Date: 6/22/20

LIFE RISK-BASED CAPITAL (E) WORKING GROUP

Tuesday, June 30, 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	Colorado	Seong-min Eom	New Jersey
Wanchin Chou	Connecticut	Bill Carmello	New York
Gilbert Moreau	Florida	Andy Schallhorn	Oklahoma
Vincent Tsang	Illinois	Mike Boerner	Texas
		Tomasz Serbinowski	Utah

NAIC Support Staff: Dave Fleming

AGENDA

1. Discuss Industry Request for Risk-Based Capital Mortgage Reporting Guidance—*Philip Barlow (DC)* Attachment 1

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

3. Adjournment

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Paul S. Graham III
SVP, Policy Development

Mike Flood
SVP, CMF Policy & Member Engagement

June 8, 2020

Philip A. Barlow, FSA, MAAA
Chair, Life Risk-Based Capital (E) Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Request for Risk-Based Capital Reporting Guidance

Dear Mr. Barlow:

The Mortgage Bankers Associations (MBA)[1] and the American Council of Life Insurers (ACLI)[2], on behalf of our respective member insurers, respectfully submit this request for risk-based capital reporting guidance to the Life Risk-Based Capital Working Group of the National Association of Insurance Commissioners (NAIC).

We appreciate all that you and other regulators, and NAIC staff, have done to date to help insurers navigate the COVID-19 pandemic, and we look forward to working with you on this request. Please feel free to contact Bruce Oliver at boliver@mba.org or 202-557-2840 or Mike Monahan at mikemonahan@acli.com, 202-624-2324 for any additional information.

Sincerely,

Mike Flood

Paul Graham

cc: Dave Fleming, NAIC Senior Insurance Reporting Analyst

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[1] The ***Mortgage Bankers Association (MBA)*** is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Its membership of over 2,300 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, credit unions, thrifts, REITs, Wall Street conduits, life insurance companies, and others in the mortgage lending field. For additional information, visit MBA's website: www.mba.org.

[2] The ***American Council of Life Insurers (ACLI)*** is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States. Learn more at www.acli.com

Request for Guidance for 2020 RBC Reporting

Introduction

Some risk-based capital reporting impacts of the COVID-19 pandemic have been addressed in *Guidance for Troubled Debt Restructurings for March 31-June 30 Statutory Financial Statements and Related Interim Risk-Based Capital Filings (where required),* issued by the Financial Condition (E) Committee on March 27, 2020, and in subsequent NAIC staff Questions and Answers. However, additional guidance is necessary on the application of Risk-Based Capital Reporting Instructions to reasonably apply them to the unusual circumstances of 2020.

Specifically, we request guidance on the application of Risk-Based Capital Reporting Instructions to the 2020 reporting of:

- Net Operating Income
- Contemporaneous Property Values
- Construction Loans
- Origination Date, Valuation Date, Property Value, and 90 Days Past Due

These requests were previously brought to the attention of the Financial Condition (E) Committee in a joint trades letter of April 10, 2020 (link below). As is reflected in NAIC staff questions and answers (link below), we understand that consideration of these requests has been referred to the Life Risk-Based Capital (E) Working Group. This request is intended to facilitate the Working Group's consideration of these requests.

Net Operating Income

Background

Net Operating Income (NOI) inputs are reported in items (14), (15), and (16), and those inputs are used to compute a Rolling Average NOI under item (36). Note 1 references under items (14), (15), and (16) provides in relevant part as follows:

> The majority of commercial mortgage loans require the borrower to provide the lender with at least annual financial statements. The NOI would be determined at the RBC calculation date based on the most recent annual period from financial statements provided by the borrower and analyzed based on accepted industry standards. …
>
> The accepted industry standards for determining NOI were developed by the Commercial Mortgage Standards Association now known as CRE Financial Council (CREFC). The company must develop the NOI using the standards provided by the CREFC Methodology for Analyzing and Reporting Property Income Statements v.5.1. (www.crefc.org/irp). These standards are part of the CREFC Investor Reporting Package (CREFC IRP Section VII.) developed to support consistent reporting for commercial real estate loans owned by third-party investors. This guidance would be a standardized basis for determining NOI for RBC.

