Memo

To: Mr. Jim Hattaway (AL) and Mr. Doug Slape (TX) Co-chairs, and members of the Risk-Focused Surveillance (E) Working Group (RFSWG)

From: Patricia Matson, Pat Tracy, and LeeAnne Creevy, Risk & Regulatory Consulting, LLC

Date: May 16, 2014

Subject: ORSA Guidance for Inclusion in Both the Analysis Handbook and Examiners Handbook

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Risk & Regulatory Consulting ("RRC") supports the efforts of the RFSWG to provide guidance to financial examiners and financial analysts on the important topic of ORSA to align with the current regulatory modernization effort. We have reviewed the ORSA Analysis and Examiners Guidance exposure documents and offer the following comments for your consideration. We would be glad to answer any questions.

Note: Our more substantial comments are included within the body of our letter. We also have included other comments on the language in an appendix to this memorandum for your reference.

General Comments

We strongly agree that analyst and examiner guidance needs to allow for a range of Enterprise Risk Management ("ERM") approaches and ORSA reporting, consistent with the idea of "Own" Risk and Solvency Assessment. Examples of where this approach is clearly highlighted include statements in the Financial Analysis Handbook such as "the analyst should NOT use the following guidance in a way that dictates specifics on the report" and "to emphasize U.S. insurance regulators are strongly supportive of an ORSA process and ORSA Summary Report that emphasizes the "Own". Unlike the detailed rules governing statutory financial reporting, which apply uniformly to all insurance companies, ORSA review guidance should avoid "checklist thinking." ERM processes and the related ORSA output will vary significantly for large, medium and small companies, and, accordingly, review guidance should appropriately recognize this concept.

Additionally, we strongly agree that ERM is usually managed at a level above the legal entity. Larger companies will tend to perform critical ERM functions at the holding company level. Having a better understanding of where ERM is performed and managed will enhance a State's knowledge of the holding company structure. This additional insight should assist with effective understanding of complex holding companies and the impact on solvency at the legal entity level. Some companies will articulate "lines of defense" for risk culture and governance, and day-to-day business unit (versus legal entity) controls. The ORSA review guidance needs to recognize where key activity and management of risk takes place. The guidance emphasizes lead State review and coordination with participating States, which we think is the best approach as ERM and ORSA impact all legal entities in a holding company group.

We also agree with the general principle that, depending on the robustness of a company's ERM program, the scope of regulatory procedures could be impacted. It appears logical and efficient to adjust the extent of regulatory review procedures up or down depending on how well the company identifies, measures, and manages its risk exposures. RRC believes that Phases 1 and 2 of the NAIC Financial Condition Examiners Handbook (the

"Financial Examiners Handbook") can be completed more efficiently in cases where the examined company has a mature ERM process and robust documentation surrounding Sections II and III of ORSA. Real-time review by the examiners of emerging high risk areas should be enhanced by ORSA and, where appropriate, the lead State could verify that critical risk mitigation efforts are in place with targeted examination work. RRC also believes ORSA should improve the States' ability to communicate about risk when dialoguing with other regulators (e.g., State, Federal and Foreign regulators).

Furthermore, we concur that a regulatory actuary should be involved in the review of ORSA. In particular, the Financial Analysis Handbook states, "Although the analyst is expected to make this initial determination, most states believe there is value in including the examiner-in-charge and actuary in the initial discussions with the insurer since the same team will be a part of the ongoing monitoring of the insurer and the ORSA Summary Report is expected to be at the center of the regulatory processes." We believe there are many components of an ORSA report that involve actuarial analysis, and therefore actuarial involvement in the review of ORSA will be helpful as part of the analysis and examination process.

The RIMS maturity model provides helpful educational material for the analyst and examiner. However, this maturity model is not specific to insurance; therefore, it is important that the characteristics of each maturity level be viewed only as a rough guideline – i.e., the judgment of the regulator is needed to interpret where on the spectrum each company sits, versus a strict application of the maturity definitions in the document. Specific comments on the maturity model and its application to insurance can be found in the attached appendix.

