NAIC National Association of Insurance Commissioners

Date: 12/14/20

LIFE RISK-BASED CAPITAL (E) WORKING GROUP
Thursday, December 17, 2020
12:00 p.m. ET / 11:00 a.m. CT / 10:00 a.m. MT / 9:00 a.m. PT

ROLL CALL

Philip Barlow, Chair	District of Columbia	John Robinson	Minnesota
Steve Ostlund	Alabama	William Leung	Missouri
Perry Kupferman	California	Rhonda Ahrens	Nebraska
Deborah Batista/Eric Unger	Colorado	Seong-min Eom	New Jersey
Wanchin Chou	Connecticut	Bill Carmello	New York
Sean Collins	Florida	Andy Schallhorn	Oklahoma
Vincent Tsang	Illinois	Mike Boerner	Texas
		Tomasz Serbinowski	Utah

NAIC Support Staff: Dave Fleming

AGENDA

1. Discuss American Council of Life Insurer's (ACLI) Real Estate Proposal—*Philip Barlow (DC)* Attachment 1

2. Discuss Any Other Matters Brought Before the Working Group—*Philip Barlow (DC)*

3. Adjournment

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Real Estate Equity RBC Proposal

December 2020

Why Address The Proposal Now?

- The proposal dates to 2015, and there have been deliberations on it with the Investments RBC (E) Working Group, and two exposures
- Consensus within the industry, the regulatory community, and American Academy of Actuaries (AAA) that current factors are too high
- Real estate equity, with appropriate RBC charges, is an attractive long-term asset class for insurers, particularly in this persistently low interest rate environment
- Insurers can add value to society by providing capital to the real estate markets in this economic environment

Proposal History

- Initial proposal submitted in 2015: 8% all Schedule A real estate classes; 12% Schedule BA
- Revised proposal submitted in 2017: 10% Schedule A; 10% Schedule BA
  - Revised in response to regulator and AAA feedback
  - AAA provided additional feedback (see slide 4)
- Industry did additional analysis on Schedule BA
- In 2018, the proposal was put on hold to enable focus on the bond RBC proposal

Recap of Most Recent Discussions

- Proposal last discussed October 2017, with primary AAA concerns:
  - Methodology for factor estimation does not adequately reflect market volatility, and more specifically the downturn surrounding Global Financial Crisis - Addressed through additional modeling
  - Methodology uses Total Rate of Return in modeling, which includes income return, which is different than methodology for bonds but consistent with common stock.
  - Formula for calculation of Fair value/Book value RBC adjustment not defended
  - Risk/characteristic analysis of BA real estate assets needs to be conducted
- April 2018: Met with NAIC to review status, outstanding issues and next steps:
  - Followed up with industry survey results on BA asset composition and risk profile

Focus Areas to Achieve Consensus

- Schedule A: Factor for Real Estate Equity investments
- Schedule BA: Proposed treatment consistent with Schedule A
- Proposed Adjustment for Unrealized Capital Gains
- Update factor for RBC Adjustment for Real Estate Encumbrances

Schedule A: Equity investments in real estate

- **Current status**: C-1 factor of 15%
  - Rationale: Article from 1991 proposed that real estate volatility is about 60 percent of that for common stock, suggesting a factor in the range of 18 percent. If one assumes full tax credit for losses, this converts to a factor of about 10 percent
- **Proposal**: C-1 factor of 10%
  - Rationale: Analyses of real estate performance data conducted or sponsored by ACLI/NAIC/Industry specialists suggest that the base C-1 RBC factor applicable to Schedule A real estate (including investment, foreclosed and held for sale real estate) should be set at 8%. Proposed factor increased to 10% to add conservatism
- **Context:** Schedule A real estate investments constitute a smaller % of life insurance company assets, of which most are company occupied for many smaller companies. Actual life insurance company realized losses on real estate totaled less than 3½% over 4 years as a result of the Global Financial Crisis

Schedule BA: Indirect equity investments in real estate

- **Current status:** C-1 factor of 23%
  - Rationale: C-1 factor is 50% more than the C-1 factor for Schedule A real estate assets to account for presumed additional risk associated with potentially lower information transparency and control within the structures
- **Proposal:** Match C-1 factor for Schedule A real estate assets
  - Rationale: Data availability and industry experience has provided evidence that this premium is overly conservative, if not altogether unnecessary for the assets classified as real estate within Schedule BA. A study showed that, since 1983, real estate held through joint ventures has performed consistently with and perhaps even slightly better than, wholly-owned real estate
- Results of the ACLI survey of member companies showed the characteristics of Schedule BA real estate and the summary is available for review

Adjustment for Unrealized Capital Gains

- RBC measures the risk of loss of statutory capital
- **Factor Development:** While the analysis and proposed factors are based on fair value, Statutory Accounting sets value of real estate at depreciated cost.
  - When statutory value is less than fair value, risk to statutory capital is much lower. E.g., if fair value is 150 and deprecated cost is 100, the property can lose 1/3 of its value with no impact on statutory capital.
  - Fair value of real estate assets held by life companies is reported in Schedule A for each individual property.
- **Proposal:** Adjust the RBC factor to recognize 2/3 of any excess of fair value over statutory value when applying it to the statutory value
  - Rationale: The excess of fair value over the statutory value is a cushion against loss of statutory capital that is not currently recognized for risk-based capital purposes. Over time, the difference between depreciated cost and fair value can become substantial. This will reduce the need to sell appreciated properties to see increases in statutory capital.

RBC Adjustment for Real Estate Encumbrances

- **Current status:** RBC is based on the total value of the real estate, with an adjustment for any encumbrance
- The proposed change is to update this adjustment to reflect the new RBC factors for commercial mortgages adopted in 2012
- The presentation is changed, but algebraically equal

QUESTIONS?