

## White Paper on High-Level Corporate Governance Principles for Use in U.S. Insurance Regulation

### Introduction

The Corporate Governance Working Group (CGWG) within the Solvency Modernization Initiative Task Force has been charged with, *inter alia*, drafting high-level corporate governance principles for use in U.S. insurance regulation. In furtherance of this charge, and based on recommendations from interested parties, the CGWG produced summaries of existing state corporate governance law, including case law (*see* Exhibit A), and international corporate governance principles and standards in place in Australia, Canada, Switzerland, and the U.K. (*see* Exhibit B). The CGWG also received a Code of Conduct from the Bermuda Monetary Services Authority (*see* Exhibit C).

On January 24, 2011, the CGWG exposed its state and international corporate governance summaries along with Bermuda's Code of Conduct for public comment on the following issues:

- Which principles and standards from the summaries should be considered for use in U.S. insurance regulation;
- Which principles and standards adopted or under development by other jurisdictions should be considered for use in U.S. insurance regulation; and
- What general considerations should U.S. insurance regulators take into account in developing corporate governance standards?

The CGWG asked that, in developing comments, interested parties be cognizant of the relevant insurance core principles, standards, and guidance under development by the International Association of Insurance Supervisors (IAIS) because such principles will form the basis for the

Financial Sector Assessment Program (FSAP) and may provide a means for other countries to assess U.S. equivalence. The most recent versions of the relevant IAIS principles – ICP 5 on Suitability, ICP 7 on Corporate Governance, and ICP 8 on Risk Management and Internal Control Systems – are attached as Exhibit D. The CGWG also asked that comments address how U.S. insurance regulators may achieve substantial compliance with the IAIS insurance core principles without placing an overly excessive burden on the insurance industry. Comments were received from the American Council of Life Insurers, America’s Health Insurance Plans, the BlueCross BlueShield Association, Motil Consulting, Inc., the National Association of Mutual Insurance Companies, and the Reinsurance Association of America. *See* Exhibit E.

This paper is organized into corporate governance principles (stated in bold type and numbered as **1, 2, 3**, etc.) and corresponding guidance (set below the principles as 2.1, 2.2, etc.). Principles are essential, high-level requirements necessary for an insurer to provide minimum levels of consumer protection and capital adequacy. Guidance supports the principle it follows and provides detail regarding what may be expected from or how an insurer can comply with a specific principle.

In developing the principles and guidance in this paper, the CGWG was mindful of the recent corporate governance and risk management recommendations provided by the IMF in the FSAP Financial System Stability Assessment and Insurance Detailed Assessment Report. *See* Exhibit F. The principles and guidance will be utilized by the CGWG as it fulfills its next charge in determining what changes may be required to the U.S. insurance regulatory structure in order to evaluate adherence with such principles. Although some of the principles in this paper reflect existing legal or regulatory requirements, this paper is not intended on its own to impose any binding legal or regulatory obligations.

### **Principle of Proportionality**

Individual insurers operate under varying risk profiles depending on the nature, scale, and complexity of their business. In order to conduct business in a sound and prudent manner for the benefit of policyholders and other stakeholders, an insurer with a higher risk profile (*e.g.* an international commercial insurer with high premium volume) requires a more comprehensive corporate governance framework than an insurer with a lesser risk profile (*e.g.* a small county mutual). Accordingly, the principles should be applied and measured in a proportionate manner relative to the nature, scale, and complexity of an insurer.

The nature, scale and complexity of an insurer should be considered individually and collectively in reaching these determinations. For example, an insurer who is relatively small but who offers multiple, complex products should implement an appropriately robust risk management function to manage those products. In determining whether and to what extent the principles must be satisfied, insurers and Commissioners should also take account of whether an insurer is subject to the premium threshold included in Section 16 of the NAIC's Annual Financial Reporting Model Regulation (#205).

