September 2013 Fraternal Benefit Societies Volume 6.2

Risk-Based Capital Newsletter

NAIC
National Association of Insurance Commissioners

Mandatory Convertible Securities

Adopted at the May 30, 2013 meeting of the Capital Adequacy (E) Task Force was a proposal to incorporate into the instructions for FR013, Replication (Synthetic Asset) Transactions And Mandatorily Convertible Securities, a new definition for Mandatory Convertible Securities and detail for the pre-conversion valuation of these securities. This proposal also changed the reference to these securities from “Mandatorily” to “Mandatory” throughout the instructions and in the title for FR013.

Low Income Housing Tax Credits

Adopted at the November 30, 2012 meeting of the Capital Adequacy (E) Task Force was a proposal to add new lines to FR007, Real Estate, to include state and all other low income housing tax credits and to specify federal for the existing lines. Corresponding changes were also made to the Equity Component of the Asset Valuation Reserve.

Working Capital Finance Notes

Adopted at the April 7, 2013 meeting of the Capital Adequacy (E) Task Force was a proposal to add lines to identify Working Capital Finance Notes on FR008, Other Long-Term Assets. This entailed a new line being added to FR010, Asset Concentration Factor, and new lines being added to FR030, Calculation Of Tax Effect For Risk-Based Capital. Corresponding changes were also made to the Equity Component of the Asset Valuation Reserve.

Further study may be undertaken to determine if different RBC factors are needed for this type of investment.

What RBC Pages Should Be Submitted?

For year-end 2013 Fraternal RBC, submit hard copies of pages **FR001 through FR046** to any state that requests a hard copy. A hard copy is not required to be submitted to the NAIC.

If any actuarial certifications are required per the RBC instructions, those should be included as part of the hard copy filing. Other pages, such as the mortgage and real estate worksheets, do not need to be submitted, but still need to be retained by the company as documentation.

Changed “Class” to “NAIC”

To be consistent with the terminology used in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* and changes being made to the *Annual Statement Instructions*, the word “class” when used with NAIC designations has been modified to “NAIC” and the word “rating” when used in reference to an NAIC designation has been changed to “designation” in the Fraternal *RBC Overview and Instructions, Blanks and Forecasting*.

In this issue…

Commercial Mortgage Proposal

A proposal to change the methodology used for risk assessment on commercial mortgages was adopted at the April 30, 2013 meeting of the Capital Adequacy (E) Task Force.

The proposal eliminates use of the mortgage experience adjustment factor. The proposal establishes five risk cohorts for commercial mortgages in good standing. Each cohort will be assigned an RBC charge. The development of the capital charges for these cohorts was based on extensive historical data and credit loss modeling. Each loan in good standing will be assigned to one of these risk cohorts based on its debt service coverage (DSC) and loan-to-value (LTV).

DSC will be defined as the ratio of Net Operating Income (NOI) divided by current Standardized Debt Service. NOI will be the property's income for the most recent annual period according to the Commercial Real Estate Finance Council (CREFC) Methodology for Analyzing and Reporting Property Income Statements. Standardized Debt Service will be the annual debt service for the loan calculated by amortizing the loan's principal balance at the RBC calculation date over a standard 25-year period at the contract interest rate. LTV will be defined as the ratio of the current principal balance to a contemporaneous property value. The principal balance will be the aggregate of all loan principal pari passu or senior to the debt held by the company at the RBC calculation date.

The property value will be the value determined at loan origination and trended forward using changes in the National Council of Real Estate Investment Fiduciaries (NCREIF) Price Index since the loan's origination date.

The RBC factor for the assigned risk cohort will be applied to the statutory carrying value of the loan. The result for each loan will be summed to determine the RBC for the commercial mortgages in good standing of the company.

To implement this change, the following Fraternal RBC forms and/or instructions were revised:

- FR003 – Mortgage Experience Adjustment: eliminate;
- FR004 – Mortgages: modify as outlined above;
- FR009 – Schedule BA Mortgages: remove reliance on FR003. Affiliated Mortgages follow a process parallel with Schedule B mortgages, while unaffiliated mortgages will follow specific guidance.
- FR010 – Asset Concentration Factor: remove reliance on FR003, and reference values from the new lines of FR004 and FR009

  FR030 – Tax Effect: remove reliance on FR003, and reference values from the new lines of FR004 and FR009

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