

To: Financial Stability Board (fsb@bis.org)
From: Danny Saenz, Co-Chair, NAIC Group Solvency Issues (E) Working Group
Date: January 30, 2014
Re: Comments Regarding December 23, 2013 Questions Regarding the November 18 2013 FSB Consultative Document on Increasing the Intensity and Effectiveness of Supervision

The NAIC appreciates the opportunity to provide comments to the consultative document on “Increasing the Intensity and Effectiveness of Supervision” and more specifically, the December 23 questions for public consultation related to the same document.

The NAIC is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

The NAIC supports the FSB’s efforts to provide guidance on supervisory interaction with financial institutions on risk culture. Insurers are risk takers and like other financial institutions, must have a prudent risk culture in order to prevent a situation which can create excessive risk to insurance policyholders. State insurance supervisors have long monitored the risk culture environment of insurers and have used different regulatory tools to help to minimize excessive risk taking. Over the last decade, insurers’ risk management techniques have become more sophisticated and evaluating risk management has become a larger part of the on-site examination of all insurance companies in the United States. More recently, in 2012, the NAIC adopted a new annual filing requirement known as the Own Risk and Solvency Assessment (ORSA), a concept developed by the International Association of Insurance Supervisors and reflected in its Insurance Core Principles. The ORSA will become a requirement in the States in 2015 and represents a risk management summary document (ORSA Summary Report) of many items States have been examining on-site over the last few years. In connection with the requirement, the NAIC is in the process of developing supervisory guidance for reviewing the ORSA Summary Report, which includes among other things evaluating the risk culture and governance of insurance groups. Consequently, we appreciate the FSB’s development of guidance in this area as we may find it helpful in developing our own guidance on the same topic.

Related to this, please find attached responses to your questions for public consultation as included in your December 23 document related to “Increasing the Intensity and Effectiveness of Supervision. If you have any questions regarding our responses, feel free to contact Dan Daveline (ddaveline@naic.org), the NAIC staff member who compiled U.S. state insurance supervisors’ comments on this consultation.

**Guidance on Supervisory Interaction with
Financial Institutions on Risk Culture
Questions for Public Consultation**

On 18 November 2013, the Financial Stability Board (FSB) published the consultative document Guidance on Supervisory Interaction with Financial Institutions on Risk Culture (Guidance). This addendum sets out some questions to consider in preparing the submissions on the consultative document.

General questions

1. Are there areas not addressed in the Guidance that should be considered in assessing risk culture?

Yes. The paper is meant to provide guidance to supervisors in interacting with financial institutions about risk culture, but focuses primarily on describing best practices in implementing and maintaining effective risk culture. While this guidance is useful to supervisors, the paper could benefit from providing additional guidance on how to obtain, understand, review and assess information regarding the practices of institutions in these areas.

2. Are there areas of the Guidance where further elaboration or clarity would be useful, without becoming too granular?

Yes. As noted above, the Guidance could elaborate further on how a supervisor can go about the process of reviewing and assessing an institution's risk culture.

3. Would the Guidance benefit from further elaboration on the definitions of corporate culture, risk culture and sub-cultures within business lines, and on the relationship between them?

We do not see this as necessary.

4. What tools would assist, in particular supervisors, to effectively assess the risk culture of financial institutions (e.g. interviews, questionnaires, analyses of internal documents such as board self-assessments, code of ethics for employees, risk appetite statements)?

Any or all of the tools suggested could be useful to supervisors in assessing the risk culture of financial institutions and we strongly encourage the FSB to develop additional guidance in this area.

5. What is the expected supervisory response if, for example, the board of directors failed in its responsibility of setting the adequate tone from the top and consequently in promoting a sound risk culture?

This is a very good question and is something that could benefit the paper by addressing. There are a number of corrective actions that supervisors could take in response to such concerns (e.g. require board membership changes, increase the scope of supervisory activity, etc.) and the paper should discuss various options available and the advantages and disadvantages inherent in each approach.

6. What suggestions do you have to improve the engagement of supervisors with financial institutions on risk culture, in particular when discussing the underlying causes of behavioural weaknesses?

