

ERM and Other Considerations Related To A Principles-Based Approach

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The Society of Actuaries

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Mr. Doodian's recent experience includes assisting clients with Sarbanes-Oxley 404 compliance; Internal Controls Documentation and Testing; Internal Audit Management; Process and Profit Analysis and Improvement; Operations Analysis and External reporting (SEC and GAAP).

Highlights of Mr. Doodian's insurance industry positions include: Major Insurance Carrier - Assistant Vice President and Unit Controller; Large General Agency – Controller; Major Life and Annuity Company - Senior Auditor; 'Big 4' Insurance Audit Practice – Supervising Senior; Mr. Doodian has also held positions at Major Money Center banks as Vice President of Special Projects, and Vice President and Division Controller.

Mr. Doodian has been directly involved in a broad range of insurance industry engagements covering operations and financial restructuring, cost reduction and performance improvement of insurers and large brokers, involving: bankruptcy reorganizations, sales and operational office consolidation, employee benefits plan restructuring, payroll and accounting system design, and regulatory control systems.

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PREFACE

This white paper is prepared for presentation by the Society of Actuaries to educate and inform its audience regarding important considerations related to the transition from a rules-based to a principles-based approach, in line with changes in regulations and internal business requirements. The paper focuses on the role of actuaries and use of a centralized enterprise risk management platform in facilitating this transition, as well as other organizational considerations necessary to ensure that objectives are met.

The paper is not intended to comprehensively cover broad scope of principles-based regulation, nor is it intended to offer legal, financial, or technical advice regarding the subject. Readers are encouraged to contact the authors for further information regarding any aspect of the subject matter covered.

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1.0 INTRODUCTION

Insurance is a global business. Whether a life or a property casualty insurer, organizational strategies are likely to reflect some element of global activity. To facilitate the global market, insurance regulators are attempting to develop a level playing field. The International Association of Insurance Supervisors (IAIS) is advocating a common regulatory platform for all insurers. In recognition of an insurer's actual risk profile, the IAIS' approach is a *principles-based* rather than a *rules-based* set of regulations. Enterprise Risk Management (ERM) is a core component of the principles-based approach. The IAIS is beginning to unveil these new insurance regulatory principles through a series of Principles, Standards and Guidelines papers.

IAIS is also attempting to exert market pressures to help achieve its regulatory goals by increasing financial transparency. In this sense, rating agencies have already begun to emphasize ERM as a core consideration for insurance ratings.

For insurance companies, insurance risk is one of the primary risk characteristics identified under the IAIS' principles-based regulation. For actuaries, there will be an impact on ratemaking and the reserve process. Changes in the reserve process also have internal implications upon other functional units in the organization—such as accounting, audit, and investment management, with increased governance from the board of directors.

Integration of principles-based regulations under global convergence has wide implications to the operations of the firm. This paper addresses applications of ERM to this operational change process surrounding the financial and accounting processes. Since reserving is a key element in financial reporting, it touches upon the management controls required in the move toward International Financial Reporting Standards (IFRS).

2.0 FINANCIAL INNOVATION AND GLOBAL CONVERGENCE

Within the financial services industry, organizations have made significant strides toward greater understanding of the financial markets and creating innovative financial instruments that reflect the needs of the general public. Financial education and technical market advances have lead to a broader involvement of the general population in the financial markets. Financial innovations have lead to greater expansion of markets, investment organizations (mutual funds, hedge funds, etc.) and an ever widening variety of new instruments (such as securitizations and derivatives).

To capitalize on these innovations, the financial industry has been reviewing the historical structural barriers (laws and regulations) that result in obstacles for new product design and distributions. The Graham Leach Bliley Act, *Financial Service Modernization Act of 1999*, is one such piece of legislation intending to restructure the financial industry for the future. New financial structures have also created unanticipated risks. These risks are of critical importance to the regulators as they may lead to financial insolvency.

Within financial institutions, failures in these markets, including inappropriate use of new instruments, have lead regulators to greater scrutiny of the associated risks. In the US, the legislative response came in the form of Sarbanes Oxley (SOX). Regulators have found that bright line rules have been ineffective in dealing with market innovations and, at least for the banking industry, can be detrimental as to the actual risks being assumed. To adjust with innovative markets, regulators are moving from rules-based to principles-based approaches. For banks, the principles-based approach has manifested into the Basel II Accord. For insurers, principles-based solvency regulation is being pioneered for

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European insurers by Solvency II. In the US, the NAIC is working closely with the International Association of Insurance Supervisors (IAIS) in the development of its principles based approach for insurers.

