June 23, 2015

Alan Seeley
Chair
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RE: OPERATIONAL RISK CHARGE IN THE NAIC RISK-BASED CAPITAL (RBC) REQUIREMENTS – Comments on the Current Proposal

Dear Alan,

Below are comments on your current proposal on calculations of the operational risk charges in Risk-Based Capital on an informational basis only for year-end 2015. We hope that you will find our observations and recommendations useful.

Improving and Expanding the Calculation of Operational Risk Charge in RBC

The importance if improving the way solvency risks are reflected in the NAIC Risk-Based Capital requirements is difficult to overestimate. We admire your work on one of its most difficult elements of this work, that is, finding the optimal way to reflect *Operational Risk* in RBC.

Related to the current proposal and decisions that still have to be made, we believe that it will be beneficial to provide further guidance to insurance companies on what risk elements are intended to be reflected in the capital requirements and what risk elements are best managed through only risk policies and controls. Some of this discussion has already taken place, but the industry still does not have full clarity on these issues. In addition, even the definition of operational risk remains open to debate or at least interpretation.

We suggest that the discussion process continue and that additional guidance be provided to the industry. We also note that some elements of the operational risk are already included, at least to some degree, in the existing RBC charges.

For example, on the P/C side, the operational risk part of more general risk of *Underestimating Loss Reserve Liabilities* is intended to be reflected, to a significant degree, in the reserving charges. Other types of risk may not currently be reflected in RBC and should be carefully considered. For example, *Cyber Risk* is a relatively new threat but is growing rapidly and should be carefully managed as a true solvency risk. Also, there remains at least some lack of clarity on whether and how each specific type of operational risk is or can be reflected in RBC, and whether some types of risks should be in RBC at all. Providing further clarity on the *definition* of operational risk and dealing with some of the more difficult examples of risk would benefit the process and may also have benefits to insurers in other areas, such as in Enterprise Risk Management (including the NAIC ORSA). We believe that while some decisions have been made and many of these discussions have taken place, the discussions have to continue. However, we do not believe that the considerations above should affect going forward with this specific proposal.

Specific Comments and Recommendations Related to the Current Proposal

Please note that our comments are limited to some of the elements of the proposal related to the calculation of Operational Risk charges for P/C insurance companies.

1. The current proposal indicates that the calculations are intended to be for informational purposes only and that additional analysis will be "performed in 2015 and 2016 before final factors are proposed."
   - We are concerned that the reference to "final factors" may create the impression that decisions on the methodology or choices related to methodologies have already been made, and that the general calculation of the charges will be based on one of the formulas included in or referenced in the proposal. We do not believe such definitive decisions have been made. Consequently, we are concerned that the current proposal may be sending a message to the industry that has never been intended. This concern is probably not limited to the P/C RBC calculation.
   - We suggest that the language referencing "final factors" be changed or that additional explanatory or qualifying statements be added. Otherwise, this seemingly minor detail of the proposal language, considered in conjunction with the rest of the proposal and other proposed changes to RBC, may potentially have significant unintended consequences for some insurance companies.

2. The calculation (PR028 L12), in the Reference column, shows the formula that can result in negatives values. While we limit our comments to the P/C RBC calculation, non-P/C calculations seem to show similar formulas.
   - We suggest changing the formula from the way it is currently shown to explicitly describe that negative values (negative premium growth) are not intended to be considered. Otherwise, it is both inconsistent with how calculations are described elsewhere in RBC and may also be easily misinterpreted, despite what appears to be correct description in the previous column.
   - We suggest that the same point be directly communicated to the software package developers even if the current language remains unchanged.

3. The description of the operational risk calculations in the current proposal states, "During testing specific consideration will be given and comparisons made to the methodology behind growth risk charge under R4 and R5 on lines (13) and (14) on page PR015, Excessive Premium Growth of the Property and Casualty RBC formula and any operational risk that is currently included therein."
   - We see this description as implying that the only comparisons to be made are those with any operational risk included in the specified charges and, even more narrowly, in the growth charges. We are unclear whether this is the statement intended to be made. We understand that other interpretations of the current language are also possible.

- In general, we strongly believe that the current RBC calculation already includes some significant elements of operational risk in a number of places within individual risk charges and certainly in more than only one or two of the risk charges.

We intentionally do *not* provide specific comments or recommendations[1] related to the formulas or the factors used in the current proposal. We believe that in the very limited timeframe, it is impractical to reopen this difficult discussion and still meet the deadlines for year-end filings or to provide sufficient guidance to the industry.

Operational Risk in RBC: The Next Step

Your work on the improving the way operational risk is reflected in Risk-Based Capital is very important. It is also very challenging. There has been much less constructive input compared to the amount of criticism related to any proposal related to operational risk charges in Risk-Based Capital. This is mostly a sign of how difficult your task is.

We urge you to go ahead with the introduction of the proposed operational risk charge calculation in RBC, at this point for informational purposes only, even though some critical decisions have not been made yet and despite any specific element of your approach possibly seen as inadequate, whether by the industry or by you. Moving forward on this issue is essential. We are glad you are doing so while remaining open to new ideas and revisions of the currently proposed approaches, and with the expectation that future modifications will be necessary.

Please note that these comments and recommendations represent my personal views and are not intended to reflect the position of the P/C Risk-Based Capital Committee of the American Academy of Actuaries, which I chaired until approximately a year ago, or the CAS Task Force on Cyber Risk, which I currently chair. These personal views should not be seen as a public policy statement, nor as a position taken by any of these two organizations.

Sincerely,

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[1] In addition, these comments are limited to some of the elements of the proposal related to the calculation of Operational Risk RBC charges for P/C insurance companies.