

# ClientAlert

January 3, 2012

## New York Regulators Expect Insurers To Proactively Manage Enterprise Risk

In a Circular Letter<sup>1</sup> issued on December 19, 2011 and addressed to all New York-domiciled insurers and health maintenance organizations, the New York Department of Financial Services announced that it "expects every insurer to adopt a formal Enterprise Risk Management (ERM) function." The Circular Letter announces the Department's expectation that all insurers<sup>2</sup> will implement measures to "identify, measure, aggregate and manage risk exposures within predetermined tolerance levels, across all activities of the enterprise of which the insurer is a part, or at the company level when the insurer is a stand alone entity."

The Circular Letter was originally issued in draft form by the Insurance Department (the predecessor to the DFS) in July 2011. Among the key differences between the draft letter and the December 19 version are the following:

- The December version "recognizes that a dedicated ERM function may be impractical or too costly for small insurers," without defining "small." The July draft had not expressly addressed this point.
- The December version clarifies that an insurer may request confidential treatment from the Department for any submissions made in connection with an ERM examination to the extent that such materials contain trade secrets or are otherwise competitively sensitive within the meaning of New York's Freedom of Information Law. The July letter had been silent on this.

In the new Circular Letter, the Department broadly defines the term "enterprise risk" as "any activity, circumstance, event or series of events involving one or more affiliates of an insurer that, if not remedied promptly, is likely to have a material adverse effect upon the financial condition or liquidity of the insurer or its insurer holding company system as a whole." As discussed below, the definition is similar to that adopted by the National Association of Insurance Commissioners ("NAIC") in December 2010 as part of its amended model Insurance Holding Company Systems Act ("Holding Company Act").

The Circular Letter indicates that the Department, when conducting an examination of an insurer's ERM function, will look for adherence to the following criteria:

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<sup>1</sup> Available on the Department's website at [http://www.dfs.ny.gov/insurance/circltr/2011/cl2011\\_14.htm](http://www.dfs.ny.gov/insurance/circltr/2011/cl2011_14.htm).

<sup>2</sup> The Circular Letter's references to "every insurer" and similar terms suggest that ERM expectations may extend even to non-domestic insurers that are licensed in New York. However, the fact that the letter is addressed to domestic insurers supports an argument that the letter is directed only at New York-domiciled entities.

- a team of insurer personnel headed by an experienced executive with authority to provide "ongoing assessments of the insurer's risk profile" to the insurer's board of directors and senior management;
- a written policy that sets forth the insurer's risk/reward framework, tolerance levels, and risk limits, using appropriate techniques to identify and quantify risks;
- prospective solvency assessments with stress testing under various scenarios, including descriptions of the risks identified, the assumptions made, the measurement approaches used and the outcomes forecast under each scenario;
- developing a risk and capital management process that monitors the "level of its financial resources relative to its economic capital and the regulatory capital requirements";
- consideration of "all reasonably foreseeable and relevant material risks" such as underwriting, asset-liability matching, credit, reputational, liquidity and market factors;
- performance of "own risk and solvency assessments" ("ORSAs") in accordance with NAIC protocols; and
- for insurers which are part of a holding company system, identifying, quantifying and managing risks that arose from transactions with the holding company of affiliates. If the processes to achieve this function are at the holding company, the insurer should be able to demonstrate how those systems anticipate and manage those risks, including not only the insurer's financial risk but harm to its reputation based on the activities of affiliates.

Although the Department did not issue a formal regulation, and courts have held that Department Circular Letters are merely advisory and lack the force of law, this Circular Letter makes clear the Department's intention to evaluate an insurer's ERM function as part of the statutory examination process.

The Department's new ERM policy is consistent with recent developments at the NAIC and in other states involving holding company regulation and self-assessment of enterprise risks. Following the 2008 financial crisis, the NAIC launched its Solvency Modernization Initiative ("SMI") in order to empower regulators to oversee not only the solvency of individual insurers but on the financial, operational and reputational condition of whole groups of affiliated companies. The initiative has been motivated by the NAIC's belief that affiliates of insurers can expose insurers to financial risks not only by virtue of specific affiliate transactions, but also by activities and operations of the affiliates themselves. The SMI has resulted, among other things, in an amended Holding Company Act that, if adopted, would impose new, more rigorous disclosure requirements on controlled insurers, including the requirement to report annually to the lead state regulator for the affiliated group on "enterprise risks" affecting the insurer. The SMI has also developed standards and guidelines for conducting ORSAs, although as of this writing the NAIC is still deliberating on precisely how to codify an ORSA requirement (*i.e.*, by amending the Holding Company Act yet again, by creating a separate statutory requirement or by other means). NAIC measures do not become effective in any state until or unless adopted by that state.

The Circular Letter represents New York's most significant step to date in implementing these group-solvency initiatives. Chadbourne is well equipped to assist our clients in complying with these developments.

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## For More Information

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