AMERICAN ACADEMY *of* ACTUARIES

Objective. Independent. Effective.™

June 6, 2016

Alan Seeley
Chair, Operational Risk (E) Subgroup
National Association of Insurance Commissioners
Via e-mail to: LFelice@naic.org

Re: *Operational Risk 2016 Factors*

Dear Mr. Seeley:

On behalf of the American Academy of Actuaries'[1] Casualty, Health, Life, and Risk Management and Financial Reporting subgroup coordinating cross-practice responses to certain RBC matters, we offer the following comments on the Operational Risk 2016 Factors document that was exposed for comment by the National Association of Insurance Commissioners' (NAIC) Operational Risk (E) Subgroup on April 11, 2016.

The Academy appreciates the opportunity to comment on the proposed Operational Risk factors to be included in the risk-based capital (RBC) formulas on an informational basis for 2016 reporting. We understand that an insurer's capital position can mitigate operational risk, in part, and are supportive of the NAIC's ongoing efforts to explore the explicit recognition of operational risk in the RBC formulas. In acknowledging this, we note the following important considerations:

First, the RBC formulas already implicitly capture some degree of operational risk, and as such, care needs to be taken to avoid double-counting this risk in the formula should additional operational risk charges be explicitly incorporated. The current Life formula C4 charge covers general business risk, including operational risk. The R4 and R5 charges in the P&C formula, as well as the H4 charge in the Health formula, include growth risk which is tied to operational risk. The NAIC should adjust the formulas as they relate to the existing factors which cover business/growth risk in order to accommodate explicit Operational Risk factors, avoid double-counting, and capture the total amount of required capital deemed necessary for operational risk.

[1] The American Academy of Actuaries is an 18,500+ member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted 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.

Second, the design and calibration of the formulas with respect to explicit Operational Risk factors should be carefully considered, and the basis and rationale for these should be made clear to stakeholders. A few specific questions to consider include:

- What is the rationale for the current calibration and selected exposure bases of the informational factors? What information will be used to evaluate the appropriateness of these calibrations and exposure bases? If explicit factors are approved, how will the effectiveness of these factors be evaluated and updated if the basis has not been defined?
- Related to exposure bases, how will reinsurance be handled, where direct premium is an inappropriate exposure basis relative to risk? Note that the existing Life C-4 component is calculated using direct premiums because guaranty fund assessments are calculated from on direct premiums. However, some companies (e.g., reinsurers) do not report direct premiums and therefore, do not hold any required capital for operational risk.
- Are the informational factors intended to represent pre- or post-covariance factors? We submit that operational risk is not 100% positively correlated with the other risks captured in the RBC formulas; therefore, any explicit operational risk factors introduced in the formulas must be subject to the covariance adjustment.
- What is the benefit of using multiple operational risk factors and exposure bases within a given formula? Considering that increased granularity drives increased complexity in defining and calibrating the factors, and may even create a false sense of precision, would it be more reasonable to reflect operational risk in the RBC formula through a simple, single factor?

Lastly, capital serves the function of absorbing unexpected losses generated by a risk manifesting itself in "tail" events. Risk-based capital identifies weakly capitalized companies through the measurement of risk exposures that fall outside statutory reserves, but does not attempt to measure risk exposures that constitute catastrophic events in the extreme tails. Providing for after-the-fact loss absorption, while important, is generally not regarded as the primary way to mitigate operational risk. The nature of operational risk is such that the most appropriate and effective way to manage the risk is through before-the-fact risk mitigation activities performed as part of a robust risk and control framework. We urge the NAIC to recognize the relatively lesser importance of capital as an operational risk mitigant through sensible design and calibration of the formulas and by placing principal focus on the Own Risk and Solvency Assessment (ORSA) and other appropriate supervisory tools.

Going forward, we pose the following additional questions and considerations for you to consider: How does the NAIC intend to evaluate the effectiveness of the proposed capital requirement for operational risk, however defined? The 2016 RBC filing will be the third informational filing with an explicit operational risk charge. How will the NAIC evaluate whether or not the charge is sufficient and provides regulators with a better perspective on identifying weakly capitalized companies? While we support the increased emphasis being placed on improving the measurement and understanding of an insurer's operational risk, we think that operational risk and its control are an integral part of running a business. Therefore, we think it is important to carefully consider the degree to which operational risk contributes to an insurer's solvency risk.

*****

Thank you for this opportunity to provide our views on the NAIC's Operational Risk 2016 Factors exposure. If you have any questions or would like to discuss this letter in more detail, please contact Nikhail Nigam, the Academy's policy analyst for risk management and financial reporting, at 202.785.7851 or nigam@actuary.org.

Sincerely,

Elizabeth K. Brill, MAAA, FSA
Chairperson, Solvency Committee
Risk Management and Financial Reporting Council
American Academy of Actuaries

Tim Deno, MAAA, FSA
Chairperson, Health Solvency Subcommittee
Health Practice Council
American Academy of Actuaries

Tom McIntyre, MAAA, FCAS, CERA
Chairperson, Property/Casualty RBC Committee
Casualty Practice Council
American Academy of Actuaries

Wayne Stuenkel, MAAA, FSA, CERA
Chairperson, Life Capital Adequacy Committee
Life Practice Council
American Academy of Actuaries