3.0 GLOBAL GUIDELINES - IAIS RESERVES AND SOLVENCY

ERM is a core principle under the IAIS regulatory guidelines' *Guidance Paper on Enterprise Risk Management for Capital Adequacy and Solvency Purposes*. Governance requirements place ERM design and monitoring directly on the Board of Directors, which then directs the implementation on the shoulders of the executives and leaders within the organization. Leadership must identify key players that are required to play significant roles in the solvency of an insurer. ERM implementations often stretch across the organizations functional areas.

4.0 STRATEGIC ISSUES FOR ACTUARIES – RESERVES

One of the major operational concerns for an insurer encompasses the reserving function. The reserving function has a direct bearing on the financial reporting for the carrier. The IAIS regulatory framework has assumed a total balance sheet (TBS) approach for capital and solvency measurement (Capital = Assets – Liabilities). Under TBS, both assets and liabilities are marked to market (M2M). For most insurer assets, M2M has been accepted as there is often a deep, liquid market to support the valuation.

Liabilities, however, do not have a deep, liquid market. The question arises as to how a M2M approach will be achieved. The IAIS solution is to establish the reserve liabilities at the present value of expected claim costs plus a *risk margin*. The risk margin will be reflective of non-diversifiable risk, i.e., model and parameter risks. Process risk, which is diversifiable, is considered part of capital requirements for the insurer. Property and casualty reserve procedures will see two changes: a discounting of the expected losses and the addition of the risk margins. The greatest difference under this principles-based approach will occur in life insurance. In life reserving, discounting and risk margins are already incorporated into the reserve methodology, however, the change will occur in the projection of future claim costs. Reserves are to be based on management's "expected losses" rather than statutory loss levels.

The reserve methodology for the valuing of mortality reserves by life insurance companies has a strong basis in actuarial theory and practice. Traditionally, this methodology has had its basis in adhering to certain formulas, parameters and assumption that were prescribed by state regulators. Under a principles-based approach, the life reserving models will transfer greater control of the formulas, parameters and assumptions to the company's management. Actuaries will play a critical role in maintaining the appropriateness of the overall reserve levels that recognize underwriting criteria, behavioral analysis for policyholders, and financial risk characteristics of the insurance products.

In addition, principles-based reserve methodologies will demand greater operational transparency. For the company's reserves, regulators will require both internal and third party review to perform model and parameter validation and verification of results. This will result in an extension of cross department efforts—accounting, audit, treasury, investment, Executive Committee and into the Board of Directors—relating to ERM of reserve levels and regulatory capital requirements. How these roles will merge into an efficient and effective ERM program represents the discussion for the rest of this paper.

5.0 ENTERPRISE RISK MANAGEMENT

ERM allows executives to manage risk more effectively by simulating the impact of future external influences on an insurance business. An accurate representation of the business in an ERM model leads

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to confidence in the model's use as a true decision-support system. According to a leading analyst, the proven benefits of ERM are:

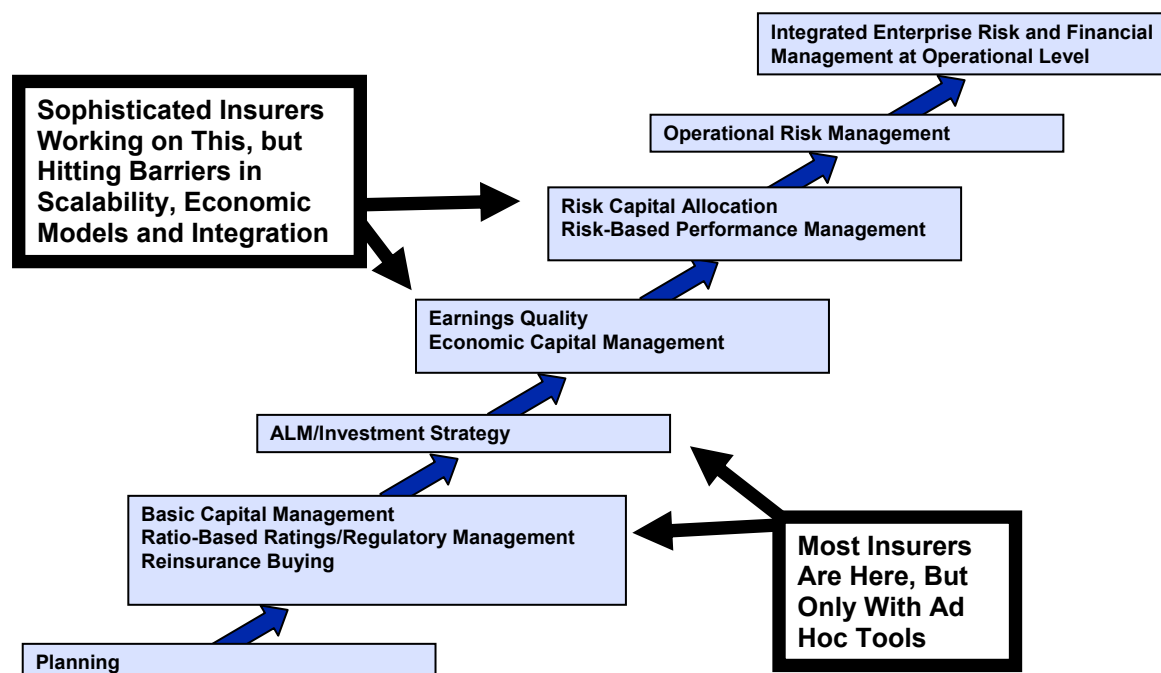
- Alignment of the strategic aspects of risk with day-to-day operational activities.
- Facilitation of more transparency for investors and regulators.
- Enhancement of revenue and earnings growth.
- Control of downside risk potential.

