



MEMORANDUM

TO: Philip Barlow, Chair, Life Risk-Based Capital (E) Working Group

FROM: Stephen Wiest, Chair, Operational Risk (E) Subgroup

DATE: March 27, 2019

RE: **Potential Further Work on Life Growth Operational Risk**

During its conference call on February 26, 2019, the Operational Risk Subgroup members adopted a motion to delete the “informational only” growth risk page and instructions from the Life and Fraternal RBC formulas. In taking that action, the Subgroup’s members asked NAIC staff to draft a memo summarizing the work conducted to date and to provide rationale both for and against conducting further work to determine whether a growth risk charge should be added to the Life RBC formula. This memorandum is the result of that direction.

Overview:

Unlike Property & Casualty and Health Risk-based Capital (RBC), Growth Risk capital requirements have not been part of the Life RBC Formula. During its review of Operational Risk the Operational Risk (OR) Subgroup relied heavily on the practices and considerations of other advanced global insurance regulators. All of the jurisdictions reviewed, except Switzerland, include a basic operational risk charge for Life insurers. However, some do not apply the growth risk charge to life insurers. Those jurisdictions that do impose a life insurer growth risk charge include: Australia; Canada; China; E.U. / Solvency II; and the IAIS Global Insurance Capital Standard (proposed). All use a factor times either premium growth, reserve growth or the greater of both. Alternatively, Bermuda applies a discretionary additional capital “add-on” for cases where the insurer’s risk profile deviates significantly from its risk assumptions or from the insurer’s assessment of its risk management policies and practices. The add-on may be applied to items such as: significant growth in premiums, and the quality of risk management surrounding operational risk.

For 2015 RBC, the OR Subgroup chose to insert an “informational only” worksheet into the Life RBC formula that aggregated life and annuity business and includes a separate section for health business. The approach measured growth in premiums over a specified threshold and applied a risk factor to the excess growth (see attachments 1A and 1B). Data was collected for 2015 through 2017 based on the RBC filings for those years.

For 2015, Annual Statement data was compared to the data included in the RBC filings. There were numerous crosscheck errors for calendar year 2015. The situation improved somewhat for calendar years 2016 and 2017. In general, the growth risk charge did not push many insurers into an RBC action level, but a few anomalies in certain large insurers’ data were observed where large single premium reinsurance or pension transactions created a cliff in growth risk RBC (i.e., a huge growth risk charge with significant impact on RBC in one year that essentially disappeared in the next).

In 2018, two alternatives were proposed. The first would add a C-4a (Business Risk) offset to the original informational method for any C-4a that was not already used to offset basic operational risk. The second alternative would apply an RBC add-on of 1.5% based on exceeding the growth thresholds, also with C-4a offset allowed. It was accompanied by an NAIC Staff analysis that is included as Appendix A to this memorandum.

Attachment 4

In addition to the concerns with the aforementioned anomalies observed that related to certain transaction types, interested parties (mainly the ACLI and the AAA) were fairly aligned in providing the following comments with regard to the initial and alternative approaches:

- Rapid growth is not a significant, unaddressed risk for life insurers. Life insurance is generally a stable, mature, long-duration business, and growing companies are already subject to higher capital charges through the existing C1- C4 factors in the current RBC formula.
- Unlike the majority of health insurance and property & casualty (P/C) insurance businesses, life insurance business is long duration in nature. Therefore, should a company experience rapid growth, any potential impact would manifest itself over many years.
- Using premium growth as an exposure proxy creates unnecessary volatility.
- Rapid growth for life insurance companies has typically been the result of an acquisition, entrance into a new market, or introduction of a new product type. In such instances, any additional risk exposure has typically been absorbed within a relatively short period of time, and normal operations continued, subject to the insurer's existing controls.
- There are other tools which regulators have at their disposal that would likely be more effective in addressing any cases of rapid growth in the circumstance where an insurer has not successfully absorbed the growth.
- The lack of any past circumstances where life insurance company insolvency was the direct result of rapid growth.
- If a growth factor were to be included at some point in the future, there needs to be a robust discussion about its applicability to life companies. Only when that need is demonstrated can there be a discussion about an appropriate basis for measurement that accurately reflects actual growth without creating unnecessary volatility.

