

# **PBA Governance Report – August 2007**

## **Exhibits**

### Exhibit 1

*Draft – 8/30/2007*

#### GOVERNANCE REQUIREMENTS FOR PRINCIPLES-BASED RESERVES AND CAPITAL FOR LIFE INSURANCE

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##### **Subsection 1. Purpose**

- A. The purpose of this section is to describe the roles and responsibilities of the insurer's board of directors, senior management, and appointed actuary in governing PBA for determining reserve and capital levels.
- B. This section provides flexibility in how companies organize to govern PBA processes, because of the variety of companies to which these guidelines might apply, and in order not to constrain changes companies may want to make to adapt to evolving best practices in governing PBA processes.
- C. Subject to written approval by the Commissioner of the insurer's domiciliary state, the insurer may assign different roles and responsibilities than those specified below to its board of directors and senior management.

##### **Subsection 2. Objectives**

The objectives of governance of PBA for determination of reserve and capital amounts for life insurers are:

- A. To support a reserve and capital determination process that meets the ultimate solvency objectives of statutory accounting, which are to ensure that the obligations of the company are met when they come due and that the company maintains capital and surplus at all times as required by statute to provide an adequate margin of safety.
- B. To assure compliance with the letter of the law(s), regulations, and other regulatory guidance surrounding PBA.
- C. To encourage compliance with the spirit of the law(s), regulations, and other regulatory guidance surrounding PBA.
- D. To clarify accountability with respect to roles and responsibilities within a company related to reserves and capital determined by PBA.
- E. To assure appropriate coordination/alignment with other internal management processes, including the company's risk management processes.
- F. To assure auditability of results.
- G. To assure proper disclosure in statutory financial reports and other public documents about the company's reserves and capital.

- H. To assure that an appropriate internal control structure exists, so that the company can comply with the preceding objectives.

### **Subsection 3. Role and Responsibilities of the Board**

Unless otherwise allowed in writing by the Commissioner of the insurer's domiciliary state, the roles and responsibilities of the insurer's board of directors with respect to governance of PBA processes for life insurers shall include the following:

- A. The insurer's board of directors shall review and assess the infrastructure (consisting of the policies, procedures, controls, and resources) that senior management has put in place to implement and oversee PBA, and shall determine whether PBA elements (consisting of the assumptions, methods, and models used to determine PBA reserves and capital levels of the company) are appropriately aligned with, although not necessarily identical to, those for other company risk management and assessment processes.
- B. The insurer's board of directors shall review PBA results, in order to understand the general level of conservatism in PBA reserves and capital levels, and significant and unusual issues and/or findings; and shall accept the PBA results or cause the results to be modified so that they can be accepted.
- C. The insurer's board of directors shall also review other reports and certifications related to governance of PBA (including but not be limited to audit, control, and compliance reports).
- D. The insurer's board of directors shall appoint the insurer's peer review independent actuary (based on understanding of qualifications and independence requirements).

### **Subsection 4. Role and Responsibilities of Senior Management**

Unless otherwise allowed in writing by the Commissioner of the insurer's domiciliary state, the roles and responsibilities of the insurer's senior management with respect to governance of PBA processes for life insurers shall include the following:

- A. The insurer's senior management shall ensure that an appropriate infrastructure (consisting of policies, procedures, controls, and resources) is in place to implement and oversee PBA, and shall assure that PBA elements (consisting of assumptions, methods, and models) are appropriately aligned with, although not necessarily identical to, those for other company risk management and assessment processes.
- B. The insurer's senior management shall review PBA results, in order to understand the level of conservatism in PBA reserves and any significant and unusual issues and/or findings; and shall resolve such issues and findings as necessary.
- C. The insurer's senior management shall adopt internal controls with respect to a principles-based valuation reasonably designed to assure that all material risks inherent in the liabilities and assets subject to such valuation are included in the valuation, and that the valuations are made in accordance with the Valuation Manual; and shall ensure that an annual evaluation is made of such controls as of the end of the preceding calendar year, and that a report of such evaluation shall be made to the company's board of directors and the commissioner.
- D. The insurer's senior management shall also review other reports and certifications related to governance of PBA (including but not limited to audit, control, and compliance reports); and shall resolve issues and findings as necessary.

### **Subsection 5. Role and Responsibilities of the Appointed Actuary**

The roles and responsibilities of the insurer's appointed actuary with respect to PBA reserves and capital shall include the following:

- A. The insurer's appointed actuary shall develop internal standards for actuarial processes, controls, and documentation, as well as for assumptions, methods, and models, in accordance with all applicable laws and regulations.
- B. The insurer's appointed actuary shall report on actuarial processes and results to the board of directors and to the senior management of the company, assisting them in understanding PBA results and significant issues and/or findings.
- C. The insurer's appointed actuary shall provide a certification on the adequacy of principles-based reserves as part of his/her annual Statement of Actuarial Opinion, as well as any internal supporting certifications that senior management or the board require as part of the internal governance processes that the company has established.
- D. The insurer's appointed actuary shall cooperate fully with internal and external auditors and the peer review actuary, and shall resolve all significant issues.

