



AMERICAN ACADEMY *of* ACTUARIES

Mr. Thomas E. Hampton
Commissioner, District of Columbia Department of
Insurance, Securities, and Banking
Chairman, NAIC PBR (EX) Working Group

June 5, 2009

Subject: Comments on Draft Valuation Manual Section VM-G
Corporate Governance Requirements for Principle-Based Reserves (“PBR”)
Re-Exposed for Comment by the PBR (EX) Working Group, May 21, 2009

Dear Commissioner Hampton:

The Life Governance Team of the American Academy of Actuaries¹ appreciates this opportunity to comment on the draft Section VM-G for the Valuation Manual, which the PBR (EX) Working Group has re-exposed for comment. We understand that the comment period is very short, so that the comments can be considered by the working group at the NAIC meeting in Minneapolis. However, we are concerned that our ability and the ability of other interested parties to comment is constrained by this short comment period. We note that the request for comments includes a statement that you do not believe that any additional exposure of the document will be necessary within the committee structure after the PBR (EX) Working Group considers the comments it receives on this exposure. In view of the short period for comment, and the substantial changes in the document since it was previously exposed in March, we think that the need for additional exposure should be re-evaluated as the process continues.

Recent discussions of Section VM-G by the Corporate Governance Subgroup and the PBR (EX) Working Group have focused on existing and expected roles and responsibilities of corporate boards of directors, and how the proposed Section VM-G may be perceived to alter existing legal standards. We do not have expertise in these matters. Consequently, we have not made any comments or edits on the wording of Section II of Section VM-G, although we are concerned about including such requirements in the Valuation Manual and believe that concerns raised by other interested parties about the content of Section II are worthy of further discussion and consideration. In the suggested wording changes included in the attachment to this letter, we focus on the roles and responsibilities of the actuary, and the information and assistance the actuary provides to the board and senior management. We also have some overall concerns about Section VM-G, which we cover in this letter.

We note that the Corporate Governance Subgroup recommended a long-term project to address standards for corporate governance for insurers as a whole. We understand that governance is typically applied by companies as a whole, and not separately or differently by function or product line. As such, it may be more meaningful to assess governance on this broader basis. The current, short-term effort to

¹ The American Academy of Actuaries is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

define corporate governance standards within the Valuation Manual is apparently driven by a perceived need for assurance of corporate governance over processes that are used to determine principle-based reserves. However, we note that over the past year, the structure of the “principle-based” reserves regime has developed to include prescribed assumptions and methods. The PBR regime will provide for an element to be determined by company models, but will include prescribed assumptions.

The changes to PBR approaches are likely to be evolutionary rather than revolutionary. As a result, additional corporate governance requirements that are needed solely due to PBR may not be substantial, at least at the outset of PBR. Furthermore, any governance requirements related to PBR processes should specify whether they apply to formulaic components, model-based components, or to both. For instance, it would seem unnecessary to require internal controls for development of assumptions that are fully prescribed.

We also note frequent use of the word “review” in Section VM-G, especially to describe responsibilities of the board. This word may be interpreted in very different ways by different parties. If this wording is retained, it is probably appropriate to describe the provisions of Section VM-G as “guidelines” or “standards” rather than “requirements,” or in some other way to allow companies flexibility in how they comply with the provisions. The wording could be refined and clarified as part of the longer-term project described above, to address corporate governance of insurance companies as a whole.

Thank you for your consideration of our views, even though the time for our comments and for your consideration is necessarily short. We would be happy to provide you with additional information, and to discuss any of the points in this letter and the attachment.

Sincerely,

Kalman Ketzlach
Chair, Life Governance Team
American Academy of Actuaries

I. SCOPE

1. The following sets forth responsibilities of the board and senior management. However, if other laws require other responsibilities that conflict with these requirements, the other law shall prevail.

II. ROLE AND RESPONSIBILITIES OF THE BOARD

NOTE. WE (THE LIFE GOVERNANCE TEAM OF THE AMERICAN ACADEMY OF ACTUARIES) DO NOT HAVE EXPERTISE IN MATTERS OF EXISTING OR EXPECTED GOVERNANCE ROLES AND RESPONSIBILITIES OF CORPORATE BOARDS OF DIRECTORS, AND WE THEREFORE ARE NOT MAKING SUGGESTIONS FOR WORDING CHANGES IN THIS SECTION OF THE DOCUMENT.)

2. The board of directors is responsible for oversight of the actuarial function, which calculates and expresses an opinion on the adequacy of such reserves, as well as, policies that are related to the adequacy of principles-based reserves.
3. Oversight includes a process for the board of directors to:
 - Review the infrastructure (consisting of the, risk tolerances, policies, procedures, controls, risk management strategies, and resources) that senior management has put in place to implement the principles based reserving function.
 - Review principle-based reserve elements (consisting of the assumptions, methods, and models used to determine principle-based reserves of the company) that senior management has put in place.
 - Review principle-based reserving results in order to understand the general level of conservatism incorporated into principle-based reserves.
 - Receive and review other reports and certifications related to governance of principle-based reserves (including but not limited to audit, control, and compliance reports) in order to attain a general level of understanding of, and reliance on, principle-based reserving processes put in place by Senior Management that includes: the adequacy of reserves; the implementation of policies; reporting; internal controls; and the work of the appointed actuary.
 - Document review of the principles based reserving function in the minutes of all Board of Directors meetings where such function is discussed.

