The effect of insurance groups’ entry into the lending market and its influence on UK commercial real estate

October 2012
METHODOLOGY

The study involved a primary research phase, in which Centre for Economics and Business Research (Cebr) undertook 20 in-depth interviews with a range of mid-tier and senior executives from the insurance sector. Some of these executives were from insurance companies which are active in lending (through investment management arms or their property teams), some represented groups contemplating entry into the lending market, while others represented companies that are not contemplating lending. Other interviewees included equities analysts who monitor and research the insurance sector; representatives of regulatory bodies, other industry stakeholders and the Association of British Insurers (“ABI”). Insurance group participants were generally either from the groups’ investment management arm or their in-house property team. This evidence has formed a primary input into the analysis contained in this report. Several participants in the in-depth interview process requested that we preserve their anonymity, due to the commercially sensitive nature of the topics under discussion. This is reflected in the attribution of quotes from these participants which feature in this report, who are referred to by their job title and the principal activity characterising their company or institution.

Disclaimer

Whilst every effort has been made to ensure the accuracy of the material in this document, neither Centre for Economics and Business Research Ltd nor the report’s authors will be liable for any loss or damages incurred through the use of the report.

Authorship and acknowledgements

This report has been produced by Cebr, an independent economics and business research consultancy established in 1992. The study was led by Oliver Hogan, Cebr Head of Microeconomics with analytical, research and modelling support from Cebr Economists Osman Ismail and Daniel Solomon. The views expressed herein are those of the authors only and are based upon independent research by them.

This study has been commissioned by DLA Piper and has utilised data and insights gathered through case study interviews with insurance companies and insurance analysts during the period June to August 2012. This research also draws upon published data from the ONS, the Bank of England, De Montfort University and the Association of British Insurers.

The report does not necessarily reflect the views of DLA Piper.
CONTENTS

Foreword 2
Key findings 3
The debt funding gap in brief 6
What’s driving insurers to lend? 7
The regulatory drivers of Solvency II 9
Barriers to lending 12
Who’s lending and how are they doing it? 15
Who are insurers most likely to lend to? 18
  Quality focus 18
  Sector mix 19
  Geography 20
  Tenants 21
  Pricing 21
  Funding 22
  Size 24
  Duration 24
  Loan-to-value ratios 25
  Fixed rates 25
  Prepayment 26
Potential impact on the UK commercial real estate market 27
  Current trends of CRE lending 27
  Predicted growth in lending by UK insurance sector 28
  The potential impact on interest rates for CRE finance 31
Future impact of insurers as CRE lenders 33
  Insurer-lenders in the context of a wider structural shift in CRE finance 35
  A competitive response from the banks? 37
  CRE incentives set to endure 37
Contact us 40
In the years since the financial crisis, the availability and character of lending to the UK’s commercial real estate (“CRE”) market has changed dramatically. Bank financing has been much more difficult to attain for the vast majority of borrowers, and this demand-supply imbalance has induced a skewing of loan terms and conditions in favour of those who are still willing and able to lend. Whilst banks remain the majority providers of debt finance, their effective withdrawal from new lending has left a gap in debt funding across sectors, specifically within real estate.

The purpose of this study is to investigate the likely size and impact of the growing involvement by insurance groups in UK lending markets and the effect, specifically, on the CRE market. Our research suggests that insurance groups, particularly life and other long-term funds, are taking advantage of the opportunities to lend on their terms.

Conversations with leading insurance industry experts, supplemented by economic modelling and analysis during this research, lead us to expect insurance groups to expand their provision of UK CRE loans by £28.1 billion over the next five years. This involves annual lending by insurance groups rising to £5.5 billion by 2017, equivalent to 15 per cent of annual CRE originations (£37.7 billion) in 2011. However, when compared to the 2007 peak in originations of £83.8 billion, insurance groups’ forecasted annual lending in 2017 represents seven per cent of the market.¹

This report shows key findings from a range of in-depth interviews, secondary research, DLA Piper expert commentary and the results of economic modelling, provided by the Centre for Economic and Business Research (“Cebr”), to determine the shape and character of insurance groups lending to the UK CRE market.

I would like to take this opportunity to thank all of those involved in the research; their input has been invaluable in helping us to deliver what we think is an interesting and thought-provoking piece of research.

Simon Cookson, Partner and Head of UK Real Estate, DLA Piper

¹ Economy-wide originations figures are drawn from De Montfort University’s Commercial Property Lending survey.
# Key Findings

## The Market
- General insurance is too short-term to get involved in CRE lending whereas life and pensions and annuity players can take a long-term view.
- Solvency II will impact insurers’ ability to invest despite many already commencing their investment strategies.
- The FSA’s Retail Distribution Review will remove the ability of annuity providers to support Independent Financial Advisers (IFAs) through commission on sales of annuities. This is likely to place greater emphasis on providing the most competitive annuity rate and on extracting the highest yielding vehicles.
- Enhanced and impaired annuities will continue to grow as a function of the UK annuity market following Government initiatives on the Open Market Option (OMO), and will require more investment choice to support individual underwriting.

## The Opportunity
- Banks are already seeking to sell parts of their loan portfolios to insurers and reduce lending, leaving a gap in the CRE debt market.
- Diversification of lending across new asset classes will benefit the insurance sector; while diversified sources of finance will promote stability within the commercial real estate sector.
- Insurance groups will provide a new source of finance for some social projects and student housing.
- Annuity funds will look to invest in other key sectors, such as, student accommodation, warehousing and distribution and some other public sector projects.