We agree with the idea of proportionality as outlined in the documents – in other words a smaller and/or less complex insurer may acceptably have a lower ERM maturity.

Finally, we believe that some additional education and guidance regarding risk interactions and diversification would be helpful. A key consideration within any ERM program is the impacts of correlation and diversification across products, business units, and risks. We suggest adding some commentary regarding these principles in the introductory remarks and also in specific guidance areas. For example, risk identification and quantification may consider risk diversification. Stress testing would typically involve both single risk stress testing and combined risk scenario testing. Treatment of diversification benefits in risk modeling is an area for which regulators will need to get more comfortable.

Specific Comments on Financial Analysis Handbook

Pages 5-6, list of specific risks – We support the commentary recognizing that the definition of the 9 branded risks here may differ from how the insurer defines and categorizes risks. We note that many companies have extensive risk disclosure in their Form 10-Ks and anticipate the critical ORSA risks will track most closely with those public disclosures. It may be worth pointing out some of the expected significant differences, such as the following:

- For most insurers, credit risk is defined to include balance sheet impacts due to movements in market spreads and migration of assets across rating classes, and not just default risk.
- For most insurers, market risk considers impacts on both sides of the balance sheet (i.e., assets AND liabilities), not just the impact on "market value of investments".
- Many insurers consider pricing, underwriting, and reserving to be processes. For life and health entities, the underlying risks are defined as mortality, morbidity, policyholder behavior, adverse selection, etc. For P&C companies, the underlying risks are usually identified by perils and geography, and by long-tail versus short-tail exposure, among others.
- In some cases legal and reputational risk are encompassed within the operational risk category.
- Many companies also identify model risk as a critical operating risk that impacts ORSA.

Page 8 – One consideration that is not mentioned in this section, which is typically a component of risk culture, is the extent to which formal risk training exists in the organization. In addition, there are some statements within the risk maturity sections that may not be clear to the user, in particular if the user is not an ERM expert, as follows:

- "Risk culture is associated with career development" under the "Managed Practices" header
- "One area has used the ERM Process" under the "Initial Practices" header (perhaps this should be "One or more business units or functional areas…")
- "Controls are based on departments and finances" under the "Ad Hoc Practices" header

These comments also apply to page 5 of the Financial Examiners Handbook.

Page 9 – Typically, risk identification processes involve a consistent, defined risk taxonomy as a starting point to facilitate consistent risk definition and categorization. We suggest mentioning this in the maturity definitions, at least for leadership and managed practices. We believe that Leadership practices will usually involve comparing the company's customized risk models to those used by the rating agencies. This comparison and analysis to rating agency risk models is a best practice and provides general insight about industry data (used by the rating agencies) versus the company's views on risk. In addition, leadership practices typically involve providing a cross-disciplined approach to the risk identification process involving specialists from a variety of disciplines, including: Human Resources, Investments, Actuaries, Attorneys, Information Systems and Technology, Market Conduct/Compliance, and Finance expertise. This comment also applies to the Financial Examiners Handbook on page 6.

Page 9 (continued) – We suggest adding some reference to the risk assessment process and the use of impact, likelihood, and speed of onset scales in the Leadership Practices section. In addition, the statement within this Leadership Practices states "Internal and external best practices, support functions, business lines, and regions are systematically gathered and maintained" is confusing, since it is not clear how some of these items could be gathered or maintained. These comments also apply to page 6 of the Financial Examiners Handbook.

Page 16 – Under "Required Documentation for Section 1": We suggest adding language at the end of this paragraph, such as "Where available, from prior full scope or targeted examinations, the field tested assessment should be included. The analyst should be mindful about improving the assessment from what was previously verified through examination fieldwork. Instead, it might be more appropriate for the analyst to indicate specific positive developments that have occurred versus improving the assessment without validation. If dramatic enhancements that could impact regulatory monitoring are indicated, the lead State could consider targeted examination work to validate the improved assessment."

