NAIC’s Annual Financial Reporting Model Regulation.
Principle 2: Off-site Monitoring and Analysis

Off-site solvency monitoring is used to assess, on an ongoing basis, the financial condition of the insurer as of the valuation date and to identify and assess current and prospective risks through risk-focused surveillance. The results of the off-site analysis are included in an insurer profile for continual solvency monitoring. Many off-site monitoring tools are maintained by the NAIC for regulators, such as the Financial Analysis Solvency Tools (FAST).

In reviewing Principle 2 and performing a comparative analysis with international standards and U.S. regulatory needs, the Working Group identified two primary areas for further consideration. These areas include a review of existing analysis processes related to corporate governance and the need for a common methodology for regulators to follow in assessing corporate governance. Regulator discussions relating to each of these topics, including proposed enhancements to processes in these areas, are outlined within this section of the paper.

Review of Existing Analysis Processes

The Working Group discussed the review of corporate governance that is currently performed through the financial analysis process and noted that the NAIC’s Financial Analysis Handbook prompts analysts to perform a basic analysis of the corporate governance of each insurer on an annual basis. This analysis focuses on a review of governance information received through the annual filing processes including a review of biographical affidavits received for new officers and directors. Based on the appearance of risk considerations, analysts are encouraged to consider performing additional procedures related to management considerations, which include following up on deficiencies identified during the previous financial examination. These procedures also outline various risk considerations related to corporate governance to help the analyst assess potential risks and determine the level of surveillance that might be warranted as a result of these risk considerations. If concerns are identified in the corporate governance review performed during the analysis process, the analyst may request additional information or explanation from the insurer and/or propose a financial examination to investigate the matter further.

In comparing these existing practices to international standards and regulatory needs, Working Group members discussed a need to clarify the role of the analyst in verifying the suitability of officers and directors of each insurer on a regular basis. While the suitability of officers and directors is initially reviewed during the licensure process and on an ongoing basis during financial examinations, analysts have a responsibility to request and review biographical information on any new officers or directors appointed in the period between examinations. The existing procedures encourage the analyst to obtain and review biographical affidavits, but may not be clear in stating that the purpose in reviewing this information is to review whether individuals have the appropriate level of background and experience to perform the duties expected of his or her position. Also, as the financial analyst is the primary individual charged with the ongoing solvency monitoring of the insurer, the existing procedures may not be clear that the analyst’s role is to appropriately communicate any suitability concerns identified with other relevant regulators (in accordance with each state’s laws and regulations), both domestically and internationally. Therefore, the Working Group is considering referring these matters relating to the ongoing monitoring and communication of suitability issues to the Financial Analysis Handbook (E) Working Group for their consideration as outlined in Exhibit D.

Another matter that came up in performing a comparative analysis is the need to follow-up on governance concerns previously identified for consideration. This could include items identified during a financial examination or items previously noted by the financial analyst and/or other regulators. As governance concerns may be identified through a number of new areas becoming available to regulators—including Own Risk and Solvency Assessment (ORSA) reports, Management’s Report on Internal Controls, rating agency comments on enterprise risk managements (ERM) and other documentation received by the insurance Department—there is an increasing need for analysts to follow up on potential issues in these areas. Currently, the procedure to follow-up on previously identified corporate governance concerns is included in the Handbook under additional management considerations, which are typically only performed if the company is considered a higher priority or if specific risks have been identified in this area. However, the Working Group is considering requesting that the procedure to follow-up on previously identified governance deficiencies/concerns be added to the standard annual statement analysis procedures for each insurer as outlined in Exhibit D.
Finally, as new analysis procedures related to holding company analysis have been added to the Handbook as a result of the Solvency Modernization Initiative, the Working Group discussed the need to encourage a review of suitability and follow-up on governance concerns to be performed during holding company analysis procedures. Therefore, this request has also been included in the proposed referral to the Financial Analysis Handbook (E) Working Group as outlined in Exhibit D.
To: Judy Weaver (MI), Chair, Financial Analysis Handbook (E) Working Group

From: Susan Donegan (VT), Chair, Corporate Governance (E) Working Group

Re: Proposed Enhancements to Analysis of Corporate Governance

Date: TBD

The Corporate Governance (E) Working Group (CGWG) has been charged with outlining high-level corporate governance principles and determining the appropriate methodology to evaluate adherence to such principles. During discussions related to this charge, the Working Group discussed the need to include further consideration of certain governance principles in the financial analysis process. Therefore, we request that the Financial Analysis Handbook (E) Working Group (FAHWG) consider adopting additional procedures/guidance into the Financial Analysis Handbooks related to the following areas:

1. Ensure the Level 1 procedures include an expectation that analysts obtain and review biographical information to consider whether officers, directors and trustees are suitable for the positions they hold within the insurer on a regular basis. Suitability includes considering whether the individual has the appropriate background and experience to perform the duties expected of his or her position. The Level 1 procedures should also include guidance explaining how analysts are expected to communicate suitability and other governance related concerns to other relevant regulators, both domestically and internationally.

2. Ensure the Level 1 procedures include a step to review and follow-up on any corporate governance issues previously identified for consideration at the company. This may include items identified during a financial examination or items previously noted by the financial analyst and/or other regulators. As governance concerns may be identified through a number of new areas becoming available to regulators including ORSA reports, Management’s Report on Internal Controls, rating agency comments on ERM and other documentation received by the Department, there is an increasing need for analysts to follow-up on potential issues in these areas. Therefore, we encourage the analyst to document the work performed to follow-up on these matters within the Level 1 procedures.

3. Ensure that holding company analysis procedures include an expectation for each of the items listed above to be addressed at the group level. As much of the governance framework and processes for groups is implemented at the holding company level, it is important to ensure that suitability and follow-up on governance concerns is also considered at this level. Much of the information that may be reported to regulators on an insurer’s corporate governance may be reported at the group level, which makes a review of these areas as part of the holding company analysis even more critical. Therefore, we encourage the analyst to document a consideration of all significant corporate governance matters as part of the holding company analysis process.