Discussion/Analysis

NOI inputs and computations are used to assess and quantify the credit risk of commercial loans, based on the expectation that a reduction in a borrower's NOI for any particular year will be highly correlated to credit risk in the future. However, NOI becomes less reliable as a measure of credit risk under unusual circumstances that are being experienced as a result of the COVID-19 pandemic, because reductions in NOI during 2020 will often reflect temporary conditions. Therefore, NOI values for 2020 may provide misleading indications of future credit risk. As a result, a strict application of 2020 NOIs in risk-based capital reporting would likely result in required capital levels that are not commensurate with the future credit risk that capital is intended to address.

For example, many properties have closed for an extended period of time and are reopening in a limited capacity only as phased-in easing of restrictions occurs. As a result, 2020 NOI may reflect less than six months of NOI in normal operating capacity. A borrower affected by such closures may not seek relief, but, absent the requested guidance, insurers could nevertheless be forced to reclassify a loan as a CM4, or CM5 for a property that will return to normal NOI in 2021, was a CM1 in 2019, and where the borrower made every payment through the shutdown. The need for the guidance to address all loans arises, not because the properties are necessarily problematic, but because the data insurers feed into the RBC calculation may be flawed. The recommended guidance below attempts to address that, without continuing that into additional periods. In that manner, it would adjust for the data flaws of 2020, without ignoring the long-term impacts that a property could face beyond 2020.

The CREF-C IRP standards include a restriction on reporting financial information when less than 6 months of relevant data is available. The COVID-19 pandemic is creating that circumstance, where relevant data, due to the closure of properties and the lack of economic activity due to stay at home orders, is leading to less than 6 months of relevant data for 2020 operations. A strict read of the CREF-C IRP standards would lead to a non-reporting of 2020 NOI in this circumstance, but that is not workable where the RBC calculations require a value.

Recommended Guidance

On March 27, 2020, the Financial Condition (E) Committee issued Guidance for Troubled Debt Restructurings for March 31-June 30 Statutory Financial Statements and Related Interim Risk-Based Capital Filings (where required) (the "RBC Guidance"). The RBC Guidance stated that COVID-19 related modifications would not affect the net operating income utilized during the December 31, 2019 RBC Filing.

Based on the CREF-C IRP standards and the RBC Guidance and for purposes of the inputs at (14), (15), (16), and the computation at (36), it will be deemed to be consistent with industry standards for an insurer to report NOI for any 12-month fiscal period ending after June 30, 2020 but not later than June 30, 2021 to be equal to the greater of: (1) actual NOI as determined under the CREFC IRP Standards or (2) NOI determined for the immediate preceding fiscal year's annual report. This guidance with respect to 2020 NOI applies to the application of the 2020 NOI in risk-based capital reporting for 2021, 2022, and 2023.

By using the 2019 NOI for use in calculations where 2020 NOI would otherwise be used, Insurers would be using the most relevant estimate for property operations in 2020 absent COVID-19. This guidance would apply to all mortgages and not just those mortgages where a COVID-19 modification occurred, because every commercial real estate property was impacted by COVID-19 and the same impacts of using irrelevant data for 2020 applies whether a modification was granted or not.

It should also be made clear that this change is for 2020 NOI only and not subsequent years. As the economy reopens and properties operate within the affected economy, their future year operations will be relevant to the risk classification of Insurer's mortgages, absent a similar event with stay at home orders and government mandated property closures. This means that the long-term impacts of COVID-19 will affect the risk ratings for Insurers mortgages as those future NOI values are factored into the analysis.

Contemporaneous Property Values

Background

Contemporaneous Property Value (40) is a field computed as: the Property Value (20) at the time the loan was originated, was revalued due to impairment underwriting, restructure, extension, or other re-writing; times that ratio (rounded to 4 decimal places) of the Price Index current to the Price Index at valuation (39).

