AMERICAN ACADEMY *of* ACTUARIES

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October 31, 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 how operational risk might be better reflected in the Life Risk-Based Capital (LRBC) formula. In response to the NAIC's Operational Risk Subgroup's move toward an add-on approach to incorporate Operational Risk (OR) into the LRBC formula, we offer here a number of comments on the prospective implementation of that approach.

Summary of July 27 Life OR Work Group Comment Letter

In our July 27 comment letter, we recommended a two-phased approach to ultimately incorporating the appropriate OR capital charge into LRBC, where Phase I 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 OR already captured in the LRBC formula;
- Consider a construct for capturing OR for business that is assumed, such as the application of an OR charge to net (that is, direct plus assumed minus ceded) premiums, rather than direct premiums (direct premiums are used in the current LRBC construct); this would capture OR for business that does not generate direct premiums (e.g., reinsurance assumed) but is exposed to OR; and
- Consider adding a growth charge to the LRBC formula. We intend to send a separate letter to you with our thoughts on adding a growth charge to the LRBC formula.

[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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In Phase II, we proposed assisting the NAIC in developing a rigorous approach to defining, monitoring, and determining appropriate capital charges for OR. Some goals of Phase II would be to:

- Develop a clear definition of OR, including sources and manifestations of OR;
- Identify appropriate applications of risk management practices to OR (e.g., data collection, reporting, mitigation, etc.);
- Create an OR taxonomy that will allow for clear and consistent benchmarking to be performed across industry;
- Identify forms of risk mitigation (e.g., risk control procedures, insurance arrangements with unrelated parties, etc.);
- Research what OR databases exist in the market and how well built out they are;
- Research historical losses related to potential events in the OR framework;
- Investigate alternative formulations for an OR charge for LRBC, 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
- Evaluate the type of clear and specific OR information that life insurers are disclosing in their ORSA filings and, where applicable, provide commentary to the NAIC.

Comments on an Add-On Approach

We understand that there are advantages and disadvantages to proxy-based and add-on approaches to determining the OR LRBC charge. If an add-on approach is used as the basis going forward, for example, we believe that adding a factor to the current life C1 charge might be inappropriate because the C1 risk does not necessarily increase OR exposure as implied by this approach. Across industry, C1 accounts for approximately half of LRBC, so this approach might imply that an increase in Asset/Credit risk exposure would lead directly to an increase in OR exposure, which might not be a supportable conclusion. Additionally, the add-on approach would not allow for OR differentiation among different products or different lines of business. An add-on approach would, however, be straightforward to apply, but it may be a somewhat rudimentary representation, or even a significant misrepresentation, of an organization's actual OR exposure. Also, a simple add-on approach would not take into account the current life C-4 charge, which many stakeholders view as a proxy for a business and OR charge. While we continue to recommend the Phase I/Phase II approach suggested in the earlier sections of this letter, we believe that our recommendation could align with the add-on approach as follows:

- Leave the current C-4 charge unchanged and change the name to "Operational Risk" or "Business and Operational Risks;"
- Consider a construct that might more appropriately recognize assumed and ceded business;
- Consider incorporating an adjustment to reflect significant organic growth; and
- Consider an add-on formula as a floor; specifically, perform the add-on calculation by applying an add-on factor to LRBC, calculated ignoring C4; separately, calculate C4; the

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final OR charge would be equal to the greater of C4 or the amount by which the add-on factor increased LRBC (when the calculation is done ignoring C4)

We believe this approach will not require significant changes to the Statutory Blanks and/or the processes used to calculate LRBC across industry. It also remains auditable and provides a charge (C4) that has a basis grounded in sound analysis. Further, it allows for the recognition of OR in LRBC in the short-term while long-term potential modifications to the charge are evaluated (i.e., items that we might expect to be captured in Phase II of our work, as noted above).

Finally, as these suggested changes or, more generally, any LRBC modifications are implemented, we encourage the NAIC to consider the financial impact to large individual organizations and across industry. One option might be to perform a before and after LRBC change study as part of the implementation of any changes. We would be happy to assist the NAIC in conducting such a study.

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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,

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

Cc: Lou Felice, Solvency and Capital Policy Advisor, NAIC