In preparing for principles-based regulations, companies need to have a strong ERM component.

5.1 Drivers of ERM

Until recently ERM was talked about, but insurance companies didn't have a motivation to act. In general, the adoption of real risk management has been slow, and as one can see from the chart below, even the most sophisticated insurers are not at the level of integrated enterprise risk and financial management at the operational level.

ADOPTION OF REAL RISK MANAGEMENT HAS BEEN SLOW



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As discussed above, regulatory and ratings agency requirements are becoming key catalysts driving a change in behavior and increasing the motivation to install ERM solutions. As companies adopt a principles-based approach, they will need to focus more on how to make ERM a part of the company's DNA so the usage of such tools becomes a regular part of the company's processes rather than a once-a-year event for ratings agency or regulatory review.

5.2 Risk Integration Imperatives

ERM requires that companies accurately model the risks in their business. It also requires that business decisions and risk modeling are harmonized, that strategic and operational decisions are consistent with the results of risk modeling and that risk modeling assumptions reflect board and management preferences. Furthermore, board and management's involvement is not limited to finance, investment, risk and actuarial functions. Those responsible for sales and marketing must be fully integrated into the ERM process. They will have to demonstrate understanding of the methodologies at an appropriate level and be able to demonstrate that their strategic and operation decisions are consistent with the company's enterprise risk philosophy.

This will have significant organizational/cultural implications and lead to significant changes in the way business is done. We now consider three of these, pricing, product development and performance measurement.

5.2.1 Pricing

Pricing should take account of all significant risks, including entering the market with an unprofitable product, the opportunity costs of not entering a particular market segment, and operational risks. There will be an increasing trend towards macro pricing, pricing in the context of a model of the whole company, both to more accurately assess capital consumption and to take account of portfolio effects.

The relative price of different lines of business will change as well as the relative price of risk groups within lines of business. Some products will be priced out of the market. The companies that discover the segments where prices can be relatively reduced quickest will be winners.

Techniques will be increasingly developed to reflect risk-adjusted return on capital. Risk neutral pricing will gain in market acceptance.

All of this will be related to and impact product design and the product mix.

5.2.2 Product Development

Product design will focus more on financial innovation, but recognize risk and hedging opportunities. Product designers will search out products which meet the customers need for risk reduction, takes full advantage of the portfolio effects, but allows for the full recognition of market, credit, operational and consumer behavioral risks to the insurer. This means greater understanding of the risks, which can now be achieved with the help of the new generation of models on the market, focusing on offering those risks important to customers, but minimizing risks through modern portfolio theory, hedging techniques such as securitizations and derivatives, as well as reinsurance strategies.

5.2.3 Performance Measurement

In order to complete the circle and ensure that ERM is fully integrated into a company, performance has to be measured in an ERM context and in particular in a context of the companies own ERM modeling. This means accurate measurement of actual risks, risk-adjusted performance measures and all levels of the organization are being remunerated on a basis consistent with their contribution to risk-adjusted company value.

Moving a company forward in sync to create the right incentives for both operating units and individuals is a key aspect of ERM, and is accomplished in two ways: by creating transparent objectives for all to follow, and by allowing for the alignment of individual incentives and company goals.

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All managements have targets for such measures as ROE, earnings growth, expense ratios, and so on. Too often, however, the targets are somewhat arbitrary, and may even conflict with each other. With an ERM process, it very quickly becomes clear which targets are achievable under current operating conditions, both in terms of reasonable expectations and in terms of luck, either good or bad. Moreover, it also becomes clear exactly what the obstacles are to improving ROE, earnings growth, and so on. For example, it is possible to test proposed price increases to see whether they are consistent with anticipated volume increases.

What that means is that management can set realistic targets, thus reducing the probability of surprises. It can also determine what actions are needed to achieve those targets; and it can reward people for taking those actions, as opposed to more general incentives such as volume growth or share price increases. This may be a shock to many – but it will encourage behavior that is in the interest of customers and shareholders and will therefore, ensure the long-term well-being of the industry.