## Barriers to Entry
- Liquidity, or lack of, remains an issue for lending to CRE and is a key factor in regard to the lack of funds available from insurance groups.
- Accounting issues under embedded value standards.
- Much of the CRE market is not yet attuned to the structure of lending that insurance groups will provide.
- Currently, few insurance groups possess the in-house expertise and infrastructure to deal with lending to commercial real estate. Lending platforms must be built up carefully over time.
Searching for investment: insurers as lenders

**The Type of Lending**
- Insurance companies are expected to draw primarily upon *annuity funds* in order to lend.
- Core assets sought will be *retail and office space*.
- Investment preferences are prime and high-quality secondary properties in central locations, principally *London and the South East*.
- *Terms of between seven and 10 years* are the minimum which insurance groups are willing to contemplate.
- Insurance groups may be willing to lend at *higher maximum Loan-to-Value (LTV) ratios* than the current market average of 50 to 65 per cent.
- Most insurance groups are looking to lend *£50 million and above* per transaction.
- Over the forecast period, we do not expect insurance groups to provide significant amounts of *development finance or lending for residential real estate investments*, as they are deemed too risky.
- Loans from insurance companies will typically be *priced over gilts* rather than LIBOR.
- Insurers groups will look mainly to *senior debt financing rather than mezzanine financing* with a focus on the structure of early redemption charges (ERCs).

**Attractions for Insurance Groups**
- Insurers will provide up to *£28 billion in lending over the next five years*.
- *Yields* within CRE lending may prove both secure and higher and more stable than those available in the debt markets.
- Potential to *alleviate the decline in UK annuity rates* through lending at higher yields.

**Key Findings**
- Insurers will provide up to *£28 billion in lending over the next five years*.
- *Yields* within CRE lending may prove both secure and higher and more stable than those available in the debt markets.
- Potential to *alleviate the decline in UK annuity rates* through lending at higher yields.

*Yields* within CRE lending may prove both secure and higher and more stable than those available in the debt markets.
- Potential to *alleviate the decline in UK annuity rates* through lending at higher yields.
We encountered near-unanimity amongst the participants in our in-depth interview process on the assertion that the CRE lending market is undergoing a structural shift: banks are retreating while new lenders move in.

“We are in an interesting macro environment. There is a lot of pressure on the banks, and we don’t see this as a short-term opportunity. We see this demand/supply imbalance as a long-term feature of the macro environment, and as such we’ve heavily invested in our real estate debt platform.”

Jamil Farooqi, Director, M&G Investments
THE DEBT FUNDING GAP IN BRIEF

There are a number of factors driving insurers to consider CRE lending as an investment option. The fall in the supply of real estate debt, because of the withdrawal of bank lending, is one and has not been matched by an equivalent fall in demand. Insurance groups with capital at their disposal can take advantage of the funding gap and may expect to receive returns over and above what is presently available elsewhere.

At present, lending cash direct to CRE investors offers a more economically attractive alternative to indirect lending through corporate bond markets.

But the funding gap is unlikely to disappear any time soon either, as banks seek to comply with the requirements of Basel III whilst offloading their distressed commercial property portfolios, resulting in much lower volumes of credit available.

“We’ve gone into this to make money. Many want finance, and relatively few are in a position to provide it. This imbalance in favour of lenders presents a profitable opportunity. You can also earn fees – which are at levels expanded compared to where they have been traditionally.”

Ashley Goldblatt, Head of Commercial at Legal & General Investment Management

“We are looking at a number of different options in terms of finding new sources of yield. The gilt and bond markets are not supportive of our annuity product and, as a result, annuity rates — even for enhanced or impaired lives — are at-all time lows. This is stopping a lot of product development, particularly in long-term care, as we cannot get the economics to work. Therefore, our actuaries and investment consultants are looking for new areas of yield.”

Head of Product Development, UK Annuity Provider

“In this market, because of the lack of competition, you can price stuff at a rate which makes sense which the banks couldn’t do when they were lending at the peak of the market…at insanely fine margins. It just didn’t make business sense, taking on equity risks for gilt returns.”

Senior Analyst, investment research company
WHAT’S DRIVING INSURERS TO LEND?

Respondents to our research highlighted several key factors which they saw as incentivising insurance groups to move into the lending space. Many saw long-term insurance or assurance funds as ‘natural’ owners of property and property debt.

**OPPORTUNITY**
- The withdrawal of bank lending has created an opportunity for insurance groups to move into the lending space

**ALTERNATIVE SOURCES OF GROWTH**
- Particularly for the UK annuity market where rates have been declining for some time
- A move away from bonds, which are providing only low yields, to other asset classes such as CRE is increasingly attractive - particularly since the property market is well-understood by many insurance groups

**RISK**
- Diversification: the performance of other asset classes such as corporate and sovereign bonds has encouraged insurers to look elsewhere to diversify their investments and risk
- Growth in de-risking corporate pension schemes: buy-in and buy-out structures offer the chance to invest in medium-dated vehicles with higher yields than the gilt or bond markets
- Long-term security: unlike banks, insurance groups are unlikely to face a “run” on deposits

**EXISTING EXPERTISE**
- In many insurance or assurance companies, some degree of in-house property expertise does already exist; hence, increasing exposure to commercial property debt would not be a complete leap into the unknown

**TRANSPARENCY**
- Commercial real estate assets can be valued in relatively conventional and transparent ways, determined largely by the fundamentals of the real economy and local commercial environment. In contrast with some more esoteric financial instruments or derivatives, which are often more susceptible to volatile pricing driven by speculation

**LONGEVITY**
- Insurance groups are able to take a longer view on investment returns and ‘ride out’ any short-term volatility in capital values; they can enjoy the long-term stability of the income stream accrued from loan repayments. Funds with long-term liabilities have an incentive to seek long-term assets to match those liabilities, and the durations involved in CRE lending means it fits this criterion well
“Insurers are certainly looking at alternative sources of investment income. Even now, the yields on commercial real estate are so much better than the bond or equity markets – so it’s something that chief investment officers will be looking at very closely.”

Tim Young, Insurance Analyst at Agency Partners

“That is the big issue: where do you get a return from at the moment? So it seems like a sensible move. You’ve got to look at higher-yielding assets at the moment, and CRE is an asset class where there are some attractions for writing longer-term business.”

Hari Sivakumaran, Analyst, Oriel Securities

“There are bonds, there are a lot of other assets – but we [property lending] provide some level of diversification, to one of the few assets which fit in with what our annuity holders want us to invest in. And we’ve got the skills and capabilities to provide that.”