Exhibit 2 - DRAFT- SVL2 Compliance Matrix

<b>Section</b>	<b>What is a Company Required to Do?</b>	<b>Who Does What? Role of Board</b>	<b>Who Does What? Role of Senior Management</b>	<b>Role of Appointed-Certifying Actuary</b>
Section 11A Compliance with standards in Valuation Manual (VM)	Certify that the minimum valuation standards as defined in the VM have been followed	<p>Receive certification with oral presentation and/or written memo on its content and the results of the PBA valuation.</p> <p>Review the nature of the material risks and assumptions that drive the valuation, the general level of conservatism, the key results and their implications. Receive reports on unusual issues and significant changes.</p> <p>Inquire about sufficiency and qualifications of staff resources</p>	<p>Review controls/standards surrounding this certification process and the nature of the material risks and assumptions that drive the valuation, the general level of conservatism, the key results and their implications. Receive reports on unusual issues and significant changes.</p> <p>Assure that qualified and sufficient staff resources exist</p>	<p>Develop internal standards for form and content of supporting certifications if required, and for internal actuarial review of certification and supporting documentation</p> <p>Prepare supporting documentation and certification, highlighting unusual issues and significant changes</p> <p>Evaluate and communicate resource requirements</p>
Section 11 B This section defines the operative date of the VM	Determine the correct operative date of the VM		Review controls around determining operative date	Determine the correct operative date of the VM

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Section 11 C (2) Requirements for which policies are subject to PBA	Identify which policies are subject to PBA valuation – and document the rationale behind those decisions	Receive and accept certification, as above	Review controls around this process	Determine which policies are subject to PBA; prepare required documentation
Section 11 C (3)(b) Requirements for form and general content of annual actuarial review	Review proposed form and content of independent actuary’s review.	(Ultimately) Receive and accept independent actuary’s PBA Review and assure that a process is in place for resolving any issues, as part of complying with the VM.	Provide full cooperation to the independent actuary, in a manner similar to work with the independent auditors. Understand form and content of independent actuary’s PBA Review report  Finalize the process that will be in place for resolving any issues, as part of complying with the VM.	Propose form and content of independent actuary’s review. Ultimately, as part of the PBA Review process, work with independent actuary to facilitate their review; review draft independent actuary’s report; discuss issues; communicate with management about any unresolved issues and make recommendations for how to resolve; prepare communications to the Board, if necessary

<b>Section</b>	<b>What is a Company Required to Do?</b>	<b>Who Does What? Role of Board</b>	<b>Who Does What? Role of Senior Management</b>	<b>Role of Appointed-Certifying Actuary</b>
Section 11 C (3)(b) Independence criteria for annual actuarial review	Implement requirements related to independence and implement controls to assure independence; Ultimately, appoint an independent PBA Review actuary that meets the requirements.	Oversee the requirements for independence. Ultimately, appoint a PBA Review Actuary. Require appropriate documentation about how independence was determined	Implement controls to assure requirements, including independence, are met.	Assist management/Board in identifying and engaging independent actuaries
Section 11 C (3)(c) Requirements for reports and other information to the commissioner	Provide reports to the Commissioner consistent with the content and format required in the VM	Receive report on compliance, as part of the certification process.	Implement controls to assure that the appropriate reports are developed and provided.	Develop and implement standards for reports, consistent with the VM  Prepare the required reports; or depending on nature of reports, non-actuarial staff may provide

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Section 11 C (4) Other VM requirements relating to reserve methods, models for measuring risk, generation of economic scenarios, assumptions, margins, and use of company experience (and transition rules)	Meet other requirements in the VM related to reserve methods; approach to modeling risks; economic scenarios; setting assumptions and margins on assumptions, etc.	Be apprised of the nature of the most important risks and assumptions that drive the valuation, and generally understand the level of conservatism. Receive reports on unusual issues and significant changes in assumptions and methods.	Assure that appropriate control processes exist around setting assumptions and margins, reserve methods, models for measuring risks, generation of economic scenarios, and for the transition to a PBR system. Review unusual issues and significant changes in assumptions and methods.	Develop and implement internal standards related to setting assumptions and margins, reserve methods, models for measuring risks, generation of economic scenarios and for the transition to a PBR system. Prepare actuarial report consistent with the requirements in section 11H(6) which covers these matters. Highlight unusual issues and significant changes for management and the Board.
Section 11 C (4) Other VM requirements relating to disclosures and reports	Develop and implement required disclosures and reports	Review key disclosures	Review and finalize draft disclosures and reports; discuss and resolve any unusual items.	Draft appropriate disclosures and reports; highlight unusual items and significant changes.

