November 4, 2010

Mr. Philip Barlow, Chair
Life Risk Based Capital Working Group
National Association of Insurance Commissioners

Re: ACLI Proposal on Risk-Based Capital for Commercial Mortgages

Dear Philip:

The American Academy of Actuaries[1] Invested Assets Work Group (AIAWG) would like to comment on the August 5, 2010 ACLI Life Insurance Company Risk-Based Capital for Commercial Mortgages proposal. The AIAWG, a work group of the Academy's Life Capital Adequacy Subcommittee, is charged with monitoring and responding to life insurance industry investment practices regarding appropriate risk-based capital treatment.

We are aware that this proposal, presented at the recent Seattle and Orlando NAIC meetings, is only an outline of an approach and that ACLI is seeking input from the Life Risk Based Capital Work Group (LRBCWG) before significant resources are spent in hiring an outside consultant and preparing a more detailed proposal. We are providing these comments in the interest of helping the LRBCWG to evaluate the proposed approach from a conceptual perspective.

The AIAWG supports the intent of the proposal to modernize the determination of commercial mortgage loan (CML) risk based capital (RBC). The shortcomings of the current approach, in particular the mortgage experience adjustment factor (MEAF), are well documented. We believe that a new structure that utilizes current data and more advanced risk management tools will overcome the identified shortcomings providing regulators with a more accurate assessment of the risks of commercial mortgages, leading to a more appropriate level of required capital. Given the early stage of the development of the proposal, we offer the following preliminary thoughts for consideration. Our comments are framed to identify areas that the LRBCWG may want to consider before finalizing a new methodology for establishing capital requirements for commercial mortgages. Our comments are organized by category: modeling, calibration and implementation.

Modeling

The AIAWG understands that the preliminary proposal by its nature limits the degree of detail that would normally be supplied in a proposal to implement a new standard. We believe that for the LRBCWG to fully evaluate the proposal, much more detail will need to be disclosed as the proposal

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists 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.

advances to an intended implementation. We are providing suggested types and areas for disclosure in both the Assumptions and Method sections below.

Assumptions

The proposal refers to the use of historical default data from commercial vendors' analytical models and databases available in the marketplace that will be the basis for the loss estimates. We believe that the LRBCWG will benefit from disclosure of the specific data, along with a description of its statistical credibility, to evaluate the ACLI's proposal. Further, it is essential to understand the extent to which the data represents CML holdings for the life insurance industry. We suggest that a final proposal should include significant disclosure of the loss assumptions including details of the incidence of default, loss given default and combined loss distributions. The final proposal should also disclose how these assumptions vary relative to the input parameters, development of the assumptions, and how the chosen assumptions correlate to the raw data. Finally, the proposal should also compare the loss assumptions to those used in the development of the current RBC factors.

We appreciate the challenges in selecting an effective parameter(s) for the purpose of loss modeling. The current RBC method was based on the assumption of an average loan to value (LTV). The proposed dual parameters of debt service coverage ratio (DSCR) and LTV may provide a stronger indicator of loss likelihood than used previously. Assuming these parameters are applied to the current value for the loans, the approach will offer the benefit of automatic reappraisal of the appropriate RBC charge. It would help to judge the complete merits of the choice of these parameters if more information were provided on the strengths and weaknesses of parameters considered.

We also believe that the proposal should include the provision to review the parameters on a periodic basis (e.g., every three to five years) to ensure the parameters remain appropriate.

Method

The proposal describes the process of determining the factors under its Calibration section in very general terms including a reference to projecting loss using existing modeling techniques. In order to evaluate the proposal, we believe that the LRBCWG will be aided in its evaluation with much more detail about the modeling techniques and assumptions.