Manager, UK insurer

“In our terms, this is a bond replacement rather than a new and higher risk approach. The covenants would have to be air-tight so large anchor tenants with long leases would be central. I cannot see us lending to developers or those with a lot of vacant space. Ideally, it would have some form of Government or local authority involvement. The student accommodation space looks interesting for that reason.”

Head of Product Development, UK Annuity Provider

“Sometimes insurers and pension funds are grouped together. But pension funds don’t tend to have as much property expertise as some of the insurers – with the exception of a few large pension funds they do not have in-house expertise like we do.”

Finance Manager, UK insurer

“Insurance companies’ balance sheets are not susceptible to the same types of runs that banks face. That gives you more flexibility to take a longer-term strategic view on property for matching assets with liabilities.”

Board member of an insurance industry stakeholder
REGULATORY DRIVERS AND SOLVENCY II

Direct lending by insurance groups also needs to be structured in such a way that it complies with existing regulations.

THE ROLE OF SOLVENCY II

The Solvency II Directive is aimed at updating and harmonising insurance industry regulations across Europe. Like Basel III for the banks, a principal feature of this Directive is the capital reserve requirements that are to be met by insurers investing their funds. These requirements are expected to be specified separately for different asset classes.

Whereas Basel III aims to increase the quality and level of capital, Solvency II aims to increase the protection of policyholders by ensuring that the quality and quantity of capital is aligned to the risks that insurers are exposed to. It will increase policyholder protection by reducing the risk that policyholders will be detrimentally impacted if an insurer gets into difficulties. Solvency II gives credit for diversification between risks in the calculation of the capital requirement.

The on-going policy negotiations and drafting processes of Solvency II were found to be of significant interest to those members of the insurance sector who are not already active in lending. Early drafts suggested favourable treatment for real estate debt which, as an asset class, would effectively incur no capital charge. This initial reading catalysed much debate and comment amongst our respondents on the potential for insurance companies to greatly expand their CRE lending. Subsequent drafts have, however, tempered this enthusiasm – capital will indeed need to be held in reserve to guard against property market shocks, and the possibility of underlying assets losing value.

Current expectations are that under Solvency II commercial property debt will be treated in a broadly equivalent manner to corporate bonds. Whilst more onerous than the zero charge implied by earlier readings of the Directive, it is expected that CRE lending will still be relatively attractive in the final framework, and that there will be lower capital charges on insurance groups lending particularly compared to direct property investment which is expected to incur a 25 per cent charge.2

An unexpected finding of the research was the limited extent to which Solvency II seems to have factored into the investment decisions of insurance companies that are already active in CRE lending. For instance, Ashley Goldblatt had no confidence that the initial favourable draft would see its way through to the eventual legislation:

“Most people who picked up on our entry thought we were driven by Solvency II. No, we weren’t – because history tells you, the one thing you can’t rely on is regulatory arbitrage to make it worth your while doing something. If the original draft stayed until the end – great news for us. Did we go into it believing that would happen? No, not at all. If you’re a regulator, why give a significant capital advantage to a minority asset class? It doesn’t make sense.”

2 Direct property investment refers to the purchasing of physical ‘bricks and mortar’ property by an investor, rather than the issuing of a loan for a third-party to purchase or build the asset.
The observation of Jamil Farooqi on this issue was not too dissimilar:

“[Solvency II] is still a regulation in some flux, so that’s definitely not the driver for our investment thesis; it’s a value-driven one just as it is across the investment spectrum.”

In regard to Solvency II, the Head of Investment at a UK life insurer had this to say:

“The inherent risk with the asset class is more of an influence than the regulation.”

However, many funds likely to support commercial real estate lending have not yet completed Solvency II compliance and, despite our unexpected findings, we think that the combined impact of Basel III and Solvency II is likely to lead to some major shifts both in terms of cost and willingness to take risks by banks and insurers. The introduction of Basel III and Solvency II may lead to major changes in the capital markets impacting, in particular, on real estate finance.

Whilst insurers which are active in CRE lending may not see Solvency II as a major driving factor in decision-making, it will still impact on investment decisions and some insurance groups may have ongoing concerns due to the uncertainty around the final details and the uncertain state of play as to its implementation. On 30 August 2012 the European Parliament rescheduled the plenary vote of the Omnibus II Directive from 22 October 2012 to 20 November 2012. On 18 September 2012 the Commission, Council and Parliament held a trialogue. Commissioner Barnier has commented on the possibility of a delay of one year, resulting in transposition in July 2014 and implementation from 1 January 2015. No new timetable has been confirmed - the current timetable of transposition by 30 June 2013 and implementation from 1 January 2014 remains in place.
We, at DLA Piper, expect Solvency II will affect the way in which insurers will invest in real estate, although there remains uncertainty pending finalisation of the rules. Until the finalisation of the level two implementing measures, it will not be fully understood how the Solvency II capital charge will impact real estate lending. The latest versions of the text would indicate that the European Commission would rather insurers have a diversification in their investment choices. Higher capital charges are foreseen for longer term investments and this will directly impact the willingness to invest in real estate - with insurers favouring shorter term covered bond type investments - a trend which has already been witnessed in the EU. Once the finalisation of Omnibus II has occurred the European Commission will publish their latest versions of the level two measures, which will enhance the clarity as to the attractiveness of real estate lending.

**Michael McKee, Partner, DLA Piper**
Direct lending by insurance groups also needs to be structured in such a way that they comply with existing regulations.

**REGULATORY**
- Insurance groups currently cannot enter into direct lending arrangements and so, to invest in commercial real estate currently, need to set up various complex structures.

**INFRASTRUCTURE AND INTERNAL CHALLENGES**
- Originating a senior loan involves close scrutiny of the borrower. Unlike banks, insurance groups are not likely to have access to enough detailed information on day-to-day financial performance - unless big, a group will not have the capacity to take on lending to CRE.
- There is no ‘industry standard’ investment management agreements which mandates CRE lending on behalf of insurance groups.
- Internal governance structures must be in place to rigorously scrutinise the decision-making, and ensure that undue risks are not being taken.
- The need for on-going active management of CRE loans - most insurance companies are not currently set up to deal with this.