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Section 11 C (4) Other VM requirements relating to certifications, actuarial opinions and memorandums	Provide required actuarial opinions and certifications, and supporting memos/documentation.	Receive opinions and certifications with oral presentation and/or written memo on its content. The Board should seek additional information and guidance if it doesn't understand the results or isn't sure whether it has sufficient understanding.	Review controls/standards surrounding this opinion/certification process (Internal Audit?)	Provide certifications and opinions  Write supporting documentation (see above) Deliver reports to the Board
Section 11 C (4) Other VM requirements relating to internal control	Develop and implement appropriate control structures over PBA valuations	Review control structure with management, and satisfy themselves that it's robust	Assure appropriate control processes are in place	Implement required controls
Section 11 C (4) Other VM requirements relating to coordination with RBC requirements	Coordinate with RBC requirements <i>Drafting note: expectations to be developed later</i>			.
Section 11 C (5) Requirements for the data and form of data, and other data analysis and reporting requirements as specified in section 11K	Prepare and file the reports and analyses with regulators, with the content and form required in the VM	Receive report on compliance, as part of the certification process and assure that requirements in the VM regarding data analyses and its reporting have been met.	Implement controls to assure that the appropriate reports are provided	Develop and implement standards for reports, consistent with the VM  Prepare the required reports; or depending on nature of reports, non-actuarial staff may provide

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Section 11 D Requirements for compliance with minimum valuation standards in any respect in which the commissioner feels the VM doesn't meet the requirements of Section 11C	Develop and implement parallel procedures for those cases in which the Commissioner imposes specific requirements by regulation			
Section 11 F The commissioner may require a change in any assumption or method that the commissioner considers to be inappropriate, unreasonable, or inconsistent with any requirement of the VM or this Act, and the company shall adjust reserves as required by the commissioner.	Modify assumptions and methods as mandated by the commissioner and adjust the PBA valuation accordingly	Receive reports that would allow the Board to understand the reasons for any material adjustments to the valuation as required by the Commissioner, and the results of such adjustments; as well as any need to modify internal PBA valuation processes to mitigate or eliminate such adjustments in the future.	Review internal analysis of the reasons for the difference of opinion and the recommended action steps; determine if an independent review of existing actuarial processes is necessary (aside from the PBA Review report)	Review and analyze any requirements by the Commissioner to modify methods and assumptions and provide a detailed report to management on the reasons for the difference. Discuss with the peer review actuary. Develop a plan to mitigate or eliminate such differences in the future.

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Section 11 G The commissioner may engage a qualified actuary (at the company's expense) to perform an actuarial examination	Cooperate with any special actuarial examination of the company that has been initiated by the Commissioner	Receive a report that would allow the Board to understand the reasons for any such actuarial examination (to the extent the company knows), and any findings related to such an exam.	Carry out the requirements of the special actuarial examination; assure full cooperation with the actuarial examiner	Cooperate fully with the actuarial examiner

Section	What is a Company Required to Do?	Who Does What? Role of Board	Who Does What? Role of Senior Management	Role of Appointed-Certifying Actuary
<p>Section 11H(1) Reserves must capture all benefits and guarantees associated with the contracts and all their identifiable, quantifiable, and material risks, including tail risk and funding of the risks</p>	<p>Establish and document a process for identifying and measuring all benefits, guarantees and identifiable, quantifiable, and material risks, associated with a contract</p> <p>Establish modeling or other standards for evaluating the existence of “tail risk”</p> <p><i>What does “funding of the risks” mean? Is this a reference to asset adequacy and credit risk?</i></p>	<p>Receive and review description of risk assessment process and how it plays out for the company’s contracts. Understand the major benefits, guarantees and risks in the company’s products.</p> <p>Obtain enough information to understand the nature and significance of tail risks</p> <p><u><i>Be apprised of the nature of the ALM profile of the company (based both on current assets and on expected future investments) and what that means for valuation.</i></u></p>	<p>Assure that the risk identification and measurement process is appropriately consistent with other company processes that identify and measure risk, including tail risk and funding of the risks. Assign control experts to advise on, and review the processes used to identify and quantify risk</p> <p>Assure that the nature and amount of resulting risk is consistent with the company’s overall risk management framework</p>	<p>Work with company risk management and control experts on development of a process to identify all benefits, guarantees, and identifiable, quantifiable, and material risks. Document the risk assessment process and summarize the specific risks, benefits and guarantees associated with each category of contract/policy and each category of assets. Build or buy models that are sufficiently robust to quantify all identifiable, quantifiable, and material risks, benefits and guarantees. Perform tests/build models to quantify tail risk.</p>

