September 11, 2023

David Paul, Chair
Enterprise Risk Management Committee
Actuarial Standards Board

Re: Proposed Replacement of Actuarial Standards of Practice (ASOPs) Nos. 46 and 47

Dear Chair Paul,

The ERM-ORSA Committee of the American Academy of Actuaries is pleased to support the *Enterprise Risk Management* (ERM) ASOP exposure draft, which would replace ASOP 46 *Risk Evaluation in Enterprise Risk Management* and ASOP 47 *Risk Treatment in Enterprise Risk Management*. The singular *Enterprise Risk Management* ASOP describes ERM as a coherent and ongoing control cycle process compared to the prior ASOPs. We applaud the efforts of the Enterprise Risk Management Committee of the Actuarial Standards Board to create a cohesive drafted standard that will have a positive impact on the profession.

We would like to offer the following comments and recommended edits to the exposure draft for your consideration:

1. “Material” or “Materiality” Generally
   “Material” is defined in ASOP 1, which is incorporated by reference. There are several places where adding “material” or “materiality” might help clarify the meaning of a phrase or reference. For example, “all risks” generally means “all material risks”, etc.

2. 1.1 Purpose
   We would recommend including an additional function from the list, to explicitly incorporate “monitoring” the ERM Framework. The functionality of monitoring is not entirely covered by either “maintaining” or “reviewing,” though there may be some overlap. While monitoring might be a function of a lower-level ERM practitioner, an actuary may be authorized to recommend maintenance or recommend review but not have the authorization to perform those functions themselves. ERM practitioners also commonly use the term “closely monitored” risk, which would support the addition of “monitoring” to the list.

   RECOMMENDATION: Add “monitoring” to the list and consider adding a “Risk Monitoring” section near section 3.5/3.6.

3. 1.2 Scope
The Scope section lists common components of ERM frameworks in items a-i. Throughout the exposure draft, the phrase "capital management and liquidity" is used frequently. We noted that liquidity is not explicitly listed as being in scope. For Actuaries performing ERM, it seems reasonable to include liquidity within the scope of ERM.

RECOMMENDATION: Replace item g. "capital management" as "capital management and liquidity."

4. 2.2 Emerging Risk
The definition of Emerging Risk refers to likelihood, impact, timing, or interdependency. Likelihood in the realm of ERM is generally associated with the statistical concept of frequency, while impact as used in this definition appears to refer to severity.

RECOMMENDATION: Replace "impact" with "magnitude," in order to resolve potentially ambiguous interpretations.

5. 2.3 Enterprise Risk Management (ERM) Framework
There are links between ERM and governance in other parts of the drafted exposure; however, in this definition there is limited connection between ERM and governance. The addition of the word "governance" as one of the processes mentioned in this section could clearly draw the connection between the two functions.

RECOMMENDATIONS: Replace "collection of processes" with "collection of processes (including governance)." Add "monitoring" to the collection of processes.

6. 2.3 Enterprise Risk Management (ERM Framework)
The intent of "finances (with capital)" in this section is unclear. It could be assumed that the intention is that a company manage its risk exposures, rather than referring to the subset of actions involving financing with capital any risk exposures. There are many tools to deal with risk exposures, not just financing (with capital). If the intent is to disclose any capital hole that needs to be filled and refer to a specific method to resolve that need, alternative phrasing may be necessary.

RECOMMENDATION: Replace "finances (with capital)" with "manages" and consider further clarification.

7. 2.4 Governance
The exposure draft's definition of "governance" does not seem to reflect an ERM approach. For example, it may be better to consider the following: governance encompasses the structures, systems, and mechanisms by which an organization operates and manages its business in order to define authority, escalation, and maintain accountability.

RECOMMENDATION: Consider changing "and escalation" to "and maintain accountability and escalation," in order to draw the connection between the processes and accountability in the section.

8. 2.13 Risk Appetite Limit
   The language implies there is only one limit that cannot be exceeded, when there might be one limit at one level and a higher limit at a higher level. The last sentence could be slightly reworded to better denote this idea.