### **Corporate Governance**

#### **1. Insurers must establish and maintain a sound corporate governance framework that adequately recognizes and protects the interests of policyholders.**

1.1 Corporate Governance is a framework of systems, policies and procedures through which an insurer effectively and efficiently: provides for sound and prudent management and oversight of the insurer's business; creates security and long-term value for policyholders, beneficiaries, and other stakeholders; exercises its corporate authority; and holds its Board members, Senior Management, and Key Persons in Control Functions accountable. It is also the framework through which an insurer seeks to

comply with the laws and regulations governing its relationship with each of its stakeholders.

- 1.2 Corporate governance includes an insurer's certificate of incorporation, bylaws, corporate discipline and ethics, accountability, responsibility, compliance, and oversight.

### **Board of Directors**

#### **2. The ultimate responsibility for the effective governance of an insurer rests with its Board.**

2.1 The Board is responsible for ensuring that appropriate corporate governance systems, policies, and procedures are implemented and applied in a sound and prudent manner and for approving and overseeing the implementation of an insurer's business objectives and strategies. Delegation of authority by the Board to its committees, Senior Management, Key Persons in Control Functions, or external parties does not absolve the Board from its responsibilities in these regards.

2.2 The Board should have appropriate systems, policies, and procedures for its own internal governance to assure that the Board's decisions objectively fulfill its duties of loyalty and care and that the Board remains accountable to policyholders, beneficiaries, and other stakeholders. The Board should at least annually review and assess the effectiveness and adequacy of its systems, policies, and procedures.

#### **3. The Board must be composed of a sufficient number of members who are independent, participate actively, and collectively have an adequate level of knowledge, skills and expertise. The Board must have the power and resources necessary to properly fulfill its governance and oversight responsibilities.**

- 3.1 The Board should be composed of a sufficient number of members with relevant experience to ensure that it can act independently of management and properly perform its oversight responsibilities through thoughtful and diligent decision-making. The Board should collectively be composed of members with the experience and competence necessary to fulfill its roles and responsibilities.
- 3.2 The Board should establish clear and objective criteria defining independence. These criteria should define independence in terms of relationships that may compromise an individual director's independence and in terms of the Board membership as a whole.
- 3.3 There should be a formal, documented process for nomination, selection, and removal of Board members.
- 3.4 Committees of the Board should have clearly defined mandates and the authority and independence necessary to carry out their respective functions.

**4. Individual members of the Board must comply with the duties of loyalty, care, and candor, acting in good faith to advance the best interests of the insurer and its policyholders or beneficiaries.**

- 4.1 The duty of loyalty generally requires a Board member to sublimate any personal interest that is not in best interest of the insurer, its shareholders, and its policyholders or beneficiaries. A member of the Board is placed in a position of trust and confidence and should not use her position to further private interests. Board members should exert all reasonable and lawful efforts to ensure that the insurer is not deprived of any advantage to which it is entitled.
- 4.2 The duty of care generally requires a Board member to discharge her roles and responsibilities in a manner as would be expected of a reasonably careful and prudent person in a similar position. A Board member should act on a fully informed basis,

considering all material information reasonably available in making business decisions and continually seek and acquire information as necessary.

- 4.3 The duty of candor generally requires Board members to convey to those charged with making a decision or taking an action for or on behalf of an insurer all information material to that decision. Information is material if there is a substantial likelihood that a reasonable shareholder would consider it important in light of the total mix of information available.

**5. The Board must clearly define its roles and responsibilities and the roles and responsibilities of Senior Management and Key Persons in Control Functions. The Board must also properly oversee Senior Management’s execution of its duties.**

- 5.1 The Board is responsible for approving an insurer’s business objectives and strategies and for overseeing the overall strategy and direction of an insurer, including its proper overall management, while day-to-day management of an insurer is the responsibility of Senior Management and other key executives. The Board should ensure that an insurer’s governance structure provides for the effective separation of oversight and management functions.
- 5.2 Specific oversight responsibilities of the Board, or a committee thereof, include the following:
- 5.2.1 Code of Conduct/Ethics – The Board is responsible for establishing the “tone at the top” of the insurer and should be actively involved in establishing and enforcing a code of conduct that sets the insurer’s fundamental corporate values.
- 5.2.2 Strategic Planning and Risk Management – The Board should approve the strategic business plan governing the insurer as well as the the insurer’s corporate mission

and provide oversight in respect of the design and implementation of sound risk management and internal control systems and functions.