ORSA reporting processes, regular meetings with senior management, meetings with the BOD, use of management letters and other communication tools, etc.

Indicators of a sound risk culture

7. Are the indicators identified in the Guidance sufficient for assessing risk culture and adequately capturing the multifaceted nature of risk culture?

In general, the indicators appear sufficient to assess risk culture at an institution.

8. Are there specific examples of good practices that can be used to support the indicators?

Providing specific examples of best practices could raise the risk of prescribing or expecting certain detailed practices as opposed to focusing on principles and outcomes. Therefore, we suggest that the FSB proceed carefully in providing specific examples of good practices supporting the various indicators.

9. Are the indicators identified in the Guidance commonly considered by the board and senior management when internally discussing risk culture? Are there other indicators that should be included?

The indicators appear appropriate and relevant for board and senior management consideration and discussion.

10. Does the paper appropriately describe the different roles of the board, senior management and other control functions in relation to defining, implementing and monitoring risk culture?

Yes. In fact, this is an area where we believe the FSB tends to be too specific (describing roles) as opposed to describing the controls in general that can achieve the objective. However, in the case of this paper, we believe the FSB has found the appropriate balance and adequately describes the roles.

11. What tools or processes are used to make risk culture tangible within the organisation?

Regular reporting on an institutions compliance with risk limits (i.e. risk dashboards) can help to make risk culture tangible. Also, assigning risk owners across various operational areas of the institution can involve more individuals in establishing a strong risk culture.

12. Are there useful descriptors of an institution's risk culture, both good and bad, that would be helpful to include in an attachment to the paper? For example "growth for growth's sake" or "it's someone else's problem".

We believe that a description of common attitudes (good and bad) towards risk culture would be helpful to include as an attachment.

To: Financial Stability Board (fsb@bis.org)
From: Danny Saenz, Co-Chair, NAIC Group Solvency Issues (E) Working Group
Date: January 30, 2014
Re: Comments Regarding November 18, 2013 FSB Principles for An Effective Risk Appetite Framework

The NAIC appreciates the opportunity to provide comments to the consultative document on “Principles for An Effective Risk Appetite Framework” published by the Financial Stability Board (FSB) on November 18, 2013 after considering previous comments received from a July 17 consultative process.

The NAIC is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

I. Background Information & General Comments

The NAIC supports the FSB’s efforts for providing guidance on risk management. As risk takers, insurers have used different types of risk management for years and state insurance supervisors have continuously modified their approaches for evaluating such techniques. Over the last decade, insurers’ risk management techniques have become more sophisticated and evaluating risk management has become a larger part of the on-site examination of all insurance companies in the United States. More recently, in 2012, the NAIC adopted a new annual filing requirement known as the Own Risk and Solvency Assessment (ORSA), a concept developed by the International Association of Insurance Supervisors and reflected in its Insurance Core Principles. The ORSA will become a requirement in the States in 2015 and represents a risk management summary document (ORSA Summary Report) of many items related to Enterprise Risk Management and Risk Management. In connection with the requirement, the NAIC has conducted a pilot project over the last two years in which ORSA Summary documents have been submitted by insurance groups to a Working Group of regulators from 16 different States. The pilot serves many purposes, including assisting supervisors in their development of regulatory guidance for reviewing the ORSA filings as well as providing guidance to the industry in accumulating their reports (Attachment One). Although development of such supervisory guidance has just begun, some of the guidance is expected to be centered on the five key principles developed in 2012 as part of the NAIC ORSA Guidance Manual. Consequently, the FSB’s development of guidance on risk management is similar to our current project to develop our own guidance on the ORSA Summary Report. It is worth noting that these five principles in the NAIC ORSA Guidance Manual are required to be discussed by the insurance group in section 1 of the ORSA Summary Report (the other two sections of the report require discussion of assessment of risk exposures, group capital and prospective solvency) and are as follows:

- 1) Risk Culture and Governance;
- 2) Risk Identification and Prioritization;
- 3) Risk Appetite, Tolerances and Limits;
- 4) Risk Management and Controls;
- 5) Risk Reporting and Communication