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<p>Section 11H(2)(a) Assumptions and methods used to calculate reserves are consistent with the company's overall risk assessment and management process</p>	<p>(1) Have a well-defined overall risk assessment and risk management process:</p> <p>Overall philosophy, policy  Risk limits  Risk assessment processes: risk identification, measurement  Risk monitoring process: reports and management structure  Risk mitigation process: reinsurance, hedging  Etc.</p> <p>(2) Assure that the methods and assumptions used to determine PBA reserves are consistent with the company's overall risk assessment and management framework</p>	<p>(1) Assure that the company has a well defined overall risk assessment and risk management process by assigning review responsibility and authority to a particular Board committee  Receive reports from management on the structure of and operation of that process  (2) Receive reports from management on how the process for establishing assumptions and methods for PBA reserves is consistent with the company's risk mgt processes</p>	<p>(1) Define the overall risk philosophies and policies of the company  Define risk limits for each major category of risk  Define basic framework/process for risk identification and risk measurement  Define management reports and management structure that will appropriately monitor risk  Evaluate and implement specific risk mitigation strategies consistent with the company's overall framework  (2) Install corresponding policies, limits, identification and measurement processes, etc. for insurance policies and contracts  (3) Develop control processes surrounding the review of actuarial methods and assumptions for PBA  (4) Assure appropriate</p>	<p>(1) Develop a thorough understanding of the company's risk assessment and management process (AA and PBA actuaries)  (2) Develop standards for setting assumptions and determining methods for PBA reserves and capital that will assure appropriate consistency with company risk assessment/management processes (AA or chief actuary)  (3) Develop more specific product-line standards for setting assumptions and methods that are consistent with company standards (PBA actuary)  (4) Develop local control processes that will assure compliance  (5) Report to AA/chief actuary, senior management and the Board on the operation of these processes and the implications of results; and provide a</p>

Section	What is a Company Required to Do?	Who Does What? Role of Board	Who Does What? Role of Senior Management	Role of Appointed-Certifying Actuary
<p>Section 11H(2)(b) Assumptions and methods provide a level of conservatism consistent with objectives of statutory financial reporting</p> <p>Section 11 H(3) Use assumptions that are set toward the conservative end of the range of plausible scenarios (to the extent that relevant and credible empirical data over the range of plausible scenarios is not available)</p>	<p>Define an appropriate level of conservatism in the assumptions and methods that are used to establish reserves and capital that is consistent with statutory financial reporting (and consistent with other company objectives)</p> <p><b><u>Drafting note: How much of this “appropriate level of conservatism” is likely to be defined in ASOPs or in the Valuation Manual? If the manual sets these standards, then the company must assure compliance with the standards in the manual.</u></b></p>	<p>Have a general understanding of the level of conservatism built into the company’s reserve/capital structure</p> <p>Receive regular reports from management on the degree of consistency between actual and target levels of conservatism</p>	<p>Define an appropriate level of conservatism for reserves and capital that is consistent with statutory accounting (and consistent with other company objectives?)</p> <p>Review the process for, and the results of, setting methods and assumptions for PBA to assure compliance with the desired level of conservatism</p>	<p>To the extent not otherwise defined in the VM, develop more specific standards for product line actuaries to follow in setting assumptions and methods that will deliver the appropriate level of conservatism (AA, chief actuary)</p> <p>Review/test specific assumptions and methods to determine if the margins comply with external and internal standards. Reporting to AA/chief actuary, senior management and the Board should include discussion of margins.</p>

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<p>Section 11H(2)(c) assumptions and methods provide margins for uncertainty, including adverse deviation and estimation error, such that greater uncertainty results in larger margins and greater reserves</p>	<p>Develop a well defined process for determining margins for uncertainty that are consistent with this provision. If the VM provides guidance for this process, assure compliance with the VM.</p>	<p>Have a general understanding of the risks that require a greater margin for uncertainty. Receive reports that describe where these greater margins are necessary.</p>	<p>Review the internal standards, and assure that they are consistent with the company's overall risk assessment processes. Assure compliance with the standards.</p>	<p>Define general internal standards for determining margins for uncertainty that recognize where greater margins are necessary (chief actuary or appointed actuary). Develop more specific product line standards as necessary (product line/pba actuary). This evaluation should be appropriately consistent with the company's overall risk assessment processes. Document these processes for review by senior management and assure that these processes are followed. Include discussion of margins for uncertainty in reporting to AA/chief actuary, senior management, and the Board.</p>