In response to these comments it was noted that:

- All RBC formulas recognize growth to a certain level for non-operational risks that are already included in the formulas, but the OR Subgroup's charge is to quantify additional operational risk that may be caused by rapid growth.
- Rapid growth is recognized as an indicator of increased operational risk by other advanced insurance regulators.
- Operational risk is constantly evolving and cyber risk and growth via merger or acquisition, and political risk are increasing the potential for increased operational risk that may result from rapid organic or transactional growth.
- The OR Subgroup members recognize that C-4a does address growth risk related to increases in direct premium volume. Therefore, any unused offset for C-4a capital charges after offsetting basic operational risk should be applied to reduce a growth risk charge.
- Rapid growth may be most impactful to smaller, more vulnerable insurers where other robust regulatory tools may be less available or reliable.
- RBC is an integral part of the regulatory framework for addressing risk.

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The OR Subgroup members acknowledged that the current informational only approach was flawed and a replacement approach could not be agreed upon during the remaining time of the OR Subgroup's existence. During its conference call on February 26, 2019, the Operational Risk Subgroup members adopted a motion to delete the "informational only" growth risk page and instructions from the Life and Fraternal RBC formulas. That action was taken in conjunction with a request to develop this memorandum.

Suggestions:

The Life Risk-based Capital (E) Working Group is best suited to evaluate the issues raised by industry concerning operational risk related to rapid growth experienced by life insurers and determine whether and when it should work on this as an agenda item for the Working Group. If the Working Group elects to move forward, some points to be considered include:

- a) The AAA suggested that should the NAIC move forward with an explicit Life RBC charge for growth, we recommend that it be based on some characteristics of growth (for example, X percent increase in reserves year-over-year) rather than premium growth or a percentage of RBC.
- b) A mechanism for smoothing large single year transactions to avoid cliffs and valleys in RBC should be considered.
- c) If a growth risk charge is implemented, any C-4a charge in excess of the amount used to offset basic operational risk should be applied to offset the growth risk charge.
- d) Growth risk for traditional health business should continue to be treated separately from growth risk for life and annuity business.
- e) Companies that file the Life RBC formula, but write the same type(s) of health business written by companies that are required to file the Health RBC formula are not currently subject to a growth risk capital requirement. The work of the Health RBC Working Group should be monitored, and when completed, adding the growth risk for traditional health business that is in the Health RBC formula to the Life RBC formula should be considered, in order to address growth in similar business across the two formulas.

APPENDIX A

Operational Risk Analysis – Growth Risk Life RBC - Proposed Growth Risk – June 2018

Analysis:

Unlike P&C and Health, Life RBC currently does not include a provision for growth risk. An informational methodology and factors were added to the 2015 RBC formula. The purpose for a growth risk charge is to provide additional capital for an enhanced level of operational risk that accompanies rapid growth. That is the assumption behind growth risk capital requirements in other jurisdictional capital formulas.

The current informational approach applied separate factors to life / annuity premiums and health premiums in excess of the growth threshold (20% for life / annuities and 25% for health). The Life RBC factors for life / annuity business were derived using an approach that attempted to replicate the industry average percentage of RBC generated by the existing growth methodology in the P/C formula. For health business, the factors and growth threshold (25%) used were the same as the ones used in the informational Health RBC growth risk method. However, that methodology may be adjusted for Health RBC and consideration should be given to using the same methodology chosen for Health RBC in the Life RBC formula (with regard to comparable health insurance business) for consistency purposes.

The Operational Risk Subgroup members recognize that the Current C-4a risk carried by Life RBC filers picks up basic operational risk. However, since C-4a is based on direct life and health premiums, as those rise, C-4a picks up additional capital. Therefore, it does seem logical to allow an offset for any C-4a risk based capital carried by Life RBC filers that is in excess of the amount of C-4a to be used to offset against basic operational risk as an additional offset to calculated growth risk.

This analysis described below used amounts reported on Page LR 29A of the Life RBC formula for calendar years 2016 and 2017. It was noted that there was one specific anomalous instance in 2016 and several instances for the 2017 data that resulted in extreme growth risk and RBC impact.

Staff Note: For purposes of the analysis, growth risk was placed outside the covariance square root and was offset by C-4a RBC that was in excess of 3% of RBC after covariance (residual C-4a). For further analysis, a decision could be taken by the Operational Risk Subgroup or the Life RBC WG as to where to include growth risk for covariance purposes. Including growth risk under the covariance square root will result in a lower capital requirement for growth risk.