We are hopeful that these items will allow for an increased focus on governance matters within the financial analysis process. The matters identified above represent initial steps to ensure greater focus in this area. The CGWG is also considering requiring additional corporate governance information to be reported to regulators on an annual basis and developing a consistent corporate governance assessment methodology/tool that can be used in both financial examination and analysis. As progress is made in these areas, the CGWG may refer additional matters to the FAHWG for its consideration. We thank you for your consideration of these items and encourage you to contact us with any questions.
Common Methodology for Corporate Governance Assessment

The second topic discussed by the Working Group in this area relates to the fact that a review of existing regulatory practices in assessing the corporate governance activities of an insurer show some inconsistencies in application from state to state and between the analysis and examination functions. Although much of the guidance provided in the analysis and examination handbooks related to corporate governance review and assessment is similar, it is currently provided at a high level and has been applied differently from state to state. For example, some states follow a scoring or rating process in reviewing the corporate governance practices of an insurer and other states complete a narrative summary. Some states gather and review extensive information on corporate governance during the analysis process while other states only focus on this area during the on-site examination. Due to the state differences in applying the existing governance guidance, it can be difficult for states to communicate and share information with each other in this area.

The existing guidance for reviewing corporate governance provided in both the financial analysis and financial examination handbooks highlights general categories to be reviewed (e.g. Board of Directors, Organizational Structure, Senior Management, Risk Management), but lacks detailed guidance to outline best practices and regulator expectations in assessing and reviewing insurer corporate governance practices. Without more extensive guidance in this area, analysts and examiners in each state are left to their own judgment in determining what practices are appropriate, which leads to inconsistent assessment, review and follow-up on noted concerns from state to state. A similar concern was raised by the assessors that conducted the 2009 Financial Sector Assessment Program on the U.S. and the following recommendation was received in this area:

As examiners gain experience, the NAIC and/or departments should consider issuing more guidance on good and bad practices in corporate governance for insurers. This would help examiners and firms to develop a clearer expectation of what constitutes effective governance for insurance business, including for groups.

In discussing this concern, the Working Group feels that the use of a common methodology for assessing corporate governance could allow for a consistent, continual and uniform assessment of corporate governance across functions and states. The methodology could provide specific guidance on best practices and regulator expectations within each common governance category to be assessed, but focus on outcomes rather than prescribing specific processes. In addition, the methodology should be flexible enough to distinguish between governance expectations for large and small insurers. The process could also allow for input from a wide range of sources including C-Level interviews, written policies and procedures, records of meetings, information included in the ORSA Report, and rating agency and other external assessments. The process could also provide a standardized rating methodology, to outline specific criteria for assessing a company’s practices in a given category. Finally, the results of the assessment could be tied to specific follow-up activities including impacts to a company’s priority rating and supervisory plan. An outline of the proposed methodology, which is intended to be referred to the Financial Analysis Handbook (E) Working Group and the Financial Examiners Handbook (E) Technical Group for further development, is provided in Exhibit E.
Exhibit E

Common Methodology for Corporate Governance Assessment

The use of a common methodology would allow for a consistent, uniform assessment of corporate governance across functions (exams and analysis) and states. Such a methodology could include the following elements:

1. Standardized Assessment Template – Regulators could be asked to assess the corporate governance practices of insurers in specific areas through use of a confidential summary template providing a uniform process to document, rate and follow-up on corporate governance practices.

   o Information Sources and Areas to be Assessed – Information may be obtained and reviewed from a number of sources in developing an assessment including C-Level interviews, written policies and procedures, information included in the ORSA Report, rating agency assessments, other external assessments, etc. Areas to be assessed could include those areas deemed most significant to regulators after considering international standards, best practices and regulatory needs. Example areas for assessment could include the following: Board of Directors; Organizational Structure; Management; Ethics; Compensation; Strategy; Risk Management and/or other areas deemed appropriate by regulators. Each of the areas to be assessed would be supported by underlying criteria, providing more guidance and direction for the assessment as illustrated below for Board of Directors:
      – Board Composition
      – Board Role and Responsibilities
      – Board Committees
      – Board Practices

   o Standardized Rating Considerations – Regulators could assess the effectiveness of corporate governance processes using a standardized rating methodology. The methodology could provide general guidance on strong, acceptable and weak practices in corporate governance for each overall area, with more detailed guidance provided for assessing each individual criterion. The methodology could also be customized for the size and type of company being assessed.

   o Results of Rating – Guidance could be provided to regulators on how the assessed rating can be used for prioritization and follow-up purposes. For example, companies receiving a rating below a certain level could be required to submit a formal response and be subject to more frequent analysis/examination follow-up procedures. In addition, the results of the assessment could be incorporated into the regulators’ Insurer Profile Summary and/or Supervisory Plan. If corporate governance practices of an insurer are assessed as weak, the assessment should be considered in determining whether a company is in a hazardous financial condition. In such instances, the regulator should consider requiring the insurer to correct corporate governance deficiencies and adopt and utilize practices acceptable to the commissioner as outlined in NAIC Model #385.

2. Continual Updates – The assessment could be updated on a continuous basis by linking annual disclosures to the various assessment categories. This could also allow the analysts to have more involvement in the process by clearly providing a means to update the rating based upon reported information. The analysts could also follow-up on previously reported issues and adjust the rating based upon changes implemented by the company, which could be subject to further investigation during future examinations (limited or full-scope).
Principle 3: On-site Risk-focused Examinations

U.S. insurance regulators carry out risk-focused, on-site examinations in which the insurer’s corporate governance, management oversight and financial strength are evaluated, including the system of risk identification and mitigation, both on a current and prospective basis. The reported financial results are assessed through the financial examination process and a determination is made of the insurer’s compliance with legal requirements.

In reviewing Principle 3 and performing a comparative analysis with international standards and U.S. regulatory needs, the Working Group identified two primary areas for further consideration. These areas include a review of existing examination processes related to corporate governance and the need for a common methodology for regulators to follow in assessing corporate governance. Regulator discussions relating to each of these topics, including proposed enhancements to processes in these areas, are outlined within this section of the paper.