<b>Section</b>	<b>What is a Company Required to Do?</b>	<b>Who Does What? Role of Board</b>	<b>Who Does What? Role of Senior Management</b>	<b>Role of Appointed-Certifying Actuary</b>
<p>Section 11H(4)            If required by the VM, engage an independent qualified actuary to perform an annual review and opinion of reserve methods, generation of economic scenarios, reasonableness of models, supportability of reserve assumptions and margins, whether all material risks have been captured, and compliance with all relevant laws, regulations, and ASOPs with respect to the company's PB valuations.</p>	<p>Engage an actuary who meets the independence and qualification requirements in the VM (per Section 11C(3)(b) above), and who the company has determined to be appropriately independent and qualified to perform the annual review of reserve methods, economic scenarios, models, etc            Receive and respond as needed to the independent review report.</p>	<p>Implement the requirements for independence. Ultimately appoint the Independent Actuary, and require appropriate documentation about how independence and qualification were determined.             Receive and respond as needed to the independent review report.</p>	<p>Implement controls to assure independence.</p>	<p>Assist management and the Board in identifying and engaging independent qualified actuaries.</p>

<b>Section</b>	<b>What is a Company Required to Do?</b>	<b>Who Does What? Role of Board</b>	<b>Who Does What? Role of Senior Management</b>	<b>Role of Appointed-Certifying Actuary</b>
<p>Section 11H(5) Adopt internal controls to assure that all material risks in the liabilities AND ASSETS are captured in the valuation and are in compliance with the VM.</p> <p>The company must evaluate the effectiveness of such controls each year and report to the Board and the commissioner</p>	<p>Develop and implement appropriate control structures over PBA valuations</p> <p>Develop an annual valuation process of the control structure.</p> <p>Report to the Board of Directors and the Commissioner on the effectiveness of the controls</p>	<p>Review control structure with management.</p> <p>Annually receive report from the company on the effectiveness of the controls, including any recommendations on how the controls need to be strengthened.</p>	<p>Assure appropriate control processes are in place that assure that all material risks are being captured, in compliance with the VM.</p> <p>Install an annual evaluation process, including identifying any control weaknesses and following up on action plans to correct those weaknesses.</p> <p>The company develops and delivers an annual report to the Board and the Commissioner on the effectiveness of controls.</p>	<p>Develop and implement controls over actuarial processes that are consistent with the agreed control framework.</p> <p>Correct any control weaknesses that are identified.</p> <p>Along with CFO, report conclusions about effectiveness of controls to the Board and the commissioner.</p>

Section	What is a Company Required to Do?	Who Does What? Role of Board	Who Does What? Role of Senior Management	Role of Appointed-Certifying Actuary
<p>Sections 11H(6) and 11H(8)(a)(b)(c)</p> <p>File a PBA valuation report with the standards prescribed in the VM</p> <p>File supporting documents, including the work papers of the independent (peer review) actuary</p> <p>File other information as requested</p>	<p>File the required reports and supporting documentation, with the mandated content and form</p> <p><b><u>DRAFTING NOTE: Need to clarify who should actually file the work papers of the independent review actuary? Do they go through the board to the regulator or is the same report sent to each body?</u></b></p>	<p>Receive a summary of the PBA valuation report, and have access to the full report</p> <p>Understand the main points of the report</p>	<p>Establish control processes to assure that such a report is prepared in compliance with these requirements and submitted in a timely manner</p>	<p>Define appropriate internal standards for, and review processes over the content and form of the report that complies with the standards prescribed in the VM.</p> <p>Prepare the report that meets these requirements.</p> <p>Submit the report in a timely manner, following whatever process is specified in the VM for submission of the report, work papers, and other required information (yet to be defined in the VM).</p>

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<p>Section 11H(7) File with the commissioner under procedures prescribed in the VM, notice of the name, title, name of firm and terms of engagement of the independent actuary, including the independent actuary's letter of acceptance demonstrating that the actuary meets the qualification and independence requirements prescribed in the VM.</p>	<p>File with the commissioner the information required from the company (name, title, name of firm, and terms of engagement of the independent actuary), and the information required from the independent actuary (letter of acceptance demonstrating that the actuary meets the qualification and independence requirements prescribed in the VM).</p>	<p>Confirm that the required material has been filed with the commissioner and that it complies with the standards prescribed in the VM.</p>	<p>Prepare and file the required material with the commissioner and assure that it complies with the standards prescribed in the VM.</p>	<p>Prepare a letter accepting the role of independent actuary, including demonstrating compliance with qualification and independence standards prescribed in the VM.</p>
<p>Section 11K File experience data as prescribed in the VM</p>	<p>File experience data as prescribed in the VM Identify such data as confidential</p>		<p>Establish controls that assure timely preparation and filing of the necessary reports. Controls should also operate to preserve the confidentiality of the information. File the experience information as required.</p>	<p>Develop data collection methods, analyses, processes and systems to assure that the required reports are submitted in a timely manner. Define appropriate control processes around this work.</p>

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Section L Definitions	All persons involved directly or indirectly in the PBA process carry out the PB valuation, according to this definition (i.e. that a PB valuation means a reserve valuation specified in the VM that uses one or more methods or one or more assumptions determined by the insurer)	Establish expectation that company will meet the PBA requirements as defined in the valuation manual	Assure that all persons involved directly or indirectly in the PBA process understand the nature of a PB valuation, according to this definition, and that valuations are implemented within the spirit of this definition	Implement PB valuations that are consistent with the spirit of this definition. Understand and follow all of the requirements/standards defined in the VM.