By comparison, the FSB document lists principles as follows:

- 1) An effective risk appetite framework;
- 2) An effective risk appetite statement;
- 3) Risk limits;
- 4) Defining the roles and responsibilities of the board of directors and senior management

By simple comparison, we support the inclusion of each of the first three principles since those are embedded in our third principle. We also consider roles and responsibilities of the board of directors and senior management in the context of the five principles, but we do not specify them in the same way as the FSB, but rather expect our supervisory guidance to consider the collective duties of the board of directors, senior management and other parties in evaluating the NAIC principles 1, 2 and 5.

II. Specific Comments

Introduction

- We are surprised by the FSB’s inclusion of business lines and legal entities within what the FSB considers an appropriate Risk Appetite Framework (RAF). Within the insurance industry, it is common that insurance groups organize themselves under multiple entities for numerous reasons. Consequently there can be dozens of insurance entities within a group and we believe it is counterproductive to require different unique risk appetite frameworks at each legal entity. Not only is this inconsistent with how risk is managed within most insurance groups, it could lead to added layers of management that would likely create added complexity within insurance groups for very little benefit. In addition, we believe this suggestion is directly in opposition to a statement later in the same section which suggests that the principles are high level to allow the institution to develop an effective RAF that is institution specific and reflects its business model and organization. We believe it is more appropriate that supervisors examine how a group conducts its risk management (including Risk Appetite Framework) and bring to management or the board those issues that could create excessive risks.
- We agree with the suggestion that supervisors should understand from a financial institution’s changes to its RAF, breaches in risk limits, deviations from approved risk appetite statements, or risks not adequately addressed. However, we believe this is appropriate for material items only as many insurers will have hundreds of risk limits. Additionally, this principle should be subject to the proportionality principle (i.e. what may be appropriate given the nature, scale and complexity of the institution). With respect to the last point, it is important to note that some insurers use risk limits as an ideal level of risk as opposed to a maximum risk capacity level. Finally, we note that a state insurance supervisor will likely expect such information to be discussed in the ORSA summary report, with the ability of the supervisor to follow up with discussions with the institution depending upon the supervisory concern with the nature of the items; therefore we suggest you delete the word “regularly” in the first and second sentence of the last paragraph of the Introduction since there are multiple methods for achieving the same objective.

Key definitions

- We believe your definition of risk appetite statement is more consistent with a risk appetite framework, as industry practice generally results in a simple, easily understood single risk appetite statement while tolerances and limits are more detailed as your definition suggests.
- We agree with your attempt to expand the definition of risk capacity to include different parties and considerations outside of regulatory needs as insurers determine their risk capacity based upon multiple inputs.

Risk Appetite Framework

- We previously described the five principles that are currently embedded in the NAIC guidance for risk management. Included in those principles is the expectation that risk management is neither driven solely from the top or solely from the bottom, but rather a culture that permeates through the organization. Having said that, we believe there are other ways to assess risk culture than to “check that the top down

risk appetite is consistent with the bottom up perspective,” and suggest this concept be written more generally similar to how it is written within section 1.1b.

- Consistent with our previous comment, we are opposed to requiring an RAF at the business line and legal entity level as it would be counterproductive.
- We believe third party outsourcing suppliers should be listed as an example only and only required depending upon the nature, scale and complexity of the situation.

Risk Appetite Statement

- We believe your definition of risk appetite statement is more consistent with a risk appetite framework, as industry practice generally results in a simple, easily understood single risk appetite statement while tolerances and limits are more detailed as your definition suggests. Consequently, this entire section fails to recognize this fact. We suggest broadening your definition to specifically include risk tolerances and risk limits and then preface this section with similar statements. We agree with your first statement in this section which indicates that the risk appetite statement should be easy to communicate and therefore easy for stakeholders to understand; however, this is not reflected in the rest of the discussion in this section unless you expand to specifically include the more detailed tolerances and limits.
- Consistent with our previous comment, we are opposed to requiring business line and legal entity level of detail as it would be counterproductive.