Review of Existing Examination Processes

The Working Group discussed the review of corporate governance that is currently performed through the financial examination process in conjunction with each full-scope financial exam. These activities include interviews with directors and officers and completing an overall assessment of an insurer’s corporate governance function through the use of Exhibit M – Understanding the Corporate Governance Structure in the NAIC’s Financial Condition Examiners Handbook. As noted in the discussion on Principle 2, the existing handbook guidance provides a high-level framework for assessing the corporate governance practices of an insurer. However, after performing a comparative analysis of existing practices to international standards, the Working Group identified several topics addressed in the ICPs that are not explicitly covered in Exhibit M of the handbook (e.g. suitability of the appointed actuary, assessment of governance for holding company groups, etc.). Therefore, the Working Group is proposing a referral to the Financial Examiners Handbook (E) Technical Group asking them to address this issue as outlined in Exhibit F of this paper.
To: Al Bottalico (CA), Chair, Financial Examiners Handbook (E) Technical Group  
From: Susan Donegan (VT), Chair, Corporate Governance (E) Working Group  
Re: Proposed Enhancements to Examination of Corporate Governance  
Date: TBD

The Corporate Governance (E) Working Group (CGWG) has been charged with outlining high-level corporate governance principles and determining the appropriate methodology to evaluate adherence to such principles. During discussions related to this charge, the Working Group discussed the need to include further consideration of certain governance principles highlighted in the International Association of Insurance Supervisor’s (IAIS) Insurance Core Principles 5, 7 and 8 within the financial examination process. Therefore, we request that the Financial Examiners Handbook (E) Technical Group (FEHTG) review these ICPs and consider the development of additional procedures/guidance into Exhibit M of the Handbook if deemed appropriate. Examples of potential enhancements to Exhibit M as a result of this review include the following:

1. Review the standards and guidance within ICP 5 on Suitability to identify whether additional guidance should be included within Exhibit M related to a review of the background and experience of Directors, Senior Managers and Key Persons in Internal Control Functions of the insurer including the position of Appointed Actuary.

2. Review the standards and guidance within ICP 7 related to remuneration to identify whether additional guidance should be included within Exhibit M related to a review of insurer remuneration policies and procedures.

3. Review the standards and guidance within ICPs 5, 7 and 8 and consider its application to insurance groups in developing guidance on how an assessment of corporate governance should be performed in a coordinated group examination.

We are hopeful that these items will allow for an increased focus on governance matters within the current financial examination process. The CGWG is also considering the development of a common corporate governance assessment methodology/tool that can be used in future financial examination and analysis processes. As progress is made in these areas, the CGWG may request the assistance of the FEHTG in this area or refer additional items for its consideration. We thank you for your consideration of these items and encourage you to contact us with any questions.
Common Methodology for Corporate Governance Assessment

As described under Principle 2, the Working Group feels it is appropriate to consider the development of a common methodology/tool for use in assessing the corporate governance practices of insurers. In considering the development of such a tool during discussions on Principle 3, the Working Group reviewed the assessment methodologies used by Standard and Poor’s Financial Services LLC (S&P) and Canada’s Office of the Superintendent of Financial Institutions (OSFI).

In reviewing S&P’s proposed General Criteria for Management and Governance Factors, the Working Group noted that S&P assesses the components of strategic positioning, risk management, organizational effectiveness and governance. Subfactors are outlined to help rate each of these components, which are scored using examples of positive, neutral and negative criteria. Finally, the ratings of each component are combined to reach an overall management and governance rating of strong, satisfactory, fair or weak.

The Working Group also reviewed the OSFI framework for assessing corporate governance noting that it includes separate assessment criteria for the board of directors, senior management, risk management and internal audit. The assessment criteria provide essential elements and detailed criteria to assist the regulator in reaching an overall rating of strong, acceptable, needs improvement or weak in each area. These ratings are then incorporated into OSFI’s overall supervisory framework to reach determinations regarding stages of intervention to be taken by the regulator.

Based on a study of these external assessments of corporate governance, the Working Group noted that there are a number of useful resources that can be utilized in developing a regulatory tool in this area. In addition, based on discussions related to Principle 3, the Working Group agreed to add some detail to its proposed assessment tool (refer back to Exhibit E). This detail included listing additional sources of information to be considered in developing an assessment, developing criteria underlying each of the critical assessment categories and developing guidance on strong, acceptable and weak governance practices for use with the tool. In addition, a reference was added to recommend that the results of the assessment be incorporated into the regulators’ Insurer Profile Summary and/or Supervisory Plan.
Principle 4: Reserves, Capital Adequacy and Solvency

To ensure that legal obligations to policyholders, contract holders and others are met when they come due, insurers are required to maintain reserves and capital and surplus at all times and in such forms so as to provide an adequate margin of safety. The most visible measure of capital adequacy requirements is associated with the RBC system. The RBC calculation uses a standardized formula to benchmark specified level of regulatory actions for weakly capitalized insurers.

In reviewing Principle 4 and performing a comparative analysis with international standards and U.S. regulatory needs, the Working Group identified four primary areas for further consideration. These areas include actuary reporting to the board of directors, actuarial involvement in the pricing process, suitability of the appointed actuary and corporate governance considerations for risk-based capital (RBC). Regulator discussions relating to each of these topics, including proposed enhancements to processes in these areas (if deemed appropriate), are outlined within this section of the paper.

Actuary Reporting to the Board of Directors

One of the issues that the Working Group considered during its review of governance requirements around the reserving process is the board of director’s role in receiving annual reports from the appointed actuary on items included within the scope of the actuarial opinion. As board reporting is referenced in international standards and generally viewed as a best practice for the governance of reserve liabilities, the Working Group decided to review existing U.S. requirements in this area.

After reviewing the existing requirements, the Working Group noted that requirements for annual reporting to the board exist for property/casualty and health entities in the Annual Statement Instructions. However, these requirements are not included in the instructions for life entities. A requirement on board reporting is included in the NAIC’s Valuation Manual for principle-based reserving, which is being developed by the Life Actuarial (A) Task Force. However, the Working Group noted that this requirement could still be years away from implementation and would only apply to business subject to principle-based reserving, which will be applied on a prospective basis. Therefore, as shown at Exhibit G, the Working Group has drafted a referral to the Life Actuarial (A) Task Force recommending that the appointed actuary be required to present the full life actuarial report to the board of directors on an annual basis.
Exhibit G

To: Mike Boerner (TX), Chair, Life Actuarial (A) Task Force
From: Susan Donegan (VT), Chair, Corporate Governance (E) Working Group
Re: Actuarial Reporting to the Board of Directors
Date: TBD

The Corporate Governance (E) Working Group (CGWG) has been charged with outlining high-level corporate governance principles and determining the appropriate methodology to evaluate adherence to such principles. During discussions related to this charge, the Working Group discussed existing corporate governance requirements relating to reserve calculations. During these discussions, members of the Working Group noted that a requirement for the appointed actuary to provide an annual report to the board on the results of reserving calculations exists for both property/casualty and health entities in the Annual Statement Instructions. However, these requirements do not currently appear to apply to life insurance entities.