The Price Index at Valuation is the value of the NCREIF Price Index on the last day of the calendar quarter that includes the date defined in (21) and (22). However, the "Price Index current" is not a defined or numbered input into risk-based capital reporting.

The Contemporaneous Property Value (40) becomes an input into the computation of RBC LTV. RBC LTV is computed as Total Loan Value (13) divided by the Contemporaneous Property Value (40), rounded to the nearest percent. RBC LTV is then a factor in determining the risk category (from CM1 to CM5) for any loan that is not 90 days or more overdue , which is then used to determine the risk-based capital requirement for the loan.

Discussion/Analysis

The "Price Index current" applied in item (40) is not a defined or numbered input into risk-based capital reporting, but it is generally assumed to mean the most recent available NCREIF Price Index. Ordinarily, this is a reasonable practice in that it is widely considered to be a reasonable indication of changes in the current value of a diverse portfolio of properties, as the index is based on appraisals that generally are based on a robust set of market information.

These are not ordinary times, however, in that various segments of markets for commercial properties may not provide adequate information to develop conclusive values for commercial properties. In addition, as we describe above, NOIs in 2020 will be artificially low as a result of temporary business shutdowns and other temporary impacts of the pandemic. Because appraisals leverage both NOIs and capitalization rates when estimating the current market value of commercial properties, the level of confidence one can place in appraisal estimates of value at year-end 2020 will be less than it ordinarily would be, and those estimates may systematically skew low. Therefore, an index based on such appraisals could create a prejudice that all properties have lost value as of the end of 2020 and cause the life companies to show a corresponding prejudiced increase in credit risk for 2020. Incorporating those lowered values into the computation of RBC LTV then results in capital requirements that are not commensurate with the credit risk they face going forward.

The alternative of applying the year-end 2019 NCREIF Price Index as the "Price Index current" for purposes of 2020 risk-based capital reporting is also imperfect in that it will be a year old at the time it is applied. However, we believe that, given the unusual circumstances, it would serve as a less imperfect measure of contemporaneous value for establishing required capital levels for insurers at year-end 2020, for the credit risk they face going into 2021.

Recommended Guidance

To prevent computed Contemporaneous Property Values from providing a misleading picture of credit risk, one that could result in artificially high risk-based capital requirements, for purposes of computing the Contemporaneous Property Value (40) for any period ending in 2020, an insurer may use the NCREIF Price Index as of 12/31/2019 for the Price Index current value.

Using the 12/31/2019 NCREIF Price Index for the Price Index current is consistent with the RBC Guidance. The RBC Guidance stated that COVID-19 related modifications are not required to be reclassified to a different RBC Category than was utilized during the December 31, 2019 RBC filing. By using the 12/31/2019 NCREIF Price Index, the Contemporaneous Property Value (40) for the filings for any period ending in 2020 will be equal. Therefore, the LTV component of the RBC calculation will not change or cause the RBC Category to change as the RBC Guidance stated.

This guidance would apply to all mortgages and not just those mortgages where a COVID-19 modification occurred, because every commercial real estate property will be impacted by COVID-19 related prejudice in valuation data, whether a modification was granted or not.

It should also be made clear that this change is for the filings for any period ending in 2020 only and not subsequent years. As the economy reopens and properties operate within the affected economy, their future year valuations will be relevant to the risk classification of Insurers' mortgages, absent a similar event with stay at home orders and government mandated property closures. In addition, the short-term prejudice in property valuation will no longer be occurring. This means that the long-term impacts of COVID-19 will affect the risk ratings for Insurers' mortgages as those future Contemporaneous Property Values are factored into the analysis.

Construction Loans

Background

Under Note 4 of the Risk-Based Capital Reporting Instructions, construction loans are categorized CM5 based on a determination by the loan servicer that "construction issues exist."