Risk Limits

- Consistent with our previous comment, we are opposed to specifying business line and legal entity level of detail as implied with your first sentence to this section, as well as item 3.1b.
- Some insurers will establish risk limits for non-quantified elements, but this current section essentially prevents this. We think language should be added that does not dissuade financial institutions from this risk management practice. To do otherwise prevents risk management from evolving, which is not a good supervisory practice.

Roles and Responsibilities

- We recognize that good risk management cannot be achieved without adequate oversight by the Board of Directors, but we are surprised at the level of specificity in this section given the other sections are much more principle-based. We think this is likely driven by the concept included in footnote 10, where it discusses how some countries use a two-tier board structure. However, we do not believe this justifies taking an approach that may be inconsistent with the way corporations are governed in other countries, including the United States. Stating, “Financial Institutions should allocate precise roles and responsibilities in accordance with their organizational structure” is helpful in addressing this point, however, the items listed in 4.1-4.6 are far too specific, and the entire section could be improved by discussing the overall objective of these roles and responsibilities as opposed to prescribing a laundry list of specific tasks to specific roles.. We recognize that there are exceptions to this with internal audit, which clearly has a control function, but many of the other specific points are arguably too specific. Alternatively, language could be added to the previously quoted language regarding precise roles which gives further discretion to the company as to how roles are allocated. The one area within our ORSA project where we do specify a particular position has certain duties is the signing of the ORSA Summary Report. Because we want to make it clear that one person must have accountability over the report, it must be signed by the Chief Risk Officer or other executive having responsibility for the oversight of the insurer’s enterprise risk management process.
- Consistent with our previous comment, we are opposed to specifying business line and legal entity level of detail as implied with your first sentence to this section, as well as item 3.1b.

If you have any questions regarding our comments, feel free to contact Dan Daveline (ddaveline@naic.org), the NAIC staff member who compiled U.S. state insurance supervisors’ comments on this consultation.

Own Risk and Solvency Assessment (ORSA) Feedback Pilot Projects
Observations of the ORSA (E) Subgroup
2012-2013 Feedback to Industry

The following are the ORSA Subgroup's observations of the ORSA Summary Reports that were reviewed as part of the 2012 & 2013 ORSA Feedback Pilot Projects. The Subgroup observed that certain components of the Reports were beneficial to the overall usefulness of the Report and understanding of the insurer/group's Enterprise Risk Management. The Subgroup did not feel these observations warranted inclusion in the *ORSA Guidance Manual*; however, insurers/groups may choose to consider these observations as they develop their ORSA Summary Reports.

1. Foundation of Report.

- When developing an ORSA Summary Report, the Subgroup noted that the foundation of the ORSA Summary Report should be developed from the reporting of ERM to the insurer/group's Board of Directors and should contain the same basic elements of what is reported to the Board of Directors. The Subgroup cautions insurer/groups not to view the ORSA Summary Report filing as a regulator only compliance report. While some of the format and content of the ORSA Summary Report should be directed to the regulator for the regulator's use in analysis and examination, regulators expect the ORSA Summary Report to be reflective of the actual ERM that the Board of Directors oversees.

2. Table of Contents.

- A comprehensive table of contents aids in the review process.

3. Provide an executive summary for large, complex ORSA reports.

- The Subgroup observed that an executive summary was helpful in that it provided a quick snapshot of the ORSA. The length and format of an executive summary will vary depending on the size and complexity of the ORSA.

4. Comparative view of multi-years of financial data provided in the report.

- While not applicable for all data elements, for some data points it was helpful to see the historical trend illustrated over a multi-year period (e.g. three-to-five years), for example:
 - Economic model parameters over a multi-year period so the reader can see how the parameters changed.
 - Liquidity ratios for multi-years.
 - A variety of graphs depicting different risks. Each graph was illustrated over a multi-year period.