5.2.3 Oversight of Senior Management – The Board should ensure there are adequate policies and procedures in place regarding the hiring, dismissal, and orderly succession of Senior Management; monitor whether Senior Management is managing the insurer in accordance with any strategies and policies set or approved by the Board; and regularly meet with Senior Management to discuss and critically review Senior Management’s operation of the insurer.

5.2.4 Control Functions – The Board should provide oversight to the insurer’s control functions by receiving and reviewing reports from those functions on a regular basis. In addition, the Board should interact with Senior Management to resolve questions and collect any additional information regarding the control functions it deems necessary.

5.2.5 Director Education and Performance Evaluation – Board members should complete an orientation program describing the obligations and responsibilities of Board members and receive continuing education on significant industry developments and risks on a regular basis. To ensure that a Board is properly fulfilling its responsibilities, there should be a formal process to review the performance and effectiveness of the overall Board as well as individual members.

5.2.6 Succession planning – To ensure that qualified Board members and Senior Management are available to govern the insurer on an ongoing basis, a succession plan should be in place enabling an orderly transition of qualified individuals when vacancies occur.

**6. Insurers must implement a remuneration policy which does not induce excessive or inappropriate risk taking.**

- 6.1 An insurer's remuneration policy should be in line with the identified risk appetites and long term interests of the insurer and have proper regard to the interests of its stakeholders. The remuneration policy should, at a minimum, cover those individuals who are members of the Board, Senior Management, Key Persons in Control Functions, and other employees whose actions may have a material impact on the risk exposure of the insurer.
- 6.2 Appropriate consideration should be given to the relevant elements of the remuneration policy and structure, such as:
- 6.2.1 Components of the overall remuneration policy, particularly the use and balance of fixed and variable components and the provision of other benefits;
  - 6.2.2 Performance criteria and their application for the purposes of determining remuneration payments;
  - 6.2.3 The individual remuneration of the members of the Board and Senior Management, and the structure of remuneration of other employees whose actions may have a material impact on the risk exposure of the insurer;
  - 6.2.4 Reports or disclosures on the insurer's remuneration practices provided to the Commissioner or the public; and
  - 6.2.5 Potential conflicts of interest that may exist in the development and implementation of a remuneration policy and structure.
- 6.3 Where an insurer includes variable remuneration as part of a remuneration package, it should be structured in a manner that does not create incentives for inappropriate risk taking and is properly aligned with the time horizon of risks. In addition, when variable

remuneration includes share-based components, appropriate safeguards should be implemented to align incentives and the longer-term interest of the insurer.

- 6.4 Where an insurer provides discretionary severance payments as part of a remuneration package, it should subject such payments to appropriate governance controls and limits.

### **Senior Management**

- 7. Senior Management must effectively carry out the day-to-day operations of an insurer in accordance with the insurer’s strategies, policies, and procedures and provide the Board with adequate and timely information to enable it to carry out its duties and functions.**

- 7.1 Senior Management is responsible for managing and executing the day-to-day operations of the insurer, subject to all applicable laws and regulations and in accordance with the business objectives, strategies, risk appetites, and internal policies of the insurer.
- 7.2 Senior Management should provide recommendations on strategic plans, objectives, and key policies and procedures to the Board for its evaluation and approval. Senior Management should assist the Board with its oversight responsibilities by ensuring that the Board has accurate and timely information, allowing the Board to conduct robust and candid discussions on operational performance, strategy, and major policies, and to appraise the performance of management.
- 7.3 Senior Management should ensure that key functions performing corporate governance responsibilities are supported with adequate resources to execute and discharge their duties.
- 7.4 Senior management should also assume responsibility in establishing the “tone at the top” of the insurer regarding the importance of ethical conduct throughout the

organization. Senior Management should be held accountable to meet ethical standards by signing and agreeing to a formal code of conduct that has been approved by the Board.

### **Suitability of Individuals**

#### **8. Board members, Senior Management, and Key Persons in Control Functions must have and retain the competence and integrity necessary to fulfill their respective roles.**

8.1 Members of the Board, Senior Management and Key Persons in Control Functions should possess the appropriate professional qualifications, knowledge and experience necessary to enable the individual to perform the duties required of her position.