The Working Group notes that a requirement on annual board reporting is included in the NAIC’s Valuation Manual for principle-based reserving. However, this requirement may still be years away from implementation and would only apply to business subject to principle-based reserving on a prospective basis. Therefore, the Working Group would like to recommend that your Task Force consider developing a requirement for the appointed actuary to present the full life actuarial report to the board of directors on an annual basis.

We are hopeful that this suggestion will allow for an increased focus on corporate governance matters within the current process to determine reserve liabilities. We thank you for your consideration of this request and encourage you to contact us with any questions.
Actuarial Involvement in the Pricing Process

Another area that the Working Group considered during its comparative analysis relating to Principle 4 is actuarial involvement in the pricing process. In studying this issue, the Working Group reviewed the fifth standard of ICP 8, which states the following:

The supervisor requires that there is an effective actuarial function capable of evaluating and providing advice to the insurer regarding, at a minimum, technical provisions, premium and pricing activities, and compliance with related statutory and regulatory requirements.

The guidance underlying the standard states that regulators may consider requiring the actuarial function may to provide certifications on the adequacy, reasonableness and/or fairness of premiums. The Working Group notes that there are no uniform requirements across the states regarding the involvement of an actuary in the pricing/rating process. However, it is a standard industry practice to involve actuaries in this process and some states have rate filing requirements in this area. In addition, all states retain the authority to involve an actuary in a review of rates during the solvency monitoring processes of analysis and examination. Finally, there is additional authority provided to the commissioner to require rate changes if a company is deemed to be in a hazardous financial condition. Based on the existing requirements in place in the U.S. as well as the overall competitiveness of the current market, the Working Group determined that no additional enhancements are necessary to adjust corporate governance practices in this area.
Suitability of the Appointed Actuary

Another area the Working Group discussed in relation to Principle 4 was governance provisions around the suitability of the appointed actuary. International standards in this area are included in ICP 5 and require the regulator to have processes in place to ensure that individuals acting as appointed actuaries have the requisite background, training and experience to fulfill their roles. To qualify as an appointed actuary for U.S. regulatory purposes, an individual must meet minimum qualifications outlined in statute, including that the actuary is credentialed and in good standing with their actuarial association. As such, the U.S. system places some reliance on the fact that actuaries are self-governed by their actuarial associations and utilize codes of conduct adopted by their association, standards adopted by the Actuarial Standards Board (ASB) and discipline by the Actuarial Board for Counseling and Discipline (ABCD). The Working Group feels that these standards provide a reasonable basis for determining whether an appointed actuary is suitable.

However, additional authority is available to the commissioner in determining whether an appointed actuary is qualified to fill his or her role for life insurers. Language included in the NAIC’s Actuarial Opinion and Memorandum Regulation (Model #822) gives the commissioner the authority to deem an appointed actuary unqualified for various reasons including incompetency, lack of cooperation or untrustworthiness as demonstrated through a notice and hearing process. However, the Working Group notes that there is no such authority or language included in the NAIC’s corresponding Property and Casualty Actuarial Opinion Model Law (Model #745). However, the commissioner does have the authority to hire an actuary when the appointed actuary’s report for a property/casualty insurer is deemed insufficient. During discussions of the Working Group, regulators noted that the Casualty Actuarial and Statistical (C) Task Force has already formed a subgroup to address this issue. Therefore, the Working Group has drafted a referral (see Exhibit H) to the Casualty Actuarial and Statistical (C) Task Force recommending that changes to the property/casualty actuarial process be considered to allow the commissioner a similar level of authority to deem an appointed actuary unsuitable as provided under Model #822.
Exhibit H

To: Rich Piazza (LA), Chair, Casualty Actuarial and Statistical (C) Task Force

From: Susan Donegan (VT), Chair, Corporate Governance (E) Working Group

Re: Qualification of the Appointed Actuary

Date: TBD

The Corporate Governance (E) Working Group (CGWG) has been charged with outlining high-level corporate governance principles and determining the appropriate methodology to evaluate adherence to such principles. During discussions related to this charge, the Working Group discussed existing corporate governance requirements relating to reserving. During these discussions, the Working Group reviewed the requirements that have been put in place to ensure that the appointed actuary meets certain qualifications. The Working Group noted that an appointed actuary must meet minimum qualifications outlined in statute, including that the actuary is credentialed and in good standing with their actuarial association.

Although the actuarial associations appear to have robust codes of conduct and procedures to discipline those who do not meet minimum standards, the Working Group raised some concerns over whether regulators have sufficient authority in determining whether an appointed actuary is qualified to fulfill his or her duties. In reviewing qualification standards for life insurance entities, it appears that additional authority is available to the commissioner in determining whether an appointed actuary is qualified to fill his or her role. Language included in the NAIC’s Actuarial Opinion and Memorandum Regulation (Model #822) gives the commissioner the authority to deem an appointed actuary unqualified for various reasons including incompetency, lack of cooperation or untrustworthiness as demonstrated through a notice and hearing process. However, there does not appear to be such authority included in the NAIC’s corresponding Property and Casualty Actuarial Opinion Model Law (Model #745).

During the Working Group’s discussions on this topic, it was informed that your Task Force has formed a subgroup to study and address this issue. Therefore, based on our charge to review corporate governance principles in place in the U.S. system, we would like to encourage your Task Force to strongly consider changes to the property/casualty actuarial process to allow the commissioner a similar level of authority to deem an appointed actuary unsuitable as provided for life insurance entities under Model #822.

We are hopeful that this recommendation will allow for an increased focus on corporate governance matters within the current reserving process. We thank you for your consideration of this request and encourage you to contact us with any questions.
Corporate Governance Considerations for Risk-Based Capital (RBC)

The final topic addressed by the Working Group for Principle 4 relates to capital adequacy and solvency. There are currently a number of requirements built into the RBC reporting process that require certification of the RBC filings and give the regulator the authority to require corrective action plans if negative trends in RBC are identified. These requirements provide for some level of governance around the RBC process. In addition, states have authority to approve the payment of dividends out of an insurance company and review management and tax-sharing agreements, which allows for some regulatory control of capital leaving a company. Finally, Own Risk and Solvency Assessment (ORSA) reporting requirements are being developed that will require companies to report on their own internal capital assessments, which will include corporate governance considerations.

