Date: 9/19/20

LIFE RISK-BASED CAPITAL (E) WORKING GROUP
Friday, September 25, 2020
1:00 p.m. ET / 12:00 p.m. CT / 11:00 a.m. MT / 10:00 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
Gilbert Moreau	Florida	Andy Schallhorn	Oklahoma
Vincent Tsang	Illinois	Mike Boerner	Texas
		Tomasz Serbinowski	Utah

NAIC Support Staff: Dave Fleming

AGENDA

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

2. Discuss Working Agenda—*Philip Barlow (DC)* Attachment 2

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

4. Adjournment

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Attachment 1

August 18, 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: Industry Recommendation for RBC Reporting of 2020 NOI

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 to the Life Risk-Based Capital Working Group of the National Association of Insurance Commissioners (NAIC) the attached materials for upcoming August 21, 2020 call, in support of the Working Group's consideration of industry's proposal for RBC reporting of 2020 Net Operating Income (NOI).

We want to thank you and other regulators, and NAIC staff, for your considerable time and attention to this request. Please feel free to contact Bruce Oliver at boliver@mba.org or 202-557-2840 or Mike Monahan at mikemonahan@acli.com or 202-624-2324 for any additional information.

Sincerely,

Mike Flood

Paul Graham

Attachment: Industry Recommendation for RBC Reporting of 2020 NOI

cc: Dave Fleming, NAIC Senior Insurance Reporting Analyst

[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, 70 life insurance companies engaged in real estate finance, 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

INDUSTRY RBC RECOMMENDATION FOR 2020 NOI

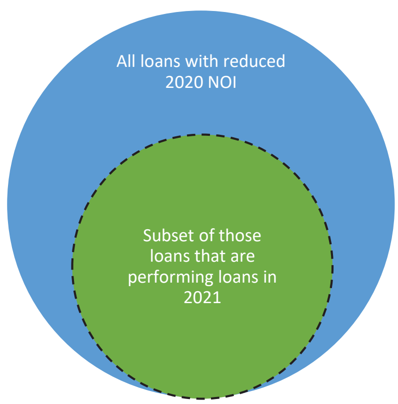
I. INTRODUCTION

Owners of certain properties that secure mortgage loans are experiencing decreases in 2020 income, including rent income, from mandatory shutdowns and other governmental actions taken to flatten the pandemic curve, and other impacts of the COVID-19 pandemic. This is especially the case for properties in the retail and hospitality sectors. As a result, their 2020 Net Operating Income (NOI) may be substantially lower than their 2019 NOI.

For at least some of those properties, however, that drop in income and NOI will prove to be temporary. As a result, loans secured by those properties will be performing loans in 2021, despite the 2020 drop in NOI.

The current treatment of 2020 NOI in life company RBC calculations for commercial mortgage loans (CMLs) does not contemplate such recovery and so it would generate an increase in RBC for loans that have recovered from 2020 that is not commensurate with their credit risk. Industry developed a proposed adjustment to the RBC reporting of 2020 NOI to better align RBC requirements for this set of loans with their credit risk in 2021, 2022, and 2023.

Notably, the proposal is intended to provide relief only to loans that were performing loans prior to the pandemic and that both (1) suffer a drop in NOI in 2020, and (2) are performing loans in 2021. The proposal is intended not to mask or shelter the increased riskiness of loans that suffer a severe drop in 2020 NOI that are **not** performing loans in 2021 or later years (e.g., loans that have become delinquent).



The proposal is designed to provide meaningful benefit only loans that suffer from reduced NOI for 2020 and are performing loans in 2021, 2022, and 2023.

II. DECISION ITEM: INDUSTRY RECOMMENDATION

To achieve the objectives described above, industry proposes the following adjustment to the RBC reporting of 2020 NOI:

- *Where RBC Reporting Instructions specify 2020 NOI as an input into the calculation of Rolling Average NOI for 2021, 2022, and 2023 RBC reporting, use the greater of—*
    - *2020 NOI; or*
    - *85% of 2019 NOI.*

III. BACKGROUND: NOI and RBC reporting

NOI is the net of all operating income from a property, less all operating expenses. Operating expenses excludes principal and interest payments on loans.