   RECOMMENDATION: Replace "They may also operate at the company level within a group" to "They may also operate at a line of business level, company level, or group level, possibly with different limits at each defined level." We would also recommend replacing "within the intended" with "within its intended."

9. 2.16 Risk Taxonomy
   The exposure draft appears to indicate that risk taxonomies must have a top-down approach, which could be needlessly prescriptive. Risk taxonomy can be affected from the top-down, as well as the current economic environment or other sources.

   RECOMMENDATION: Replace the first sentence with a broader definition, such as "Beginning with broad risk classifications that encompass and are further broken down into more narrowly defined classifications to the level of granularity that is appropriate for the organization."

10. New Section 2 Definition - Form F Enterprise Risk Report (ERR)
    Similar to sections 2.8, Own Risk and Solvency Assessment (ORSA), and 2.9, ORSA Report, it may be beneficial to include a definition for "Form F: Enterprise Risk Report (ERR)" as well as a brief explanation of what the report covers. This could increase the involvement of actuaries in writing the annual ERR filing, which applies to more companies than ORSA. Increased actuarial involvement may improve the quality of these reports. Alternatively, significant changes in ORSA and ERR could require ASOP maintenance, thus anything included must be generic.

    RECOMMENDATION: Incorporate a new section that defines and describes Form F: ERR. It may also be prudent to add a section analogous to section 3.9, Own Risk and Solvency Assessment (ORSA), with similar appropriate items.

11. 2.18 Stress Testing
    Within this section, the draft exposure refers to stress testing as a special type of scenario analysis, which could involve positive and negative stresses depending on the situation. It is useful to understand scenarios or stresses, including assumption changes, that may have an adverse result for some part of a company's business with a positive result for another part of a company's business at an entity level. Total stress may be either adverse or not, with different effects by portion of business or for new business compared to existing business. Some companies believe they must zero out any positive results from

any segment of the business that shows positive results. Instead, they use only the adverse result that applies to parts of the business adversely affected at the entity level, which is not the intent of stress testing.

RECOMMENDATION: Modify “adverse” to “net adverse assumptions” and consider further clarification to ensure understanding that the assumption itself is stressed and that the final model result may not always be negative.

12. 2.19, 3.1, 4.1 Three Lines of Defense
Originally, the “three lines of defense” model was used; however, the model has been revised to the “three lines” model, dropping the words “of defense”.

    RECOMMENDATION: Delete “of defense” in the sections listed and in any section headers.

13. 2.19 Three Lines of Defense
As the exposure draft considers the three lines, it may be prudent to add independence to the second line while offering more neutral language in the third line as we consider the ERM framework or model used.

    RECOMMENDATION: Revise the “second line” to read, “identifies where there is separate oversight and effective challenge of risk-taking activities, with some independence from the first line.” Revise the “third line” to read “is the role undertaken by auditors, which includes reviewing the effectiveness of the implemented ERM framework.”

14. 3.1 Governance
It may be helpful to clarify that actuaries might be performing risk management in any line of the three lines model, not just in the second line as was previously implied (for example, actuaries could be working in the third line in an auditing role). Of course, actuaries generally are most commonly in the first line, while ERM actuaries are most commonly in the second line.

    RECOMMENDATION: Revise the second sentence to “If an organization uses the three lines model, the actuary should understand which line(s) their risk management activities fall under,” and delete “However, the actuary may work in both the first and second lines.”

15. 3.2. Risk Identification
RECOMMENDATIONS: Revise subsection a to say, “how risks relate to the objectives of the organization;” revise subsection d to say, “risks through any financial and non-financial lens(es) relevant to the organization;” and revise the final portion to say, “When performing actuarial services related to the identification of emerging risks, the actuary should also take into account the interactions with other risks previously identified and how these risks represent new threats to and opportunities for the organization.”

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16. 3.3 Risk Classification
    RECOMMENDATIONS: Consider the order of the two points, so that the section instead reads:
    "When performing actuarial services related to risk classification, the actuary should use a risk inventory and prioritize risks on the basis of 1) the financial and operational significance of the risk, and 2) assessment of the importance of a risk to the organization's business objectives." Note the suggestion to also delete "management" in the reference to the assessment of the importance of a risk, as management's assessment could differ from the risk manager's assessment.