Pages 20 and 21 – In the section "Most Relevant Information Documented by the Analyst from Section II", the second paragraph toward the end references "more extreme situations" that insurers may use for stress testing as compared to economic capital. Economic capital stresses are typically extreme tail (for example 1/1000) events, and stress testing should contemplate moderately adverse stresses. We would suggest recognizing this by changing the language to refer to "more or less extreme situations."

Page 21 (continued) – We strongly agree with the comments in the second paragraph. We also have the following specific comments on the list of example stresses on pages 21 and 22:

- Within credit, we suggest further distinction between default risk and spread widening. Even if spread widening does not result in any additional loss in asset book values, it can result in the need to sell assets at a loss to cover obligations if assets and liabilities are not well matched.
- Narrowing of credit spreads is also an important risk, as it can result in lower than expected reinvestment spreads and inability to meet contractual guarantees.
- We suggest moving the equity security loss item from Credit to Market.
- We suggest reference to morbidity in Pricing/Underwriting, in light of the criticality of this risk for health insurers, in particular.
- Liquidity should address the ability to generate cash from the investment portfolio in a crisis based on the company's stressed payment needs. Other sources of cash, like bank borrowing or accessing public

markets should have realistic time frames and consider the impact stress events could have on those sources.
- Liquidity should also address the ability to handle multiple events at the same time.

These comments also apply to page 15 of the Financial Examiners Handbook.

Page 22 (continued) – Under item 5. "Liquidity": We suggest adding the following two items at the end of the bullet listing. This same comment applies to page 15 of the Financial Examiners Handbook:

- Ability to generate cash from the portfolio or other sources in a crisis
- Ability to handle multiple events at the same time from a liquidity perspective

Page 23 – Under the header "More Specific Considerations for Reviewing Section II", we suggest adding the following question: "How sensitive is the holding company to cash flow disruptions at the legal entities?"

Page 25 – In the second paragraph, the definition of economic capital (a comparison of the required capital per the calculation of various types of material risks to the amount of capital available to pay claims) is confusing. It may be clearer to define required economic capital as the amount needed to cover risk exposures over a defined time period and with defined confidence, and then separately define available economic capital as the amount available based on an economic balance sheet. In this same paragraph, we also disagree that calculations for available capital "are generally based on a market consistent (fair value) balance sheet, wherein GAAP equity may be used as a starting point…". Companies in the U.S. have generally moved away from a "pure" market consistent or fair value approach, and instead use an internally defined version of economic capital, which allows for consideration of the long term, non-traded nature of liabilities. In addition, many companies arrive at this balance sheet by calculating values directly from the underlying instrument cash flows, rather than by starting with GAAP values. We also suggest that the document make reference to another, relatively common, method of defining the economic balance sheet, which involves a projection of the statutory balance sheet over a long period of time, typically called the "statutory runoff" approach.

Page 25 (continued) – We disagree with the statement "Most insurers that utilize economic capital models use them as much for day to day decisions as they do group capital management" in the third paragraph. While this is true for companies in the "Leading" maturity bucket, it can take quite a bit of time to evolve to this level of use, and a company can have good ERM practices but not yet be at a state of using economic capital models in day to day decisions. The sentence in the middle of the third paragraph, "In addition, because economic capital models are commonly the basis for which such groups manage their capital levels to the action or inaction by companies in response to material changes or immaterial changes can be revealing with respect to how much models are informative to manage in their day to day decisions", is confusing. Lastly, we suggest that in the last paragraph further commentary be added on the challenges of back-testing economic capital models in light of their focus on tail events. While back-testing of models can generally be useful as a validation tool, it is almost impossible to back-test the required economic capital results since an extreme tail event that is close in nature to that estimated in the model is unlikely to have ever happened. Perhaps referencing back-testing of specific risk distributions, or the baseline economic balance sheet, would be more informative.