For performing loans, the CM category is based on a matrix of Debt Service Coverage (DSC) and Loan to Value (LTV). NOI affects RBC reporting because NOI is an element of DSC.

$$DSC = \frac{\textit{Net Operating Income (NOI)}}{\textit{RBC Debt Service}}$$

In 2013, regulators determined to dampen the direct impact of changes in NOI on RBC reporting by adopting a weighted rolling-average approach to applying NOI values, as follows:

- *50% of preceding year NOI*
- *30% of next preceding year NOI; and*
- *20% of next preceding year NOI.*

IV. SUPPORT

A. The proposal would not shelter bad loans.

Regulators have raised concerns about whether the proposal would shelter or mask bad loans. The hypothetical scenarios below illustrate that the proposal would provide limited relief to loans that have recovered from 2020 – and that it also would not shelter loans that have not recovered from 2020.[1] That is, loans that are delinquent would receive no benefit from the proposed adjustment to 2020 NOI.

Scenario 1: $10 million CM1 loan with 25% reduction in 2020 NOI

2021 loan status	2021 RBC without adjustment	2021 RBC with adjustment
Performing loan	1.75%	0.90%
Delinquent – not in foreclosure	18.00%	18.00%
Delinquent – in foreclosure	23.00%	23.00%

Assumes 60% LTV loan with 1.70x starting debt service ratio falling to 1.44x with adjustment and 1.27x without adjustment.

Scenario 2: $10 million CM2 loan with 50% reduction in 2020 NOI

2021 loan status	2021 RBC without adjustment	2021 RBC with adjustment
Performing loan	3.00%	1.75%
Delinquent – not in foreclosure	18.00%	18.00%
Delinquent – in foreclosure	23.00%	23.00%

Assumes 60% LTV loan with 1.25x starting debt service ratio falling to 1.06x with adjustment and 0.62x without adjustment.

[1] These are simplified hypothetical scenarios. Other factors, e.g., 2018 and 2019 NOI amounts, would affect results.

B. The proposal would increase aggregate RBC requirements.

Regulators have expressed a concern that the proposal might ignore the impacts of reduced 2020 NOI. While the scenarios above illustrate how the proposed adjustment can provide a benefit to individual loans, not all loans will necessarily benefit in this way. That is, while in many cases, the adjustment would result in no increase in RBC, in other cases, loans would be subject to a large increase in RBC despite the adjustment. The difference in impacts across loans would be a function of how close any loan is to the threshold to the next CM category (e.g., a CM1 loan (0.9%) that is close to the threshold for CM2 may become a CM2 loan (1.75%) despite the NOI adjustment).

To determine the aggregate RBC impact of the impacts across individual loans, industry asked companies to apply a hypothetical 15 percent reduction in NOI across their entire respective portfolio. One way to think about this exercise is to view it as a rough estimate of the RBC impact of a 15% reduction in NOI to an "average" life company commercial mortgage.

Specifically, companies were asked to apply a hypothetical 15 percent NOI shock across their entire mortgage portfolios. Companies were asked to provide their best estimates of actual 2020 RBC levels, and of hypothetical 2020 RBC levels if all property 2020 NOIs declined 15% from their 2019 levels.

Based on reporting representing nearly 25 percent of CML outstanding, for the average loan for which NOI is reduced by 15 percent, the average RBC capital charge would increase an average of about 8 percent. This indicates that the proposal to limit the 2020 NOI shock to 15 percent NOI for loans would still generally result in an aggregate increase in CML RBC in the range of about 8 percent, for loans subject to the proposed 85 percent floor, and so would effectively impose an additional RBC charge for the 2020 reduction in NOI.

C. Quarterly NOI data is not readily available for RBC purposes.

In response to regulator questions in the Working Group call of July 30 about the feasibility of developing a proposed treatment of 2020 NOI based on quarterly NOI data, industry conducted a survey to determine the ready availability of such data.

The survey asked for the number of loans each insurer held in portfolio and approximately how many of those loans require the borrower to provide, and the company routinely collects, quarterly operating statements.

Responses by 27 companies, with a total of approximately 23,000 loans, showed that quarterly operational information is both required and routinely collected on only about 7 percent of loans outstanding. Accordingly, any approach that relied on the use of quarterly NOI would not be operationally feasible for the industry.

IV. CONCLUSION

Industry believes the proposed adjustment to 2020 NOI is necessary to strike the right balance of preventing RBC from overstating the credit risk of a loan that has recovered from a reduced NOI in 2020, and recognizing the increased credit risk of the loans that have not recovered from a reduced NOI in 2020.

If large numbers of properties recover strongly and remain financially strong in 2021, the adjustment may apply to a relatively large pool of loans. Alternatively, if smaller numbers of those properties recover, the adjustment would apply to a smaller pool of loans.

