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ERM, ORSA and Corporate Governance: The Small Company Challenges

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Executive Summary

Challenges for small companies in 2015 and beyond will require new focus on improving corporate governance structures, refining risk management governance, and ensuring that knowledgeable and qualified Board members make these decisions. The NAIC push to enact new model laws and regulations that do not exempt small companies or fraternal insurers will require some dramatic structural and procedural changes that take time and resources to implement.

Solvency Modernization Initiative (SMI)

The National Association of Insurance Commissioners (NAIC) continues its push for new regulation and laws to complete SMI. SMI is a post-financial crisis critical self-examination to update the United States companies' insurance solvency regulation framework. The SMI scope includes the entire U.S. financial regulatory system and all aspects relative to the financial condition of an insurer, and is not limited to the evaluation of solvency-related areas. The SMI focuses on key issues such as capital requirements, governance and risk management, group supervision, statutory accounting, financial reporting, and reinsurance.

New NAIC Corporate Governance Models

With the NAIC adopted models – the Corporate Governance Annual Disclosure Model Act (CGAD) and supporting Model Regulation – the NAIC has made an affirmative decision not to exempt small companies from any corporate governance requirements. In fact, the Working Group highlighted the need for small companies to focus on improving their corporate governance structure, in part by getting their risk management governance framework solidly in place with ongoing monitoring and reporting, and by establishing requirements for the Board as a whole to include the knowledge, industry experience and skilled qualifications to make decisions based on the risk tolerance and risk profile of the company.

Non-Prescriptive Guidance for Both ORSA and the Corporate Governance Models

The NAIC continues to allow companies complete flexibility in the implementation of model laws and regulations as long as the requirements are met. All of these models state a company's ERM program or Corporate Governance structure "can vary significantly based upon the size, type, complexity and structure of an insurer," which means that small

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companies may have an ERM or Corporate Governance structure that meets their specific requirements and may look nothing like large company structures.

The NAIC defines corporate governance "as structures, policies and processes through which an organization or entity is managed and controlled." The annual filing is important and gives the company an opportunity to describe its corporate governance and ERM structures, along with filing its updated policies and procedures for review. Regulators will use this information to increase their understanding of how a company governs its operations. Ultimately, the company should use both the ORSA Summary Report and the Corporate Governance Annual filing to give regulators a detailed and substantive overview of the strength of the company's risk management and governance framework. This transparency could help limit the scope and depth of future risk-focused analysis or examination, cutting exam and penalty costs to the company.

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Meeting the New Corporate Governance Challenge as a Small Company

The new model act and regulation will require all companies to tighten and document their governance structures, by-laws, charters, policies and procedures in order to assure that the Board of Directors and any of the Board committees have been assigned the ultimate responsibility for governing the insurer. An annual filing is required to document how the corporate governance of the Company is providing proper leadership, including documentation of the roles and responsibilities of a risk management senior team, the Board, the CEO and Chairman of the Board. The NAIC models require a governance structure that facilitates the Board and key executive roles to act in good faith and in a manner the Director or Board of Directors reasonably believe to be in the best interests of the Company.

New Qualification Requirements for Board Directors

The most significant challenge for many small companies including small fraternal and mutual insurers (who are not exempt from these models) may be the qualification requirements for Board members. Regulators will be reviewing the make-up of the Board for appropriate background, experience and integrity to fulfill their prospective roles. The Board as a whole should possess the core competencies needed to oversee the insurance company. Core competencies cited by the models are; accounting or finance; business judgment; industry knowledge; management; leadership; as well as vision and strategy. The Board will also need to create suitability standards (position descriptions) for officers and key persons in control functions like the CEO, the Board Chair and the committee chairs, to assure they have the appropriate expertise, experience and professional integrity to adequately fulfill their responsibilities. The Company charter or other Board documents must clearly articulate the responsibilities of the Directors, including such basic requirements as attendance at Board meetings and reviewing meeting materials in advance in order to ask questions and evaluate the issues knowledgeably.

Regulators will be looking for Corporate Governance Guidelines that clearly document established key governance principles that address at least the following:

- Board leadership
- Qualifications for Directors
- Director independence
- Director responsibilities
- Structure and functioning of Board committees
- Charters for those committees
- Board access to management and advisory resources
- Director and management compensation
- Director initial and continuing education
- Board and management performance evaluation
- Management succession

In larger companies, the Board often creates a Corporate Governance Committee to handle these responsibilities, but smaller companies might not have the breadth of Directors able to serve on this type of committee. In that case, a small company Board will need to handle these functions, and with the right charters, Corporate Governance Guidelines and leadership, small companies can also manage these requirements as suitable for their organization.