5. Mapping of legal entities to business units described in the Report.

- Some ORSAs referred to business units but did not define which insurers were included in each unit. Mapping of legal entities to the business units in the ORSA would assist in understanding in which unit(s) the domestic insurers are included thereby providing greater clarity to the data provided, for example,
 - A chart that lists the business unit in the first column and the insurers which are included in that business unit in the next column.
 - A clearly illustrated flowchart by business unit.

6. Glossary of terms and acronyms that are not defined in the body of the Report.

- The Subgroup noted some ORSAs included a glossary which was helpful because some terms and acronyms may be specific to the insurer/group or may be defined or interpreted differently by different persons reading the ORSA.

7. Detail of actual risk limits to support the assertion that the Company has risk limits.

- Some ORSAs said “we have risk limits” but did not identify the actual risk limits. The Subgroup does not suggest listing all risk limits, but rather those that are key/material to the insurer/group.

8. If risk limits, appetites and tolerances have changed, discuss the change.

- The Subgroup noted that where the insurer/group identified that changes have occurred in risk limits, appetites and tolerances, it is helpful to also include an explanation of why the change was made, who within the risk management structure approved the change, and the decision process for implementing these types of changes.

9. Discuss risks prospectively.

- The Subgroup noted that while the prospective solvency assessment included capital projections, it would also be helpful to better understand the prospective risk associated with those capital projections. The insurer/group should consider including a prospective discussion of risks, including risk exposures expected to increase/decrease in the coming years and steps the insurer/group plans to take that may change risk exposures. The term “prospective” should pertain to both known and potential future risk.

10. Discuss Risk Mitigation.

- The Subgroup noted that a discussion of risk mitigation activities in addition to risk indicator/limit monitoring aids in understanding the management and control of significant risks and to also understand where residual risks exist that are not mitigated.

11. Perform combined stress scenarios in addition to single stress scenarios, for example:

- A table illustrating both individual stress scenarios impact on capital and combined stress scenarios impact on capital if multiple severe events occurred.
- Combining market distress, interested rate changes and catastrophes.

12. When using tables and graphs, provide an explanation of the table or graph.

- The Subgroup suggests including a key/legend, or explanatory text when including tables and graphs that contain complex data elements, abbreviations or acronyms. Explanatory text is helpful in understanding the graph.

13. Provide an explanation of how capital models are calculated and discuss the group capital analysis performed by the insurer/group.

- In addition to reporting “Our risk capital is \$x at Dec.31 20xx.”, also explain how that capital number was derived (i.e. explain the capital model). For complex calculations, provide a high level summary explanation. The Subgroup noted it was easier to understand the capital number if it was accompanied by an explanation of how the insurer/group calculates its capital model. When a diversification benefit is used, provide a discussion of how the correlation amounts are developed, tested and updated. This information could be provided in a separate exhibit, if lengthy.
- The Subgroup noted that while an insurer/group may not have discussed internal economic capital model validation, the insurer/group should consider a summary discussion of model validations and note that the regulator may ask about the validation process in follow-up discussions in order to better understand the insurer/group’s internal economic capital model process.

14. If the insurer/group is international, the ORSA should include overall group capital in Section 3.

- The Subgroup noted that while there is a group capital assessment in the U.S., the international standards for group capital may differ. The Subgroup noted it was beneficial for those international groups to include a description of their group’s overall group capital. (Note that per the *ORSA Guidance Manual*, the group capital assessment is not limited to international groups.)

- To the extent that the U.S. business is interconnected and/or reliant on the international affiliates/parent, the ORSA should include a discussion of the overall group capital (including international) and a discussion of the relationship and interconnectedness.

15. List of risk owners (i.e. department accountable for the risk).

- The Subgroup noted this information helped in understanding the structure of the overall ERM Framework for the insurer/group for example:
 - Within Section One, include an explanation of the governance structure, or a list/table of departments or business units that identifies responsibilities and accountabilities.
 - Identify the individuals/groups/committees responsible for establishing ERM strategies, risk appetites, tolerances and limits; managing risk day-to-day; assessing effectiveness of ERM; and etc.
- The Subgroup noted a table identifying the risk owners, the assigned risk, their role and responsibility, and to which committee/department/chief officer they report on their risk management was helpful in understanding the insurer's risk management structure.