Priority 1 – High priority
Priority 2 – Medium priority
Priority 3 – Low priority

CAPITAL ADEQUACY (E) TASK FORCE
WORKING AGENDA ITEMS FOR CALENDAR YEAR 2020

2020 #	Owner	2020 Priority	Expected Completion Date	Working Agenda Item	Source	Comments	Date Added to Agenda
				Ongoing Items – Life RBC			
1	Life RBC WG	Ongoing	Ongoing	Make technical corrections to Life RBC instructions, blank and /or methods to provide for consistent treatment among asset types and among the various components of the RBC calculations for a single asset type.			
2	Life RBC WG	1	2020 or later	~~**A. 'Evaluate the overall effectiveness of the C3 Phase 2 and AG 43 methodologies by conducting an in-depth analysis of the models, modeling assumptions, processes, supporting documentation and results of a sample of companies writing variable annuities with guarantees and to make recommendations to the Capital Adequacy Task Force or Life Actuarial Task Force on any changes to the methodologies to improve their overall effectiveness.**~~ ~~**B. Develop and recommend changes to C-3 Phases II and AG 43 that implement, for 2018 adoption, the Variable Annuities Framework for Change.**~~ **1.Monitor the impact of the changes to the variable annuities reserve framework and risk-based capital (RBC) calculation and determine if additional revisions need to be made.** **2.Develop and recommend appropriate changes including those to improve accuracy and clarity of variable annuity (VA) capital and reserve requirements.**	CATF	Being addressed by the Variable Annuities Capital and Reserve (E/A) Subgroup	
3	Life RBC WG	1	2020 or later	Provide recommendations for recognizing longevity risk in statutory reserves and/or RBC, as appropriate.	New Jersey	Being addressed by the Longevity (E/A) Subgroup	
				Carry-Over Items Currently being Addressed – Life RBC			
4	Life RBC WG	1	2020 or later	Update the current C-3 Phase I or C-3 Phase II methodology to include indexed annuities	AAA		
5	Life RBC WG	2	2020 or later	Develop guidance, for inclusion in the proposed NAIC contingent deferred annuity (CDA) guidelines, for states as to how current regulations governing risk-based capital requirements, including C-3 Phase II, should be applied to contingent deferred annuities (CDAs). Recommend a process for reviewing capital adequacy for insurers issuing CDAs and prepare clarifying guidance, if necessary, due to different nomenclature then used with regard to CDAs. The development of this guidance does not preclude the Working Group from reviewing CDAs as part of any ongoing or future charges where applicable and is made with the understanding that this guidance could change as a result of such a review.	10/21/13 Referral from A Committee	It is important to consider the implications of work being done by the CDA and VA Issues Working Groups to ensure consistency in addressing these charges. The Working Group is monitoring the progress of that work.	
6	Life RBC WG	1	**2020**	Review and evaluate company submissions for the RBC Shortfall schedule and corresponding adjustment to Total Adjusted Capital.			10/16/2015
7	Life RBC WG	1	**2020**	Review and evaluate company submissions for the Primary Security Shortfall schedule and corresponding adjustment to Authorized Control Level.			10/16/2015
8	Life RBC WG	1	**2020**	Continue consideration impacts and modifications necessary due to the Federal Tax Cuts and Jobs Act and develop guidance for users of RBC on those impacts.			3/24/2018
9	Life RBC WG	1	**2020**	Determine if any adjustment is needed to the XXX/AXXX RBC Shortfall calculation to address surplus notes issued by captives.	11/1/17 Referral from the Reinsurance (E) Task Force		3/24/2018
~~**10**~~	~~**Life RBC WG**~~	~~**1**~~	~~**2019**~~	~~**Address changes needed due to elimination of the e fraternal annual statement blank.**~~			9/1/2018

2020 #	Owner	2020 Priority	Expected Completion Date	Working Agenda Item	Source	Comments	Date Added to Agenda
10	Life RBC WG	1	**2020**	Determine if any adjustment is needed due to the changes made to the *Life and Health Guaranty Association Model Act, Model #520.*			9/1/2018
11	Life RBC WG	1	**2020**	Determine if any adjustment is needed to the reinsurance credit risk in light of changes related to collateral and the changes made to the property RBC formula.			9/1/2018
				New Items – Life			
12	Life RBC WG	1	2021	Discuss and determine the bond factors for the 20 designations.	Referral from Investment RBC July/2020		
13	Life RBC WG	1	2021	Discuss and determine the need to adjust the real estate factors.	Referral from Investment RBC July/2020		