8.2 Competence relates to an individual's professional or formal qualifications and knowledge or relevant experience within the insurance and financial industries or other related businesses.

8.3 Competence of the Board should also include an appropriate diversity of qualities and variety of skills in order to promote the effective functioning of the Board as a whole. Competence for Board members also includes having the appropriate level of commitment to perform a role, including a commitment to prepare for and attend all corporate, board, or committee meetings, to stay informed about issues relevant to the company, to consult with management as needed, and to respond to emergencies as required.

8.4 Integrity may be demonstrated through both personal behavior and business conduct. Personal behavior may be assessed by examining criminal indicators (such as conviction of an offense involving dishonesty, misappropriation of assets, embezzlement, or fraud), financial indicators (such as improper conduct in financial accounting or bankruptcy or insolvency proceedings), and regulatory indicators (such as regulatory action taken

against the individual for withholding information from public authorities or market conduct transgressions).

8.5 The presence of any one indicator may, but need not in and of itself, be indicative of a person's suitability.

**9. A Significant Owner should have the integrity to fulfill her role and the financial soundness to obtain her status.**

9.1 An owner's financial soundness is based upon an ability to support the insurer in meeting all of its applicable financial solvency requirements. Integrity may be demonstrated through both personal behavior and business conduct.

**10. Insurers must demonstrate initially and thereafter, when requested by the Commissioner, the suitability of Board members, Senior Management, Key Persons in Control Functions, and Significant Owners. Insurers should notify the Commissioner of any changes in Board members, Senior Management, Key persons in Control Functions and Significant Owners on a timely basis.**

10.1 The suitability assessment of Board members, Senior Management, Key Persons in Control Functions and Significant Owners of an insurer should be conducted as part of the licensing procedure before an insurer is permitted to operate. Where an insurer is already licensed, the insurer should demonstrate to the Commissioner when requested the suitability of Board members, Senior Management, Key Persons in Control Functions, and Significant Owners.

10.2 An insurer should make available to the Commissioner the structures, policies, and procedures it has adopted to ensure the suitability of Board members, Senior Management, Key Persons in Control Functions, and Significant Owners.

10.3 The information to be made available and the Commissioner's assessment of such information may differ depending on the position of the person being assessed in relation to the interests to be safeguarded. At a minimum, a résumé indicating the professional qualifications as well as previous and current positions and experience of the individual should be made available along with any other information deemed necessary to assist in the assessment.

10.4 Insurers should notify the Commissioner in a timely manner of any circumstances that may materially adversely affect the suitability of its Board members, Senior Management, Key Persons in Control Functions and Significant Owners.

### **Reporting and Transparency**

#### **11. Insurers must maintain a reliable financial reporting process supported by clearly defined roles and responsibilities of the Board and Senior Management.**

11.1 An insurer must have adequate systems and controls to ensure that its financial reports present a balanced and accurate assessment of the insurer's business and general financial health and viability as a going concern.

11.2 The insurer may appoint an Audit Committee of the Board to provide oversight to the financial reporting process. Where a separate Audit Committee is not practical, the Board, as a whole, is responsible for this function.

#### **12. Insurers must regularly share material information on its governance processes with the Commissioner and relevant stakeholders.**

12.1 Information that may be appropriate for communication on at least an annual basis to the Commissioner and relevant stakeholders includes:

- 12.1.1 the insurer's overall strategic objectives, covering existing or prospective lines of business and how they are being or will be achieved;
  - 12.1.2 the insurer's governance structures, including the allocation of responsibilities between the Board and Senior Management, as well as information on the organizational structure and reporting lines;
  - 12.1.3 background information on members of the Board and its committees, including their respective expertise, qualifications, track-record, other positions held by such members, and whether such members are regarded as independent;
  - 12.1.4 the general design, implementation and operation of the insurer's remuneration policy; and
  - 12.1.5 major ownership and group structures, and any significant affiliations and alliances.
- 12.2 Information submitted to the Commissioner regarding the insurer's corporate governance as well as the operations of the insurer's corporate governance function should be subject to review and assessment during the financial condition examination or analysis.