Page 26 – The comment that "even insurers that use internal capital models will usually track their perceived capital requirements from such (rating agency) models and will include them in the ORSA summary report" is probably true for leadership and managed maturity levels. However, while we would expect to see statutory capital and in most cases some form of economic capital in the ORSA summary report, we would not expect all companies to include rating agency capital (other than that expressed as a % of RBC). This comment also applies to page 20 of the Financial Examiners Handbook.

Page 28 – We suggest adding a section on liquidity with the following guidance, "Most insurers will use operating cash flow in normal environments to fund their operations. The stressed scenarios should evaluate how much liquidity is realistically available from asset sales and other contingency plans. This liquidity analysis should address the legal entities and holding company. Ideally, the liquidity plan will address asset risk in a market crisis. Financial leverage and non-liquid investments will increase liquidity risk. Highly liquid companies will not require as much cushion as highly illiquid companies. If sufficient liquidity is not available under a stress scenario, that issue should be discussed with the company and viewed as a solvency risk."

Page 30 – We suggest including commentary regarding the use of stress scenarios in the "Review of Section III – Prospective Solvency Assessment" section. It appears critical that prospective solvency be considered not only in a best estimate scenario but also in stress scenarios. This comment also applies to page 20 of the Financial Examiners Handbook.

Specific Comments on Financial Examiners Handbook

Page 11 – An additional procedure that may be useful related to Risk Culture and Governance is review of formal training materials on ERM. We also believe that it may be useful to add a bullet within the Risk Culture and Governance section that reads, "Review the company's current process for accumulating, prioritizing and reporting on significant and emerging risks to the board of directors, top management and line management. Also, obtain an understanding as to how long this process has been in place and how it has evolved over time."

Page 12 – Risk Identification and Prioritization section – the following could be added:

- Reviewing the approach for and results of assessing risk likelihood, severity, and speed of onset,
- Verifying that top risks are assigned risk owners responsible for monitoring the risk and overseeing risk mitigation plans;
- Determining what outside sources, such as rating agencies, AICPA Risk Alerts, competitors' Form 10-K disclosures about risk, etc. have been used by the company as part of its risk identification processes;
- Considering how the company assures it fully considers financial reporting and prospective risk in its analyses and hasn't missed something significant; and
- Assessing the company's process and scale by which it prioritizes the key risks identified (Note: the examiner could compare this to the risk guidance in the Financial Examiners Handbook).

Page 12 (continued) – Risk Appetite, Tolerances and Limits section – the following could be added:

- Assessing how risk appetite, tolerance and limits are defined for the holding company and legal entities.
- Determining whether the company considers legal entity capital requirements in setting its overall risk appetite.

Page 13 – Risk Management and Controls section – the following could be added:

- Considering the Company's mapping from the control source to legal entities where appropriate (e.g., the company should have mapping information as to how this works).

Page 13 (continued) – Risk Reporting and Communication section – the following could be added:

- Determining how risk information is used by senior management and the board of directors for strategy and planning purposes (note: if no clear connection exists, the maturity level should be assessed as low).

Page 22 – Under section 1b., "Internal Capital Models", we suggest adding a fourth bullet that reads, "Stress scenarios and testing applied."

Page 22 (continued) – Under leadership exam impact, we recommend adding, "Examination testing should consider validating (e.g., as part of Phase 3) the strong maturity level environment which should reduce time needed in executing detailed examination procedures (e.g., Phase 5 substantive type testing)."

Page 23 – In the first box under Section I, consideration could be given to adding, “The maturity level of ERM can be assessed similar to the corporate governance process. Assessing (perhaps through a scoring mechanism) the quality of both the company’s corporate governance environment and its ERM function is possible in the planning stage of an exam (i.e., Phases 1 and 2).

Page 24 – Under Section II that discussed stress testing we suggest adding, “The documentation should discuss the risks, capital and liquidity in sufficient detail to address future solvency concerns.”

Other Comments on Financial Analysis Handbook

Page 10 – The statement "The organization manages business areas and has a diverse portfolio collection to balance risk positions" in the "Leadership Practices" section is confusing. This comment also applies to page 8 of the Financial Examiners Handbook.

