



AMERICAN ACADEMY *of* ACTUARIES

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July 27, 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 Actuaries¹ appreciates the opportunity to share our views on how operational risk (including a prospective growth charge) might be better reflected in the Life Risk-Based Capital (LRBC) formula. As we mentioned during our call with you and Lou Felice on May 24, 2016, we have been monitoring the activities of the NAIC's Operational Risk Subgroup and offer our assistance in the development and refinement of operational risk (OR) and growth charges for the LRBC formula. While these comments are submitted on behalf of the Life Operational Risk Work Group, we have also been coordinating our efforts with the Academy's cross-practice work group on operational risk.

In particular, we'd like to offer our assistance to the NAIC in refining the charge for growth and OR that satisfies our understanding of the NAIC's objectives regarding the life RBC formula. In addition, we believe that OR and the growth charge should:

- Give appropriate consideration to the existing C-4 charge for "general business risk," noting that this C-4 charge incorporates OR, and that the other existing RBC charges also incorporate OR to some extent. We believe particular care needs to be taken to avoid double-counting of OR within the LRBC formula;
- Consider the advantages and disadvantages of a proxy-based approach versus an add-on approach for calculating an OR charge;
- Consider the viability of a growth charge in the LRBC formula, recognizing the different nature of life, P&C, and health insurance; 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.

- Consider the correlation of OR relative to other risks in the LRBC formula (i.e., should OR be part of the LRBC covariance adjustment?).

Given the above considerations, as well as the NAIC’s objectives to incorporate an explicit OR charge within the various RBC formulas to satisfy, in part, concerns raised in the Financial Sector Assessment Program (FSAP) review of the U.S. insurance regulatory system and to make the U.S. RBC formula more comparable to solvency requirements in other jurisdictions, we suggest a two-part approach for incorporating OR and the growth charge for LRBC.

Phase I

The first phase could be implemented as soon as practicable and involves the following:

- Change the name of the current C-4 component to “Operational Risk” or to “Business and Operational Risks” in order to formally recognize the operational risk already captured in the formula;
- Consider applying the OR charge to net premiums (as opposed to direct premiums, which are used in the current RBC formula) to capture OR for business that does not generate direct premiums (e.g., reinsurance) but is exposed to OR; and
- Consider adding a growth charge to the LRBC formula, including evaluation of the ACLI’s proposed growth charge. We intend to send a separate letter to you with our thoughts on adding a growth charge to the LRBC formula.

This first phase contemplates little change in the amount of capital required for OR for the industry as a whole and for many insurers, because the current RBC formula would be largely unchanged (pending a decision on a growth charge). We recognize that the approach in this first phase is a refinement of the current LRBC approach for capturing OR and does not specifically match the structure contemplated by the informational filings conducted by the NAIC for 2014-2016. Leaving the LRBC formula largely unchanged is reasonable because, as discussed extensively in other forums and comment letters, the existing “C-4 Business Risk” component in the LRBC framework already captures operational risk; therefore, certain suggested C-4 changes to the LRBC formula are not necessary, such as the changes being considered with the informational factors under consideration by the NAIC’s Operational Risk Work Group. We also recognize that this first phase would reduce the number of life companies that do not have a C-4 / OR charge by changing the premium definition from direct to net, which, on balance, we believe to be an improvement in how OR is recognized across the industry.

This slightly modified approach to calculating an OR charge is an add-on or proxy-based approach (i.e., one where it would be assumed that approximately X percent of total RBC should be attributable to OR). There may not be sufficient data to support a proxy-based approach (or modifying the factor to back in to a proxy-based approach result, e.g., choosing a factor level in such a way that, industrywide, you’d end up with approximately X percent of RBC being attributable to OR) at this time. We will continue to study possible improvements as operational risk data is examined further across the industry. In addition, this approach does not change the treatment of the OR charge in the LRBC covariance adjustment, as we have not seen significant

quantitative evidence to support such inclusion. This approach leaves the OR charge outside the covariance adjustment. We will continue to study any operational risk data points that might suggest otherwise and continue to contemplate possible enhancements to the formula.

Phase II

In the second phase, we propose to assist the NAIC in developing a rigorous approach to defining, monitoring, and ultimately determining appropriate capital charges and other mitigating factors for operational risk. We envision this occurring through a multiyear project open to all interested parties, and comprising the following key steps:

- Develop a clear definition of operational risk, including sources and manifestations of operational risk;
- Identify appropriate applications of risk management best practices to operational risk (e.g., data collection, reporting, mitigation, etc.);
- Create an operational risk taxonomy that will allow for clear and consistent benchmarking to be performed across industry;
- Implement forms of risk mitigation (e.g., Directors & Officers Insurance, Errors & Omissions Insurance, risk control procedures, etc.);
- Investigate alternative formulations for an OR charge for RBC, including the structure of the OR informational filings, further consideration of calibration (e.g., 3 percent of total RBC) to international regimes, and consideration of the correlation of OR with the other risks in LRBC (C-1 – C-3); and
- Create a framework for the type of clear and specific operational risk information that should be included in ORSA.

We have not yet developed a specific project plan or timeline for Phase II, but are willing to adjust our research efforts to coordinate with discussions being conducted by your working group. Our work group has started discussions on a potential growth charge and will provide our thoughts in a separate communication, including consideration of the ACLI's proposal. We anticipate providing that communication on a life growth risk charge within the next few months.

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,

Brian O'Neill MAAA, CFA, CERA, FSA
Chairperson, Life Operational Risk Work Group
American Academy of Actuaries

Cc: Lou Felice, NAIC