Based on these existing practices, it is clear that there are a number of governance considerations related to capital and solvency within the U.S. system. However, there is not currently a charge built into the RBC formula for risks associated with a company’s governance practices or operations. Such a charge has been discussed at various points in time by the Capital Adequacy (E) Task Force and the Solvency Modernization Initiative RBC (E) Subgroup. Based on staff inquiries to these groups, it appears that prior discussions on this topic have not resulted in much momentum towards the development of an operational risk charge in RBC, primarily due to the difficulty of quantifying a charge on a company-specific basis.

In discussing this issue, members of the Working Group shared concerns regarding the difficulty of developing a corporate governance or operational risk charge that could be very precise or distinguish between the risk profiles of various insurers. In addition, the Working Group has noted that its focus is on developing corporate governance standards as well as taking steps to identify and address deficiencies from a qualitative standpoint. Therefore, the Working Group feels that it is not necessary to consider the development of a governance capital charge for insurers at this time.
**Principle 5: Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities**

The regulatory framework recognizes that certain significant, broad-based transactions/activities affecting policyholders’ interests must receive regulatory approval. These transactions/activities encompass licensing requirements; change of control; the amount of dividends paid; transactions with affiliates; and reinsurance.

In reviewing Principle 5 and performing a comparative analysis with international standards and U.S. regulatory needs, the Working Group identified four primary areas for further discussion. These areas include suitability of persons, outsourcing of critical functions, investments and reinsurance, and risk management/compliance. Regulator discussions relating to each of these topics, including proposed enhancements to processes in these areas (if deemed appropriate), are outlined within this section of the paper.

**Suitability of Persons**

As discussed under previous principles within this document, the suitability of individuals serving in critical functions at insurers is a critical element of effective corporate governance and of great importance to regulators domestically and internationally. The first line of defense in addressing suitability issues within the U.S. solvency system is the licensing process. If regulators are concerned that an owner or officers of an applicant don’t have the requisite background, experience or integrity to write a certain line of business, the applicant can be denied a license.

In recent years, the NAIC has made great strides to increase the level of consistency and uniformity in licensing practices across the states. However, the process for granting an initial license continues to vary to a certain extent from state to state, often to address state specific concerns.

The Working Group considered the standards contained within ICP 5 as well as the results of the FSAP review in performing a comparative analysis of this topic. The following recommendation was identified relating to suitability of persons:

- Specific requirements in relation to individuals’ fitness and propriety should be adopted. Gaps in the requirements of departments should be filled—companies should have to notify the department of concerns about the fitness and propriety of key individuals and departments should be able to disallow functionaries from holding two positions that could result in material conflict.

In reviewing these standards and recommendations, the Working Group weighed the desire to comply with international standards with the needs of the U.S. regulatory system and came to the conclusion that only limited enhancements should be sought in this area. For example, the Working Group does not feel it is necessary to define in legislation which specific positions of an insurer are required to meet suitability standards and what those suitability standards should consist of. This is due to the fact that there are existing requirements for all officers of an insurer to file biographical affidavits that are reviewed during the initial licensing process and subsequently reviewed during financial analysis and examination processes. Defining specific suitability requirements in this area could result in limiting the current process without providing a discernible benefit.

However, one area where the Working Group does feel there is some room for enhancement is in relation to the insurer’s responsibility to notify the department of changes in the suitability status of directors and officers. The current process generally requires biographical affidavits to be filed whenever a new director or officer is named, but only certain states require this information to be updated for existing officers/directors on a regular basis. As regulators have continually discussed the need to obtain information on governance matters more frequently than every 3-5 years during the examination, the Working Group feels that this is an area where the company should be obligated to self-report concerns. However, to ensure that this information is protected and confidential, the Working Group decided to include a specific disclosure question (see question #7) within the list of corporate governance disclosures proposed at Exhibit A. This question would provide regulators with some information on the suitability standards that an insurer has developed for its officers and directors and whether there have been any changes in the suitability status of those individuals. By structuring the disclosure in this manner, regulators can receive information on suitability concerns that is self-reported by the company without defining in statute or regulation each incident that must be reported to the department.
Outsourcing of Critical Functions

The Working Group also reviewed U.S. requirements related to an insurer’s outsourcing of critical functions. Based on this review, the regulators noted that there are a number of requirements in place for insurers that outsource critical functions to third parties, including regulatory review and approval of significant outsourcing agreements through the holding company laws, model laws regarding the use of managing general agents, controlling producers, investment custodians and other third-party administrators, as well as specific guidance for examiners in reviewing outsourced functions during an examination.

The existing practices in the U.S. were compared to the seventh standard of ICP 8, which states the following:

The supervisor requires the insurer to retain at least the same degree of oversight of, and accountability for, any outsourced material activity or function (such as a control function) as applies to non-outsourced activities or functions.

After comparing the existing requirements in place in the U.S. to this standard and its underlying guidance, the Working Group determined that enhancements in this area do not appear necessary in this area. In the Working Group’s opinion, the existing practices in the United States fully meet the international expectations and regulator needs in this area.
Investments and Reinsurance

Another area in which a comparative analysis was performed related to Principle 5 focuses on governance requirements around investment and reinsurance activities. As the investments of insurers are subject to one of two NAIC model laws that both outline specific governance requirements requiring board of director involvement, the Working Group determined that it wasn’t necessary to consider enhancements in this area at this time. However, the Working Group noted that corporate governance standards related to reinsurance decisions are not as pronounced in the current U.S. process. In performing a comparative analysis to international standards in this area, regulators reviewed standard one of ICP 13, which states the following:

The supervisor requires that cedants have Reinsurance and risk transfer strategies appropriate to the nature, scale and complexity of their business, and which are part of their wider underwriting and risk and Capital management strategies. The supervisor also requires that cedants have systems and procedures for ensuring that such strategies are implemented and complied with and that cedants have in place appropriate systems and controls over their risk transfer transactions.

The guidance in support of this standard states that responsibility for developing and agreeing upon a reinsurance strategy should rest with the board of directors and senior management. In addition, the board and senior management should also be responsible for monitoring for compliance with the strategy through regular approval of the reinsurance program and its performance.