Page 11 – We suggest that both managed practices and repeatable practices include reference to having a defined risk appetite statement, as this is a basic, core tenet required for a good (not necessarily leading) ERM program. This comment also applies to page 8 of the Financial Examiners Handbook.

Page 12 – It is not clear what is meant by the statement "Management is clearly defined and enforced at every level" under the "Managed Practices" header. Perhaps this should say "Risk management is clearly defined…." This comment also applies to page 9 of the Financial Examiners Handbook.

Page 13 – We also note that Leadership companies typically have a well-developed risk communication document that is shared with the board of directors, executive/senior management and middle level management. This type of risk communication document is often viewed as being on par or possibly even more important than a review of historical financial reports. Note this same comment applies to the Financial Examines Handbook on page 10.

Page 14 – We suggest adding a question asking for examples of where ERM processes have resulted in different strategic decisions at the company, as this typically provides evidence that risk culture is strong and risk management processes are actively utilized.

Page 18 – We strongly agree with the comments in the second paragraph regarding the benefits of risk exposure in both normal and stressed environments. It should provide supplemental insight on how RBC looks under stress and also fresh insight on the holding company.

Page 24 – The statement in the second paragraph under the header "Review of Section III - Group Assessment of Risk Capital" which states, "insurer combines the qualitative elements of its risk management policy with the quantitative measures of risk exposure in determining the level of capital needed" is confusing, as it is not clear how a qualitative element is quantified for purposes of capital. We suggest adding an example of how Section III might use summarized information (CAT models would be a good example) that incorporate both qualitative and quantitative measures.

Page 24 (continued) – Third paragraph that starts, "Section III, unlike Section I, where the enalyst assessment…". There is a typo in the word "analyst".

Page 28 – In the discussion about capital "cushion" it may be useful to distinguish between available capital and required capital. Use of the term economic capital or regulatory capital without specifying required versus available may lead to confusion.

Page 28 (continued) – We suggest adding "The liquidity analysis should provide substantial insight on the quality of capital" under the Quality of Capital guidance.

Other Comments on Financial Examiners Handbook

Page 7 – We think the risk appetite guidance using a 99.7% confidence level may get too specific and set a high bar; as such, it may be worth reconsidering this level.

Page 12 –Note that in the first bullet under "Risk Identification and Prioritization" – the word organizations should have an apostrophe (i.e., it should be "organization's").

Pages 13 to 14 – Under each of the five ERM Key Principles sections (below the sections that read "Initial Analyst Assessment:", "Summary of Exam Results:" and "Final Exam Assessment:"), a section could be added that reads, "Comments: Add any insight that explains the major reasons for differences between initial analyst and examiner assessment."

Page 14 – In the middle of the paragraph under the "Stress Testing" header, in the sentence that reads, "Before such an evaluation is designed, the examiner should obtain information from the analyst to determine the extent to which that the state…", the word "that" needs to be deleted.

Page 14 (continued) – In the middle of the paragraph under the "Stress Testing" header, in the sentence that starts, "The presumption is that the analyst's evaluation of such assumptions and methodologies may have been more cursory and the examiner's evaluation would therefore by more in-depth,…" there is a typo. The word "by" should be "be".

Page 17 – Right above the header that reads "Required Documentation for Section II", a bullet could be added at the end of the listing that reads, "Do the stress scenarios utilized address holding company and legal entity issues from both a capital and liquidity perspective?"

Page 19 – The third full paragraph refers to "involving an actuary or individual with experience in advanced mathematics/statistics…" in reviewing the insurer's internal model. We suggest that this section reference involving an actuary only, since actuaries have both the advanced mathematics/statistics background needed along with a deep understanding of insurance company operations and risks. Use of a non-actuary for this very complex and important task is unlikely to result in the desired outcome.

Page 19 (continued) – Again, there is a reference to using the example of 99.5% confidence level for meeting policyholder claims; therefore, we note the same question as earlier as to whether this level may lead to "checklist thinking" that should be omitted from a guidance document.