



MORTGAGE BANKERS ASSOCIATION

July 14, 2017

Electronically transmitted to: jgarber@naic.org

Kevin Fry, Chairman
Investment Risk-Based Capital (E) Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: MBA Comments on ACLI Real Estate Proposal for Life Insurers Exposed by the
Investment Risk-Based Capital (E) Working Group with Comments due July 14, 2017

Dear Mr. Fry:

The Mortgage Bankers Association¹ (MBA) appreciates the opportunity to provide comments on the American Council of Life Insurers (ACLI) risk-based capital proposal for life insurance company holdings of commercial real estate equity that was exposed by the Investment Risk-Based Capital (E) Working Group with comments due July 14, 2017.

As NAIC has described risk-based capital (RBC), it "is a method of measuring the minimum amount of capital appropriate for a reporting entity to support its overall business operations in consideration of its size and risk profile."² We strongly support proposed changes to better align RBC with actual life insurance company risk profiles, as we describe below.

Direct investment. We support the proposed reduction in the C-1 base factor for direct equity investment in real estate. The current 15.0 percent C-1 base risk factor (based on the relative correlation of equity real estate to common stock) is inconsistent with the actual risk profile of equity real estate. A factor based on historical experience would better tie capital to risk.

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. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, **life insurance companies** and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

² NAIC, *Risk-Based Capital*; Briefs, Letters, MOUs, Testimony & Speeches (June 13, 2016); http://www.naic.org/cipr_topics/topic_risk_based_capital.htm.

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Encumbrance factors. We support proposed revisions to RBC factors for encumbrances on equity investments in real estate. Current encumbrance factors are based on the current C-1 factor for direct equity investments in real estate (15 percent), adjusted by the average RBC factor for commercial mortgages under standards that are no longer in effect (3 percent). We agree that RBC treatment encumbrance factors should be harmonized with proposed reductions in the C-1 base factor for investments in real estate and with the current RBC factor for commercial mortgages.

Adjusting for unrealized gains / losses. We support proposed partial recognition of the impact of unrealized gains / losses for RBC purposes. Such an RBC adjustment would appropriately reflect impacts of market values on the ability of a life insurance company to support its overall business operations.

Schedule BA real estate. The current 23.0 risk factor for real estate holdings reported on Schedule BA is 50 percent greater than the C-1 base factor for direct investment. We believe that this higher factor is not justified by the actual risk profile of such holdings relative to the risks of direct equity investment in real estate. As described in the proposal, the risk profile of such holdings is sufficiently similar to the risk of direct investment in real estate as to support a factor based on a look-through approach.

In sum, we believe that the proposed changes would better align capital requirements with actual risk profiles, would allow life companies to more efficiently allocate capital, and would result in a positive diversification effect for life companies' overall investment portfolio. If you have any questions or comments about MBA's support for the proposal, please contact Bruce Oliver at boliver@mba.org or (202) 557-2840.

Sincerely,



David H. Stevens, CMB
President and Chief Executive Officer
Mortgage Bankers Association

cc: Julie Garber, CPA, Senior Manager, Solvency Regulation, NAIC



Steven Clayburn
 Senior Actuary, Health Insurance & Reinsurance
 steveclayburn@acli.com

July 14, 2017

Mr. Kevin Fry
 Chair
 NAIC Investment Risk-Based Capital Working Group

RE: RBC – Real Estate Proposal

Dear Mr. Fry:

The American Council of Life Insurers¹ (ACLI) appreciates the opportunity to comment on our real estate proposal for life insurers. It is our hope that there is an agreement to implement all the recommendations in the proposal to ensure that the RBC assessment methodology and charges for the real estate sector more accurately reflect that sector's underlying risks and promote consistency in methodology.

To recap, three key components of the proposal's recommendations are as follows:

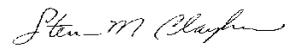
1. Revise the C-1 factor for real estate assets held on Schedule A to be a base factor of 10% . The proposed factor would be applicable for all categories of real estate reported in Schedule A of the Life and Health Annual Statement.
2. Implement an adjustment within RBC to partially reflect the impact of unrealized gains / losses on the potential for loss of statutory surplus, thus, recognizing the conservative statutory accounting basis of depreciated cost.*
3. Revise the factor for Schedule BA real estate to the recommended 10%, equivalent to the proposed factor for Schedule A. All other mechanics would parallel the proposal for Schedule A Real Estate.

*One item to note is that in the proposal, within the proposed adjustment for market versus book value, NAIC2 (the NAIC bond factor for a Baa equivalent (currently 1.30%)) is the recommended floor RBC factor for equity real estate. With the currently proposed expansion of the bond factors to 20, there will be three Baa bond factors. To err on the conservative side, we suggest mapping the proposed floor RBC factor for equity real estate to a level consistent with the lowest rated Investment Grade bonds.