On April 22, 2020, NAIC staff posted a question and answer for the RBC Guidance regarding the treatment of construction loans affected by the COVID-19 pandemic, as follows:

> **Q3**-Some construction projects are not allowed to operate because of government imposed stay-at-home orders. Current RBC rules specify that a loan with "construction loan issues" (e.g., abandoned) is required to have a CM5 rating. Is the guidance that loans are not required to be reclassified to a different RBC category as a result of government-mandated delays in any required principal and interest payments in the first and second quarters of 2020 also intended not to require reclassification of construction loans in cases of government-mandated delays in construction?

> **<u>A3</u>**-Yes. No RBC category change is required to be changed for March 31 and June 30 as a result of government-mandated construction delays in the first and second quarters of 2020. The expectation is that further, more deliberative discussion is expected to occur in the future, likely through the Life Risk-Based Capital (E) Working Group, regarding these loans for future reporting periods.

Consistent with the RBC Guidance the Question and Answer was interpreting, Question and Answer 3 applies only to March 31 and June 30, 2020 reporting.

Recommended Guidance

For purposes of Note 4 to the Risk-Based Capital Reporting Instructions, government-mandated construction delays due to COVID-19 that occur at any time during 2020 are not “construction issues.” This guidance would apply to all mortgages and not just those mortgages where a COVID-19 modification occurred.

Origination Date, Valuation Date, Property Value, and 90 Days Past Due

Background

Under Description/explanation of item in the Risk-Based Capital Reporting Instructions for Date of Origination (2), Property Value (20), Year of Valuation (21, and by reference Quarter of Valuation - 22), the filer is instructed to update these values if the loan has been restructured, extended, or otherwise re-written, or refinanced. A loan is traditionally treated as restructured when a loan modification or forbearance occurs.

In addition, the Description/explanation of item 90 Days past Due? (29) requires an insurer to specify if a loan is 90 days past due. Depending on the structure of the forbearance related to COVID-19, a loan in forbearance may be shown on an insurers statements as being 90 days past due, even though the Borrower is abiding by the terms of the forbearance. This is done when lender is protecting its rights under the loan agreement for a loan that may have gone into default prior to requesting forbearance.

On April 22, 2020, NAIC staff posted a question and answer for the RBC Guidance regarding the treatment of these values, as follows:

> **<u>Q2</u>** - Is this guidance intended to apply to all COVID-19 loan modifications that occur through June 30, 2020, so that an insurer that modifies a loan in accordance with the parameters of the guidance within that period is not required to adjust the origination date, valued date, or property value as of the modification date (as required under current RBC rules for loan restructures) for current or future RBC reporting periods?

> **<u>A2</u>** - Yes. The intent of the guidance is to encourage insurers to make prudent loan modifications for borrowers who are temporarily unable to meet their contractual payment obligations because of the effects of COVID-19 and is not intended to have long-term negative impacts under current RBC rules. Consistent with this intent, if an insurer modifies a loan in accordance with the parameters of the guidance, the insurer is not required to adjust the origination date, valued date, or property value for current or future RBC reporting periods. In addition, an insurer is not required to reclassify to a different RBC category (such as within CM categories (e.g., CM1 to CM2) or within standing categories (e.g., In Good Standing, Overdue, Not in Process, In Process of

Foreclosure)) for March 31 and June 30. The expectation is that further, more deliberative discussion is expected to occur in the future, likely through the Life Risk-Based Capital (E) Working Group, regarding these loans for future reporting periods.

Consistent with the RBC Guidance the Question and Answer was interpreting, Question and Answer 2 applies only to March 31 and June 30, 2020 reporting.

Recommended Guidance

For purposes of the Description/explanation of item in the Risk-Based Capital Reporting Instructions for Date of Origination (2), Property Value (20), Year of Valuation (21 and by reference Quarter of Valuation - 22), and 90 Days Past Due? (29), no changes to these values are required for any COVID-19 related modifications that occur during 2020.This guidance is consistent with the Question and Answer issued by the NAIC, but extended for COVID-19 modifications that occur through the end of 2020. As insurers deal with COVID-19 related issues with their mortgages, it is common for insurers to make interim modifications that provide a short initial period of mortgage relief.