In reviewing U.S. standards in this area, the Working Group noted that there are existing practices in place for regulatory review of an insurer’s reinsurance strategy and program, including the requirement for companies to submit reinsurance agreements to their domestic regulator for review and test procedures included in the Financial Condition Examiners Handbook. One area identified for potential enhancement relates to the board of directors’ role in reinsurance decision-making. It is the expectation of regulators that a board of directors should be involved in setting and reviewing the reinsurance strategy put in place at the insurer. However, the Working Group did not identify any explicit statutory requirements for board involvement in this area, as there are for the development and approval of an investment strategy. To provide regulators and other stakeholders with more information regarding the board’s role in overseeing a company’s reinsurance strategy, the Working Group has developed a proposed interrogatory for inclusion in the Board of Director’s section of the Annual Statement’s General Interrogatories (see Exhibit I). By gathering information through an interrogatory, regulators can gain a better understanding of current practices before determining if an explicit regulatory requirement is necessary in this area.

The Working Group also identified another topic relevant to corporate governance processes around reinsurance, related to the work of the Reinsurance (E) Task Force in developing standards for reviewing collateral reduction applications. Members of the Working Group feel that there should be some consideration of a reinsurer’s corporate governance practices when reviewing and approving capital reduction applications. Therefore, the Working Group has drafted a proposed referral for the Reinsurance (E) Task Force recommending inquiring of the domestic supervisor regarding the reinsurer’s corporate governance practices during a review of collateral reduction applications. See Exhibit J for a copy of the draft referral.
Exhibit I

BOARD OF DIRECTORS

16. Is the purchase or sale of all investments of the reporting entity passed upon either by the board of directors or a subordinate committee thereof? Yes [ ] No [ ]

16.1 If no, please explain the board’s role in investment decision making:…………………………………………………………………………………………………………..

17. Does the reporting entity keep a complete permanent record of the proceedings of its board of directors and all subordinate committees thereof? Yes [ ] No [ ]

18. Has the reporting entity an established procedure for disclosure to its board of directors or trustees of any material interest or affiliation on the part of any of its officers, directors, trustees or responsible employees that is in conflict or is likely to conflict with the official duties of such person? Yes [ ] No [ ]

19. Does the board of directors (or a subcommittee thereof) review and approve of the reinsurance strategy and program in place at the reporting entity on an annual basis? Yes [ ] No [ ]

19.1 If no, please explain the board’s role in reinsurance decision making:…………………………………………………………………………………………………………..
Exhibit J

To:    Michael F. Consedine (PA), Chair, Reinsurance (E) Task Force

From: Susan Donegan (VT), Chair, Corporate Governance (E) Working Group

Re: Proposed Enhancements to Analysis of Corporate Governance

Date: TBD

The Corporate Governance (E) Working Group (CGWG) has been charged with outlining high-level corporate governance principles and determining the appropriate methodology to evaluate adherence to such principles. During discussions related to this charge, the Working Group discussed the need to include consideration of a reinsurer’s corporate governance as part of the process to review collateral reduction applications. Therefore, we request that the Task Force consider inquiring of a reinsurer’s domiciliary supervisor regarding the following items during the review of collateral reduction applications:

- Any significant concerns the supervisor has regarding the reinsurer’s corporate governance practices and procedures.
- Any significant concerns the supervisor has regarding the suitability of officers and directors of the reinsurer.

We are hopeful that these inquiries would allow information to be shared between jurisdictions to ensure that all significant governance concerns are appropriately considered before a reduced collateral application is approved. We feel that this step, along with a review of each jurisdiction’s compliance with international corporate governance standards, should allow for sufficient consideration of corporate governance in this area. We thank you for your consideration of this request and encourage you to contact us with any questions.
Risk Management and Compliance Functions

The last area the Working Group focused on in its comparative analysis of Principle 5 was corporate governance practices around the risk-management and compliance functions of an insurer. While there has been much discussion regarding risk management as part of the ORSA discussions held at the Group Solvency Issues (E) Working Group, there continue to be a limited number of standards for insurers in this area. In reviewing the international standards that have been developed in this area, the Working Group notes that the third and fourth standards of ICP 8 state the following:

The supervisor requires the insurer to have an effective risk management function capable of assisting the insurer to identify, assess, monitor, manage and report on its key risks in a timely way.

The supervisor requires the insurer to have an effective compliance function capable of assisting the insurer to meet its legal and regulatory obligations and promote and sustain a corporate culture of compliance and integrity.

In addition, a specific recommendation was received in this area as a result of the 2009 FSAP as follows:

The relevant laws, regulations or standards should be changed to include a requirement that an insurer have in place comprehensive risk management policies and systems capable of promptly identifying, measuring, assessing, reporting and controlling their risks.

The Working Group recognizes that the Group Solvency Issues (E) Working Group is currently working on the development of an ORSA Model Act that would require insurers above a certain premium threshold to develop and maintain a risk management framework. By including this as a statutory requirement, the U.S. should be able to improve its standing related to the international standards on risk management. However, the Working Group does not believe it is appropriate to adopt a more extensive statutory requirement for the sole purpose of fully meeting international standards in this area. Instead, regulators feel that the exact nature and extent of an insurer’s risk-management function should be determined by the directors and officers of the insurer. Nevertheless, the Working Group does believe that the stakeholders of an insurer, including regulators and policyholders, should have a right to understand the role of the board with regard to risk management and compliance. Therefore, the Working Group is proposing the addition of several questions to the Board of Director’s section of the Annual Statement’s General Interrogatories to obtain additional information regarding company practices in this area (See Exhibit K).
The following interrogatories are proposed to be included with the other changes shown in Exhibit I:

20. Does the reporting entity maintain a risk management function that identifies, assesses, monitors, manages and reports on its key risks to the board of directors on an annual basis?  
   Yes [ ] No [ ]

20.1 If no, please explain the board’s role in overseeing risk management at the reporting entity………………..  
   ………………………………………………………………………………………………………………………………………………………………………

21. Does the reporting entity maintain a compliance function that monitors compliance with applicable state and federal laws and regulations and reports to the board of directors on compliance matters on an annual basis?  
   Yes [ ] No [ ]

21.1 If no, please explain the board’s role in overseeing compliance at the reporting entity………………..  
   ………………………………………………………………………………………………………………………………………………………………………
Principle 6: Preventive and Corrective Measures, Including Enforcement

The regulatory authority takes preventive and corrective measures that are timely, suitable and necessary to reduce the impact of risks identified during on-site and off-site regulatory monitoring. These regulatory actions are enforced as necessary.

In reviewing Principle 6 and performing a comparative analysis with international standards and U.S. regulatory needs, the Working Group identified two primary areas for further discussion. These areas include regulator authority to require corrective action for corporate governance deficiencies and regulator authority over individual officers/directors. Regulator discussions relating to each of these topics, including proposed enhancements to processes in these areas (if deemed appropriate), are outlined within this section of the paper.