**PAST MISTAKES**
- Internal prejudices could inhibit the readiness of insurers to expand into CRE lending - our research highlighted an awareness of the past mistakes of the banking world and the need to persuade management at all levels that the returns are worth the risks.

**RISK**
- Insurance groups are risk-averse institutions and are unlikely to act hastily.
- Loans by insurance groups do not naturally fit with syndication (that is not to say that the market will not develop to allow this, but currently there is no indication that it will).

**EXPERTISE**
- The need for greater skills and expertise required from in-house asset managers to deal with new asset classes may result in a rise in investment management outsourcing and a subsequent increase in costs.

**ILLIQUIDITY**
- Highly illiquid nature of CRE loans in the short-term – long-term insurance funds and those investing annuity capital with stable liability patterns still face at least some risk of unanticipated financial distress.

**PREPAYMENT**
- Where prepayment is unavoidable, insurers and assurers would usually look to have “make whole” provisions which would compensate the lender for having to reinvest the capital and for losing returns whilst doing so.

**VALUING CRE LENDING FOR ACCOUNTING PURPOSES**
- Insurance groups are not currently set up to value commercial real estate for accounting purposes (however, that is not to say it will not develop).
Insurance groups are inherently risk-averse institutions and are unlikely to act hastily in response to an apparently profitable market opportunity. A recurrent theme in our conversations with insurers and analysts was the awareness of the mistakes made by the banks in the boom years, where the desire for ever-greater profitability exacerbated lending expansion to reckless and unsustainable levels.

“Specifically in response to the global financial crisis, we saw the drop off in lending and the banking market’s problems generally…we observed the emerging massive supply/demand imbalance in the real estate debt space, with the withdrawal of traditional lenders and the need for alternative capital, so we started to build the platform in order to be able to respond to that.”

Jamil Farooqi, Director, M&G Investments

There are also internal challenges faced by investment managers in insurance companies. For instance, an Investment Manager at a large UK insurance company informed us that:

“We would certainly have to demonstrate to the funders before we can do anything in a new sector, that [it is suitable]…It’s a huge amount of work to convince the powers that be that we should enter into a new sector. We get a lot of business in spaces where we already are.”

An Investment Manager at a different UK insurance group spoke of this in similar terms:

“For most lenders, it’s already tough enough to take fairly straightforward transactions to a credit committee. How much personal beating up do you want to get for taking something that you really have to work hard to convince people that it makes sense? Most organisations are not interested in that.”

The Actuarial Director of a UK annuity provider put his view more starkly:

“I doubt that we will consider this [CRE lending] in the short-term. There are several issues behind this point but the major problems we have are liquidity for the loan during its term, the rate at which we can lend against what we are putting up in annuity rates given the need to allow for default and the difficulties in accounting for lending under embedded value. Put simply, lending of this nature or, indeed, any lending falls into the “too difficult box” for us.”

Management at all levels, board members, shareholders, analysts, investors and policyholders would likely require a great deal of convincing that the returns are worth the risks, and that all potential outcomes have been considered in appropriate depth.

A Financial Analyst at an investment research company with expertise in the insurance sector expressed the view that:

“There’s a difference between picking up long-duration premium yield assets; and another part of the investment function saying, ‘I don’t like gilts, equities, I’m sure there’ll be some inflation, I’ll have a punt on property instead’. That’s completely different and will be constrained by the normal parameters of portfolio management, asset allocation and risk appetite.”

There must also be an internal governance infrastructure surrounding this process, to rigorously scrutinise the decision-making, and ensure that undue risks are not being taken. This is necessary in order to satisfy the demands of investors, internal compliance as well as external regulators, in particular, the Financial Services Authority in the UK. An asset management representative of a large UK life insurance company explains:

“The key for us is ensuring that our underwriting makes complete sense, and if you are matching on the annuity side, you have absolute clarity on your assets and liabilities, what that means from a cash flow perspective, a risk perspective etc…Your credit analysis has to be robust and there is a need to understand the legal structures and documentation for the transactions. This is necessary to give comfort to sponsors. In asset management, we are in the business of taking this type of risk.”
The highly illiquid nature of CRE loans in the short-term is a further challenge. Annuity providers, either operating solely or within larger insurance companies, with stable liability patterns, still face at least some risk of unanticipated financial distress. Were such risks to be realised, capital which is sunk in commercial property would be extremely difficult to access. Sales of loan books are typically at least as lengthy and complex as originating the loans themselves, and distressed circumstances can necessitate a heavy discount.

The Chief Financial Officer of a UK general insurance company explains how the illiquidity of CRE-secured loans would appear to be a deal-breaker:

“What we do not plan to do is invest in anything that we cannot sell, so it would need to be traded debt. We have mortgage-backed securities, so we are not religious about not investing in those kinds of things, but we feel that the short-term illiquidity issue, in light of the size of CRE loans, renders them out of our league.”

Whilst the illiquidity risk does not preclude the possibility of CRE lending from long-term funds, it does influence the scale of lending which can be made available. The Head of Investment at another UK insurance company reflected these sentiments in his comment:

“The key risk is illiquidity. There’s an on-going requirement to generate cash to pay out of the fund. Too high a weighting in property presents an illiquidity risk which is just too high.”

All of these challenges require a certain level of expertise and experience, which must be sourced from external parties or built up over time. In summary, these represent very significant barriers to entry which must be overcome for sensible senior lending to take place. An Investment Manager at another UK insurer referred to this barrier in relation to satisfying regulatory requirements:

“CRE debt is not of the same importance to us as for Aviva or L&G because it incurs a higher capital charge. The way Aviva and the rest solve this is by agreeing something specific with the FSA for their property debt portfolio. That requires a lot of resource, which frankly with the volumes we write, is not really worthwhile.”
WHO’S LENDING AND HOW ARE THEY DOING IT?

