



AMERICAN ACADEMY *of* ACTUARIES

Follow-up of the American Academy of Actuaries' Life-Risk Based Capital Committee's Codification Subgroup on Changes to the C-1 Treatment of Real Estate (Fallback)

**Presented to the National Association of Insurance Commissioners' Life Risk-Based
Capital Working Group
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Codification Subgroup

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Summary

The NAIC's Life Risk-Based Capital Working Group was not comfortable with the cash-on-book return approach, presented by the American Academy of Actuaries' Life Risk-Based Capital Committee at the December, 2000 NAIC meeting. Therefore, the Academy Committee is proposing the use of the status quo (i.e., a 10% factor for investment real estate and a 15% factor for foreclosed and Schedule BA real estate). However, to implement this approach the committee needs to request (from company records) a split of real estate on Schedules A and D between investment and foreclosed real estate. See the attached draft instructions. The draft instructions use, as a source, the AVR pages, which in turn ask for the information from company records.

"Fallback" Instructions

REAL ESTATE LR007

Basis of Factors

Companies that have developed their own risk-based capital factors 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 some tax effect for losses, a factor of 10 percent was chosen. Foreclosed real estate would carry a somewhat higher risk at 15 percent. The foreclosed real estate factor is lower than the factor for mortgages in foreclosure (20 percent) because the NAIC's *Annual Statement Instructions* require that mortgages in foreclosure be written down when they are moved to the foreclosed real estate category. Since a surplus reduction has already been taken, the factor is lower. Schedule BA real estate also has a 15 percent factor because of the additional risks inherent in owning real estate through a partnership.

Encumbrances have been included in the real estate base since the value of the property subject to loss would include encumbrances. Encumbrances receive a 7.75 percent factor for real estate encumbrances not in foreclosure and 12.75 percent for real estate encumbrances in foreclosure and encumbrances on Schedule BA real estate.

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 3) for how the individual property or joint venture calculations are completed.

Line (1) should equal Page 2, Column 4, Line 4.1.

Line (3) should equal Page 2, inside amount, Line 4.1.

Line (5) + Line (9) -should equal Page 2, Column 4, Line 4.2 + Page 2, Column 4, Line 4.3.

Line (7) + Line (11) should equal Page 2, inside amount, Line 4.2 + Page 2, inside amount, Line 4.3.

~~Line (9) should equal Page 2, Column 4, Line 4.3.~~

~~Line (11) should equal Page 2, inside amount, Line 4.3.~~

Line (17) should equal Schedule BA, Column 10, Line 0999999.

Line (19) should equal Schedule BA, Column 7, Line 0999999.

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 3).

(Figure 3)

Real Estate Worksheet

		(1)	(2)	(3)	(4)	(5)	
		Statement	Involuntary		Statement	Encumbrances	S
	<u>Description</u>	<u>Value</u>	<u>Reserves</u>	<u>Encumbrances</u>	<u>Value</u>	<u>Factor</u>	Re
	<u>Company Occupied Real Estate</u>						
(1)	All Properties Without Encumbrances^			XXX	0.1000	XXX	
	All Properties With Encumbrances:						
(2)					0.1000	0.0775	
(3)					0.1000	0.0775	
(199)	Total Company Occupied Real Estate						
	<u>Foreclosed Real Estate</u>						
(1)	All Properties Without Encumbrances^			XXX	.1500	XXX	
	All Properties With Encumbrances:						
(2)					.1500	.1275	
(3)					.1500	.1275	
(299)	Total Foreclosed Real Estate						
	<u>Investment Real Estate</u>						
(1)	All Properties Without Encumbrances^			XXX	.1000	XXX	
	All Properties With Encumbrances:						
(2)					.1000	.0775	
(3)					.1000	.0775	
(399)	Total Investment Real Estate						
(499)	Total Real Estate (Line (199) + Line (299) + Line (399))						
	<u>Schedule BA Real Estate</u>						
(1)	All Joint Ventures w/o Encumbrances^			XXX	.1500	XXX	
	All Properties With Encumbrances:						
(2)					.1500	.1275	
(3)					.1500	.1275	
(199)	Total Schedule BA Real Estate						

^ For each category, Line (1) should also exclude properties or joint ventures that have a negative statement value. These should be listed individually.

@ Column (6) is calculated as the net of Column (1) less Column (2) multiplied by Column (4).

& Column (7) is calculated as Column (3) multiplied by Column (5).

* Column (8) is calculated as the sum of Column (6) plus Column (7), but not less than zero or more than the net of Column (1) less Column (2).

** This factor is yet to be determined.

*** This factor is yet to be determined, but it will be Column (4) - .0225.

• **REAL ESTATE**

			(1)
		<u>Annual Statement Source</u>	<u>Statement Value</u>
	<u>Real Estate</u>		
(1)	Company Occupied Real Estate	AVR WS p. 37, line 18, column 1	
(2)	Company Occupied Involuntary Reserves	Page 3 Column 1 Line 25, in part	
(3)	Company Occupied Encumbrances	AVR WS p. 37, line 18, column 3	
(4)	Total Company Occupied Real Estate	Line (1) - (2) + (3)	
(5)	Foreclosed Real Estate	AVR WS p. 37, line 20, column 1	
(6)	Held for Income Involuntary Reserves	Page 3 Column 1 Line 25, in part	
(7)	Foreclosed Encumbrances	AVR WS p. 37, line 20, column 3	
(8)	Total Foreclosed Real Estate	Line (5) - (6) + (7)	
(9)	Investment Real Estate	AVR WS p. 37, line 19, column 1	
(10)	Held for Sale Involuntary Reserves	Page 3 Column 1 Line 25, in part	
(11)	Investment Encumbrances	AVR WS p. 37, line 19, column 3	
(12)	Total Investment Real Estate	Line (9) - (10) + (11)	
(13)	Total Real Estate (pre-MODCO/Funds Withheld)	Lines (4) + (8) + (12)	
(14)	Reduction in RBC for MODCO/Funds Withheld Reinsurance Ceded Agreements	Company Records	
(15)	Increase in RBC for MODCO/Funds Withheld Reinsurance Assumed Agreements	Company Records	
(16)	Total Real Estate (including MODCO/Funds Withheld.)	Lines (13) - (14) + (15)	
	<u>Schedule BA Real Estate</u>		
(17)	Schedule BA Real Estate	Schedule BA Column 10 Line 0999999	
(18)	Schedule BA Real Estate Involuntary Reserves	Page 3 Column 1 Line 25, in part	
(19)	Schedule BA Real Estate Encumbrances	Schedule BA Column 7 Line 0999999	
(20)	Total Schedule BA Real Estate (pre-MODCO/Funds Withheld)	Line (17) - (18) + (19)	
(21)	Reduction in RBC for MODCO/Funds Withheld Reinsurance Ceded Agreements	Company Records	
(22)	Increase in RBC for MODCO/Funds Withheld Reinsurance Assumed Agreements	Company Records	
(23)	Total Schedule BA Real Estate (including MODCO/Funds Withheld.)	Lines (20) - (21) + (22)	

* Column (2) is calculated as Column (3) divided by Column (1).

** The RBC requirement is calculated for each individual property and then summarized on this page. Refer to the worksheet included in the Real Estate portion of the instructions.

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