AMERICAN ACADEMY *of* ACTUARIES

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December 19, 2016

Mr. Alan Seeley
Chair, Operational Risk (E) Subgroup
National Association of Insurance Commissioners

Re: Proposed Operational Risk Factors and Growth Charge for the Life RBC Formula

Dear Mr. Seeley:

The Life Operational Risk Work Group of the American Academy of Actuaries[1] appreciates the opportunity to share our views on the NAIC's Operational Risk Subgroup's Oct. 17, 2016, exposure draft that proposes changes to the Life Risk-Based Capital (LRBC) formula. Specifically, while we recognize the need to improve the measurement of Operational Risk (OR) in the LRBC formula and align with other jurisdictions, we continue to oppose the add-on approach in favor of an improved proxy-based approach, for the reasons listed in our Oct. 31, 2016, letter.

However, if the exposed add-on approach is pursued, we would like to point out some things that we believe warrant further consideration. Finally, we offer comments on the informational growth charge under consideration for the LRBC formula.

General Comments on the Exposed Add-On Approach

It is our understanding that the exposed add-on approach would work as follows:

1. The Company Action Level (CAL) RBC after covariance would be calculated as it is currently;
2. The Gross OR charge is equal to X% of the amount in step 1 (3% is the exposed recommendation), yielding the OR Floor;
3. The OR Floor from the second step would be compared to the existing C-4a amount. If the OR Floor is greater, an add-on would be made to CAL RBC, equal to the excess of the OR Floor over C-4a; and

[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.

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4. If the OR Floor is less than the existing C-4a amount, there is no additional add-on charge.

While we continue to have overall concerns about an add-on approach in general, as expressed in our previous letters and as detailed later in this letter, we do recognize that this exposed approach does in many ways follow the add-on floor construct that we proposed in our Oct. 31, 2016, letter as a suggested way to incorporate any such add-on approach adopted in concept. We would, however, offer the following suggested considerations to the exposed approach:

- Change the name of the C-4a charge to be "Operational Risk" or "Business and Operational Risk."
- Any additional charge arising from the add-on floor should be named "Additional Operational Risk Margin" or "Supplemental Operational Risk Charge."
- Consider a construct that recognizes the operational risk exposure for reinsured business, such as the application of a charge to net retained business as opposed to directly written business.
- Consider calculation of the add-on floor to LRBC *excluding the current C-4a and the current C0 charges* (currently, it is applied to LRBC after C4 and C0 are added on); a calculation of the floor as 3% of LRBC inclusive of C4 and C0 would potentially double-count a portion of OR; this modification would address that.

Concerns With an Add-On Approach

Based on the latest RBC statistics released by the NAIC (*Aggregated Life RBC and Annual Statement 2015 Data),* the C-4a amount for a number of insurers will be greater than the OR Floor; consequently, the add-on would be zero for those insurers. Consequently, should the 3% level be chosen for the add-on floor calculation, we believe that such a floor would serve the meaningful purpose of only increasing OR charges in unique and/or idiosyncratic situations (such as companies in run-off or those that have years where they write very little premium in the normal course of business).

We would like to reiterate, however, that we continue to have concerns with an add-on approach, should that ever become the *primary determinant* of the OR charge. Those concerns are as follows:

- The concept behind the add-on approach is that an insurer's exposure to OR is proportional to other risks. Consider, for example, the treatment of investment activities in the add-on approach. As illustrated in the NAIC's RBC statistics cited earlier, the C1 component establishes capital requirements for certain investment risks and represents more than half of the aggregate life industry capital requirements. Therefore, by extension, more than half of the operational risk charge would be based on investment activities under the add-on approach. However, there is no basis (quantitative or expert judgment) that suggests that more than half of a life insurer's OR arises from investment activities.

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- The add-on approach does not allow for OR differentiation among different products or different lines of business. It is a rudimentary representation, or may even be a significant misrepresentation, of an entity's actual OR exposure.

- The add-on approach does not recognize OR exposure that arises from many activities that are not directly captured in financial statements (e.g., fraud, misrepresentation, bad sales practices, cyber-risk, etc.)

- Developing a justifiable level for the gross OR charge (e.g., 3%), using either a sound qualitative or quantitative line of reasoning, will be challenging.

