



AMERICAN ACADEMY *of* ACTUARIES

Governance Requirements for Principles-Based Reserves and Capital for Life Insurance

From the American Academy of Actuaries' Life Governance Team

**Presented to the National Association of Insurance Commissioners' Life and Health Actuarial Task Force
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Life Governance Team

Helen Galt, F.S.A., M.A.A.A., Chair

Peter Bondy, F.S.A., M.A.A.A.

Vincent Granieri, F.S.A., M.A.A.A.

Kalman Ketzlach, F.S.A., M.A.A.A.

Barbara Lautzenheiser, F.S.A., M.A.A.A.

Sheldon Summers, F.S.A., M.A.A.A.

Thomas Campbell, F.S.A., M.A.A.A.

Michael Harwood, F.S.A., M.A.A.A.

Perry Kupferman, F.S.A., M.A.A.A.

William Schwegler, F.S.A., M.A.A.A.

Principles Based Governance Report – August 2007

The Corporate Governance Team of the American Academy of Actuaries Life Practice Council (the “Team”) believes that effective corporate governance is critical to successful implementation of Principles-based approaches (PBA) for determining insurance reserves and insurer capital requirements for life insurers, because of the flexibility that companies will have in using PBA. Various constituencies of life insurance companies, including policyholders and regulators, rely on the board of directors and management to ensure that the company’s obligations are met when they come due and that the company maintains reserves and capital at all times as required by statute to provide an adequate margin of safety.

Possible submission for valuation manual

Our Team has reviewed material on governance from several different sources. We have discussed the extent to which we believe that governance requirements with respect to PBA should be included in the Valuation Manual and/or in other authoritative sources. Exhibit 1, Governance Requirements for Principles-based Reserves and Capital for Life Insurance, attached to this report, is intended as material on governance that could be included in the Valuation Manual, but its requirements would need to be synchronized with the final Standard Valuation Law requirements. This material, in substance, is a description of roles and responsibilities. It has been written to conform to the format that is used for other material in the Manual. We updated this recommendation based on a detailed review of requirements in the July 2007 draft of the Standard Valuation Law (SVL2).

We have not identified any reason for differences between the governance structures or requirements for PBA reserves and PBA capital. We believe that the material we recommend in Exhibit 1 for inclusion in the Valuation Manual would apply to determination of both reserves and capital requirements using PBA. But this raises the question of where should the authority reside to oversee these requirements? Is it through the Valuation Manual, the Instructions for RBC or in a wholly separate document/committee that applies to both reserves and capital?

Exhibit 2 (not attached – to be added at a later date, prior to submission to the (EX) Principles-based Reserving Working Group) to this report is a grid containing our analysis of what companies would need to do to comply with the new SVL changes from a governance perspective. It is intended to demonstrate the kinds of internal standards and processes that companies should establish to assure compliance, but it is not intended to be a formal standard of practice. We believe that companies should have flexibility to implement their specific governance structures for several reasons:

- In considering governance structures, we note that PBA reserve requirements are likely to apply initially only to a small portion of the business in force. We believe that companies can implement PBA governance structures most effectively and efficiently by integrating these structures into their existing policies and procedures.

- Corporate governance for each insurance company is reviewed and evaluated as part of the NAIC’s Risk-Focused Surveillance program. In addition, we recognize that many insurers are also subject to governance requirements of other regulators and other bodies (e.g., stock exchanges). We believe that PBA requirements should not force companies to establish practices and processes that are parallel to but different from those they need to meet other requirements.
- In general, effective governance processes should minimize duplication and redundancy; both because of the cost involved in implementing appropriate governance standards and procedures, and because of the need to focus well designed and consistent procedures on the most important governance issues.

We drafted our governance recommendations to be “principles-based”, in order to provide flexibility for companies to adapt to changing needs and evolving best practices. While we believe that the Valuation Manual is an appropriate place to include such guidance on corporate governance, we also recognize that this is more importantly a regulatory organizational decision. We do suggest that our submission be exposed for comment at the earliest opportunity.

Suggested modifications to required Actuarial Opinion

We understand that the Valuation Manual drafting team has tentatively concluded that no separate company certification of principles-based reserves will be required. Instead, the language of the Actuarial Opinion may be modified to incorporate principles-based concepts. We do not find such an approach problematic, but we encourage the consideration of governance issues in the work on overall company opinions. In this regard, we offer Exhibit 3, attached, for consideration. Individual companies could still decide that they need internal certifications and reports in addition to those required for external legal and professional purposes to meet their own corporate governance needs.

Governance structures across the globe

In the course of our work, we reviewed several illustrative governance structures across the globe. We highlighted three structures in this report in Exhibit 4, attached. These are the structures of the Canadian Office of the Superintendent of Financial Institutions (“OSFI”), the New York Stock Exchange (“NYSE”), and the International Association of Insurance Supervisors (“IAIS”). In particular, the OSFI structure has been in place for several years. It is an example of a set of principles-based governance requirements that apparently have been operating effectively, and it applies to a wide range of financial institutions including those that are similar to the companies that would be subject to PBA.

The NYSE structure is also largely principles-based, has been in effect for several years, and is also apparently operating effectively. The NYSE structure is also noteworthy because many of the larger companies that will be subject to PBA requirements already have to meet the governance standards imposed by the NYSE. In light of that fact, we believe that there are opportunities for companies to integrate principles-based governance requirements for reserves and capital with the processes they already use to manage and control their business. On the

other hand, there are significant risks and costs of having to duplicate processes if companies have to meet detailed rules-based governance standards for PBA that do not provide sufficient flexibility.

We note in particular that the NYSE has requirements for financial literacy and experience of audit committee members. There is a large pool of potential members of boards and board committees who could meet these requirements. The pool of potential board members who have experience specific to insurance companies and products is much more limited. We believe that boards of directors can effectively and practically oversee financial management of insurance companies with financial literacy and experience requirements for audit committee members (such as in the NYSE requirements), as long as communications to the Board by the Appointed Actuary and the independent reviewing actuary are sufficiently clear and complete.

The IAIS governance structure is currently under development. We expect that the IAIS will be doing a great deal of additional work on governance and related matters over the next few years. We have included a summary of the IAIS work on governance related matters in Exhibit 4 of our report, because the NAIC is participating in development of the IAIS structure, and will likely consider converging with governance standards that the IAIS develops.

Other Governance Team work products

We have also attached as Exhibit 5 to this report the comments that our Governance Team provided to the Capital Adequacy Task Force (“CADTF”) on a draft corporate governance for risk management model law and regulation.