5.3 Holistic Scenario Analysis

Without a total company model, it is impossible to adequately understand and manage the business risks. As a result, insurance executives are turning to ERM modeling to help them manage financial risks and measure value across the entire enterprise. With the right ERM process in place, they can deliver valuable benefits that enable their companies to:

- Better understand and manage risk
- Improve asset-liability management
- More efficiently allocate capital
- Optimize reinsurance purchasing
- Enhance performance management
- Maintain or improve ratings
- Increase shareholder value

To realize these benefits, technology solutions to support ERM initiatives are mission-critical. It is therefore essential for executives to give the appropriate consideration to the technology choices available.

To achieve appropriate levels of ERM as outlined by the IAIS regulatory guidelines, the ERM software should be engineered to model an entire insurance company. Software is critical as its uses for risk management considerations need to be integral to the management of the daily operations of the organization. The software solution must support enterprise-wide management of capital and investments, risk and liabilities, reinsurance, corporate planning and economic modeling. This means that all of the company's assets and all of its liabilities are run through the same set of scenarios at the same time.

By modeling the total company, the ERM solution provides management with an aggregated view of all aspects of their business. The strategic ability to view the company's "big picture" can lead to improved ratings, better overall performance and increased shareholder value.

The ERM solution should provide comprehensive support for all aspects of the business—from direct insurance modeling to group structure and consolidation accounting in a multi-economy environment. Specifically the technology should support:

- Direct insurance business
- Assumed reinsurance

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- Ceded reinsurance
- Investments
- Financial reporting
- Taxation
- Multiple currencies
- Group structure

5.4 Migration to Central Risk Management Platform

An insurance company should not be required to replace its existing models to implement an ERM solution. The ERM software must be able to be implemented on top of all the company's existing data models across the enterprise. This protects the firm's investment in data, business logic and expertise.

In addition, the ERM software should allow users to make the best use of whatever data they choose or are able to access. Even if they start by using aggregate data, they should have the opportunity to use the detailed data when they are ready—with a perfectly smooth transition.

Some key requirements for group-wide risk models are:

- Consistent scenarios
- Dependencies modeled by common underlying drivers
- Proper accounting aggregation to entity and group level
- Group level management decisions
- Local decisions reflecting global situation
- Robust simulation modeling engine and output data base technology
- Leverage existing models, parameters and data

5.5 Scalability Challenges of Combining Non-Life and Life Models

Non-life models typically require large numbers of paths, particularly due to catastrophe risk. Life models typically require large numbers of time periods, due to long-term commitments. If a company has both Life and Non-life businesses, it can be challenging to construct models that include both Non-life and Life because of scalability issues often found in existing platforms. Companies sometimes end up compromising their models by constructing a large number of paths for some parts of the model, and large number of time periods for others, then merging scenarios, for example, via a stratified sampling from the larger set or replication of the smaller set.

When evaluating an ERM platform, it's important for companies to choose a model technology that provides the scalability to support massive models without requiring a compromise in the modeling accuracy and to look for an integrated platform that enables a robust management decision feedback mechanism, jointly resolving group-level and segment-level goals and constraints across all entities in a group. These capabilities are essential to an accurate assessment of a group-wide risk profile.

6.0 EDUCATION AND TRAINING

As mentioned earlier, movement to a principles-based approach and ERM is a transformational process that requires commitment and active involvement across specialties and across the enterprise. Organizational transformations, even small ones, can only be achieved through dedicated education and training programs that bring all resources into alignment with enterprise objectives.

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6.1 Accounting Department

Education and training of the accounting department on the new principles-based approach should be one of the first educational sessions in preparation for the new methodology. While the accounting department will still need to book entries based on information from the actuarial department, it will be extremely important for the accounting department personnel to understand the impact of a shift to a principles-based approach to reserving. It would weaken controls if the accounting department did not understand the underlying concepts and potential effect on the numbers that they will be booking. For example, the accounting department must be able to identify numbers and/or trends that may contain potential errors. In addition, the accounting function is intertwined with many other functions. Accordingly, early training, along with the preliminary scoping of necessary procedural changes within the accounting department could impact other departments as well.

6.2 Internal Auditing Department

In their role as internal gatekeepers, the internal auditing department is a key management asset in assuring that internal controls are operating effectively. Accordingly, it is imperative for internal audit professionals in insurance companies to gain more than a cursory understanding of the new principles-based approach. The shift to the new approach may change audit programs and testing procedures significantly. Should audit managers and staff not understand the underlying concepts of the new principles-based approach it will be difficult, if not impossible for them to develop meaningful audit programs to test reserves. Also, a lack of understanding would make it difficult for the audit staff to interpret the results of audit tests and thus constrain their ability to present meaningful results to senior management. Preparing and presenting to the audit committee the annual audit plan takes place months before the start of an audit year. Therefore, it is imperative that the education and training of the internal audit management team begin long before the planning phase of the annual audit.

