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June 9, 2016

Mr. Alan Seeley
Chair, Operational Risk Subgroup
National Association of Insurance Commissioners
Attn: Jane Barr
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197
Via E-mail: JBarr@naic.org

Re: Proposed Operational Risk Factors 2016 Reporting

Dear Mr. Seeley:

The National Association of Mutual Insurance Companies (NAMIC) appreciates the opportunity to comment on the Operational Risk Factors proposed for the informational filing for year-end 2016.

NAMIC is the largest property/casualty insurance trade association in the country, with more than 1,400 member companies representing 40 percent of the total market. NAMIC supports regional and local mutual insurance companies on main streets across America and many of the country's largest national insurers. NAMIC member companies serve more than 170 million policyholders and write nearly $225 billion in annual premiums. Our members account for 54 percent of homeowners, 43 percent of automobile, and 32 percent of the business insurance markets. We have several thoughts about this exposure that apply generally to the concept of operational risk and specifically to the changes proposed to the property-casualty formula.

The comment request from the Subgroup relates to the proposed risk charge to be applied and the structure of the informational filing for an operational risk charge that is under consideration for addition to RBC. The Subgroup has been discussing this for a couple of years, but we feel it remains important with each exposure of issues related to this charge that we go back to the basic problems with an RBC charge for operational risk and express those clearly to the subgroup. This exercise may help us find the best approach to addressing operational risks. NAMIC asserts that the solution may not be in an addition to risk based capital.

I. More Capital is Not the Answer to Operational Risk

First and foremost, operational risk is a subjective risk that can have very minor impacts or very significant impacts. In the event operational risk evolves, the current enterprise risk management system works to find ways to limit, mitigate, or transfer the risk to minimize the impact on the enterprise. This is a completely subjective process that is unique to each organization and one that is not addressed by holding extra capital. Further, the new Corporate Governance Annual Disclosure model act is aimed at addressing a significant portion of potential operational risk in a manner that is more suited to the qualitative nature of operation risk. A capital charge seems both

arbitrary and redundant. The best regulatory approach to such a situation is a supervisory one, not a capital based approach.

In previous joint industry letters to this subgroup, NAMIC has joined the industry in stating that increased capital is not the best or most effective approach for addressing a qualitative risk, such as operational risk. In a risk-focused world, we believe the better approach would be to include enhanced regulatory oversight of targeted companies. This may include leveraging existing financial examination, financial analysis, and review of ORSA, the CGAD and Enterprise Risk reports to identify the response to operational risks. And it may include communications with Internal Audit functions within firms to determine if appropriate controls are being put in place. This would provide the best regulatory means of helping companies achieve operational excellence.

II. If Capital Charge Used – Capital Neutral

Secondly, even if the subgroup determines that there is no way to avoid some sort of capital charge for operational risk, this subgroup has had multiple conversations over the years that reveal no overall weakness in the RBC formula. Several have testified over the years that the operational risk you seek is embedded in existing RBC premium and reserves capital requirements in various expense factors that are inherently part of the RBC formula. We have discussed the existing excess growth risk factor specifically, but the cost of fraud, IT issues, training, employee turnover, succession planning, legal and monetary controls and other basic operational controls are built into each company's existing expense structure that is captured in policyholder premium or loss adjustment expense under reserves. Any proxy or add-on approach that is applied to arrive at an estimate of an operational risk capital charge unless supported by proof that capital levels are inadequate must be capital neutral to recognize the current existence of adequate embedded capital within premium and reserve capital calculations.

III. Option to Develop an Operational Risk Calculation

We propose that a possible solution to the problem set forth above could be removal of operational risk as a direct RBC <u>requirement</u> and instead utilizing an operational risk <u>calculation</u> much like the approach the Group Capital Calculation Working Group is taking to address international pressures to have data related to group capital. This hybrid approach to capital could inform the Subgroup as it evaluates options for developing an operational risk charge over the next several years. This calculation combined with information developed by the ORSAs filed over the next several years could provide more meaningful information for regulators about addressing operational risks within organizations.