The number of insurance companies currently active as lenders is still reasonably small. This is consistent with Mark Wood’s, ex-Axa Equity & Law CEO and ex-Prudential Financial UK and European Chief, assertion that:

“It is going to be a sub-division of the insurance industry that will drive growth. It won’t be something that’s uniformly evident across all insurance companies.”

**RECENT EXAMPLES OF HIGH-PROFILE CRE LOANS FROM INSURERS**

It is not surprising (given the analysis of the previous section) that insurance companies have already begun to take advantage of the potentially profitable opportunities that are open to them. Some high-profile CRE loans that have recently been issued from the insurance industry include:

- Legal & General’s £121 million property loan, sourced from its annuity business, to student accommodation developer UNITE;
- Aviva and Canada Life’s £209 million long-dated senior loan to refinance commercial property fund Picton;
- M&G’s provision of a £266 million senior loan to property investor Round Hill Capital for its acquisition of a student housing portfolio;
- Canada Life’s £80 million loan provision to refinance The Great Victoria Partnership’s prime retail holdings;
- MetLife’s £169 million senior loan to developer Hines for the acquisition of a central London office complex, and
- Cornerstone’s (a member of the US insurer MassMutual Group) provision of a £83 million senior loan to Derwent London plc, secured on prime central London offices.

While this activity has led some to speculate that the insurance sector as a whole is set to play a major role in plugging the current CRE finance gap, others are more cautious, as there remain, in their view, considerable barriers to entry to undertaking this type of activity.
LIFE AND NON-LIFE FUNDS

For the purposes of this report, long-term life funds are defined as those which work within life insurance, pension fund management and annuity provision. By contrast, general funds are defined as those which support the provision of general insurance, for example motor and home insurance cover.

General funds, by the nature of the risks which they cover, have short-term investment horizons and, as a result, different investment criteria from their long-term fund peers. The traditional way for these funds to make money, through investment gains, has not produced a regular profit for some time and has resulted in a preference for short-term, liquid investments such as short dated bonds and equities. Long-term funds, on the other hand, are generated in completely different markets and are principally driven by longevity. Life insurance funds have a component of their investment in long dated, less liquid assets and may be looking to other sources of income, such as CRE lending.

However, our research tells us that it is annuity funds that we are likely to see increasingly investing in commercial real estate, especially following the implementation of Solvency II. Annuity funds are changing from the traditional provision of standard annuities (where all annuitants are paid the same rate regardless of personal circumstances) to enhanced or impaired annuities, which individually underwrite each life based on a range of conditions. Annuity rates have fallen precipitously in recent years as UK fiscal policy and use of the gilt market (low interest rates and quantitative easing [QE] respectively) has seen gilt and bond yields fall to historic lows. Consequently, annuity funds have started to assess the availability of other sources of yield which conforms to their need for income rather than capital appreciation, thus the interest in CRE lending.

Conceptually, long-term insurance funds (such as life, pension and annuity) could be considered ‘natural’ owners of property and property debt. Properly underwritten loans will provide stable cash flows that will naturally match their long-term liabilities. A board member at a regulatory body provided a useful insight on this point:

“The financial crisis and the problems encountered by the banks exposed the mismatches in the banking model. In theory, the bank lending model should not work because matching short-term liabilities with long-term assets is an inherently dangerous structure. People are now realising that, for an insurance company to do it, it is about intermediating capital or investments into loans.”

Mark Wood explained the attractiveness of property lending to long-term funds in these terms:

“Where a company has a balance sheet, dominated by relatively-fixed liabilities of several decades, with very large annuity books – where they enter into contracts with individuals to pay a fixed amount over the duration of the term of the individual’s life – they need a set of cash flows which are predictable; and match the liabilities which they have taken on. Several forms of property ownership are conducive to creating those types of cash flows – whether there’s some sort of rental income [in the case of direct investment] or interest payments [in the case of property lending].

Alternatively, where you have insurers facing property and casualty risk, or insurers writing catastrophe risk, then the nature of the assets which they will invest in are fundamentally different. They will be much more short-dated: mainly corporate bonds, with an average duration of 15-18 months, rather than 20-30 years.”
These general insurers, facing shorter-term liability patterns and the possibility of disasters necessitating sudden and large pay-outs, are much less likely to be attracted to increasing exposures to long-term assets, such as CRE loans, to match those liabilities. As noted by a strategy representative of a large UK non-life insurer:

“Our approach is deliberately conservative; because we need access to readily-realisable liquid funds, we do not want so much risk around our asset strategy when we are already faced with catastrophe risk.”

The Chief Finance Officer of a UK-based general insurer articulated this in terms of how their insurance business works:

“The business proposition is all about taking insurance risk, and not taking asset-side risk.”

Mark Wood also articulated the unsuitability of CRE lending for insurers with short-term liability patterns in terms of satisfying regulatory requirements:

“The regulator would require them to hold far more solvency capital if their [non-life] investment portfolio became skewed towards longer-term assets like CRE loans. I think there would be little appetite for that sort of investment due to those regulations.”

The nature of life, pension and annuity funds, (long-term with certain liabilities) mean that lending from these sources is likely. Additionally, the acceleration in the move from defined benefit (DB) to defined contribution (DC) pension schemes in the UK means that there are considerable opportunities for pension funds to review investment strategies. Critically, this trend has increased the corporate demand for de-risking of pension funds following the move from DB to DC. Annuity providers are now actively involved in the buy-in and buy-out markets where they take the liability of retired members (and their payments) onto their books. By the nature of the lives underwritten, there is both more certainty on liability and a growing demand for medium-dated investment instruments.

As the Head of Product Development at a UK annuity provider highlighted:

“There are literally hundreds of smaller (less than 2,000 member) DB schemes still in place, all of which are technically capable of being de-risked by either an annuity firm signing a contract to pay annuitants (“buy-in”) or through buying out the liabilities for a “dowry”. We are only interested in retired or near retired members, preferably with medical/lifestyle conditions which would produce an enhanced rate (shorter mortality), but there are lots around. This means that we need to support lives of less than 10 years at rates of over 6% on current actuarial valuations. I can see commercial property offering this scope provided it has the right structure.”