Changes the Adoption of the Own Risk Solvency Assessment Model Act (ORSA) Brings to Financial Examinations

The other area of governance that the NAIC has included in both ORSA and CGAD materials is the way reporting responsibilities should be organized for each critical risk area of the Company. With the adoption of the ORSA Model Act, regulators intensify their regulation of Enterprise Risk Management (ERM), requiring strong governance structures functioning at all corporate levels and founded on an ERM program.

This requirement will be another challenge for small insurers, since ORSA requires a holistic approach to risk governance with clearly defined and articulated roles, responsibilities and accountabilities. Under ORSA, the Board of Directors is ultimately responsible to establish and maintain a risk management policy by assessing and approving

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risk decisions made by the Risk Committee and approving the annual ORSA risk report, as well as establishing the Company's risk appetite statement and related risk tolerances. This does not mean that the day-to-day risk decisions are to be made by the Board, but that the Company will have a risk governance team with responsibility for daily oversight. Risk management as well as development of key risk indicators, risk incident reporting, and applicable policies and procedures for the Company are critical to help avoid or mitigate those risks. Under ORSA, the Chief Risk Officer (CRO) or ERM Director will run this risk governance team and report to the Board in a regular, transparent manner. The Board will set the overall risk policy and make key risk policy decisions.

The requirements for clearly defined roles can also be challenging for a small company that may not have the resources to hire a CRO. For small companies, making this role a part-time position can be successful as long as the responsibility and authority to run the risk governance team and implement a corporate risk policy is assigned and the ERM framework is fully established.

ORSA also requires that the insurer's strategic business planning process be integrated fully with the Company's Enterprise Risk Management decision-making. Some regulators have indicated that Board members may be interviewed as a part of a risk-focused examination based on the ORSA report filing. Unlike in the past, Boards must have sufficient training to make sure they understand their new ORSA role with risk governance responsibilities.

The risk governance team could be a new function of an existing senior management team, or a new team comprised of senior officers with ultimate responsibility for decision-making in their roles as head of key company departments. For a small company, the President or CEO will want to create a team with at least one other officer and not take sole responsibility for the risk governance development and ongoing improvement.

With the new ORSA governance requirements, Department of Insurance financial examiners will now review the overall risk-management function of an insurer and the ORSA report-development process and work papers. The exam will cover the insurer's processes for identification of risks throughout the company that could threaten solvency, risk-mitigation strategies, internal controls, and control implementation.

Regulators want to understand the frequency by which information on each critical risk area is reported to and reviewed by senior management and the Board. Reports will include:

- Risk management processes
- The review and approval of the ORSA summary report if applicable
- The actuarial function on the adequacy of reserve provisions
- The prospective solvency position of the insurer
- Investment decision-making processes
- Reinsurance decision-making processes
- Business strategy/finance decision-making processes
- The compliance function
- Financial reporting/internal audit processes
- Major marketing initiatives
- Results of negotiations and information on reasonably foreseeable prospective risks
- Market conduct decision-making process

Again, in larger companies, the Board will create an Audit, Risk and Compliance Committee or potentially three different committees with charters that will assist the Board in fulfilling its oversight responsibilities for the financial reporting process, enterprise risk management program, system of internal controls, audit process, and Company compliance with laws and regulations.

How does the NAIC regulate insurers' corporate governance today?

The regulatory corporate governance framework today in the U.S. is an exception-based model. This non-prescriptive way to help ensure effective governance for U.S. insurance companies is different than the European model prescribed in Solvency II. The NAIC model laws and regulations are based on a conservative framework for accounting, regulatory approval of significant transactions, restrictions on investments, and ongoing monitoring of financial indicators of concern. The regulators monitor for expected outcomes and if these expectations are not met, they choose from a wide range of tools to encourage and/or require corrective actions. They do not prescribe how these insurers implement laws or regulations, as implementation methods differ based on the size and structure of the insurer. This framework has worked successfully, and the ORSA model and the draft Corporate Governance Models are all written with the same non-prescriptive perspective.