Regulator Authority to Require Corrective Action for Corporate Governance Deficiencies

One of the most important issues facing regulators in their review of an insurer’s corporate governance practices is the ability to work with the company to resolve significant deficiencies that are identified during the regulator’s assessment of corporate governance. As regulators have begun to more closely review the corporate governance practices of insurers as part of risk focused surveillance, a greater number of deficiencies in corporate governance practices of insurers have been identified. Some of the more common deficiencies identified include a lack of qualified or independent board members, a lack of board oversight in critical areas, a lack of succession planning, limited risk management practices and the absence of an internal audit function. While the Working Group does not feel it is the role of regulators to step in and require corrective action every time a potential deficiency is noted, it does feel that a regulator’s role is to require corrective action when significant deficiencies are identified that could impact the ongoing solvency of the insurer.

The primary tool that regulators have available for dealing with significant corporate governance deficiencies is the NAIC’s Model Regulation to Define Standards and Commissioner’s Authority for Companies Deemed to be in a Hazardous Financial Condition (Model #385). As this model is required for NAIC accreditation, all accredited states must adopt the critical elements of this model regulation. In reviewing the model, the Working Group noted that Section 3 lists standards that may be considered, either singly or in combination, by the commissioner to determine whether the continued management of the insurer might be hazardous to policyholders, creditors or the general public. Item K of this section allows the commissioner to consider whether management fails to possess and demonstrate the competence, fitness and reputation deemed necessary to serve the insurer, which allows for suitability concerns to be the grounds for a hazardous financial condition determination. This particular provision of the model has been adopted by all but four states. Another provision of Section 3 that could be utilized in addressing corporate governance deficiencies is Item A, which allows the consideration of adverse findings reported in exam reports, audit reports or actuarial opinions. This particular provision has been adopted by all states.

Other sections of Model #385 applicable to corporate governance concerns were added in 2008 and will not be required for accreditation purposes until 2014. Item T, also under Section 3, allows for consideration of any other finding determined by the commissioner to be hazardous to policyholders, which could allow for the consideration of other corporate governance deficiencies that may not be covered under Items A or K.

After the commissioner has deemed an insurer to be in a hazardous financial condition, Model #385 grants the commissioner the authority to take corrective action. Section 4B(10) of the Model allows the commissioner, upon a finding of hazardous operation, to issue an order requiring the insurer to correct corporate governance practice deficiencies. This element was also added to Model #385 in 2008 and will not be required for accreditation purposes until 2014. Currently, this corrective action language has been adopted by 23 states. It represents the strongest, most specific authority available to a commissioner in the realm of corporate governance issues.

The Working Group noted that the standards and authority outlined in the Model #385 are elements of the NAIC Accreditation Standard for Corrective Action. Although Section 3 and Section 4 of the model are mentioned as required provisions, the current accreditation standard does not require particular elements within each of those sections. As such, there is no explicit requirement for the states to adopt significant elements from the 2008 revisions. As the language in 4B(10) is critical to allow regulators to require corrective action when significant
corporate governance deficiencies are identified, the Working Group proposed a referral to the Financial Regulation Standards and Accreditation (F) Committee requesting an amendment the critical elements required for accreditation to include language similar to that of 4B(10) in Model #385 (see Exhibit L).

The Working Group also discussed the need to provide more guidance to regulators regarding when the authority provided under Model #385 would be appropriate to exercise. Currently, the Working Group is concerned that there is a lack of guidance regarding how corporate governance deficiencies should be addressed within the solvency monitoring framework. Although many of the more minor deficiencies are typically addressed through management letters issued at the conclusion of an examination or through inquiries from the assigned analyst, there is often confusion regarding the action to take in addressing more serious issues. To assist regulators in applying the existing authority for addressing significant deficiencies, and to tie in the proposal on a common assessment methodology, the Working Group added a reference to Model #385 to the outline of Exhibit E. This reference encourages regulators to consider whether a rating of weak corporate governance as determined through the use of a common assessment methodology could be an indicator that the company is operating under a potentially hazardous financial condition. If this determination is made, regulators are encouraged to consider taking action under the remedies provided within Model #385.
To: Eleanor Kitzman (TX), Chair, Financial Regulatory Standards and Accreditation (F) Committee

From: Susan Donegan (VT), Chair, Corporate Governance (E) Working Group

Re: Proposed Enhancements to Analysis of Corporate Governance

Date: TBD

The Corporate Governance (E) Working Group (CGWG) has been charged with outlining high-level corporate governance principles and determining the appropriate methodology to evaluate adherence to such principles. During discussions related to this charge, the Working Group discussed the importance of individual elements included within the 2008 revisions to the NAIC’s Model Regulation to Define Standards and Commissioner’s Authority for Companies Deemed to be in a Hazardous Financial Condition (Model #385). Section 4B(10) of Model #385 allows the commissioner, upon a finding of hazardous operation, to issue an order requiring the insurer to correct corporate governance practice deficiencies. This particular element of Model #385 represents the strongest, most specific authority available to a commissioner to require correction of corporate governance deficiencies. As this particular element has been identified as critical to the effective regulation of an insurer’s corporate governance, the Working Group would like to recommend that it be added to the list of critical elements required to be adopted as part of the NAIC Accreditation Standard for Corrective Action.

By including this item as a required element, regulators can ensure uniformity in ensuring that significant corporate governance deficiencies can be corrected when an insurer is deemed to be in a hazardous financial condition. We thank you for your consideration of this request and encourage you to contact us with any questions.
Regulator Authority over Individual Officers/Directors

The second topic the Working Group focused on in its comparative analysis of Principle 6 was related to regulator authority to take action when concerns are identified related to an individual officer or director’s suitability. As discussed in previous principles, the U.S. system reviews the suitability of officers and directors during the initial licensing process and on an ongoing basis through examination and analysis. In reviewing the international standards relating to this topic the Working Group considered the fifth standard of ICP 5 on Suitability:

The supervisor takes appropriate action to rectify the situation when Board Members, Senior Management and Key Persons in Control Functions or Significant Owners no longer meet suitability requirements.