### **Risk Management and Internal Controls Systems**

#### **13. Insurers must implement and operate within effective risk management and internal controls systems as part of an overall governance framework.**

- 13.1 An insurer's risk management system should be designed to identify, assess, monitor, manage and report on reasonably foreseeable material risks. The risk management system should take into account the probability, potential impact, and time duration of risks. It should also take into account the insurer's overall business strategy, objectives, and risk appetite, contain appropriate processes and tools for identifying, assessing,

monitoring, managing, and reporting on risks, and define the limits on the risks that the insurer accepts or retains to ensure that it is able to continue to operate following an extreme loss event.

13.2 The risk management system should take into account relevant current and emerging local or business specific risks, as well as enterprise-wide risks, and be embedded in the organizational structure and strategic oversight process of the insurer.

13.3 The risk management system should develop policies and procedures to manage, mitigate, and report on risks that are clearly articulated, transparent, and communicated throughout the insurer. Policies and procedures should describe the links between an insurer's risk appetite, regulatory capital requirements, economic capital, and the processes and methods for monitoring risk.

13.4 An insurer should have an adequate and effective internal controls system that is designed and operates to provide reasonable assurances over the insurer's key policies and procedures and relevant risk management and compliance measures.

13.5 The insurer should regularly review the risk management and internal controls systems to help ensure that necessary modifications and improvements are identified and performed in a timely manner.

### **Control Functions**

#### **14. Insurers must implement and maintain effective control functions with the necessary authority, independence, and resources to achieve their objectives.**

14.1 Control functions add to the governance checks-and-balances of an insurer and are a source of support for the Board in the fulfillment of its duties.

14.2 A control function should be led by a person of appropriate seniority and expertise. While Senior Management has primary responsibility for executing internal controls,

having Key Persons in Control Functions is essential to provide expertise, leadership, objectivity and independence.

14.3 Insurers should position each control function and its associated reporting lines into the insurer's organizational structure in a manner that enables such function to operate and carry out its responsibilities effectively.

**15. Insurers must implement and maintain a risk management function capable of properly identifying, assessing, monitoring, managing, and reporting on the risks it faces.**

15.1 The risk management function should be sufficiently independent and avoid conflicts of interest with other management functions. Day-to-day management and oversight of the risk management function should be provided by Senior Management.

15.2 The risk management function should establish its own risk tolerances through the adoption of a formal risk tolerance statement. The statement should set out the insurer's overall quantitative and qualitative tolerance levels and define tolerance limits for each relevant and material category of risk, taking into account the relationships between risk categories. The insurer should embed the risk tolerances into its ongoing risk management efforts to assist in making appropriate risk management decisions.

15.3 The risk management function should include provisions for the quantification of risk for a sufficiently wide range of outcomes and be responsive to change using appropriate techniques. Its measurement of risk should be supported by accurate documentation providing appropriately detailed descriptions and explanations of risks.

15.4 The risk management function should allow the insurer to gain and maintain an aggregated view of its risk profile at a solo and group level. Risks that should be considered and documented within a risk management function include underwriting

risks, market risks, credit risks, operational risks, liquidity risks, legal risks, counterparty risks, reputational risks, reserving risks, and business contagion risks.

15.5 The risk management function should be utilized by the insurer to determine the level of internal economic capital that should be held for solvency purposes. The quantification of risks as well as the scenario analysis and stress testing performed should be utilized by the insurer in making these decisions.

15.6 The risk management function should require that strategic decisions be made consistent with established risk management policies and tolerances after giving due consideration to the risks quantified and the amount of capital maintained for risk management purposes. Individuals responsible for strategic decisions should be subject to the oversight of and held accountable by the Board.

15.7 Information regarding the risk management function of an insurer and its economic capital needs should be shared with the Commissioner on a regular basis through the filing of an Own Risk and Solvency Assessment (ORSA) and be subject to review and assessment during the financial condition examination process.