Exhibit 3

Opinion Covering PBA Reserves

(With wording adjusted for consistency with 7/12/07 draft SVL)

**Note. The illustrative statements below could be integrated as needed into a comprehensive opinion regarding company results, and could be useful in documenting governance of PBR.**

To: Board of Directors of \_\_\_\_\_ Insurance Company

I, \_\_\_\_\_, am Chief Actuary of \_\_\_\_\_ Insurance Company. I am a member of the American Academy of Actuaries and meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion contained herein. I have effected an examination of the actuarial assumptions, methodologies, and calculations used in determining reserves under Section 11 of the Standard Valuation Law (principles based approaches) for the year \_\_\_\_ for \_\_\_\_\_ Insurance Company, and have found the reserves in total to be adequate and appropriate. These examinations included such tests of the actuarial calculations as I considered necessary.

With respect to this presentation made to the Board of Directors at their \_\_\_\_\_ meeting, it is my opinion that:

1. I have considered and captured all benefits and guarantees associated with each block of business and their identifiable, quantifiable, and material risks, including tail risk and funding of the risks. (Note. Wording is aligned with SVL2 section 11H(1).) Among other risks, these include investment, expense, persistency and mortality or morbidity risk specific to each block of business separately.
2. I have also considered but have not reflected risks that were immaterial, unidentifiable, unquantifiable, or otherwise inappropriate to be reflected in reserve calculations. Among other risks, these include catastrophic events and other business risks measured to determine overall company surplus levels. (*Drafting Note: this statement may be included in an internal certification to senior management and the board, but not necessarily in the public Statement of Actuarial Opinion.*)
3. Assumptions and methods used to calculate reserves are consistent with but not necessarily identical to, those utilized within the company's overall risk assessment and management process. These assumptions and methods provide a level of conservatism consistent with the objects of statutory financial reporting; and they provide margins for uncertainty including adverse deviation and estimation error, such that the greater the uncertainty the larger the margin and resulting reserve. For those assumptions for which credible data are not available, assumptions have been toward the conservative end of a plausible range of future experience. (*Drafting Note. Wording is aligned with SVL section 11H(2).*)

4. I have cooperated with and made all relevant information available to the independent actuary that the company has engaged to perform an annual review and opinion of reserve methods and related matters as required in the Valuation Manual, so that he/she could appropriately carry out his/her responsibilities to the Board and as provided in the Valuation Manual.
5. I have complied with all statutory and other legal requirements. I know of no significant or material concern from any regulators with regard to the calculation or overall level of reserves.
6. I am familiar with the internal controls the company has in place and the evaluation the company has performed of the effectiveness of its internal controls as required by the Valuation Manual. (*Drafting Note. Wording is aligned with SVL2 section 11H(5).*) The controls around the reserve process are currently sufficient and appropriate. I have (not made any changes to these controls at this time) or (I have implemented any necessary changes to control processes).
7. I have prepared a report on the principles based reserve valuation that complies with all regulatory requirements

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Note. For practical implementation reasons, a company may choose to ask its board to approve the overall process and principles that will be used in a PBR valuation, before the board receives an opinion covering PBR results.

## Exhibit 4

### Corporate Governance Benchmarking

We (the Corporate Governance Team) have reviewed several structures for corporate governance from around the world. We list below several key points of three structures that may be of interest as external and internal governance standards are developed for and by companies that will be subject to PBA requirements for some of the business they issue and have in force.

- A) Governance requirements of the Canadian Office of the Superintendent of Financial Institutions (“OSFI”) – These requirements may be of particular interest because they have been in effect for several years, apparently are operating effectively, and they are applicable to companies that are similar to the companies that will be subject to PBA.
- 1) OSFI’s framework applies to all types of financial institutions that OSFI regulates. OSFI reviews of corporate governance include both an assessment of governance processes (based on specified characteristics) and of the company’s effectiveness in carrying out its governance responsibilities.
  - 2) Triennial reviews are the norm; but the level and frequency of OSFI scrutiny depends on OSFI’s assessment of risk in each company. OSFI provides ratings of each company based on a series of ratings grids and criteria for each of six oversight functions (the board, senior management, risk management, internal audit, compliance, and financial analysis).
  - 3) Each insurance company appoints an Appointed Actuary (“AA”), who must provide OSFI and the company with a detailed report on the valuation, data checks, assumptions, and assumption changes for all significant products.
  - 4) Each insurance company also appoints an External Reviewer (“ER”) (an independent actuary), who reviews the AA’s work for the purposes of: a) Narrowing the ranges of practices by AAs; b) Improving the quality of AA work; c) Maintaining and strengthening confidence in AA work; and d) Providing significant professional education for the AA.
  - 5) The company’s external auditor must review the accuracy of actuarial calculations, test internal controls, and review assumptions and modeling techniques, to assess whether actuarial liabilities are within a reasonable range.
- B) Governance requirements of the New York Stock Exchange (“NYSE”) – These requirements may be of particular interest because they have been in effect for