17. 3.4.1. Quantitative Components of Risk Appetite Framework
    We noted that the exposure draft has "quantitative" misspelled in the header. In part a., "risk metric" is not defined in the ASOP, which should be considered. In offering that definition, incorporating "materiality" should also be considered. In part c., it seems necessary to clarify that the risks are not constrained, but rather that the amount is constrained. Refining that language to reflect "risk appetite limits that constrain the amount of individual risks and the aggregation of risks at or below levels supported by the organization's available capital" would address that concern. In part d., the concept being described is whether the limit is well enough defined that management retains an ability to further mitigate the risk, even after the limit has been reached. It may be helpful to edit the last portion to read "… risk appetite limit sufficiently defined to allow management time for additional risk mitigation strategies."

    RECOMMENDATION: "Quantitative" needs to be spelled correctly in the header. Consider the refinements to parts a, c, and d as noted above.

18. 3.4.2. Qualitative Components of Risk Appetite Framework
    The example provided in part a. is a quantitative, rather than a qualitative one. A commonly used ERM example refers to an organization maintaining current ratings levels, as maintaining ratings may be partially decomposable into quantitative limits, with multiple aspects that are qualitative. This example is so commonplace, it seems like it is the best way to ensure anyone will immediately grasp the difference.

    RECOMMENDATION: Revise Subsection a to read "a. qualitative risk appetite limits related to the level of risk the organization is willing to take (for example, an organization maintaining current ratings levels)." Revise Subsection b to read "b. governance related to setting qualitative risk appetite limits, including authority levels to respond to limit breaches."

19. 3.5 Risk Mitigation
    The exposure draft introduces the term, "mitigation program," which is undefined and potentially unnecessary. It may also be helpful to mention that mitigating one risk may increase another risk or create one that did not exist prior to the mitigation (for example,

reinsurance helping with one part of the risk but now there is an additional counterparty risk).

It should be recognized that there are ways to test the proposed risk mitigation activities other than scenario analysis, so it may be too prescriptive to say, "should test … using scenario analysis." It could also be interpreted that all risk mitigation effect measurements need to be within a quantitative (run the model) type of approach, which has the effect of minimizing risk manager intuition. We would urge the drafters to reconsider this language.

RECOMMENDATION: Eliminate the term, "mitigation program," and revise that sentence to read, "When performing actuarial services related to risk mitigation, the actuary should test the proposed risk mitigation activities using scenario analysis or other methods to confirm that the risk mitigation has the intended effects." Revise subsection c to read "the extent to which the proposed risk mitigation transforms the risks less tolerated by the organization into other risks the organization is more willing to manage, including any new or increased other risks that arise due to the risk mitigation."

20. <u>3.6 Risk Metrics</u>
We would note that inherent risk prior to any risk mitigation, as well as residual risk after any risk mitigation, are fundamental to ERM and should be defined.

RECOMMENDATION: Add a definition of "inherent risk" and "residual risk" in Section 2 definitions.

21. <u>3.6.1 Developing or Modifying Risk Metrics</u>
We would note that indicators can be leading, lagging, or coincident and all three should be represented in this section. Additionally, the list does not mention the actuary considering the effectiveness of the risk metric.

RECOMMENDATION: Revise item e. to read "leading, lagging, or coincident indicator". Add a new item, "effectiveness of the risk metric."

22. <u>4.1 Required Disclosures in an Actuarial Report</u>
The item list is "if applicable," yet in item h. there is another "as applicable," which seems duplicative.

RECOMMENDATION: Revise subsection h to read, "the role the actuary played in the design, preparation, or review of an ORSA and in drafting or as signatory to ORSA report (see section 3.9)."

The Academy appreciates the efforts and engagement of the ASB within the ERM space and looks forward to our continued collaborative efforts to develop a framework that offers a pragmatic and forward-looking approach to this evolving area. If you have any questions or would like further information, please contact Will Behnke, the Academy's Risk Management and Financial Reporting policy analyst (behnke@actuary.org).

Sincerely,

Charles V. Ford
Chairperson
ERM-ORSA Committee
American Academy of Actuaries