¹ 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 94 percent of industry assets, 93 percent of life insurance premiums, and 97 percent of annuity considerations in the United States. Learn more at www.acli.com.

We look forward to discussing this issue in the future with the Working Group.

Sincerely,

A handwritten signature in cursive script that reads "Steven M. Clayburn".

Steven M. Clayburn, FSA, MAAA

cc: Julie Garber, CPA, NAIC Sr. Manager, Solvency Regulation

July 14, 2017

VIA email

Kevin Fry – Chair, NAIC Investment Risk-Based Capital (E) Working Group
Attn: Julie Garber
NAIC
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

Re: Risk-Based Capital for Real Estate Proposal

Dear Mr. Fry,

This letter is written on behalf of Principal Life Insurance Company (Principal) in support of ACLI's proposal to update the Risk-Based Capital (RBC) charge for real estate investments. We appreciate the opportunity to comment on this proposal.

Principal supports the ACLI proposal and encourages the Working Group to adopt it. The proposal is based on sound analysis of relevant experience data, and the conclusions are a significant improvement from today's treatment of real estate investments. As the ACLI proposal notes, the current RBC treatment for real estate was developed based on a simplistic perception of the relative volatility of real estate investments vs. common stock investments, and included little real analysis of the risk profile of real estate investments.

Base Real Estate Factor

ACLI's proposal includes updating the base charge for real estate investments based on analysis of real estate investment performance over more than 35 years. As is the case with all RBC components, we support periodic review of the charge to ensure factors are appropriate and relevant, and we support changes when justified by experience. Based on the experience analysis in ACLI's work, 10% is a prudent updated base charge for real estate investments.

Schedule BA Real Estate

Principal supports removing the premium on the charge for real estate investments reported on schedule BA. Real estate held through structures, such as LLCs and joint ventures, does not expose the insurer to additional risk. In fact, such structures serve to reduce certain risks, by allowing for partnerships with experts in various local markets and experts in certain types of real estate investments. Real estate properties held through these structures had equivalent, or slightly better performance over the past few decades, including during the

financial crisis of 2008 – 2010. In its proposal, ACLI refers to a study of actual experience on real estate held through joint ventures that supports this conclusion. We support the same charge for real estate investments, whether they are owned directly and reported on schedule A, or owned through a structure and reported on schedule BA.

Treatment of Encumbrances

Principal supports the proposal to update the treatment of encumbrances in the RBC calculation for real estate. The proposal is consistent with RBC for commercial mortgages and results in intuitive results, in total, for properties with encumbrances.

Recognition of Unrealized Gains in RBC Calculation

Principal supports the recognition of market value excesses over carrying value in RBC for real estate, including the ACLI formula, which allows credit for 2/3 of the market value excess and provides risk-sensitive recognition when market values drop below book value, even before a permanent impairment is recognized. We believe this approach would be a straightforward interpretation of the risks around these properties. If a real estate investment has a significant unrealized gain and its market value is very high, it stands to reason that the risk of loss on this property is lower. We also note that all of the requisite elements for the calculation already exist in the statutory accounting framework.

Conclusion

Principal applauds the work of the Investment RBC Working Group to modernize the RBC treatment for investments of all types, including real estate investments. The framework proposed by ACLI is well-reasoned and based on analysis of relevant data, resulting in RBC that is much more responsive to the actual risks borne by insurers through investment in real estate. We encourage the Working Group to adopt the proposal and implement the new factors without delay.

We appreciate the opportunity to comment and hope that our input is helpful to the Working Group. We are happy to discuss our comments with you and any interested members of the Working Group, at your convenience.

Sincerely,

Sam Early, Actuary, FSA, MAAA
Principal
711 High St.
Des Moines, IA, 50392

cc: Julie Garber, NAIC



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July 24, 2017

Kevin Fry
 Chair, Investment Risk-Based Capital Working Group (IRBC)
 National Association of Insurance Commissioners

Via email: jgarber@naic.org

Dear Kevin:

On behalf of the C1 Work Group (C1WG) of the American Academy of Actuaries¹, we appreciate the opportunity to provide comments on the April 9, 2017 proposal for risk-based capital (RBC) requirements for Real Estate, exposed by the IRBC. This exposure is an update to the American Council of Life Insurers' (ACLI) August 7, 2015, proposal, "*Life Insurer C-1 Asset Risk-Based Capital Requirement – Real Estate.*"

The C1WG provided [comments](#) on the earlier proposal. Subsequent to the August 2015 exposure, the C1WG and members of the ACLI's Real Estate group have continued to discuss the technical aspects of the proposal and in particular, some of our concerns with the methodology. We appreciate the changes in this updated proposal, but continue to have concerns in a few areas.