6.3 Asset / Liability Management

Proper matching of assets and liabilities is a significant risk-based function either within the treasury department or undertaken by a cross functional asset liability committee. Therefore, it is especially important for the treasury department to become educated on the impact that the new principles-based based approach may have on the liability side of the equation and that those responsible for liabilities become educated on the impact that the new principles-based based approach may have on the asset side of the equation..

6.4 Executive Committee and Board of Directors

The personal liability of members of the Executive Committee and the Board of Directors has increased significantly in the recent past. Due to their role in overall strategy and guidance, it is important that this group as much or more than any other, have a thorough understanding of the concepts and impact of the shift to a principles-based approach. In Europe, Solvency II currently envisages all board members (including sales and marketing) will be required to demonstrate their understanding of company ERM policy and models used as well as having to demonstrate that company strategy and ERM modeling are in sync (use tests). For example, loss reserves represent the most significant risk on an insurance company's balance sheet. Without a thorough understanding of the impact of this change, it would be difficult for these executives to carry out their responsibilities to stakeholders in managing the company and making educated decisions. Also, it would be difficult for this group to present

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current and future financial conditions of the company to the investment community without the proper understanding of the concepts of the principles-based approach.

6.5 Actuaries

The shift from the formula driven, rules-based approach to a principles-based approach now being embraced by regulators and company executives, had its genesis in the efforts of actuaries striving to achieve greater transparency and clarity in risk-based decisions related to product development and pricing. Accordingly, actuaries are now being thrust to the forefront in helping educate and train others throughout the organization in the concepts and practical relevance of the principles-based approach—its role in ERM and risk-based decision-making.

At the same time, actuaries, now potentially exposed to new areas of responsibility and liability, must seek additional knowledge regarding the holistic view of risk and the role of other organizational units impacting risk and risk decisions, both financial and operational. This education especially includes knowledge about how centralized risk management platforms facilitate the principles-based approach.

The nature of the proposed changes is centered on a basic change in how loss reserves will be estimated: one from a dictated formula-based methodology to one where greater discretion and judgment are used in arriving at a range of estimated reserves. With greater discretion in selecting reserve models, parameters, and assumptions, comes greater levels of verification and validation of the reserve and pricing methodologies. It is a change in the inherent way actuaries will look at their responsibilities. They will not only have to make judgments, but also document and defend those decisions. Also, they will have to work more closely with claims, marketing, and financial professionals to fully understand the experience data being used in the development of loss estimates, as well as the impact that those estimates may have on the financial and capital positions of their companies. For actuaries, there will be a continuation of the behavioral shift from the comfortable silo of the actuarial department to a very robust environment coordinating with many insurance and financial specialists. The companies that adapt to this change will have a competitive advantage over those that struggle with this fundamental way the company conducts its business.

6.6 External Reporting

Education of the professionals responsible for external reporting can make the difference between a smooth, uneventful reporting year and one requiring an inordinate amount of time on the part of professionals entrenched in replying to questions raised by regulatory agencies (including the SEC and NAIC) regarding changes in the methodology from a formula-based approach to a principles-based approach. The adequate and timely education of these reporting professionals will facilitate the appropriate development of meaningful and required disclosures. Also, early education of the external reporting groups regarding the new approach is important to allow for any disclosure requirements by them if needed to restate prior years' numbers for comparative purposes.

6.7 Investment Community Relations

Effectiveness of the investment community is based in part on its ability to understand the underlying concepts and composition of the numbers contained within financial statements. The shift to a principle-based approach, and a move toward international accounting frameworks (such as IFRS), may significantly change both the balance sheet and income statement of a company. Without a thorough understanding of how such changes in the reserving process may impact a company's

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financial statements, it will be difficult for the investment community to evaluate a company's value—not only on a stand alone basis, but also in comparison to other like investment opportunities. This understanding is critical not only for a financial firm's own potential investment, but also on behalf of the clients that may look to it for advice. Accordingly, the investment community has a vested interest in being educated on the new methodology as early as possible.

