AMERICAN ACADEMY *of* ACTUARIES

April 15, 2014

Alan Seeley
Chair, Operational Risk Subgroup
National Association of Insurance Commissioners

Dear Mr. Seeley:

The American Academy of Actuaries[1] Life Capital Adequacy Subcommittee (LCAS) appreciates the opportunity to comment on the Operational Risk Subgroup's March 20, 2014 exposure of a revised proposal that suggests a new "C-5" factor in the NAIC Life Risk-Based Capital (RBC) formula to provide for operational risk. Our comments are limited to those elements of the proposal affecting the Life RBC Formula.

The LCAS believes that the information obtained from risk-focused examinations and ORSA will provide more useful information to regulators about an insurer's operational risks and risk management practices than a new charge for operational risk. However, we understand the desire of the NAIC to incorporate a specific charge for operational risk into the RBC formulas to facilitate comparisons with solvency regimes in other countries. In our view, the Life RBC formula already contains a risk charge for many types of operational risk in the C4 component, but assuming the NAIC goes forward with a new operational risk charge, given the amount of analysis performed to date, we strongly believe that any changes to the operational risk charges for 2014 RBC calculations be informational only.

We have reviewed the eight types of operational risk contained in the new exposure. With respect to Life RBC, we believe that the majority of these operational risks are currently covered within the Life RBC formula. As noted in the Life section of the Academy's January 30, 2014 letter to the NAIC Operational Risk Subgroup, the current C4 factor covers "business risk," a term that comes from the Society of Actuaries' (SOA) risk taxonomy of the 1970's, which was incorporated into Life RBC as it was developed in the early 1990's. In current risk management taxonomy, "business risk" could be characterized as "operational risk." Therefore, we strongly suggest that the current C4 component of Life RBC be renamed "Operational Risk" to be more consistent with modern risk terms and international solvency regimes.

Further, if there were to be a new C5 charge for operational risk added to the Life RBC without a recalibration of aggregate capital requirements, we believe that the total RBC formula would be excessive.

[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.

We suggest the following enhancements to the current Life RBC formula for 2014 informational filings:

- Rename the C4 component "Operational Risk"

- Evaluate a modification to the current C4 component to capture Op Risk for reinsurers:

  The current C4 charge is based on direct life, annuities, and A&H premiums, with no offset for ceded premium or increase for assumed premium. Determining C4 from direct premium results in an understated operational risk charge for reinsurers whose premium is primarily "assumed." For the purpose of the informational filing, one option could be a revised C4 charge as follows: 50% of the current C4 factors applied to direct premiums, plus, an additional 50% of the current C4 factors be applied to net premiums (that is, direct plus assumed minus ceded). This change recognizes that operational risk can emanate from either party to a reinsurance transaction. This suggested change will have a greater impact on reinsurers, so analysis of the 2014 filings, along with input from industry and interested parties will be essential before any change is made to the Life RBC formula.

- Evaluate an additional charge in the current C4 component to explicitly capture risk from rapid growth:

  Rapid growth may be a source of additional operational risk exposure. The NAIC Operational Risk Subgroup draft of December 9, 2013 contained a charge of 3% of gross written premium in excess of 120% of the prior year's gross written premium. We suggest evaluating this additional charge in the 2014 informational filing. Quantitative analysis on the efficacy of this metric will be essential in order to justify an increase in the C4 component.

Additional information to support refinement of the Op Risk charge

We encourage the Operational Risk Subgroup to continue discussions with insurers and other interested parties to better understand how insurers quantify operational risk in their company's capital models. The Subgroup may want to consider conducting a written survey of insurers to better understand how operational risks are monitored and mitigated. There may be some useful key risk indicators that regulators could collect to provide insight into operational risk. For example, exposure to operational risk for life insurers tends to be related to transactions (e.g., number of policies issued or lapsed) or to the method of distribution (e.g., suitability and compliance issues). Further, these risks tend to be managed by business insurance (e.g., D&O, E&O insurance coverage) that will offset these risk exposures, if the risks materialize. Customized surveys for Life, Health, and P&C insurers that gather data about the typical sources of operational risk and how operational risk is mitigated will help refine the operational risk charges.

Additional information to support analysis of informational RBC filing

We encourage the Operational Risk Subgroup to consider how this information will be evaluated and refined. For example, the Subgroup should consider the following:

- What is a reasonable percentage of capital requirements to be allocated to operational risk? In 2012, the C4 component represented approximately 5.5 - 6% of total capital requirements, per the NAIC's Statistical Department. How much should the enhanced C4 component add to the total capital requirements?
- How will the Subgroup determine if the change helped to better identify weakly capitalized companies?

Conclusion

The Exposure states that after testing, "it may be decided that the current C-4 Business Risk charge will be retained…" As stated above, we believe that the Life RBC formula already contains a risk charge for many types of operational risk in the C4 component; therefore, the current C4 charge could be simply be rebranded "Operational Risk." We also recommend that potential enhancements to C4, described above, should be investigated and tested. Finally, we strongly recommend an informational only filing of the new operational risk charges in 2014 RBC filings.

The LCAS looks forward to continuing a dialogue with the Operational Risk Subgroup. Please contact John Meetz, the Academy's life policy analyst (meetz@actuary.org; 202-223-8196) if you have any questions.

Sincerely,

Jeffrey Johnson, FSA, MAAA
Chairperson
Life Capital Adequacy Subcommittee
American Academy of Actuaries

cc: Doug Slape
Commissioner Julie Rathgeber, Chair, NAIC Capital Adequacy Subgroup