Life and other long-term funds experience liabilities of a different nature as there is much less uncertainty about when capital will be required for payment to policyholders or annuitants, as well as a much longer duration over which the liabilities span (in some cases, measured in decades). Consequently, these long-term funds have more scope to ‘tie up’ capital for the durations required for property lending and can tolerate illiquid assets of this nature on their balance sheets. As reported by a Senior Account Manager in the property lending team of a large UK life insurer:

“The difference for us is we are investing annuity money, we’re still selling annuities and we have to invest the money somewhere and we see CRE lending as an asset class which still fits our requirements.”

This distinction between long-term and general funds was widely-acknowledged in our conversations with insurers and analysts, with no reports of general funds seeking to significantly grow their exposure to property debt. Analysts have indicated that they would have concerns about the stability of any non-life insurers undertaking such a strategy in an aggressive manner.

The different business models within the UK insurance sector lead us to conclude that virtually all of the sector’s future growth in commercial real estate debt issuance will be accounted for by long-term funds.
WHO ARE INSURERS MOST LIKELY TO LEND TO?

Against the background of reduced bank financing there is a growing awareness of the expansion of senior debt issuance from the insurance industry. The activities of insurance companies are being monitored very closely within the CRE industry and amongst CRE brokers. We found that insurance companies are frequently being approached by prospective customers seeking loans for investment. An Equities Analyst who researches property companies explains that:

“Pretty much every property company is having conversations with insurers now. What has been interesting in the last six months or so is that, when I go round and talk to property companies, they are all looking at Aviva and Canada Life.”

Furthermore, as observed by Ashley Goldblatt, there are also deals that insurance companies can make that these prospective customers may not have considered:

“We [Legal & General] are prepared to do deals of types which people may not have thought were possible. People arrive with the preconception that our interest lays in shops, offices and sheds – but actually, our first deal involved none of these. Furthermore, the majority of deals in the pipeline have nothing to do with shops, offices or sheds. We are not actually going out targeting these. But with active lenders currently few and far between, all with exclusive interests in prime retail, prime office and central London, our message is that we are prepared to look at alternative assets. Those messages will not be lost on the inner circles of the property world. Quite the opposite, there will be bells going off in their heads.”

Jamil Farooqi provided informative insights into that insurance group’s approach:

“We provide financing to people on new acquisitions, refinancing or effective recapitalisation/restructuring deals. We also bought some loans in the secondary market and we have provided loan-on-loan financing. This ability to look across different opportunities is important for us, so that we can find what we think is the best relative value. In other words, rather than just focusing purely on one, smaller sub-segment; we look across the opportunity set.”

The awareness generated by the media and trade press coverage (not least of the transactions outlined in section above) played an important role. Insurers have reported that the way they market their chosen deals is very important, by generating consciousness of a company’s lending activities, and for broadcasting facets of the deal which may be unusual or ‘exotic’. This can spur approaches by customers who may not have previously considered insurance companies as viable options for their specific requirements.

QUALITY FOCUS

We encountered no appetite amongst insurance companies to commence lending against ‘less than good secondary’ property or for speculative lending. Mark Wood provided relevant insight:

“The last thing insurers are going to do is downgrade the quality on the property portion of their portfolios. If anything, they are going to go for more big-ticket, higher-grade deals with tighter covenants, rather than diversifying into a more risky base.”

As a Senior Account Manager at a large UK insurer reports:

“We have just been picking long-term, investment grade income for properties with good property fundamentals. We have not needed to expand from that at all. We’re picking and choosing what we want to lend against.”

The Finance Manager of a UK life insurer lent further support to this feature of the market:

“The deals we are interested in are very core: big ticket deals, very core assets backing annuity liabilities: big chunks of proper, premium-class commercial real estate.”
Whilst prime assets are expected to be the overwhelming focus of insurance groups’ CRE lending, there is also likely to be some appetite for high-quality secondary assets. Jamil Farooqi explains how those organisations with more extensive property lending infrastructure and expertise are able to find value outside of the highly concentrated ‘super-prime’ market:

“To the extent that you can only look at the super-prime, and perhaps don’t have the real estate skills to review the next segment of property, you may come under margin pressure in those cases. We’ve set ourselves up to target the market on an opportunistic basis. This ability to look across the different opportunities is quite important for us, so that we can find what we think is the best relative value.”

**SECTOR MIX**

A recurrent theme of the in-depth interviews with insurers was their goal of diversification as a means of limiting exposures to sector-specific shocks. Unsurprisingly, the main types of property indicated as most likely to be attractive included high-quality retail and office space. These are well-understood sectors, with no shortage of good quality tenants in the prime space. However, there were few categories of property that would be considered strictly off-limits and certain types of property were acknowledged as plausible options against which lending could be secured; both are discussed in more detail below.

**Warehousing and distribution:**

“We are still seeing some warehousing, with people like the big UK supermarkets, who are obviously very good-quality tenants. Their warehousing space is just as integral to their business as their retail space.”

Account Manager, large UK life insurer

“Generic storage is useful, because the sites are near-enough identical, adaptable, and can be valued straightforwardly by space and location.”

Investment Manager at UK insurer

**Healthcare, specifically GP surgeries:**

“Local GPs can borrow in their own name and the incomes are effectively guaranteed by their income from the government.”

Investment Officer, UK insurance company, property lending team

“We cover a couple of primary healthcare property investment companies, and [one has] had a £100 million Aviva facility for a few years now. What they are buying are primary care centres, let to the NHS - so government-backed tenants - for 25-30 years. The fit is perfect for that kind of annuity fund.”

Senior Analyst, property department, investment research company

**Public sector projects:**

“We have a lot of experience in the healthcare market, and there can be a very natural follow-on from this. If we have financed a hospital with a council, the next natural step can be the fire station.

We would not be surprised if 30 per cent of our loans involve government income paying the mortgage, be it through hospitals, schools, job centres and government offices (incl. local). While the real estate is privately-owned, the government is the tenant in 30% of our properties, and they are paying the leases. This covers all GP surgeries for instance – all privately-owned with government tenants.”