several years, apparently are operating effectively, and they are already applicable to many of the larger companies that will be subject to PBA.

- 1) The NYSE requires listed companies to adopt and disclose their corporate governance guidelines and the charters of specified board committees, and to adopt and disclose a code of business conduct and ethics for directors, officers, and employees. A majority of the directors must be independent (have no material relationship with the listed company).
  - 2) The company's board of directors must have a nominating/corporate governance committee and an audit committee. All members of these committees must be independent directors. All members of the audit committee must be financially literate, and at least one committee member must have accounting or related financial management experience.
  - 3) The company must have an internal audit function, to provide management and the board (or its audit committee) with on-going assessment of the company's risk management processes and system of internal controls.
- C) Governance provisions in papers and standards of the International Association of Insurance Supervisors ("IAIS") – The IAIS work on corporate governance may be of particular interest because the NAIC is participating in this work, and may very well converge with some or all of the governance standards that the IAIS develops.
- 1) The IAIS has established a corporate governance task force to develop overarching principles for governance of insurers. This task force is currently taking stock of existing governance requirements around the world.
  - 2) Some of the existing IAIS standards papers contain provisions related to governance. The "IAIS Common Structures for the Assessment of Insurer Solvency" paper presents the common structures in three categories (financial, governance, and market conduct). The common structure element for governance is that "the supervisory regime should require insurers to have and maintain corporate governance policies, practices and structures and undertake sound risk management in relation to all aspects of their business. Sound governance is a pre-requisite for a solvency regime to operate effectively."
  - 3) The responsibility for the assessment of risk and the management of the financial position of the insurer primarily rests with the board and management of the insurer. The company (board and management) is responsible for valuation of liabilities. The company should make appropriate use of experts with necessary knowledge, skills, and experience; but use of such experts in preparing the insurer's financial statements shouldn't lessen

either the responsibility of management to produce reliable financial statements or the responsibility of the external auditor to express an opinion on such statements.

- 4) Sound governance and management include review of strategies, policies, and decision making with respect to risks the company assumes. Risk monitoring systems must be well integrated into the organization, and measures must be taken to ensure that risks can be measured, assessed, monitored, reported, and controlled in a consistent manner.
- 5) The IAIS also currently has a series of guidance papers out in draft form for comment on several issues related to governance. These are guidance papers on Enterprise Risk Management (ERM) for Capital and Solvency Purposes, on Capital Requirements, and on Use of Internal Models by Insurers.

The guidance paper on ERM provides that an insurer should establish, and operate within, a sound ERM framework as part of its overall governance structure. The framework should be integrated with the insurer's business operations, reflecting desired business culture and behavioral expectations and addressing reasonably foreseeable and relevant material risks faced by the insurer in accordance with a properly constructed risk management policy. The establishment and operation of the ERM framework should be led by and informed by senior management and overseen by the insurer's board. An insurer should regularly perform an own risk and solvency assessment (ORSA), encompassing all reasonably foreseeable and relevant material risks including, as a minimum, underwriting, credit, market, operational and liquidity risks and identifying the relationship between risk management and the level and quality of financial resources needed.

Exhibit 5

**Comments on the Corporate Governance for Risk Management Act (draft)  
Corporate Governance for Risk Management Model Regulation (draft)**

**From the American Academy of Actuaries' Life Governance Team  
Presented to the National Association of Insurance Commissioners' Capital  
Adequacy Task Force December 10, 2006**

The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

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The Life Governance Team of the American Academy of Actuaries has reviewed the NAIC draft Corporate Governance for Risk Management Act (“Act”) and the accompanying Corporate Governance for Risk Management Model Regulation (“Regulation”). Both documents were exposed for comment by the NAIC’s Capital Adequacy Task Force (CADTF).

Both the proposed draft Act and the Regulation attempt to link principles-based approaches to valuation to the broader regulation of risk management. The draft Act and Regulation have a scope that extends beyond principle-based valuations. They are intended to regulate the risk management practices of all authorized insurers doing business in a state that adopts the law, regardless of whether they employ principles-based valuations. They impose specific requirements on a company’s board of directors and grant the commissioner authority to expand those requirements by regulation. They also authorize states to impose punitive penalties for non-compliance.