Guidance underlying the standard states that the supervisor should have the ability to order the dismissal or replacement of an unsuitable individual, suspend or revoke the company’s license, or impose additional reporting and solvency monitoring requirements if the individual is not replaced. The Working Group also considered the following recommendation that was received on this topic as a result of the 2009 FSAP:

The insurance laws should be changed to provide the supervisory authority with powers to fine individual directors and senior managers of insurers, and to bar them from acting in responsible capacities in the future.

While the Working Group understands that assessing the suitability of officers and directors is a responsibility of an effective regulator, it does not necessarily feel that U.S. regulators should seek additional authority to fine individual directors and officers or to bar them from acting in similar capacities in the future. Based upon the current authority provided to regulators through the licensing processes as well as Model #385 and 18 U.S.C. §§ 1033–34, the Working Group feels that there is existing authority in this area. As described under the previous topic, Model #385 allows suitability concerns to be the basis for deeming a company to be in a hazardous financial condition. Once a company is deemed to be in a hazardous financial condition, the regulation allows for a number of potential remedies, including the following:

- Require the insurer to reduce, suspend or limit the volume of business being accepted or renewed;
- Require the insurer to increase its capital and surplus;
- Require the insurer to provide a business plan to the commissioner in order to continue to transact business in the state; and/or
- Require the insurer to correct corporate governance practice deficiencies, and adopt and utilize governance practices acceptable to the commissioner.

Based upon these remedies in Model #385 and the authority provided by 18 U.S.C. §§ 1033–34 to bar individuals convicted of certain crimes from working for an insurer, the existing authority provided to U.S. regulators in this area appears to meet the international standards outlined in ICP 5 and suit the needs of U.S. regulators. Therefore, the Working Group does not recommend any additional enhancements in this area.
Principle 7: Exiting the Market and Receivership

The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines solvency and establishes a receivership scheme to ensure the payment of policyholder obligations of insolvent insurers subject to appropriate restrictions and limitations.

In reviewing Principle 7 and performing a comparative analysis with international standards and U.S. regulatory needs, the Working Group identified two primary areas for further discussion. These areas include exiting the market and receivership and other related processes. Regulator discussions relating to each of these topics, including proposed enhancements to processes in these areas (if deemed appropriate), are outlined within this section of the paper.

Exiting the Market and Receivership

The Working Group noted that there are a number of standard practices in place for insurers withdrawing from the market, including the submission of a market withdrawal plan. In addition, there are strict requirements for dealing with entities that need to be placed into receivership for conservation, rehabilitation or liquidation purposes. These requirements include the involvement of a court in overseeing the receivership proceedings, which provides for governance around the continued operations of an entity in these circumstances by appointing a receiver.

As the governance around the process for an individual entity to exit the market or to be placed in receivership is well-defined, the Working Group determined that governance enhancements would not be beneficial in this area. However, one area that was considered relevant for discussion was the concept of resolution or contingency planning for large insurance groups. Contingency planning for large groups is addressed in the Dodd-Frank Act and is currently being considered at the International Association of Insurance Supervisors (IAIS) through the ComFrame project. The idea behind contingency planning is that large groups with significant affiliate relationships and interconnectivity should have plans in place to take appropriate action to reduce the risk of failure and the impact of a failure. While the application of contingency planning concepts within the U.S. regulatory system is not something that lies within the scope of the Working Group’s charges, it is clear that contingency planning in whatever form would rely heavily on strong corporate governance practices including board involvement. As the Group Solvency Issues (E) Working Group is expected to determine how U.S. insurance regulators should proceed in this area, a referral has been developed to communicate the importance of board oversight and corporate governance in the contingency planning process (see Exhibit M).
To: John M. Huff (MO), Co-Chair, Group Solvency Issues (E) Working Group  
    Danny Saenz (TX), Co-Chair, Group Solvency Issues (E) Working Group  
From: Susan Donegan (VT), Chair, Corporate Governance (E) Working Group  
Re: Corporate Governance Recommendations on Resolution/Contingency Planning  
Date: TBD  

The Corporate Governance (E) Working Group (CGWG) has been charged with outlining high-level corporate governance principles and determining the appropriate methodology to evaluate adherence to such principles. During discussions related to this charge, the Working Group reviewed governance practices relating to Principle 7 of the U.S. Financial Solvency Framework – Exiting the Market and Receivership. The discussions on this principle led to the topic of resolution/contingency planning as addressed in the IAIS’ ComFrame project and in the Dodd-Frank Act. During these discussions, it was noted that the Group Solvency Issues (E) Working Group, with assistance from the Receivership and Insolvency (E) Task Force, would be determining how to proceed with resolution planning considerations for U.S. insurance groups. However, as resolution/contingency planning relies heavily on strong corporate governance practices, the CGWG requests that your working group consider the importance of corporate governance in its decision making regarding any standards that may be developed in this area for large insurance groups. Specifically, the CGWG feels that the following items represent corporate governance best practices in developing and approving resolution/contingency plans:

- The Board of Directors of the ultimate controlling entity should review and approve the group’s resolution/contingency plan on an annual basis.
- The Board of Directors of each significant insurance entity within the group should review and provide input to the group’s resolution/contingency plan on a regular basis.

We are hopeful that this input will assist your working group in fulfilling its responsibilities related to resolution/contingency planning. We thank you for your consideration of these items and encourage you to contact us with any questions.
Other Related Processes

The other reviewed by the Working Group in this area was processes outside of solvency regulation that relate to the governance of insurers. For the most part, these other processes relate to market conduct requirements that insurers are required to comply with. The Working Group previously discussed the need for insurers to maintain a compliance function that reports to the Board of Directors on a regular basis. This discussion resulted in a proposal to add a general interrogatory on the insurer’s compliance function and the Board of Directors’ role in this process. As a result of discussions related to the corporate governance of market conduct matters, the Working Group reiterated its support for the interrogatories proposed at Exhibit K.

Overall Conclusion

As a result of the comparative analysis that has been performed, the Working Group concludes that the U.S. system of ensuring appropriate corporate governance practices of insurers is largely effective and robust. However, the analysis also highlights several areas where improvements can be made to ensure greater protection for policyholders without significantly increasing the regulatory burden placed upon insurers. In finalizing the Solvency Modernization Initiative work in this area, regulators are committed to providing a comprehensive set of corporate governance standards and practices that can be effectively implemented and uniformly reviewed across the United States. The Corporate Governance (E) Working Group plans to reach final conclusions in making policy decisions in this area prior to the conclusion of the NAIC’s December 2012 National Meeting, before taking steps to implement those policy decisions in 2013 with the assistance of various other NAIC groups.