Account Manager, property lending team, UK life insurer

**Student accommodation:**

“We have done student accommodation for the first time, but to a certain extent, it’s really on the back of what assets provide an element of government income. This has included fire stations, police stations...and we’ve done a university, but it has been backed by the university. While others have financed universities when it’s backed by student demand – ours are not, we want the guaranteed funding from the university. Our student accommodation is not, therefore, dependent on student demand. Rather we have guarantees from the university.”

Senior Account Manager in an insurance companies’ property team
“As for the nomination by the university or the payment from students themselves – we are flexible. In the example of our student accommodation deal with Round Hill, the dynamics of student demand made it attractive. But it’s a case-by-case consideration.”

Jamil Farooqi, Director, M&G Investments

Social housing:

“On the property side, we have commenced some lending to the sector in the form of bilateral loan arrangements. But it is early days yet. We are approaching it from a commercial lending perspective, which the market is not quite attuned to yet. The way we look at loans, is a little different to the way housing associations have tended to raise funds. So it takes time for them to become accustomed to the way we are offering finance. While it is not as efficient for them, unfortunately, they have very little choice because their existing lenders are not lending.”

Business Development Director, UK insurer

“We observed a company trying to structure development funding for social housing with the insurers. They say they can structure it so that it provides a cash flow profile, because it is underpinned by the housing association. But at the moment, it does not fit with the regulations which determine the kinds of business they are allowed to get involved in. It is not quite as easy as coming up with a structure…what the company said to me is that they are trying to do the first one, and then follow it up with hopefully tens of millions, billions, over the next 20 years. ‘Commitment’ would be too strong, but they are very keen…They have a lot of money that they are looking to tie up in a long-term, secure revenue stream. This would be absolutely suitable — they could probably get 30 or 35 years for a housing association, for the right kind of product.”

Equities Analyst with expertise in the insurance sector

These choices will, of course, vary according to the prospective deals which come to the insurers’ attention, as well as the in-house competencies and sector-specific expertise required to execute them.

We encountered aversion to two specific areas, residential and development finance, which were widely reported to us as ‘off-the-table’. The insurers we interviewed are not seeking to lend against residential property, while the additional construction risk carried in the provision of development finance was deemed unacceptable to their risk appetites. This was reflected in a number of comments. An Account Manager in an insurer’s property lending team indicated that:

“We are not interested in residential because we are not set up to deal with the complexities of residential deals. They require a lot of experience and knowledge that does not naturally lead on from our skill set.”

Whilst also noting:

“We do not fund commercial developments. There is too much risk attached to them.”

A Business Development Director at a life insurance company active in the UK property debt market observed that:

“Commercial development finance is a heavily labour-intensive sector, which is why we do not invest in developments or lend secured on development property. We do not believe the returns are marked enough to warrant the extra construction risk. On top of this are the time and effort required to manage such deals, which renders them not very efficient from our perspective.”

GEOGRAPHY

There is an appreciable geographic bias towards London and the South East, although insurers do not rule out lending elsewhere. Whilst London and the South East will be the predominant recipients of insurance companies’ debt financing, profitable opportunities in less-contested locations will be available to those institutions with access to the requisite property analysis and local expertise.

Prime central London real estate is also one of the few areas of the market which can still secure financing from some banks. In addition, there exists the real possibility of write-downs in value of non-performing regional loans leading to reductions in the overall debt distributed across other markets. Inflows of non-domestic investment to London...
property are expected to continue. In this context, the liquidity of the London market and perceived reliability of capital values’ upward trajectory makes property in these markets attractive for many classes of investor all over the world.

The view that overall CRE lending activity will be concentrated upon core markets was shared by an Investment Manager at a UK insurance group, who informed us:

“I would expect the market to stay focused on London and the South-east, and specifically the central district: City, West End and Mid-town. That’s where the bulk of activity will undoubtedly be focused.”

However, we note that profitable financing deals do not lie exclusively within this territory. An Account Manager at an insurance group active in UK property lending describes how they encounter viable opportunities in all UK regions:

“We’ve got investments all over the place to be perfectly honest. We do have some in London, but we have them all over the country. It doesn’t matter if it’s an investment-grade tenant, if it’s in Newcastle, Bristol, Sunderland. As long as we’re happy with the lease, and we’re happy with the property… again, we’re looking for long-term leases.”

A Finance Manager at a large UK life insurer also agreed with these sentiments:

“Their’s obviously a lot of people looking at prime assets in London. There’s not a lot of people financing assets outside of London, even at lower LTVs where perhaps there’s good businesses, good tenants, that you could do financing deals with. I think that needs to be looked at.”

An Investment Officer at a large UK life insurer also agreed with these sentiments:

“We’re perfectly happy to look around the whole of Britain, to try to find opportunities we think work. But most of the market has reluctance to do so.”

Prospective deals outside of London and the South East may be less straightforward to underwrite and execute. However, those with established lending platforms and the necessary expertise to robustly analyse the underlying real estate could encounter lesser competitive pressures while looking at such deals outside of the core South-Eastern CRE markets.

TENANTS

Insurance companies will endeavour to minimise tenant and vacancy risk, seeking deals in which tenants can be reasonably relied upon to occupy the property for the long duration of the CRE loan. This places further emphasis on the need to transact loans secured on prime properties in good locations. An Equities Analyst observed that:

“With a good, long-term fixed tenant, the asset is one you’ll be happy to put on your balance sheet. You can afford to take these long-duration assets onto your books because you’ve got long-term fixed liabilities, something the banks do not have. With a good quality tenant and resulting de minimis credit risk, you are more likely to take on the deal.”

This relates directly to the section above on sector mix in which we made references to the potential suitability of public sector projects and Government-guaranteed tenants were outlined.

PRICING

We encountered a number of perspectives on the issue of the pricing of CRE loans by insurers. These are neatly summarised by the Business Development Director of a life insurance company, who explains:

“As with traditional property lending, pricing varies by market forces: the market defines how finely you have to sharpen your pencil. The general underwriting process doesn’t change that much.