16. Flowchart of Risk Management & Control.

- The Subgroup noted a flowchart or detailed explanation of how enterprise risk management and control flows within the organization (bottom-up or top-down or both) was also helpful in understanding the insurer's risk management structure.

17. Explanation of how compensation and incentives are tied to risk management.

- The Subgroup noted that a discussion of how compensation and incentives are tied to ERM was helpful in gaining an understanding of the corporate risk culture. While the report may discuss the topic briefly, detail on the compensation and incentive plans could be helpful to include in a supplemental exhibit.

18. Include Heat Maps.

- The Subgroup noted that the inclusion of heat maps helped to identify the key risks of the insurer/group. The inclusion of heat maps should be accompanied by a brief explanation and interpretation, as needed.

19. When using multiple capital models, create a graphical illustration to compare the different model results, for example:

- Where the group capital assessment included three different models, the insurer/group included a full page table that showed each model side-by-side including such information as the definition, assumptions, and target vs. actual capital. This format made it very easy to compare the different capital assessment models.

20. Use of Most Current Data.

- When using capital models, the Subgroup observed that it was helpful if the insurer/groups identified available capital and required capital (if available) as of the most current reporting period.
- When the ORSA Summary Report identifies that ERM data and reports are evaluated or calculated quarterly, the Subgroup observed that it was helpful if the insurer/group included information from the most recent quarter.

21. References to other ORSA documents.

- The Subgroup noted that if other documents were referenced in lieu of further explanation, it would be helpful if those documents are readily available upon request, and/or attached to the ORSA Report.
- The Subgroup observed that an appendix of reports and tools actually used by the insurer/group gave the regulator a good sense of what information is used by ERM committees and the Board of

Directors who oversee the insurer/group's ERM. For smaller supplemental reports, consider including them as an appendix.

- For larger supplemental ERM reports, the Subgroup observed that it was helpful to include a list of related ERM reports, including a report description or snapshot, that support the information provided in the ORSA Summary Report, so that the regulator can clearly understand the type of additional information that would be available and which report to request, if necessary.

22. Provide more stress testing on liquidity, especially for life insurance business, rather than a single focus on capital, for example:

- Provide detailed stress scenarios regarding liquidity position along with a brief explanation.
- Consider including a discussion on sources of liquidity and contingent financing.

23. Discuss emerging risks in the prospective risk section of the ORSA.

- The Subgroup observed that as prospective risk is a key component of the regulatory risk-focused surveillance process, understanding the emerging/prospective risks identified in the ORSA will help regulators focus their examination and analysis of the insurer/group.
- The Subgroup also observed that in addition to knowing that emerging risks are monitored it was helpful to identify the key emerging risks and understand how those emerging risks are elevated from an emerging status to a current risk within the risk identification and management process.

24. Identify risks associated with intercompany dependencies.

- The Subgroup observed this is helpful in understanding affiliate risks.

25. Include a discussion of information technology risk.

- The Subgroup observed this is helpful in understanding risks such as information security, business system failure, costly use of resources, etc.

26. Risk Ranking/Rating.

- The Subgroup observed that where the insurer/group identified the priority ranking/rating of their material risks, it aided in better understanding the risk exposure. Risk ranking/rating can be provided in varying formats (e.g. lists, charts, graphs, or dashboards).

In preparation for the insurer/group's actual filing:

27. Attestation Placeholder.

- The *Risk Management and Own Risk and Solvency Assessment Model Act* (#505) contains a requirement for an attestation and signature. The insurer/group should consider inserting a placeholder for this attestation, including contact information.

28. Expected Filing Date.

- In advance of the filing year, the insurer/group and lead state regulator should reach an understanding of when the insurer/group expects to file the ORSA Summary Report.

29. Walk-Through Discussion with Regulator.

- Upon filing the ORSA Summary Report annually, the insurer/group and lead state regulator should plan to schedule a meeting/webinar/conference call where the insurer/group can describe and walk through their ORSA Summary Report and answer questions from the regulator.