This approach may help regulators develop a methodology to analyze the actual strength of the company's internal controls for operational risk. As part of the financial analysis function, there are supplemental procedures included in the Financial Analysis Handbook that are designed to identify potential areas of concern. The analyst is supposed to become familiar with the insurer's plans to reduce unplanned operational risk. A calculation of operational risk could be tested against the findings of the analyst to assess any correlation. Then the work of the analyst could be used to determine whether a company exhibited weak operational controls that would eventually subject them to additional capital requirements. Based on the various types of responses, the target level could be adjusted down for companies who have strong internal controls and mitigation strategies and adjusted up for companies with weaker controls and strategies.

IV. Assessment of the Exposed Formula

In the event neutrality is not possible for this informational filing, a very low charge is suggested even for the capital add-on approach to avoid creating disruptions in the NAIC RBC formula and

unintended consequences. The current proposal includes 1) the larger of a 1.1% of net premium or net reserves or, alternatively; 2) a 3% capital add-on. The exposure also includes options for the treatment of growth risk. We address both of these below:

Basic Operational Risk – There are two alternative calculations for basic operational risk. The first proposed methodology uses a factor of 1.1% multiplied by net premiums and the same factor multiplied by net loss reserves, with the greater resulting calculation becoming the basic operational risk RBC requirement. The second alternative is what is called the capital add-on approach that takes total RBC after covariance and multiplies it by a factor of 3% to get a new total RBC after covariance. NAIC staff did a study of the basic operational risk with the test results focusing on a 3% target for an after covariance proportion of basic operational risk to total RBC. Using this target resulted in a small percentage of additional companies ending up in action level when compared to the total population of companies.

1. **Net Premium/Net Reserve Proxy Approach** – This approach, which approximates operational risk, does not differentiate companies with strong controls, robust ERM, and sound mitigation strategies relative to their less effective counterparts. For this reason it will not have the desired effects of identifying operationally weak companies, encouraging better operational risk management or protecting policyholders against operational risks evolving within their insurers. Without some evidence that added capital is needed to address this risk that is not embedded in existing capital requirements, we believe the factor should be less than 1% in the informational filings. Until a more appropriate and focused approach is developed, we urge the subgroup to start with a very small percentage like .1% to .2%. There is a great deal of uncertainty over the correct way to measure operational risk, and there are numerous revisions underway in the P&C RBC formula in the coming years. This poses the risk of adverse and unintended consequences.
2. **Capital Add-On Approach** – This approach also approximates operational risk by applying an arbitrary factor to total RBC after covariance. The 3% target has been chosen as a charge that may be comparable to other jurisdictions. We would urge the subgroup to start with a smaller percentage – less than 1% - until a full analysis of the needed capital levels (if any) in the U.S. has been completed. This should include an assessment of the overall effectiveness of the informational charge in identifying companies with weak operational programs.

Excess Growth Risk as an Element of Operational Risk – While the informational factors for growth risk are unchanged for 2016 reporting, we offer some comments on the recent test results conducted by NAIC staff related to P&C growth risk. The test results of the P&C growth risk suggested that under the current methodology, uncoupling growth risk from R4 and R5 inside the square root reduces the after covariance growth risk RBC requirement. It was noted that no clear pattern emerged when comparing the existing versus proposed methodology when it comes to predicting action level companies. No one method was a better predictor than the other over the four-year period that was reviewed.

In the development of the original formula, growth risk was seen as correlated with underwriting risk. We believe this still holds true today, as with many other factors that already consider operational risk. We assert that the current methodology for assessing Excessive Premium Written Growth Risk has been honed to more accurately address the major rationale for this risk charge: premiums growing too fast and/or too large overwhelming available resources. We have attached our industry comment letter from 2015 that details the many reasons why the current growth risk methodology is the best way to proceed.

Thank you for your consideration of these comments. If there are any questions please feel free to contact me at 317-876-4270.

Sincerely,

Michelle Rogers
Director of Financial and Regulatory Policy
National Association of Mutual Insurance Companies