**16. Insurers must implement and maintain an effective compliance function capable of assisting the insurer in meeting its legal and regulatory obligations.**

16.1 The compliance function should establish, implement, and maintain appropriate mechanisms and activities to promote and sustain a corporate culture of compliance and integrity within the insurer. The function should identify, assess, report on, and address all key legal and regulatory obligations.

16.2 The head of the compliance function should have the authority and obligation to promptly inform the Board directly in the event of: (1) any major non-compliance by a

member of management; or (2) a material non-compliance by the insurer with an external obligation.

**17. Insurers must implement and maintain an effective actuarial function capable of evaluating and providing advice to the insurer regarding reserves, premium and pricing activities, and compliance with relevant statutory and regulatory requirements.**

17.1 The actuarial function should have access to and periodically report to the Board on the performance of its duties, and have the authority and obligation to promptly inform the Board of any circumstance that may have a material adverse effect on the insurer from an actuarial perspective.

17.2 The Appointed Actuary should not hold positions within or outside of the insurer that may create conflicts of interest or endanger her independence. If any such conflicts exist, the Board should subject them to appropriate controls.

17.3 If the Appointed Actuary resigns or is removed by an insurer, the insurer should provide notification to the Commissioner which includes the reasons why the Appointed Actuary resigned or was replaced.

**18. Insurers must implement and maintain an effective internal audit function capable of providing the Board independent assurance in respect of the insurer's governance, risk management, and internal controls.**

18.1 The internal audit function should provide independent assurance to the Board 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.

18.2 To help ensure independence and objectivity, the internal audit function should be free from conditions that threaten its ability to carry out its responsibilities in an unbiased manner. For example, the head of the internal audit function should have direct and unrestricted access to Senior Management and the Board and those performing the internal audit function should not be involved operationally in the insurer's business units. Threats to the independence of the internal audit function should be managed at the individual auditor, engagement, functional, and organizational levels.

18.3 The internal audit function's ultimate responsibility should be to the Board, not Senior Management. The internal audit function should report regularly to the Board.

**19. Material functions or activities that are outsourced must be subject to the same level of oversight and accountability as if those functions or activities were performed internally.**

19.1 When an insurer outsources functions either externally to third parties or internally to other affiliated entities, it should have oversight and clear accountability for all outsourced functions as if these functions were performed internally and subject to the insurer's own standards on corporate governance and internal controls. The insurer should also ensure that the service agreement includes terms on compliance with jurisdictional laws and regulations, cooperation with regulators, and access to data and records in a timely manner.

19.2 Before an insurer enters into material service contracts, the Board should ensure there is an appropriate assessment of the risks of such outsourcing, ensure such outsourcing is subject to appropriate controls, and approve of the outsourcing agreement. Ongoing outsourcing arrangements should be subject to periodic reviews, with reports thereon to be made available to management and the Board.

### **Regulatory Oversight**

**20. The Commissioner may require an insurer to demonstrate the adequacy and effectiveness of its corporate governance framework and has the power to require an insurer to remedy any identified deficiencies.**

20.1 An insurer bears the burden of demonstrating, to the satisfaction of the Commissioner, that its corporate governance framework is adequate and effective.

20.2 The Commissioner should assess whether an insurer's overall corporate governance framework is effectively implemented and remains adequate by undertaking periodic on-site inspections and other reviews as appropriate to the nature, scale and complexity of an insurer's business and its risk profile. Where significant changes in an insurer's corporate governance framework are identified, including through information provided by the insurer, the Commissioner should update its assessment.

20.3 The Commissioner should have the power to impose various measures of a preventive and corrective nature in respect of an insurer whose corporate governance framework is inadequate or ineffective.

### **Definitions**

"Commissioner" means the chief insurance regulatory official of a State, or the Commissioner's representatives. Other commonly used titles for this position include superintendant, director and administrator.

"Control Functions" means those functions serving a risk, control, or governance checks-and-balances role, such as the risk management, compliance, internal audit, and actuarial functions.

“Key Persons in Control Functions” means decision making individuals in control functions such as the heads of the risk management, compliance, internal audit and actuarial functions, as well as the appointed actuary if such person is not the head of the actuarial function.

“Senior Management” means the body responsible for executing decisions made by the Board and for managing the insurer on a day-to-day basis.