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August 23, 2017

Mr. Kevin Fry  
 Chair, Investment Risk-Based Capital Working Group  
 National Association of Insurance Commissioners

**RE: July 24th, 2017 comment letter from the American Academy of Actuaries regarding April 9, 2017 Real Estate Equity RBC Proposal**

Dear Mr. Fry:

The American Council of Life Insurers<sup>1</sup> (ACLI), in coordination with Industry representatives, charged with proposing updated methodology and factors for assessment of real estate equity RBC, appreciate the opportunity to address concerns raised in the July 24, 2017 comment letter from the American Academy of Actuaries (Academy). Our letter provides supporting analyses that address the specific concerns raised by the Academy. As a next step, we request a dedicated meeting be scheduled to discuss the April 9<sup>th</sup> proposal and this follow-up analyses and to develop a consensus proposal that addresses all concerns. The meeting should include the Investment RBC Working Group, the Academy, and ACLI industry experts.

After the investment of over 5 years of analysis, and a clear consensus that the current framework is overly conservative, we remain optimistic that the NAIC will adopt an appropriate required capital framework for equity real estate. Substantial time has been spent by all involved working toward a reasonable and defensible recommendation, and further analyses should consider:

1. Equity real estate as an asset class (including company occupied properties) constitutes 1-2% of life industry assets, and less for P&C/Health.
2. The ACLI analyzed the life insurance industry's actual results during the 2008-2012 downturn, the most severe since the Great Depression. The industry reported cumulative losses of approximately 3.5% over that period.

Academy Concern #1: Factor Estimation

The Academy expresses concern that the primary methodology, which was based on data from 1978 through 2013, underweights the last downturn during the Global Financial Crisis (GFC).

- In response to the Academy's concerns, ACLI updated the analyses to include all available data through mid-year 2017 and identified additional sources to extend the historical data back to 1961, versus the original analysis which was based on data beginning in 1978. The results of analyses of the extended series support a factor of 8.1%. The ACLI continues to

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<sup>1</sup> ACLI is a Washington, D.C.-based trade association with approximately 290 member companies operating in the United States and abroad. ACLI advocates in federal, state, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers' products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing 95 percent of industry assets, 93 percent of life insurance premiums, and 98 percent of annuity considerations in the United States. Learn more at [www.acli.com](http://www.acli.com).

believe the proposed 10% factor is conservative and is supported by the sector's strong historical and current performance.

- Performance of equity commercial real estate has continued to be strong, and is expected at a minimum to be positive for the short to intermediate term, as most market observers do not expect the economy to slow dramatically in the next few years.
- The Academy recommends extending the availability of observations within the data assuming 0% quarterly returns for future periods. This methodology would allow for greater recognition of the GFC with the data. ACLI believes that this approach is overly punitive. However, given the Academy's recommendation, ACLI has performed analyses using the expanded data set and estimation of future performance using 0% returns. The results of this analyses suggest a factor of 9.6%, which ACLI believes is supportive of the current proposal's conservatism.
- ACLI would welcome the opportunity to share data and the above referenced draft analyses with the Working Group and the Academy to work together toward a consensus factor recommendation.

#### Academy Concern #2: Income and Asset Valuation Reserve (AVR)

The Academy suggests that a portion of income should be excluded from total return for the analysis and that the proposal is 'silent' on the AVR.

- Including income in determining RBC for equity real estate is consistent with the RBC methodology for common stock, which uses the S&P 500 Total Rate of Return (TROR). We are not aware of any criticisms of or concerns about this approach at that time or later.
- The current RBC for real estate and common stock assumes no risk offset for expected loss from either AVR or reserves. If a base AVR contribution were to be used for real estate, then a risk offset should be used in the determination of RBC, which would be less conservative than our proposal.
- Our analysis of equity real estate used data from the NCREIF Property Index (NPI).
  - Income is important to common stock, similarly to equity real estate. We examined both over the time period 1978 through 2014. S&P 500 dividends accounted for about 40% of the period's TROR, while real estate income represented 54% of the NPI's TROR.
  - Excluding dividends in estimating a common stock factor would raise the RBC factor 6% or more.
  - Common stock dividends are different from property income. Dividends are paid to investors at a company's discretion. Earnings can be retained, and spent or stockpiled if the company chooses. Dividends may be paid out of surplus when corporate income is reduced.
  - In contrast to common stock dividends, the income data reported in the NPI TROR is not discretionary. The income reported is based on the earnings of the property, and is an accounting item. Investors may choose to reinvest a portion of it in expansion or improvement of properties over time.
- Due to long term property leases, with multiple tenants and staggered terms, for equity real estate, income has historically been more durable than value during economic downturns. This is similar to corporates, where income is more stable than common stock value.