III. ROLE AND RESPONSIBILITIES OF THE SENIOR MANAGEMENT

(NOTE. WE (THE LIFE GOVERNANCE TEAM OF THE AMERICAN ACADEMY OF ACTUARIES) DO NOT HAVE EXPERTISE IN MATTERS OF EXISTING OR EXPECTED GOVERNANCE ROLES AND RESPONSIBILITIES OF SENIOR MANAGEMENT. THEREFORE, WE ARE COMMENTING ON THIS SECTION OF THE DOCUMENT ONLY WITH RESPECT TO MATTERS REGARDING THE ASSUMPTIONS AND PROCESSES THAT ARE USED BY ACTUARIES IN DETERMINING PRINCIPLE-BASED RESERVES.)

4. Senior management is responsible for ensuring that an appropriate infrastructure (consisting of policies, procedures, controls, and resources) is in place to implement and oversee principle-based reserve processes, and assure that principle-based elements (consisting of assumptions, methods, and models used to determine principle-based reserves of the company), other than those that are prescribed for use in determining principle-based reserves, are consistent with those for other company risk assessment processes.
5. Senior management is responsible for reviewing principle-based reserving, consistent with its established risk tolerances, in relation to the risks of the products it offers, the various strategies used to mitigate those risks, ~~the pricing of the products~~, and the emerging experience of the company. In addition, senior management is responsible for reviewing any significant and unusual issues and/or findings in light of the results of principle-based reserving processes and other stress tests that the company conducts, in order to understand the level of conservatism in principle-based reserves.
6. Senior management is responsible for adopting internal controls with respect to a principle-based reserve valuation reasonably designed to assure that all material risks inherent in the liabilities and assets, subject to such valuation are

included, and that the valuations are made in accordance with the Valuation Manual and regulatory and actuarial requirements. Senior management is responsible for ensuring that an annual evaluation is made of such internal controls and that a report of such evaluation is made to the company's board of directors and the commissioner.

7. Senior Management responsibility for model-based valuations using principle-based approaches which include:
- (i) Resources are adequate to carry out the modeling function with skill and competence.
 - (ii) A process exists that ensures models and procedures produce appropriate results relative to valuation objectives. The process must provide reasonable assurance that valuation requirements will not be underestimated. ~~Other than for elements that are prescribed for use in determining principle-based reserves,~~ the burden is on the insurer to satisfy the commissioner that a model or the procedures of the process are appropriate and that regulatory valuation requirements will not be distorted as a result of its use.
 - (iii) A process exists that validates data for determination of model input assumptions, other than input assumptions that are prescribed for use in determining principle-based reserves.
 - (iv) A process exists that ensures model input is appropriate given insurer experience, other than model inputs that are prescribed for use in determining principle-based reserves.
 - (v) A process exists that reviews model-based valuations to find errors and limit weaknesses. The process must provide a credible ongoing effort to improve model performance. The process must include a regular cycle of model validation that includes monitoring of model performance and stability, review of model relationships and testing of model outputs against outcomes.
 - (vi) A review procedure and basis for reliance on principle-based reserve processes put in place that includes: reporting on the adequacy of reserves; ~~the~~ implementation of policies; ~~reporting;~~ internal controls; and the work of the appointed actuary.

IV. ROLE AND RESPONSIBILITIES OF THE APPOINTED ACTUARY

8. The insurer's appointed actuary is responsible for reviewing and approving ~~internal standards for actuarial processes, controls, and documentation; as well as for~~ assumptions, methods, and models that are used in determining principle-based reserves; ~~as well as for reviewing and approving internal standards for actuarial processes, controls, and documentation used for such reserves in accordance with all applicable laws and regulations.~~ The appointed actuary does not review or approve assumptions or methods that are prescribed for use in determining principle-based reserves, but does confirm that the prescribed assumptions and methods are being used as required.
9. The appointed actuary is responsible for providing a summary report to the board and to senior management of the company on the ~~actuarial~~ processes used to determine and test principle-based reserves ~~and results to the board of directors and to senior management of the company,~~ to assist in the board's oversight and general level understanding of principle-based reserve results and significant and unusual issues and/or findings.
10. The appointed actuary is responsible for providing an opinion-certification on the adequacy of company statutory reserves, both those developed using principle-based approaches and those developed using other approaches, reserves as part of his/her annual Statement of Actuarial Opinion, as well as any internal supporting certifications that senior management or the board of directors require as part of the internal governance processes that the company has established.
11. The appointed actuary is responsible for cooperating fully with internal and external auditors and regulators, ~~and is responsible and~~ for working with these auditors and regulators to resolving all significant issues.