AMERICAN ACADEMY of ACTUARIES

November 14, 2012

To: Mark Birdsall, Chair, NAIC Life Risk-Based Capital Working Group

From: The American Academy of Actuaries' Invested Asset Working Group

Subject: ACLI Commercial Mortgage RBC Proposal

The American Academy of Actuaries[1] Invested Asset Work Group (AIAWG) appreciates the opportunity to comment on the American Council of Life Insurers (ACLI) May 18, 2012 proposal to NAIC Life Risk Based Capital (E) Working Group (LRBCWG) for a new method to determine risk-based capital (RBC) and asset valuation reserves (AVR) for commercial mortgages.

Generally, the proposal is an improvement from the current RBC calculation for commercial mortgages based on a static factor of 2.6%, adjusted by the Mortgage Experience Adjustment Factor (MEAF.) The ACLI proposed methodology does a better job of responding as the risk profile of an insurer's commercial mortgage holdings changes.

While the AIAWG recognizes the desire to take action on this proposal by the end of this year, thereby minimizing the time remaining for further analysis of the proposal, some of our concerns relate to the timing of implementing this proposal.

The AIAWG believes that the assumptions used to derive RBC for all asset types (e.g., corporate bonds and commercial mortgages) should be consistently defined. The NAIC's C-1 Factor Review (E) Subgroup has not completed its work of reviewing and updating capital factors for all asset types. The AIAWG has identified some assumptions in the ACLI proposal that differ from the methodology for determining the capital requirements for corporate bonds. These differences are present with some aspects of the current corporate bond factors and some aspects anticipated to be part of the updated corporate bond factors. For example, the derivation of C1 factors for corporate bonds includes an intended offset for the expected losses included in policy reserves. At this time, the Academy's C1 Work Group is reviewing the level of expected losses captured in statutory reserves. The ACLI's proposal defines expected loss as the "mean" loss. The offset for expected losses should be consistently defined for corporate bonds, commercial mortgages, and other asset types.

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists 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.

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In addition to the consistency issues arising from a comparison of the commercial mortgage proposal with the methodologies for other asset types, the AIAWG has some further questions that warrant analysis. For example, we are not certain what level of correlation has been assumed among individual commercial mortgage loans. Experience suggests that defaults among commercial mortgages are positively correlated in times of economic stress. A better understanding of the assumed level of correlation would be informative. We do not know if the resulting C1 factors would change from those proposed, but think the issue of correlation warrants additional analysis.

While the AIAWG is supportive of the draft proposal, we think that final approval and implementation of the proposed change should be deferred until the work of the C-1 Factor Review (E) Subgroup has been substantially completed. Even though the proposal is an improvement over the current MEAF approach, we think deferral is the most prudent course, particularly given the extensive time typically needed to update RBC factors. However, if the LRBCWG determines to adopt the ACLI's proposal for the 2013 RBC calculations, the AIAWG suggests a modification to the normal approval process wherein the proposal is adopted in principle with some flexibility to change the RBC Instructions. If the timeframe for making changes to the Instructions cannot be modified, then we suggest an interim adoption of the ACLI proposal, as exposed, along with the continued commitment from the ACLI, regulators, and interested parties to continue review of the proposed method.

Conclusion

The AIAWG is supportive of the proposal and agrees with the manner in which the methodology captures changes in the risk composition of a company's commercial mortgage holdings in the RBC calculation. We think further discussion is needed to determine the optimal timeframe for implementation. The AIAWG and its sister work group, the Academy's C1 Work Group, are currently working with the NAIC to review and refine, as appropriate, the treatment of investment risks in the RBC framework. The AIAWG is available to assist the LRBCWG with this proposal on commercial mortgage capital requirements and other issues.