- Real estate income is usually more durable than corporate bond income in downturns. When bonds default, they typically do not continue paying coupons. In contrast, while commercial real estate income may decline in a downturn, it is not typically a cessation of income.
- Income return is the primary rationale for most institutional investors in the sector. Real estate is a stable and diversifying component for institutional investors such as pension plans and life insurance companies. The long holding periods of real estate versus common stock point to income as the driver of investor interest, rather than short term capital gains.
- Based on an ACLI analysis of 2012 industry holdings, over 25% of Schedule A real estate was in Company Occupied assets. The income from these assets is less subject to fluctuation as the company's need for space is less cyclical. Furthermore, companies continue to need physical space to conduct their business even in a downturn.
- Equity real estate generally does not back fixed liabilities. A material portion of equity real estate income backs surplus, or participating or long-term liabilities, not short-term fixed liabilities.
- The base factor in AVR represents expected loss of principal for fixed income investments. Similar to common stock, as an equity asset, real estate does not have a base factor.

#### Academy Concern #3: Market Value Adjustment

The Academy supports a market value adjustment; however, it has concerns with the magnitude and methodology.

- We believe that statutory real estate market values are reliable. The inclusion of a market value adjustment will encourage state insurance auditors to review these values.
- The Academy suggests reflecting taxes in the adjustment. The ACLI believes that the current adjustment does in fact compensate for current levels of tax. An alternative would be to allow for a full adjustment with a reduction for the corporate tax rate, but we continue to endorse our current recommendation.
- The Academy questions the floor level of RBC for assets with market values significantly higher than statutory values, and therefore gains that are not reflected in surplus. The floor level would only be applicable to assets that have significantly higher market value than book value.
  - For example, an asset with a \$100 million statutory value and \$200 million market value has a 50% market value "cushion" before there is any risk of statutory loss.
- We recognize that this market value adjustment would require increasing capital in a declining real estate market. Increases in RBC from declining equity real estate values in a downturn would provide early insight to regulators.

#### Academy Concern #4: Leverage in BA

Although the Academy stated it had no opinion on the proposed recommendation regarding applying the same factor for Schedule A and BA, the Academy comments that properties on Schedule BA may be levered, and may have higher risk profiles, than those in Schedule A.

- Independent research, as referenced in our proposal, has demonstrated that properties held through joint venture structures have no higher volatility than, and have in fact tended to outperform, direct wholly-owned assets.

- The leverage adjustment in the current proposal for Schedule A and BA assets increases the RBC to account for leverage. In the example on page 10 of our proposal, a property on Schedule A or BA that has no encumbrance has a 10% RBC factor (before market value adjustment) and an encumbered asset has a factor of 22.38% of the company's investment.
- Different factors are used for encumbered and non-encumbered assets.
- Here is another example outlining what has been described in our April 9<sup>th</sup> proposal: Life Company X has \$120m dollars to invest in equity real estate and identifies two options: (See page 10 of our proposal for Option 2, assuming that Company X doesn't hold the debt.)

	Option 1	Option 2
Building A	\$120m all cash	
Building B		\$60m Debt/\$40m Equity
Building C		\$60m Debt/\$40m Equity
Building D		\$60m Debt/\$40m Equity
Total Debt	\$0m	\$180m
Total Equity	\$120m	\$120m
RBC	\$12.00m	\$26.85m
RBC as % of Equity	10.00%	22.375%

- With the same amount of money at risk, \$120m, Life Company X can choose to increase the risk in their holding by using leverage, but our proposal adjusts the required RBC for increased risk.

#### Implementation

Developing and analyzing a new factor is just one part of the process. Another part is ensuring that any schedules and/or exhibits that would refer to or use the changes ultimately adopted need to be reviewed and updated. ACLI has developed proposed changes to the RBC instructions taking into consideration the changes in our April 9<sup>th</sup> proposal. A review by NAIC staff and the Investment RBC Working Group and exposure for all interested parties to examine is necessary. We have attached the proposed changes for the Real Estate (LR007) instructions as Appendix A to this letter. We have also developed proposed exhibit changes, in excel, that we can provide staff.

Again, ACLI appreciates the opportunity to follow-up with these analyses and comments that address concerns expressed in the Academy's letter. We thank the NAIC for their continued attention and efforts in this important update of the RBC treatment of equity real estate investment. We are optimistic that all parties can come to an agreement on all areas of the proposal. The ACLI and its industry experts are committed to working to finalize this aspect of the C-1 RBC Factor updates.

