July 24, 2017

Kevin Fry
Chair, Investment Risk-Based Capital Working Group (IRBC)
National Association of Insurance Commissioners

Via email: jgarber@naic.org

Dear Kevin:

On behalf of the C1 Work Group (C1WG) of the American Academy of Actuaries[1], we appreciate the opportunity to provide comments on the April 9, 2017 proposal for risk-based capital (RBC) requirements for Real Estate, exposed by the IRBC. This exposure is an update to the American Council of Life Insurers' (ACLI) August 7, 2015, proposal, *"Life Insurer C-1 Asset Risk-Based Capital Requirement – Real Estate."*

The C1WG provided comments on the earlier proposal. Subsequent to the August 2015 exposure, the C1WG and members of the ACLI's Real Estate group have continued to discuss the technical aspects of the proposal and in particular, some of our concerns with the methodology. We appreciate the changes in this updated proposal, but continue to have concerns in a few areas.

As we have stated in the past, the C1WG supports a lower capital charge for equity real estate than is currently in the Life RBC formula. The proposed methodology is a significant improvement over the current approach, where the C1 factor is based on the relative correlation of equity real estate to common stock. We support the overall structure of the proposal that includes a reduced base factor. However, at this time, we cannot support the specifics of the April 2017, proposal for the following reasons:

1. **Data Questions:**
   In our review of the loss assumptions, we do not think the methodology for reflecting loss (and therefore, the recommended 10.0 percent base factor) adequately captures the extreme fluctuations in the real estate market. We are concerned that the ACLI's modeling underweights the 2007-9 data.

[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.

The ACLI modeling uses ten consecutive years of accumulated historical experience in defining loss assumptions. Because there is not a full ten-year period starting during the 2007-9 real estate downturn, experience from the downturn years is not modeled at the start of a scenario where it would have the greatest impact in measuring risk. The C1WG thinks the 2007-9 period should be more highly weighted in the loss assumptions. Using a historical period of five (rather than ten) consecutive years is an alternative for developing the loss assumptions that would place a higher weight on the 2007-9 experience. For periods where data is not available, using a 0% return in developing the loss assumptions could be utilized.

Based on our cursory review of the data and discussions with the ACLI, we think a base factor closer to 12% is more appropriate.

2. **Income Offset:**
The methodology for developing the base factor assumes the investment income received on real estate provides an offset to the real estate losses. The C1WG has considered the use of an income offset in developing the real estate factors. Using income to offset the losses is consistent with the C1 factors for common stock. In addition, using an income offset is consistent, to some degree, with the development of the bond factors through the Risk Premium offset assumption. Therefore, the C1WG agrees with using a portion of the income to offset the losses in the development of the RBC factors, but do not think using all of the income is appropriate.

The ACLI's recommendation assumes 100% of the income can be used to absorb losses. Given that income is much more significant for real estate than dividends are to common stock, we have some concerns with using all of the income in the real estate factor development. Theoretically, the percentage of income to be included is the amount retained and not paid out in expenses or claims (to the extent real estate assets back product liabilities). We are not certain how to quantify that portion of real estate income that remains after expenses or claims.

The ACLI's recommendation is silent on the Asset Valuation Reserve (AVR). As there is coordination between the AVR contribution factors for real estate and the level of income assumed in the base RBC factors, we think a complete proposal covering both RBC and AVR is needed before adoption.

3. **Market Value Adjustment:**
The proposal includes an adjustment to the base factor for the difference between current market value and statutory statement value. This adjustment is based on two-thirds of the difference. Because real estate is more of an equity investment (as opposed to a fixed-income investment), an adjustment for market value could be justified from a risk perspective. However, we do not support the proposed mechanism for reflecting the market value adjustment. There may be other viable methods to reflect differences between market and statutory value worthy of consideration, but do not think this particular proposal is consistent with RBC principles.

This market value adjustment is based on the appraised value, arguably a value that may not be reliable in all circumstances and representative of the true market value. Further, this adjustment would require more capital in a declining real estate market, introducing an undesirable pro-cyclicality to the RBC requirements by magnifying the impact of declining real estate market.

If regulators decide to introduce a market value adjustment, we offer the following comments on the specifics of the ACLI proposal:

a. The two-thirds reduction assumption. The ACLI has described this adjustment as a conservative reduction to the unrealized gain. We suggest reflecting taxes in the adjustment, effectively reducing the adjustment further.
b. The adjustment to the base factor is subject to a 1.3 percent floor. This floor is tied to the current C1 factor for NAIC 2 bonds. We question the relationship between a real estate investment and BBB bonds. In our view, a more comparable fixed income investment based on the risk of equity investment would be a B bond.

We have no opinion on the ACLI's recommendation to use the same factor for Schedule A Real Estate and Schedule BA Real Estate. However, we believe that further consideration of the risk differences between the properties reported in the two schedules is needed and suggest deferring this decision to the Schedule BA subgroup. In particular, we note that many of the real estate investments reported on Schedule BA contain leverage; the existence of leverage changes the risk profile, suggesting that using the same factor as is used for Schedule A Real Estate may not be appropriate.

While we understand that real estate is not a material asset class for the industry in aggregate, the asset class can be material for some individual insurers. We reiterate our general support for revising the current factors, but would like to see additional consideration and explanation of certain aspects of the proposal. Further, we'd like to evaluate a complete recommendation that includes the corresponding changes to the AVR and an estimate of the average factor and impact on RBC.

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Please contact Nancy Bennett (bennett@actuary.org), the Academy's Senior Life Fellow, or Stephanie Connolly (connolly@actuary.org; 202-223-8196), the Academy's Life Policy Analyst, if you have any questions.

Sincerely,

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C: Steve Clayburn, ACLI