For perspective, the current CML RBC factor, for loans in good standing, was developed using a rigorous approach involving a number of assumptions. Loans were evaluated individually while being modeled as a portfolio where aggregate loss of the portfolio was used to measure risk. A key assumption was that the portfolio was comprised of a representative mix of loan types and maturities. The portfolio was subjected to various mortgage experience cycles with the starting point itself being a random point in the cycle. Default incidence varied by type of loan and position in the experience cycle. The amount of loss given its occurrence also varied by type of loan and was a combined function of the possible paths of recovery (i.e., restructure and foreclosure.) We believe the LRBCWG's evaluation of the proposal will be aided if, at a minimum, the "existing modeling techniques" as stated in the proposal are carried out at least to this degree of robustness in the modeling. Similarly, the LRBCWG would benefit with a complete disclosure of all elements embedded in the model accompanied with a significant level of detail of its output.

Calibration

We believe the LRBCWG may want to consider that the calibration for mortgages in good standing in this proposal be validated at a portfolio level in addition to the proposed testing of, as yet undetermined, model cells calibrated to 92%. The model cell calibration may be sufficient, or even more than sufficient, but the problem with it is that unless tested with representative portfolios, the calibration at the portfolio level is not known. The RBC factors for bonds were, as noted in the proposal, calibrated to the 92nd percentile by testing each bond rating category individually. But that work was substantiated by reviewing representative bond portfolios that determined that coverage at a portfolio level exceeded 96%. The comparable target for a portfolio of commercial mortgages in good standing, in the present factor, is 94%. This is because when those mortgages are combined with all other mortgage categories prior studies concluded that combined mortgage coverage, similar to bonds, exceeds 96%. While we are not endorsing a particular percentage measure, we do believe that the LRBCWG will want to know the portfolio calibration to fully evaluate the proposal.

The time period should also be considered as part of evaluating a method's calibration. The general approach with RBC has been to evaluate risks over the period of time that will show a rapid deterioration in statutory surplus. For perspective, in the prior development of factors, portfolios of bonds and mortgages were modeled over specific periods. Bonds were modeled over the industry average time to maturity of ten years. Mortgages were modeled to their maturity with a portfolio average time to maturity of seven years.

The above factors and time frames are the basis for the current factors. We are aware of the potential change to RBC calibration in the future and therefore suggest that the modeling output be designed in such a way that prior work could be reused if, for example, the metrics on calibration (e.g., percentile measure or time period covered), were to change.

Implementation

While a preliminary proposal by its nature does not provide complete detail, the AIAWG believes that providing comments relative to implementation will help identify potential unidentified areas for the LRBCWG to consider as the proposal advances to a more complete state. These issues follow:

Will agricultural loans be reviewed in this process? The current proposal only addresses commercial loans. Does this mean that the MEAF will continue to be used for agricultural loans? Similarly, other types of loans may need to be treated separately (e.g., golf properties.)

Will the evaluation of floating rate and fixed rate loans be treated separately? We are aware that DSC is currently typically higher than normal for floating rate loans because of the low interest rate environment. We would expect that the variable rate of a floating rate note will naturally lead to greater variability of the DSC measure for those loans. Given this variability of the measure the AIAWG believes that, as a predictor of risk, it may perform differently for floating vs. fixed rate loans.

Data may not be available at some companies that is needed to implement the proposed methodology. In each of those instances, an alternative approach will need to be developed. We have identified two examples below:

- In some instances companies omit an initial appraisal at loan origination. Since the LTV risk input is dependent on knowing a property's value, an initial estimate of the market value (MV) of the property is needed to derive the LTV at inception. Future LTV's also rely on the MV at inception because future MV will be estimated by applying a proposed index to the initial MV.

- Another area where data availability may be an issue is that not all companies have access to property reports that can be used as financial statements for the purpose of deriving current debt service coverage. Further, for those companies that have Commercial Mortgage Securities Association (CMSA) based reports it will need to be recognized that the reports were designed for investment professionals and are not audited financial statements.

Conclusion

While we have provided a number of comments in this letter, the AIAWG would like to reiterate our support of this preliminary proposal. We believe that it has the potential to become an effective replacement for the current CML RBC approach. The AIAWG plans to monitor the proposal as it advances and will be prepared to provide additional comments to the LRBCWG to aid in your evaluation of the proposal.

Sincerely,

David Berger, FSA, MAAA, Co-Chair of the AIAWG
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