7.0 TRACKING REGULATORY PROGRESS

The principles-based approach has, and is receiving significant international and domestic attention, with many industry professionals advocating adoption. However, it is important to realize that there has been no definitive decision on a final version or on adoption by U.S. regulatory entities. Since certain decisions remain open, the specifics of the methodologies being considered are subject to change. Therefore, it is important for companies to develop and continue education and training programs, along with strategies for implementation, but to remain flexible on specific decisions relating to regulatory issues that are still undecided. What should be taking place are discussions at every level of organizations that address the potential impact, with appropriate sensitivities and various implementation scenarios. Additionally, each organization should appoint a small team to track changes that may occur in the proposals and evaluate and report how each new potential change may affect their organization. This report will be a critical component in management's evaluation of the relative impact and selection of appropriate future strategies. The wide-spread impact of the transition to principles-based approach mandates that a tracking team be implemented as soon as possible to enable accommodation for any unexpected acceleration of formal adoption by regulators.

8.0 IMPACT ASSESSMENT

In the U.S., the shift to a principles-based approach is not currently mandatory, and a company needs to maintain its current financial reporting practices, which it may be using for several years more. However, due to the significant commitments in adopting ERM, companies need to consider what methodology would be best—not only considering how the change would affect its P & L, but also the impact on it capital; currently and going forward. A company should assume proactive positions and present to its management committee sensitivity models on how such a change would impact the financial standings of the company. In addition, companies would need to report their rationale for choosing one approach over the other. In addition, companies would need to report their rationale for choosing one approach over the other.

Change to a principles-based reserving approach obviously involves financial calculations, but as important, are the underlying operational considerations that influence these calculations. For example, there may be an increase in the importance of collecting and reporting historical claim data, as well as very specific data points, such as geography, health data and personal habits of the insured pools. This data will enable the identification of possible trends and sequences that will allow for adequate interpretation and analysis of the data. In addition, how that data flows operationally and procedurally in the most efficient way possible will need to be reviewed. This may also encompass a review of IT systems and capabilities and lead to the potential reorganization of data to allow for the appropriate level of actuarial analysis and review.

8.1 Internal Controls

As with any change in methodology, proper internal controls require that there be a well documented development of the new methodology. Also there should be an independent validation of the new

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methodology, including not only recalculation and mathematical accuracy, but a validation from professionally qualified professionals that the models have been developed in accordance with the proper specifications using the appropriate actuarial assumptions.

The new principles-based approach is based on using historical trends and actual experience to estimate future trends and expected losses. Accordingly, the integrity of the experience and trend data is one of the most important aspects of the proper implementation of the change to a new reserving approach. Unless steps to ensure data integrity are put high on the implementation list, it will be extremely difficult to have confidence in the integrity of modeling results.

All assumptions and model development must be validated independently before being used in the actual booking of reserves. Not only must the models be validated for mathematical accuracy, but after validation models must be controlled for such things as change management and version controls, with limited access to such models. In addition to independent validation that assumptions used in the development of the principles-based models, companies must assure that assumptions are re-evaluated on a periodic basis within reasonable intervals and each re-evaluation should include some form of validation.

8.2 Ability to Leverage Sarbanes-Oxley Infrastructure

The advent of Sarbanes-Oxley (SOX) has placed an enormous burden on a company to be able to state to its shareholders that internal controls are adequate and operating effectively. A company's independent auditors will opine on the adequacy of the systems of internal controls and whether or not they are operating effectively. SOX now requires that companies review and evaluate its internal controls using a risk-based approach. A change such as the shift to a principles-based reserving approach puts it in a high-risk category for SOX purposes. Controls around the change in approach, as well as the ongoing controls, will come under intense scrutiny for SOX. While controls may have been in place under a company's formula-based approach, they may not be adequate with the shift to a principles-based approach. Many of the specific controls, such as controls over modeling spreadsheets, independent validation of models and methodology, and adequate controls over data integrity are all important controls in a SOX environment. It should be noted that even though a company may not be subject to SOX, the NAIC's Manual Audit Rule, which will go into effect in 2010, will require a SOX-like certification by company management. Regulators will be interested in the controls over the reserving process and the change process from a formula-based approach to the more discretionary principles-based method. An important ingredient in a SOX-compliant environment is the use of a reserve committee, which will be explained in more detail below.

8.3 Reserve Committee

As mentioned above, a main component of an adequate control environment in the reserving process is the incorporation of a Reserve Committee. The committee is typically made up of senior and some mid-level managers to review the recommended reserve level that will be used in the financial statements. The committee composition should include representation from the actuarial department, the finance/accounting department, the investment department, the claims department and the underwriting department. Since a principles-based approach to reserving is much more discretionary and allows much more room for a company to use judgment in establishing reserve levels, the need for a reserve committee is an important and necessary control.

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8.4 Assessment of Potential New Risks Related to Principles Based Approach and IFRS

The transition from a formula-based approach to a principles-based approach gives rise to new risk concerns. As mentioned above, data integrity risks are higher under a principles-based approach. Claim data must be properly controlled, from proper input of claims data to proper classification and the appropriate sorting of claims data is extremely important. Operational risks are also extended as IFRS and IASB are introduced into the US accounting framework.

