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May 25, 2017

Mr. Alan Seeley
Chair, Operational Risk (E) Subgroup
National Association of Insurance Commissioners
Via email: lfelice@naic.org

Re: Commentary on Implementation and Ongoing Monitoring of the Life Risk-Based Capital (LRBC) Operational Risk Factor

Dear Mr. Seeley:

The Life Practice Council Operational Risk Work Group of the American Academy of Actuaries[1] continues to appreciate the opportunity to share our views on the exposed Operational Risk (OR) charge to be implemented in the 2017 filing year in the LRBC formula. While we recognize the desire to align the measurement of OR in the LRBC formula with the measurement of OR under other regulatory frameworks, we would like to briefly reiterate our views (as laid out in previous letters) about the structure exposed, the documentation, and areas to consider for future updates to the operational risk RBC charge.

We understand the objective of the NAIC's OR Subgroup and accept the direction taken by the subgroup. That said, in the following letter, we have outlined four main areas to consider for future updates that we believe, if pursued, can lead to a more technically sophisticated and appropriate OR charge:

1) Review methodology for growth charge;
2) Consideration of double-counting issues;
3) Creating clear and concise documentation; and
4) Review use of an add-on approach.

**<u>Review Methodology for Growth Charge (Informational Exposure)</u>**

The exposed OR growth charge was informational only, but we believe further investigation is needed. While we have summarized some of our concerns in a previous letter,[2] we will be

[1] The American Academy of Actuaries is a 19,000-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.
[2] American Academy of Actuaries, "ORWG Comments to the NAIC on Proposed Operational Risk Factors and Growth Charges for the Life RBC Formula," Oct. 31, 2016.



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sending a separate letter outlining our comments on the informational growth charge and suggestions for further analysis. In short, we believe additional consideration should be given to i) the specific definition chosen for growth; ii) the level of growth chosen, which would trigger a charge; and iii) the level of charge that is applied if a charge is triggered. We are concerned that the potential for writers of certain products (e.g., single premium products) might be disadvantaged unfairly under the currently exposed (information only) structure. We look forward to working on these issues in the coming months.

**Consideration of Double-Counting Issues**

We have communicated previously what we believe to be a potential double-counting issue with the current proposal for the LRBC OR charge.[3] We are pleased that you plan to address the issue with the 2018 Life RBC filing and have created additional illustrations to discuss with you in the coming months. As a reminder, we essentially believe that a double-counting issue may potentially exist in situations where a subsidiary writes direct business and that subsidiary "rolls up" to a parent company. We look forward to working on this issue in the coming months.

**Creating Clear and Concise Documentation**

All elements of the RBC formula are subject to review and refinement over time. Part of this process is to review the documentation of the methodology, assumptions, and decisions that went into the development of the factors. Consequently, it is important that the documentation include a robust discussion of the methodology, factor choice, and other issues considered in the choice of the final factor.

While Attachment 5 of the materials accompanying the OR Subgroup's March 20, 2017, conference call is a good start, additional documentation is needed for the levels chosen for the various metrics affecting the OR charge (e.g., the 3 percent for the add-on floor, the 20 percent for the growth charge threshold). This documentation would help a reviewer to understand the thinking/basis for their selection. In addition, more robust documentation will provide a basis for the review and potential refinements of the OR factors.

**Review Use of an Add-On Approach**

As we have stated in a prior letter,[4] we have concerns with an "add-on" approach, should the basic OR charge ever increase to a level where the basic charge (currently exposed at 3 percent) become anything other than a floor. The current Life RBC formula contains a proxy-based OR charge (the C-4 Business Risk) and we have seen no rationale for changing from this proxy-based charge to an add-on approach. For reference and documentation, our concerns are as follows:

- The concept behind the add-on approach is that an insurer's exposure to OR is proportional to other RBC risks. Consider, for example, the treatment of investment activities in the add-on approach. The C-1 component establishes capital

[3] American Academy of Actuaries, "ORWG Comments to the NAIC on Proposed Changes to Life RBC," March 17, 2017.
[4] American Academy of Actuaries, "ORWG Comments to the NAIC Regarding the Add-on Approach," Dec. 19, 2016.



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requirements for certain investment risks and has represented approximately 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.

- The add-on approach does not allow for OR differentiation among different risks, products, or 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 percent), using either a sound qualitative or quantitative line of reasoning, will be challenging.

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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 Heather Jerbi, assistant director of public policy, at jerbi@actuary.org.

Sincerely,

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

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



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