Only certain portions of the draft Act and Regulation address issues related specifically to principles-based reserves and capital. Risk-management governance and principles-based governance are distinct issues. They will be addressed separately in this comment letter.

### **Governance for Risk Management**

Both the Act and the Regulation deal with regulating internal company management processes in a way that extends beyond current regulatory control over corporate governance and well beyond statutory issues. This proposed regulatory control deserves careful scrutiny for several reasons.

First, such new regulations may not be needed because:

- The NAIC’s new Risk Focused Surveillance framework includes substantial review of a company’s risk management and control processes, which will guide the scope and depth of future regulatory examinations.
- Companies already have risk management systems in place in the form of concentration limits, asset class limits, underwriting retention limits, asset-liability matching, stringent controls over business and operating risks, etc.
- Actuarial judgment is already a significant component of insurance company financial reporting in the form of the assumptions and methods underlying GAAP reporting, asset adequacy testing, and various aspects of the calculations of life insurance company statutory reserves and capital.
- The rating agencies provide ongoing incentive to identify and manage risks. For example, Standard & Poor’s has added an assessment of a company’s risk management processes as a specific criterion for determining a company’s rating.

Thus, the existing environment should be considered before new regulations are added.

Second, the draft Model Regulation, in particular, takes ideas from a number of sources, the applicability of which has not been established for U.S. insurance companies.

- For example, the Regulation takes many concepts from the banking industry and Basel II
- A 2003 report from the independent Group of Thirty Consultative Group on International Economic and Monetary Affairs is the basis for several recommendations on governance/control practices.
- The Regulation also references various standards from the International Association of Insurance Supervisors.

More importantly, adopting concepts piecemeal from several different sources may result in losing the balance among various governance objectives and constraints that was ultimately reflected in each separate proposal.

Finally, the Act and Regulation could be interpreted as risk management “best practices”. While well-intended, the codification of these practices (many of which were taken from the banking industry) would not provide for the evolution of risk management tools and practices for U.S. insurance companies, and certain requirements might soon prove to be barriers to efficient and effective risk management.

Therefore, more time is needed to review specific provisions in the Act and Regulation, and to obtain the expertise of other professions since many of the provisions extend beyond the scope of the expertise of the actuarial profession.

The Team does have expertise to comment on governance related to principles-based reserves and capital. This is addressed in the following section.

### **Governance for Principles-based Reserves and Capital**

Only small portions of the draft Act and Regulation are devoted specifically to principles-based valuations. In the draft Act, the only mention of principles-based valuations is found in three general sentences in Section 5. In the Regulation, principles-based valuations are addressed primarily in Section 7, “Certifying Actuary Statement and Certifying Actuary Report for Principles-based Valuations.”

The regulations relating to the Certifying Actuary such as the qualifications of the Certifying Actuary, the content of the Certifying Actuary’s Statement, and the contents of the Certifying Actuary’s Report should be in a Valuation Manual, as provided for in draft revisions to the Standard Valuation Law. With these topics addressed in the Valuation Manual, the regulatory framework would have the necessary flexibility to encompass new ideas and best practices as they emerge.

Academy work groups are already developing proposed governance procedures specific to principles-based reserves and capital on a number of fronts. The proposed valuation law itself contains such governance requirements as the charge to quantify all material risks, the need to engage an independent qualified actuary to conduct an annual detailed peer review, and provision of reports and other information to the Commissioner. The Valuation Manual referenced in the law, and Actuarial Standards of Practice, are expected to provide guidance with respect to assumptions, conservatism, modeling and “Other requirements deemed necessary by the NAIC....” Detailed supporting documentation will be required, including reports that would be available to state regulators. In addition, the current draft revisions to the Standard Valuation Law also include authority for the state Commissioner to conduct an additional independent review.

Thus, the proposed principles-based approach will provide a rigorous framework for governance in the form of standards, review processes, certifications, disclosures, required submission of company data, and regulatory powers. We expect that many of these standards and processes will be consistent with the proposed requirements in the draft Corporate Governance for Risk Management Act and Regulation. However, the Valuation Manual and Actuarial Standards of Practice would be a more appropriate location for these provisions.

The scope of internal corporate governance should be considered further as the exact requirements for principles-based approaches for valuation take form.

## **Conclusion**

An appropriate risk management process for determining statutory reserves and capital should exist within companies, regardless of whether they use a principles-based approach. However, the need for governance in a principles-based approach does not necessarily translate into detailed regulation of a company’s entire risk management process. With respect to governance for principles-based valuations, we have in mind a process that identifies specific governance objectives, describes the policies and processes the company would need to meet these objectives, reviews the extent to which the framework being developed already includes needed governance, and assesses the extent to which additional regulations are needed.