In general, we continue to support a proxy-based approach to reflecting OR in the LRBC formula, and believe that the C-4a charge in the current LRBC formula provides an adequate and reasonable construct (with the potential modifications suggested earlier in this letter).

Additionally, as highlighted in our July 27, 2016, and Oct. 31, 2016, comment letters, we continue to believe that, industrywide, there is a need for a more robust analysis of operational risk drivers and impacts. We are committed to contributing to this effort; the results of such analysis may inform, among other regulatory items, the ongoing incorporation of OR into RBC.

Suggested Modifications to Mechanics of Exposed Approach

This exposed approach is expected, in most cases, to result in a higher CAL for an insurer with downstream subsidiaries or that had entered into certain reinsurance arrangements with affiliated companies. There are several situations involving reinsured business and/or subsidiary companies whose LRBC rolls up to a parent for which this add-on construct will result in an operational risk charge that includes double-counting of certain items. We believe this consequence is not intended and would suggest the following modification to the calculation to address the problem:

The double-counting arises because the CAL of the subsidiary is included in the CAL of the parent, and thus, the OR of the subsidiary is included in the parent. Two examples illustrating this are shown in the attached appendix:

- A parent insurer cedes business written directly to a subsidiary. Because the subsidiary has no direct premium, there is no C-4a offset to the OR charge for the subsidiary, so the full 3% OR charge arises. Thus, the total OR has increased for the parent due to the reinsurance of the business to the subsidiary.

- The parent company and the subsidiary company both write direct business. The aggregated OR charge is larger for the parent when compared to the situation in which the business is written directly by an unrelated company on a stand-alone basis.

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The proposed revision to the OR calculation does two things:

- Excludes the C0 charge of the sub (i.e., CAL of the sub) when determining the OR charge for the parent.
- Splits the C4 charge used for the purpose of determining the C4 offset between the parent and sub in proportion to the amount of the premium in each company.

As shown in the attached examples, these two modifications remove the double-counting of the OR charge.

While we propose that the above modifications to the calculation address the double-counting issue for insurance subsidiaries, we suggest a more detailed review by regulators and other interested parties to ensure that all idiosyncratic (but possible) situations are properly reflected in the LRBC formula.

General Comments on the Growth Charge (Informational Exposure)

It is our understanding that the exposed growth charge would be calculated, as follows:

1. A factor (which currently appears to be 5%) would be applied to any direct and assumed premiums in excess of 120% of the prior year's direct and assumed premiums; and
2. The result would be added onto LRBC, similar to the way C-4a is currently reflected.

While we acknowledge that significant growth at a life insurance company may be of concern to regulators, we do not believe increasing capital requirements is the best approach to mitigate the potential risk or to alert regulators of the situation. Significant growth is not a "first order" risk in the classical definition of risk. Rather, significant growth would be considered more of a "second order" risk that may increase exposure to other risks (e.g., mechanical or processing errors). In the RBC formula, each component represents the amount of capital deemed necessary to protect statutory surplus from a predefined level of risk. For example, the C-1 component protects statutory surplus from a specific level of bond losses in the event of default. If additional capital is required for significant growth, what loss is being absorbed?

While we recognize the need for a regulator to be alerted to an insurer undergoing significant growth, we believe that other methods exist to identify significant growth. For example, the trend in the RBC ratio or other indicators may provide regulators with better information than increasing capital requirements based on premium growth. Written premium may not be the best representation of growth in a life insurance company, especially for insurers with material annuity business due to irregular single premium deposits, pension risk transfer business, or other circumstances.

As currently designed in the informational exposure, we believe the growth charge will be a poor indicator of risk and will provide misinformation to regulators. We recommend that the NAIC explore alternative indicators as well as smoothing methods (i.e., averaging or excluding

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significant non-recurring premium). Otherwise, this approach will likely have significant unintended consequences and will not provide good information to regulators.

We remain committed to assisting the NAIC in this matter, but continue to oppose the add-on approach to capture OR and increasing capital requirements for significant growth, as expressed in our July 27 and Oct. 31 comment letters.

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Thank you for the opportunity to comment. If you have any questions or would like to further discuss these topics, please contact Amanda Darlington, life policy analyst, at darlington@actuary.org.

Sincerely,

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Cc: Lou Felice, Solvency and Capital Policy Advisor, NAIC
Philip Barlow, Chair, NAIC Life RBC Work Group

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