As we have stated in the past, the C1WG supports a lower capital charge for equity real estate than is currently in the Life RBC formula. The proposed methodology is a significant improvement over the current approach, where the C1 factor is based on the relative correlation of equity real estate to common stock. We support the overall structure of the proposal that includes a reduced base factor. However, at this time, we cannot support the specifics of the April 2017, proposal for the following reasons:

1. Data Questions:

In our review of the loss assumptions, we do not think the methodology for reflecting loss (and therefore, the recommended 10.0 percent base factor) adequately captures the extreme fluctuations in the real estate market. We are concerned that the ACLI's modeling underweights the 2007-9 data.

¹ The American Academy of Actuaries is a 19,000-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.

The ACLI modeling uses ten consecutive years of accumulated historical experience in defining loss assumptions. Because there is not a full ten-year period starting during the 2007-9 real estate downturn, experience from the downturn years is not modeled at the start of a scenario where it would have the greatest impact in measuring risk. The C1WG thinks the 2007-9 period should be more highly weighted in the loss assumptions. Using a historical period of five (rather than ten) consecutive years is an alternative for developing the loss assumptions that would place a higher weight on the 2007-9 experience. For periods where data is not available, using a 0% return in developing the loss assumptions could be utilized.

Based on our cursory review of the data and discussions with the ACLI, we think a base factor closer to 12% is more appropriate.

2. **Income Offset:**

The methodology for developing the base factor assumes the investment income received on real estate provides an offset to the real estate losses. The C1WG has considered the use of an income offset in developing the real estate factors. Using income to offset the losses is consistent with the C1 factors for common stock. In addition, using an income offset is consistent, to some degree, with the development of the bond factors through the Risk Premium offset assumption. Therefore, the C1WG agrees with using a portion of the income to offset the losses in the development of the RBC factors, but do not think using all of the income is appropriate.

The ACLI's recommendation assumes 100% of the income can be used to absorb losses. Given that income is much more significant for real estate than dividends are to common stock, we have some concerns with using all of the income in the real estate factor development. Theoretically, the percentage of income to be included is the amount retained and not paid out in expenses or claims (to the extent real estate assets back product liabilities). We are not certain how to quantify that portion of real estate income that remains after expenses or claims.

The ACLI's recommendation is silent on the Asset Valuation Reserve (AVR). As there is coordination between the AVR contribution factors for real estate and the level of income assumed in the base RBC factors, we think a complete proposal covering both RBC and AVR is needed before adoption.

3. **Market Value Adjustment:**

The proposal includes an adjustment to the base factor for the difference between current market value and statutory statement value. This adjustment is based on two-thirds of the difference. Because real estate is more of an equity investment (as opposed to a fixed-income investment), an adjustment for market value could be justified from a risk perspective. However, we do not support the proposed mechanism for reflecting the market value adjustment. There may be other viable methods to reflect differences between market and statutory value worthy of consideration, but do not think this particular proposal is consistent with RBC principles.

This market value adjustment is based on the appraised value, arguably a value that may not be reliable in all circumstances and representative of the true market value. Further, this adjustment would require more capital in a declining real estate market, introducing an undesirable pro-cyclicality to the RBC requirements by magnifying the impact of declining real estate market.

If regulators decide to introduce a market value adjustment, we offer the following comments on the specifics of the ACLI proposal:

- a. The two-thirds reduction assumption. The ACLI has described this adjustment as a conservative reduction to the unrealized gain. We suggest reflecting taxes in the adjustment, effectively reducing the adjustment further.
- b. The adjustment to the base factor is subject to a 1.3 percent floor. This floor is tied to the current C1 factor for NAIC 2 bonds. We question the relationship between a real estate investment and BBB bonds. In our view, a more comparable fixed income investment based on the risk of equity investment would be a B bond.

We have no opinion on the ACLI's recommendation to use the same factor for Schedule A Real Estate and Schedule BA Real Estate. However, we believe that further consideration of the risk differences between the properties reported in the two schedules is needed and suggest deferring this decision to the Schedule BA subgroup. In particular, we note that many of the real estate investments reported on Schedule BA contain leverage; the existence of leverage changes the risk profile, suggesting that using the same factor as is used for Schedule A Real Estate may not be appropriate.

While we understand that real estate is not a material asset class for the industry in aggregate, the asset class can be material for some individual insurers. We reiterate our general support for revising the current factors, but would like to see additional consideration and explanation of certain aspects of the proposal. Further, we'd like to evaluate a complete recommendation that includes the corresponding changes to the AVR and an estimate of the average factor and impact on RBC.

Please contact Nancy Bennett (bennett@actuary.org), the Academy's Senior Life Fellow, or Stephanie Connolly (connolly@actuary.org; 202-223-8196), the Academy's Life Policy Analyst, if you have any questions.

Sincerely,

Nancy Bennett, MAAA, FSA, CERA
 Jerry Holman, MAAA, FSA, CFA
 Co-Chairpersons, C1 Work Group
 American Academy of Actuaries

C: Steve Clayburn, ACLI