Additionally, the discretionary part of setting of reserve levels under a principle-based approach requires a different set of controls procedures than under a formula-based one. Companies changing to a principles-based approach may consider implementing a reserve committee, if one is not already in place.

With any new change in methodology and/or procedures, risks arise from the implementation of related new systems, new processes and/or policies. The transition associated with such changes should include controls to mitigate such risks. These controls might include:

- Additional reconciliation procedures between new data transfer points
- Running dual processing until the comfort on the new process is acceptable
- Increasing the number and level of reviews of data coming through the new process
- In-depth review of changes to spreadsheet formulae and controls over the many changes that are required during the transition process
- Adequate levels of review and approval of all methodology and process changes

9.0 IMPLEMENTATION ISSUES

Effective implementation of significant change within organizations always requires clear understanding and acceptance of the purpose and benefits by those individuals and groups affected by the change. Specifically within the insurance industry, it is especially important to establish a framework in which stakeholders share a common legal, ethical, political and business perspective. Such a common frame of reference is the enabler of transparency, open communication, understanding and collaboration, all of which are essential to success.

9.1 Legal Component

Law exists through the process of legislation, regulation and litigation, each of which stands alone in importance, and all which combine to create precedential knowledge embodied in case history. For example, principles-based accounting has been law in the U.S. since 1969 (*Continental Vending – U.S. v. Simon*, 425 F.2d 796 – 1969), and confirmed in subsequent cases dealing with the issue of accounting information being “fairly presenting” vs “in accordance with GAAP.” Accordingly, the first pillar of understanding needs to be a thorough understanding and acceptance of the legal issues and implications bearing on the subject of principles-based accounting and transition to IFRS.

9.2 Ethical Component

Good corporate governance dictates that ethical considerations include practices and behavior bearing on personal, business and social responsibility. Model standards relating to these matters must be codified in writing and supported by example of actual behavior. Such ethical standards and behavior serve to guide and frame day-to-day conduct and judgments by practitioners and decision makers. This is especially important under a principles-based approach, where the judgment of professionals is a primary ingredient for decision-making.

ERM and Other Considerations Related To A Principles-Based Approach

9.3 Political Component

The transition from GAAP to IFRS involves many diverse stakeholders with conflicting vested interests, potentially causing an intense political environment at every level—international, national, and state governments, regulators and associations, as well as individual companies. In order to remain effective, companies must neutralize the impact of political issues that detract from the corporate mission. Implementation of IFRS will be impacted as the IFRS and IASB respond to these various political issues.

9.4 Business Component

Business considerations for transitioning to principles-based accounting take into account a number of major areas—strategic, governance, risk management, actuarial, financial, controls, external communications, technology, marketing and operations. To be effective, companies need an overall framework statement that includes corporate missions and goals, as well as the expectations and boundaries that guide strategies and plans for each of these major business areas within each of the applicable business units.

9.5 Strategies and Plans

Transitioning to IFRS is a long-term process requiring sustained commitment, with clear articulation of corporate and individual business unit strategies and plans that address each of the business areas identified in paragraph 9.4 above, including applicable resources, schedules and deliverables. Plans should answer the question, “Who does what, why, where, when and how?” Plans need to be standardized and collectively vetted to assure that they are synchronized and complementary to the overall corporate missions and goals.

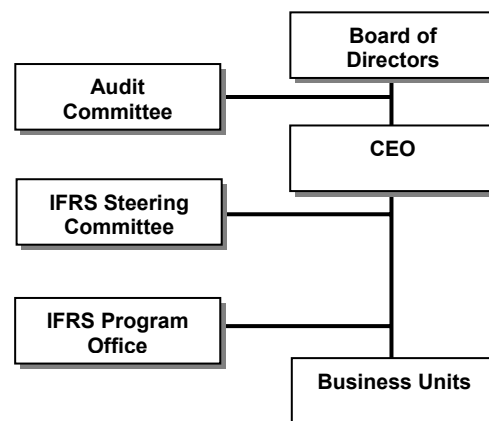
Each company will most likely develop its own approach to transitioning to IFRS, based on a number of factors, such as legacy issues, resources, technology, cost and appetite for change. In any case, experience has demonstrated that certain steps should be considered when implementing large-scale change. These steps help determine where the organization is, where it needs to be, and how it will get there.