Sincerely,



Steven M. Clayburn, FSA, MAAA

cc: Julie Garber, CPA, Sr. Manager, Solvency Regulation, NAIC  
Members of the Investment RBC Working Group

*(These proposed changes are only formatted in this style to be in portrait orientation. The appropriate landscape Word document can be provided.)*

**REAL ESTATE**  
LR007

*Basis of Factors*

~~A group of Life Insurance company real estate investment professionals coordinated by the ACLI developed an analysis of Real Estate risks and proposed factors to the NAIC in a report dated January 2016. The NAIC determined to use a higher factor of [10.0%] pre-tax to provide a margin for potential risk concentrations such as geography or property type. Since the analysis was done based on analysis of market value impacts, an adjustment is made to the factor as it is applied to the statutory carrying value to partially account for the difference between market value and statutory carrying value. Companies that have developed their own risk based capital factors for real estate have used a range of factors from 5 percent to 20 percent. One study indicated real estate volatility is about 60 percent of common stock, suggesting a factor in the range of 18 percent. Assuming a full tax effect for losses, a pre tax factor of 15 percent was chosen. Foreclosed real estate would carry a somewhat higher risk at 23 percent pre tax. Schedule BA real estate also uses the same factor and approach as the directly held Schedule A real estate. has a 23 percent factor pre tax because of the additional risks inherent in owning real estate through a partnership. The pre tax factors were developed by dividing the post tax factor by 0.65 (0.65 is calculated by taking 1.0 less 0.35).~~

~~RBC is adjusted for the excess of market value over statutory carrying value. The risk analysis to support the factors was developed on a market value basis. Where statutory carrying value is lower than market, there is a reduced risk of statutory capital being reduced. A reduction in RBC is developed to partially adjust for this reduction in risk to statutory capital.~~

~~Encumbrances have been included in the real estate base RBC. The totalsince the value of the property is subject to loss as real estate, but the loss is limited by the presence of the would include encumbrances. The RBC factor is applied to the total statutory value of the property gross of any encumbrance. A credit is then provided for non-recourse Encumbrances at a level reflecting the average risk of a commercial mortgage, receive a factor of 121.75 percent pre-tax, for real estate encumbrances not in foreclosure and 20 percent pre tax for real estate encumbrances in foreclosure and encumbrances on Schedule BA real estate.~~

All references to involuntary reserves as it relates to real estate were removed to comply with the codification of statutory accounting principles.

### *Specific Instructions for Application of the Formula*

#### Column (1)

Calculations are done on an individual property or joint venture basis and then the summary amounts are entered in this column for each class of real estate investment. Refer to the real estate calculation worksheet (Figure 7) for how the individual property or joint venture calculations are completed.

*[Editor's Note: Based on proposal – we would need to confirm or revise all of these data sources]*

Line (1) should equal Page 2, Column 3, Line 4.1.

Line (2) should equal Page 2, inside amount, Line 4.1.

Line (4) should equal AVR Equity Component Column 1 Line 20.

Line (5) should equal AVR Equity Component Column 3 Line 20.

Line (7) should equal AVR Equity Component Column 1 Line 19.

Line (8) should equal AVR Equity Component Column 3 Line 19.

Line (14) should equal Schedule BA, Part 1, Column 12, Line 1799999 plus Line 1899999, in part.

Line (15) should equal Schedule BA, Part 1, Column 12, Line 1799999 plus Line 1899999, in part.

Line (17) should equal AVR Equity Component Column 1 Line 75.

Line (18) should equal AVR Equity Component Column 1 Line 76.

Line (19) should equal AVR Equity Component Column 1 Line 77.

Line (20) should equal AVR Equity Component Column 1 Line 78.

Line (21) should equal AVR Equity Component Column 1 Line 79.

Low income housing tax credit investments are reported in Column (1) in accordance with SSAP No. 93, Accounting for Low Income Housing Tax Credit Property Investments.

#### Column (2)

The average factor column is calculated as Column (3) divided by Column (1).

#### Column (3)

Summary amounts are entered for Column (3) based on calculations done on an individual property or joint venture basis. Refer to Column (8) of the real estate calculation worksheet (Figure 7).

#### Line (17)

Guaranteed federal low-income housing tax credit (LIHTC) investments are to be included in Line (17). There must be an all-inclusive guarantee from an ARO-rated entity that guarantees the yield on the investment.

#### Line (18)

Non-guaranteed federal LIHTC investments with the following risk mitigation factors are to be included in Line (18):

- a) A level of leverage below 50 percent. For a LIHTC Fund, the level of leverage is measured at the fund level.
- b) There is a tax credit guarantee agreement from general partner or managing member. This agreement requires the general partner or managing member to reimburse investors for any shortfalls in tax credits due to errors of compliance, for the life of the partnership. For an LIHTC fund, a tax credit guarantee is required from the developers of the lower-tier LIHTC properties to the upper-tier partnership.

Line (19)

State LIHTC investments that at a minimum meet the federal requirements for guaranteed LIHTC investments.

Line (20)

State LIHTC investments that at a minimum meet the federal requirements for non-guaranteed LIHTC investments.

Line (21)

State and federal LIHTC investments that do not meet the requirements of lines (17) through (20) would be reported on Line (21).

