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March 8, 2021

Philip Barlow
Chair
Life Risk-Based Capital (E) Working Group
National Association of Insurance Commissioners (NAIC)

Dear Philip,

On behalf of the American Academy of Actuaries¹ C1 Work Group (C1WG), we appreciate the opportunity to provide comments on the exposed January 21, 2021, proposal to restate the capital requirements for real estate in the Life Risk-Based Capital (LRBC) formula. The C1WG is generally supportive of a different approach for calculating capital requirements for real estate. As 30 years have passed since the current real estate factors were set, a review of the capital requirements is a prudent exercise. The C1WG has reviewed the proposal and is unable to find agreement with the proposal without additional justification/explanation. In reviewing the proposal, we have the following conceptual concerns:

1. Market Value vs. Statutory Value Issues

Establishing capital requirements based on market value inputs when real estate is carried at amortized cost in statutory financial statements is a departure from RBC precedents. Clearly, changing statutory accounting to a market value basis and determining capital requirements directly on those market values would be a more direct approach. With a restatement to market value, both total adjusted capital and the required capital calculation would be different (i.e., both the numerator and the denominator of the RBC ratio would change).

It appears that the proposed structure is an attempt to fix the current LRBC approach that overstates capital requirements by applying a market risk measure to depreciated book value by inserting an adjustment involving unrealized capital gains. Taken together, this approach is intended to reflect the likely lower risk of loss to statutory surplus.

¹ The American Academy of Actuaries is a 19,500-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.

While the work group agrees there should be work to refine the capital charge to recognize the likely lower risk to statutory surplus than the current approach has produced, the use of a market basis risk measure combined with the offset of a portion of unrealized gains to state the risk to capital of an asset valued under statutory rules on a book value basis is unsupported by either fact or theory. Statutory accounting holds real estate at cost less accumulated depreciation unless there is an impairment. At impairment, a restated holding value at market incurs a loss (if less than current book value). Assuming real estate generally increases in value over time, losses measured on a book value basis will be less than those determined on a market value basis.

The use of an arbitrary portion of unrealized gains to convert the market risk measure to the actual book value measure of this asset class is not a supportable approach in the determination of statutory capital requirements. Simply stated, the proposed 2/3 adjustment is not supported by a factual analysis. The capital requirements should be derived based on the likelihood of the occurrence of loss measured as the amounts of future book loss amounts over an appropriate horizon and stated degree of statistical confidence. Developing the adjustment directly from a statutory-based model would provide support for the proposed 2/3 adjustment. A more direct approach could involve a factor for a specific market to book value combination applied directly to depreciated book without further adjustments.

Because of these issues, we have concerns over the reliability of using market measures and unrealized gains to replicate the actual risk of loss on a statutory book basis. As noted above, we suspect the risk is lower than a pure market risk, but do not know how much lower it might be. If this recommended approach were used, is the 2/3 adjustment too high or too low, and could it vary depending on specific conditions? Without more information shared about how the adjustment converts the market measure to a book value, we are unable to come to disposition on the proposed approach. Further, we are concerned that using one scalar applied to the difference between market value and book value would achieve the desired result. If there is a linear relationship between the unrealized loss and the 95th percentile of book value impairments, a scalar might be appropriate, but the C1WG is not convinced of this linear relationship.

We also would question the minimum condition of the NAIC 2 bond factor because there is no clear rationale provided for the relationship between the bond factor used to capture credit risk and real estate capital requirements.

Lastly, we too would raise the question from the February 26, 2021, Life RBC Working Group meeting as to whether it is appropriate to use a market determined risk measure,

the base factor, in combination with unrealized gains where gains (and losses) are already implicit in the statutory base measure itself.

2. Implementation Issues with the Use of a Market Value Measure

If the capital requirements are amended to include a market value measure, specific instructions are needed to define how market value is to be calculated. The LRBC formula needs to be calculated using a consistent definition of the market value calculation, as was done in establishing capital requirements for commercial mortgages.

3. Recommended Statistical Safety Level

The proposal is based on a Statistical Safety Level at the 95th percentile over a 2.5-year time period; what is the basis for the recommended time horizon? The time horizon for bonds was set at 10 years, the typical credit cycle for bonds; what does the 2.5-year period represent? This recommendation moves away from current capital requirements determined relative to those for common stock (i.e., based on a 60% correlation); as such, a time horizon based on the volatility of market returns for an asset carried at amortized cost does not seem consistent with the principles of statutory RBC.

4. Assuming Same Risk Profile for All Types of Real Estate

- a. The proposal is recommending nearly identical treatment for all types of real estate. The C1WG would need to see the data that supports the conclusion that the risk profiles for real estate reported on Schedule A are similar to the risk profiles for real estate reported on Schedule BA; our understanding is that the difference in risk drives different reporting. In particular, we would need to better understand how encumbrances can be determined and reported on a look-through basis on Schedule BA so that the implementation of the proposal will reflect the spirit of accurately identifying risk on a look-through basis.
- b. While real estate is a relatively small asset class for the life insurance industry (approximately 1% of invested assets), using one factor for all types of real estate may not be an appropriate representation of the various risks within the real estate sector. We note that commercial mortgages on hotel properties receive different LRBC treatment, establishing a precedent for different experience for hotel properties. Further, as noted during the February 26, 2021, Life RBC Working Group meeting, using the same factor for distressed properties raises additional concerns.

- c. Properties in development are riskier than properties that are producing income. While there may be materiality and other practical considerations, should different capital requirements be established?

We recognize the importance of this asset class for life insurers and support the review of the capital requirements. However, we continue to have concerns with several aspects of the proposal. We acknowledge that the current LRBC capital requirements may be overstated for certain real estate investments (e.g., where the market value exceeds statutory value by a large amount). Fundamentally, the risk to statutory surplus is less for real estate properties whose statutory value is less than the market value. Consequently, a reduction to the capital requirements has merit, but the proposal's approach to start with market value returns and then adjust statutory values is complex and may not achieve the desired level of required capital that a more direct calculation could produce.

Again, thank you for the opportunity to provide the C1WG comments and should you have any questions or wish to discuss anything in these comments, please contact Khloe Greenwood, the Academy's life policy analyst (greenwood@actuary.org).

Sincerely,

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Copy: Dave Fleming, NAIC