- Examine and achieve a full understanding of current legal and regulatory requirements and schedules regarding implementation of IFRS.
- Perform a detailed situational assessment to determine the current state of those business areas identified above (and others as applicable), taking into account factors such as adequacy in satisfying objectives, current operational cost, and ability to accommodate change.
- For each of the areas addressed in the assessment, determine what is needed to transition to IFRS over selected time frames, or to achieve required milestones or events.
- Perform an analysis to determine what can be accomplished under the current environment, and what needs to change in order to meet IFRS requirements.
- Prioritize the findings from the analysis above based on criteria such as appetite for change and resources required—time, funds, people, and solutions available.
- Develop an implementation plan that defines and schedules resources and deliverables, and that provides for measurement and accountability for results.
- Educate all stakeholders (internal and external) regarding the negative and positive impacts of the transition to IFRS.

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10.0 GOVERNANCE AND OVERSIGHT

Implementation of principles-based regulation (IAIS, NAIC) and accounting changes (IFRS, IASB) will be dispersed throughout the organization but needs to be controlled from a central authority that can guide and monitor progress. For example, there are six organizational entities involved in the process of IFRS governance and oversight. Each of these entities carries a degree of responsibility and liability related to the effective implementation of IFRS. Accordingly, it is important to achieve clear and transparent communication throughout this value chain. The summary of responsibilities outlined below serves as a starting point for developing the governance and oversight structure and process. The IFRS Steering Committee and IFRS Program Office are primarily focused on staging issues related to the transition to IFRS. The other entities are focused on both the initial transition to IFRS and ongoing performance under IFRS.



- **Board of Directors:** The Board of Directors is responsible for establishing the overarching expectations for implementation of IFRS, including benefits and timeframes, and for expectations under IFRS.
- **Audit Committee of the Board:** The Audit committee of the Board is responsible for assuring that processes and controls are in place and adhered to with respect to implementation of IFRS, and for assuring that results under IFRS meet expectations.
- **CEO:** Like the Board and Audit Committee, the CEO is responsible for both initial implementation of IFRS and ongoing performance under IFRS—defining overall strategy and performance, ensuring that resources are made available, that constraints are minimized, and ensuring that effective communication is achieved among all stakeholders.
- **IFRS Steering Committee:** The IFRS Steering Committee comprises key stakeholder management that can collectively translate expectations of the CEO into a structure that facilitates management of IFRS implementation—setting guidelines, resolving issues, and ensuring that formal project management is in place and working effectively.
- **IFRS Program Office:** The IFRS Program Office is the official management entity responsible for ensuring that all IFRS objectives are translated into deliverables and that those deliverables meet expectations. This includes assigning resources and establishing performance expectations, including schedules.
- **Business Units:** Business units are responsible for executing the tasks and creating the deliverables involved in the initial implementation of IFRS and ongoing performance under IFRS.

11.0 SUMMARY

Principles-based regulation and IFRS, used by most of the world today, has growing support within the U.S. for a number of reasons, including pressures to standardize due to the increased globalization and integration of economies, the complex and burdensome nature of U.S. standards on domestic and international companies, the need for U.S. companies to remove barriers and increase competitiveness, and the potential cost efficiencies for U.S. companies under IFRS vs GAAP.

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The advancement of principles-based regulation is to provide for a level playing field in the global insurance markets. In addition, it offers regulators the ability to optimize economic realities of the marketplace with the market, credit and operational risks of insurers as they arise from product innovations that combine financial theory and applications with insurance risks. The end goal is greater financial security of insurance markets through better solvency measures.

Expectations are that IFRS will increase transparency, facilitate the ability to compare globally and thus create a more informed global market environment, enhance the efficiency of capital allocation, and introduce opportunities to improve operations. At the same time, transition to IFRS will be influenced by opposing political views and constrained by operational issues and costs that will make ongoing implementation difficult.

Negative influences can be overcome and benefits gained more quickly through proper planning, preparedness, and effective execution. This requires sustained leadership commitment and mobilization of resources under a disciplined program management structure capable of large-scale, multi-year implementations involving complex financial models and enterprise risk management expertise. In addition, as transition to IFRS unfolds, U.S. stakeholders such as FASB and the SEC will strive to ensure that U.S. interests are fully protected, and especially struggle with acceptance of the IASB as the global standards setter.

ERM is based on the framework of obtaining greater control among organizational risks. This requires insurance professionals to recognize economic, political and regulatory trends external to risk bearing organizations and to prepare these organizations for change. For insurers, we have identified two changes that are critical to US insurance operations. The first is the regulatory shift from rules based to principles-based regulation. The second is the adoption of IFRS for financial statements. These changes represent substantial external trends that have been developing for a number of years.

On balance, the benefits are expected to outweigh the negatives. However, companies are better served by mastering the technical issues early in the process, while remaining flexible in their ability to recognize and accommodate changes as the process moves forward. Companies that are able to sustain this balance will gain greater benefits than those that wait for more perfect settings. ERM is a framework that can assist companies in this quest.