This is being done to provide additional clarity to what assistance is needed for the mortgage. At the onset of the COVID-19 pandemic, insurers had no clarity around the length of stay at home orders, which businesses would be allowed to reopen in which phases, and how fast economic activity would return after these orders ended. To provide long term relief for a mortgage that possibly could be facing only a short closure would be unnecessary and imprudent. Therefore, many of these initial modifications will likely be re-looked at during the 3rd and 4th quarters to provide relief consistent with the COVID-19 impacts for the individual mortgage. Insurers need the balance of 2020 to make these informed decisions. Not providing this extension of time will force insurers into modifications prior to the RBC Guidance end date of June 30 that may not be necessary or prudent but is the only way to preserve the RBC treatment provided under the RBC Guidance.

Links

- RBC Instructions: file:///Q:/Policy%20–%20Commercial-Multifamily/Active%20Documents/Life%20company%20RBC/committees_e_capad_lrbc_final_instructions.pdf
- NCREIF website: https://www.ncreif.org/data-products/naic-price-change/
- March 27, 2020 RBC Guidance: https://content.naic.org/sites/default/files/inline-files/Guidance%20for%20Insurers%20from%20Financial%20Condition%20%28E%29%20Commitee_0.pdf
- April 22, 2020 Q&A: https://content.naic.org/sites/default/files/inline-files/QA%20on%20Guidance%20for%20Insurers%20from%20Financial%20Condition%20%28E%29%20Commitee_2.pdf
- April 10, 2020 joint trades letter to the Financial Condition (E) Committee: https://www.mba.org/Documents/jointtrades_letter_to_ECommittee_re_RBC_guidance_041020_final%20(1).pdf

Appendix: Selected RBC Reporting Instructions

Column #	Heading		Description / explanation of item
(2)	Date of Origination	Input	Enter the year and month that the loan was originated. If the loan has been restructured, extended, or otherwise re-written, enter that new date.
(14)	NOI second prior	Input	Enter the NOI from the year prior to the value in (15) See Note 1.
(15)	NOI prior	Input	Enter the NOI from the prior year to the value in (16) See Note 1.
(16)	NOI	Input	Enter the Net Operating Income for the most recent 12-month fiscal period with an end-date between July1 of the year prior to this report and June 30 of the year of this report. The NOI should be reported following the guidance of the Commercial Real Estate Finance Council Investor Reporting Profile v.5.0. Section VII. See Notes 1, 3, 4, 5, and 6 below.
(20)	Property Value	Input	Property Value is the value of the Property at time of loan origination, or at time of revaluation due to impairment underwriting, restructure, extension, or other re-writing. (Note 9.)
(21)	Year of valuation	Input	Year of the valuation date defining the value in (20). This will be either the date of origination, or time of restructure, refinance, or other event which precipitates a new valuation.
(22)	Quarter of valuation	Input	Calendar quarter of the valuation date defining the value in (20).
(29)	90 days past due?	Input	Enter 'Yes' if payments are 90 days past due.
(36)	Rolling Average NOI	Computation	For 2013 – 100% of NOI For 2014 – 65% NOI + 35% NOI Prior For 2015 – 50% NOI + 30% NOI Prior + 20% NOI 2nd Prior For loans originated or valued within the current year use 100% NOI. For loans originated 2013 or later and within 2 years, use 65% NOI and 35% NOI Prior
(39)	NCREIF Price Index at Valuation	Computation [should this be an input?]	Price index [at valuation] is the value of the NCREIF Price Index on the last day of the calendar quarter that includes the date defined in (21) and (22).
(40)	Contemporaneous Property Value	Computation	Contemporaneous Value is the Property Value times the ratio (rounded to 4 decimal places) of the Price Index current to the Price Index at valuation (39).
(41)	RBC LTV	Computation	The Loan to Value ratio is the Total Loan Value (13) divided by the Contemporaneous Value (40) rounded to the nearest percent.
*	[Price Index Current]	[Input]	[Not defined, and not a numbered input or computation.]