AMERICAN ACADEMY of ACTUARIES

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January 7, 2015

Alan Seeley
Chair, Operational Risk (E) Subgroup
National Association of Insurance Commissioners
Via email LFelice@naic.org and JBarr@naic.org

RE: NAIC Operational Risk Proposal

Dear Mr. Seeley,

On behalf the American Academy of Actuaries,[1] the undersigned individuals[2] appreciate the opportunity to comment on questions raised during the National Association of Insurance Commissioner's (NAIC) Operational Risk (E) Subgroup call on December 4, 2014. Those questions include:

1. Would an industry survey on the amount of operational risk (OR) embedded in the current RBC factors have value?

   We believe that an "industry survey" to quantify the embedded OR in each RBC component would have limited value in advancing the NAIC's goal of quantifying the explicit amount of OR captured in the risk-based capital (RBC) formulas (with the exception of the C-4 Life RBC business risk component). Because individual companies are concerned with their specific exposures, insurers may not be up to date with the ongoing technical developments for the current RBC factors; as such, they would have very little insight on what is embedded in the current RBC formula for OR. The exposure bases for calculating RBC include multiple metrics, including premium, face amount, reserves, etc. Few insurers could adequately identify how their OR relates to the exposure base in the RBC formulas.

   In addition to the cost-benefit expense consideration of conducting such a survey, we have two primary concerns with conducting an industry OR survey: the definition of OR; and the quantification of OR.

   First, the draft survey discussed during the December 4 call did not include a definition of OR. The definition of OR for survey purposes must be both clear and specific if uniform and comparable results are to be gathered. OR by its nature varies in magnitude (severity and probability) by company as do the approaches companies use for classifying risk events and gathering data.

[1] The American Academy of Actuaries is an 18,000+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.
[2] The undersigned include the chairpersons of the Life Capital Adequacy Committee, Property and Casualty Risk-Based Capital Committee, and Health Solvency Work Group and Senior Life Fellow of the Academy.

Second, when considering the best way to develop OR charges for the NAIC's RBC formulas, it is critical for the regulators to remember that data on losses due to OR is virtually non-existent and, where available, significantly varies from one year to the next. In addition, we do not believe that many insurers would be able to quantify the amount of OR captured in their RBC calculation in aggregate or within each of the risk components. The factors of the regulatory RBC formula were developed from broad industry experience for the different risk categories.

The C-4 component in the Life RBC formula for general business risk is based on RBC factors applied to premium income, annuity considerations, and separate account liabilities. Due to the difficulty of quantifying the broad range of risks classified as general business risks, the Life RBC factors were not developed using a quantitative risk analysis with a targeted calibration level. Instead, the C-4 factors were developed using a rough estimate of a company's exposure to guaranty fund assessments without attempting to exactly mirror the assessment formulas.

ORs do not lend themselves to quantification in the same manner as financial and claim risks. Out of necessity, the development of risk factors for OR will involve judgment. Thus, we caution the NAIC to avoid an overly detailed analysis of OR that would lead to RBC charges based on a false sense of accuracy..

Some companies have developed an internal risk assessment that might include quantification of OR. In this regard, there could be some benefit in seeking input from companies on how they quantify OR for their own internal risk assessment purposes. If the Subgroup chooses to pursue this type of industry survey, we would be happy to assist the Subgroup in developing survey questions.

As an alternative to an industry survey, regulators could gain insights by reviewing results of other materials on OR. We suggest the NAIC review the following resources:

- Joshua Corrigan and Paola Luraschi, "Operational risk modelling framework," Milliman, 2013.
- "Economic Capital Modeling in the Insurance Industry: A solid foundation for future advantage?," Financial Services, KPMG, 2012.
- Neil Cantle, Dominic Clark, Jeremy Kent, and Henry Verheugen, "A brief overview of current approaches to operational risk under Solvency II," Milliman White Paper, Milliman, 2012.
- "Operational risk for insurers," Ernst & Young, 2011.
- "Chapter 12 Operational Risk," *Operational Risk Management*, Presentation, The GARP Risk Series, Global Association of Risk Professionals.
- OpRisk Advisory and Towers Perrin, "A New Approach for Managing Operational Risk: Addressing the Issues Underlying the 2008 Global Financial Crisis," Joint Risk Management Section (Canadian Institute of Actuaries, Casualty Actuarial Society, Society of Actuaries), 2009.
- "Operational Risk Management (ORM) Survey of U.S. Insurers," Insurance, KPMG, 2009.

2. Should strategic or reputational risk be included in definition of operational risk?

We do not think strategic risk or reputational risk should be included in the definition of OR. Strategic risk is the result of poor strategic decisions, such as entering a new market or choosing to offer (or not offer) a new product. Poor decisions or strategic failures can manifest in various aspects of an insurer's operations over time. Strategic risk is identified as a separate risk category in many risk taxonomies (e.g., the Global Association of Risk Professionals, Basel II, etc.) and is not included with OR. We do not see the value in creating another risk taxonomy.

RBC is a tool for identifying weakly capitalized insurers. Typically, insurers will manage strategic risk by holding free or vitality capital. We do not think it is possible to quantify the risks associated with a poor decision, especially when that decision resulted in doing nothing.

Reputational risk is considered to be a second order risk. It is a consequence of a risk event. As such, we do not believe that it rises to the level of being considered within the definition of operational risk.

In conclusion, we acknowledge the importance of considering the effects of OR when establishing regulatory capital requirements. However, it is important for the NAIC to consider the degree to which additional regulatory capital is the best mechanism for protecting policyholders from OR. Increasing capital requirements is not always the most effective means to mitigate the impact of certain risk events (e.g., liquidity, strategic risks, etc.).

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Thank you for this opportunity to provide additional feedback on the NAIC's operational risk questions. If you have any questions or would like to discuss these issues in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202.223.8196 or sarper@actuary.org

Sincerely,

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