The non-prescriptive framework is an excellent fit for small companies since the regulators expect that they will use techniques that are appropriate to the nature, scale and complexity of their risks, in a manner that adequately supports risk and capital decisions. These instructions in the ORSA Guidance Manual set up an expectation that small companies' governance and ERM programs may look different than large companies' but as long as each structure meets the needs of the Company and facilitates compliance with the requirements, both will be judged adequate by the regulators.

Summary: Small Companies Can Meet These Challenges

Small companies will be able to implement new Corporate Governance

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Guidelines, criteria for selection of Board members, position descriptions for key Board members and senior executives, and charters for committees like the Corporate Governance Committee or the Audit, Risk and Compliance Committee. Implementing these changes in a small company may take guidance and assistance from outside consultants, but will give them the added benefit of embedding an ERM framework into their governance structure. Because the new NAIC models tie ERM, ORSA and Corporate Governance together into one holistic approach for managing an insurance company, the results of implementing the framework will differ for a small company, and the impact may be felt even more strongly.

The importance of moving toward these new requirements should not be underestimated, since the changes in any company will take time and resources. The NAIC adopted the CGAD at the Fall National Meeting on November 19, 2014. The intent is for the states to pass legislation and implement regulations for these to become effective January 1, 2016, with reporting to begin June 1, 2016. The benefit for all companies will be a new governance framework that ties together risk management, strategic planning and effective governance in a new way that will align the U.S. financial services industry with the existing European models to provide stronger solvency requirements in related economies worldwide. ■

Carol Stern is a Senior Consultant at First Consulting & Administration, Inc. and is an intrinsic member of the operational compliance, enterprise risk management (ERM) and corporate governance consulting practice. With 30 years of experience in the industry, she brings a Chief Compliance Officer perspective to the practice for corporate governance, insurance, annuity, retirement and wholesale broker dealers. For ten years, she coordinated the compliance risk management function in implementation of policies, procedures and reporting to establish an ERM program including development of key risk indicators and a formal risk assessment process.

'National Association of Registered Agents and Brokers Reform Act of 2015' Signed Into Law

by Kevin G. Fitzgerald and Nicholas R. Paquette [1]

The new year has brought substantial changes to the future of nonresident insurance producer licensing regulation. On January 12, 2015, President Obama signed into law H.R. 26, which includes the National Association of Registered Agents and Brokers Reform Act (the "Act").[2] The Act creates a new process to achieve nonresident licensing reciprocity for "Insurance Producers." [3] This article is intended to provide an overview of the Act, its effect on producers, and how it impacts State regulation of nonresident producer licensing.

The Act amends the Gramm-Leach-Bliley Act and establishes the National Association of Registered Agents and Brokers ("NARAB" or "Association"). The Association will be an independent nonprofit organization established under District of Columbia law that will "provide a mechanism through which licensing, continuing education, and other nonresident insurance producer qualification requirements and conditions may be adopted and applied on a multi-state basis without affecting the laws, rules, and regulations, and preserving the rights of a State, pertaining to:" (1) licensing and other qualifications for insurance producers that are not members of the Association; (2) resident or nonresident producer appointment requirements; (3) supervising and disciplining resident and nonresident insurance producers; (4) establishing licensing fees for producers; and (5) prescribing and enforcing laws regulating the conduct of producers. Put simply, the Association provides a structure for establishing nonresident licensing reciprocity for members throughout all 50-states, the District of Columbia, any territory of the United States, and Puerto Rico, Guam, American Samoa, the Trust Territory of the Pacific Islands, the Virgin Islands, and the Northern Mariana Islands (individually referred to herein as "State", and collectively the "States").

What Does This Mean for Insurance Producers?

At the outset, we note that producer participation in NARAB is entirely optional and therefore the Act will have no effect on those producers who choose not to obtain membership in the Association. These nonmember producers will remain subject to the nonresident licensing requirements in all states in which they choose to do business. Those insurance producers that choose to become members of the Association, however, may find that the process to obtain multi-state licensure more efficient than has historically been the case, particularly

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2 H.R. 26, 114th Cong. (2015).

3 The Act defines "Insurance Producer" to mean "any insurance agent or broker, excess or surplus lines broker or agent, insurance consultant, limited insurance representative, and any other individual or entity that sells, solicits, or negotiates policies of insurance or offers advice, counsel, opinions, or services related to insurance."