This analysis looked at applying the existing informational approach with C-4a offset (referred to as Method 1), and as an alternative it used an enhanced “add-on” approach that applied an additional growth charge of 1.5% of RBC after covariance with the same C-4a offset based on exceeding the growth threshold in the informational approach (referred to as Method 2). The analysis focusses on 4 basic areas:

1. Number of companies triggering growth risk
2. Average impact of growth risk on RBC ratio > 5%
3. Combined impact of growth risk and basic op risk (after C-4a offset)
4. Profile of high impact companies

Method 1 – Informational Approach:

- In 2016, 163 companies triggered the informational growth risk method before a C-4a offset. One company accounted for 62% of the total. After application of residual C-4a, the number was reduced to 106 companies. The average impact of growth risk across the population of triggering companies was 11.3% of RBC after covariance and before C-4a offset (4.3% without one large company's result). After C-4a offset, the percentages were reduced to 9.5% and 2.5% of RBC after covariance, respectively.

Attachment 4

- In 2017, 139 companies triggered the informational growth risk method before C-4A offset. Five of these companies accounted for 73% of the growth risk capital. After the application of residual C-4a, the number was reduced to 83 companies. The average impact of growth risk across the population of triggering companies was 20.1% of RBC after covariance and before C-4a offset (5.4% without 5 large company results). After C-4a offset, the percentages were reduced to 16.2% and 3.2% of RBC after covariance, respectively.
- For 2016, just over 32% (54) of triggering companies had a decrease of more than 5% in their RBC ratio after considering the C-4a offset.
- For 2017, just over 30% (42) of triggering companies had a decrease of more than 5% in their RBC ratio after considering the C-4a offset.
- In 2016, about 1/3 of the companies that triggered growth risk also were subject to positive basic operational risk (@ 3% add-on less C-4a).
- For 2017, about 1/4 of the companies that triggered growth risk also were subject to positive basic operational risk (@ 3% add-on less C-4a).
- In 2016, of the 54 companies that triggered growth risk with an impact of greater than 5% of their RBC ratio, 31 of these companies had a TAC of below \$25 million. Only 3 reported TAC over \$500 million. Three companies moved to an RBC action level as a result of growth risk. One had an anomalous amount of growth risk.
- In 2017, of the 42 companies that triggered growth risk with an impact of greater than 5% of their RBC ratio, 19 of these companies had a TAC of less than \$25 million. Eight reported TAC over \$500 million. Two companies moved into an RBC action level as a result of growth risk. Three others remained in an RBC action level.
- Of the 106 Companies with net growth risk after C-4a offset in 2016, 42 also triggered growth risk in 2017 (about 40%).

Method 2 - Enhanced Add-on Method:

- In 2016, 61 companies triggered the enhanced add-on method after C-4A offset. The average impact of growth risk across the population of triggering companies was 0.7% of RBC after covariance with a maximum of 1.5% of RBC after covariance.
- In 2017, 46 companies triggered the enhanced add-on method after C-4A offset. The average impact of growth risk across the population of triggering companies was 0.4% of RBC after covariance, with a maximum of 1.5% of RBC after covariance.
- Maximum impact on any company was less than a 1.5% reduction in RBC ratio in both 2016 and 2017.
- For 2016, 51 of the 62 companies triggering growth risk also had positive basic op risk charges. This was due to the companies either not reporting any C-4a capital, or reporting C-4a capital that was less than 3% of RBC after covariance.
- For 2017, 36 of the 46 companies triggering growth risk also had positive basic op risk charges. This was due to the companies either not reporting any C-4a capital, or reporting C-4a capital that was less than 3% of RBC after covariance.

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- In 2016, of the 61 companies that triggered growth risk, 40 companies had a TAC of below \$25 million. Eight reported TAC over \$500 million. No companies moved to an RBC action level as a result of growth risk. Two companies were already at an RBC action level.
- In 2017, of the 46 companies that triggered growth risk, 24 companies had a TAC below \$25 million. Seven reported TAC of over \$500 million. One company moved to an action level as a result of growth risk. Three other companies were already at an RBC action level and remained.
- Of the 61 Companies with net growth risk in 2016, 24 also triggered growth risk in 2017 (about 40%).

Initial Observations:

1. Interested Parties have noted potential unintended consequences with single premium products and assumption of lump sum liabilities such as pensions whereby large premium amounts are reported in one year and disappear the next year. These transactions may cause an extreme growth risk result in the transaction year followed by a reduction in the subsequent year.
2. Although there are some pure health insurers that file Life RBC, much of the health business written by life carriers is of a long-term nature (e.g., LTC and disability) and it may not be appropriate to apply traditional health factors or growth threshold to such business.
3. If the informational charge is retained, consideration should be given to covariance treatment of growth risk, and whether it should be combined with any other risk under the covariance square root.
4. If an enhanced “add-on” is preferred, then consideration should be given as to whether a single factor is appropriate or if a tiered factor, based on extent of excess growth, is more risk sensitive.