

Corporate Governance Insights

We were delighted to hear from many of you that our recent statewide series of Insurance Company Corporate Governance Workshops with Pennsylvania Deputy Commissioner Stephen Johnson offered valuable information for directors and senior management. Based upon the follow-up questions and requests we have received, we will be circulating a series of e-mails over the upcoming months that share information responsive to some of those requests, as well as information on the status of NAIC adoption and state implementation of new regulatory requirements.

Our first installment, which addresses the Board's role in corporate compliance and regulation of non-insurer affiliates, is below.

Enterprise Risk - The Board's Role in Corporate Compliance: Oversight of corporate compliance is part of a Board's fiduciary duties to the company and an integral part of a company's enterprise risk evaluation. Appropriate Board oversight of compliance includes (1) assuring the program is adequate and effective for the identified exposures; and (2) timely receipt of information on compliance issues, including reports on material exposures and the company's ongoing compliance efforts.

While an insurer's Board is not responsible for understanding every compliance issue facing the company, the Board must be able to determine that the compliance program is designed to identify compliance issues, and evaluate and address the exposures they create. Several essential elements of an effective compliance program are listed below:

- 1. One or more employees with compliance authority and resources.** At the core of an effective compliance program is one or more employees who are charged with compliance oversight and implementation, and who have adequate resources to carry out those duties, ranging from a Chief Compliance Officer/Department, whose primary role is overseeing and managing compliance issues, to individuals within specific business units that address compliance in addition to other duties. Regardless of where the compliance responsibilities are placed, responsible individuals must be able to effectively identify, monitor, evaluate, train, investigate and respond to compliance issues. There also must be periodic reports to the Board on the status and effectiveness of the compliance program.
- 2. A system for identifying and evaluating compliance rules and risks.** A compliance program must include a process for identifying compliance rules applicable to the insurer, including requirements found in statutory and regulatory provisions, case law, market conduct and financial examinations, and enforcement actions, among others. The compliance program also must evaluate the level and scope of the insurer's exposure with respect to the various rules and standards, and determine the resources necessary to address the risks.
- 3. Written standards of conduct.** Once compliance rules have been identified and evaluated, standards must be woven into the fabric of the company's business. This is

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done by determining the business processes affected by each rule and creating written standards for addressing each rule within the relevant business processes. These standards must be reviewed periodically to assure they remain relevant and up-to-date.

4. Education and training. Identified rules and written standards are irrelevant without effective communication and training. Affected employees must receive training on compliance rules and the standards of conduct expected for each business process. Employee compliance with such standards can be reinforced through the company's ongoing process and performance reviews, as well as periodic training.

5. A system for responding to violations. A process should be established to receive and respond to violations. That process will include, at a minimum, an internal investigation of the issue, documentation and recording of the results of the investigation, and a formulated, timely, response as required. Compliance violations should also be tracked to identify gaps or patterns that can be addressed through additional training or a change in the company's processes.

Corporate compliance is a key element of an insurer's operations. A Board can satisfy its fiduciary duties in that regard by assuring the company's program is designed to create a culture of compliance and that it receives sufficient information to be made aware of, and address, material compliance exposures.

For additional information on or assistance with your corporate compliance program, please contact Joel Hopkins at (717) 257-7525 or jhopkins@saul.com.

Non-Insurer Affiliates - No Longer Exempt from Regulation: New regulatory provisions that became effective in many states, including Pennsylvania, give regulators significant authority to evaluate actions of non-insurer affiliates that may have an adverse impact on the financial condition or liquidity of an insurer or the insurance holding company system (IHCS) as a whole, including affiliate transactions within an IHCS that do not involve an insurer.

While regulators traditionally focused on transactions within an IHCS only if such transactions involved an insurer, lessons learned from the recent financial crisis have caused regulators to now also focus on transactions within the IHCS that do not involve an insurer. This allows regulators to assess the risks to the "enterprise" as a whole, and to act promptly if activities of non-insurer affiliates could have an adverse impact on the insurer. As part of this new focus, regulators are concerned not only with the direct financial impact of affiliate actions and transactions, but also with the reputational risk that such actions or transactions may pose to an insurer.

Although non-insurer affiliate transactions are not subject to pre-transaction reporting, such transactions may be identified and assessed by regulators via the following new regulatory requirements and authority:

- **The Enterprise Risk Report:** The ultimate controlling person in an IHCS will have to file an Enterprise Risk Report annually to disclose information on a number of specified areas of the IHCS that could produce enterprise risk. Required information includes the

identification of corporate guarantees within the IHCS, the source of funds to support such guarantees, IHCS business plans and strategies, capital resources and material distribution patterns.

- Financial Statement Filings: In addition to an insurer's financial statements, the financial statements of the IHCS and non-insurer affiliates must be filed upon request of the regulator.
- Financial Examinations: Regulators may examine not only an insurer, but also any and all of its affiliates to ascertain the enterprise risk such affiliates pose to the insurer.

If a regulator determines that an unsatisfactory level of enterprise risk exists, the regulator may deem an insurer to be in hazardous financial condition, even when an insurer's own financial or risk-based capital ratios are not currently impaired. With such a finding, a regulator may take action against, or place limitations on, the insurer. Factors a regulator may consider in determining hazardous financial condition include:

- Whether transactions among affiliates, subsidiaries or controlling persons for which the insurer receives assets or capital gains do not provide sufficient value, liquidity or diversity to assure the insurer's ability to meet its obligations;
- Whether any entity within the IHCS is insolvent, threatened with insolvency or delinquent in payment of its obligations; and,
- Whether the management of the insurer – including persons who indirectly control the operation of the insurer – fail to possess and demonstrate competence, fitness and reputation deemed necessary to serve the insurer.

Based on the new tools available to regulators to assess enterprise risk, IHCS management should evaluate the possible regulatory impact of all risk within an IHCS, including the risk presented by transactions that do not directly involve an insurer.

For additional information on or assistance with enterprise risk considerations, please contact Fran Roggenbaum at (717) 257-7526 or froggenbaum@saul.com.