Borrowers are very happy to borrow from us and there is a slow realisation that lending long-term does not necessarily need to be expensive. There has been a misconception in the market that borrowing from an insurer is an expensive proposition. Gilt yields are at an all-time low and the yield curve is very flat, so rates are very low for a long duration.”

Who are insurers most likely to lend to?
Others likened insurers’ attitude to pricing as similar to the approach previously taken by the banks (LIBOR plus margin). However, it is clear that insurers act independently of rates, such as LIBOR, in reference to their own risk profile when making investment decisions. A Senior Account Manager at a large UK life insurer informed us that:

“We operate on a margin over gilts. Our typical mark-up depends on the product stream, on the investment profile of the loan, and how we price the risk.”

A Senior Analyst at an investment research company informed us that, because insurers are getting to grips with how to price different transactions, the extent to which they can plug the gap left by the banks will continue to be enhanced:

“18 months ago, [insurers] looked like a useful source, but the prospective borrower needed to be right at the secure end of the risk spectrum. Now that insurers are starting to get to grips with the right pricing, if they can price it sensibly, and the assets are good, then they are happy to replace the banks.”

Furthermore, the above-mentioned analyst asserted that despite new higher interest margins, borrowers may actually save in net terms by borrowing from insurers:

“…at the moment, loan providers are taking advantage of the fact that rates are so low, and they are formulating deals that are palatable to both parties. Whether the market will return to the 50-60 basis point margin…we don’t know what the economics for the insurers would be at that point, but clearly it is much more attractive now because they are earning a really nice margin and long-term income.”

The same analyst also informed us that:

“We could direct you to a number of the recent announcements from pure commercial property companies who have started to secure money from Aviva. They have gone beyond the pseudo ‘gilt-edged’ investment to pure, commercial propositions. So, while insurers’ activities could not be described as more aggressive, they are definitely becoming more accommodating in filling the gap left by banks, subject to their own not too onerous requirements.”

**FUNDING**

The funding of loan issuance has important implications for the character of lending, since the cost of capital faced by the lender will determine what returns are necessary to make the loan attractive. The Business Development Director at an insurance company, well-established in property lending, said:

“We are growing organically with new annuity monies.”

Exceptions to this include M&G, which, as the investment manager for a broad group of internal and external clients, is well-placed to access diverse pools of capital, with differential return risk and return requirements, enabling them to provide junior as well as senior debt. Jamil Farooqi said that:

“We provide flexibility on the actual leverage we can provide. It is not purely senior lending. We also have the capacity to provide junior lending. From a borrower’s perspective, we want to provide a one-stop solution, and take away a lot of the execution risk of having to corral three or four banks together, along with a number of junior lenders. We are seeing a fair amount of failure risk in the market, where one party in a group falls over and it sinks the deal.”

However, this is not expected to be a hugely significant part of the sector’s finance provision. As Mark Wood put it to us:

“Because of the scale of the individual investments that insurers make, it is only the very smallest insurers who find that going through an intermediary … to get access to the property markets is efficient. Thus the proportion of insurers’ assets invested in property that will go through an intermediated fund will remain relatively small.”

Our research findings also suggest that insurance companies are receptive to providing syndicated loans, alongside consortia of other debt providers. This would allow the sharing of the risks associated with any one investment amongst various organisations. It also enables the analytical and underwriting expertise of many institutions to focus upon the deal, which can improve investors’ confidence regarding the future performance of the underlying asset. However, this is not something that is currently readily available to insurance groups.
Whilst insurers may be interested in syndication the reality is that the opportunities are currently somewhat limited. There have been examples in the last 12 months of insurers syndicating with banks, but in the majority of cases the different approach to lending and in particular loan length means that there would need to be a significant amount of convergence before active syndication becomes a reality.

Toby Barker, London Head of Real Estate Finance, DLA Piper
Most insurers that we interviewed are seeking to transact in large ticket sizes, with most expressing a preference for deals of £50 million and above. For instance, Mark Wood informed us that:

“Because of the credit crisis and Solvency II, the pressure on insurance companies to move to safer and safer assets means that investment funds available from insurers will be for blue-chip, large, and a relatively small number of big property exposures.”

Contributing to this preference for large ticket sizes is the technical challenge associated with the provision of this type of finance, which many insurance companies have not historically undertaken. By moving down the spectrum of loan sizes, the duplication of due diligence and scrutiny procedures for each deal quickly becomes a very labour-intensive and, at present, probably prohibitively expensive, process. With the levels of capital at insurers’ disposal, their comparative advantage lies in the issuance of larger loans.

Some notable exceptions to this are long-established lenders, for example Aviva and Canada Life, which already possess the in-house expertise, infrastructure and relationships to undertake many smaller originations, from £5 million upwards.3

An Investment Officer at a UK life insurer informed us that:

“If the term isn’t right, then the business is no good to us. It just won’t back the annuity.”

Our research suggests that terms of between seven and 10 years are the minimum which insurance companies are prepared to contemplate, with most expressing a strong preference for 10+ year deals. For instance, Aviva (the insurer with the largest UK CRE loan book) is not willing to lend for durations of fewer than 15 years. Some insurers reported 25 or even 35 year deals as possibilities where the underlying asset and tenant are sufficiently strong. Mark Wood told us that:

“There is an absence of other investment classes which provide the same length of investment return as property. Because most corporate bonds are relatively short-dated, the amount of matching which can be achieved using a corporate bond portfolio is limited and, therefore, insurers look for other assets that they can extend the duration of their portfolio with. Property is obviously an important way of doing that.”

One exception to the exclusively long-duration focus is M&G: drawing upon more flexible sources of funding, they are well-positioned to provide shorter duration deals (for example, in the three to five year range) than the average loan sourced from the insurance sector.

Historically, commercial property financing has predominantly involved loan durations of between four and seven years (see Figure 1). Should insurance groups seek to lend on the terms mentioned above, this implies a ‘ceiling’ on the amount of the CRE lending gap which can be addressed by the insurance sector. In practice, this limit shall be determined by the extent to which property investors can shift their preferences towards the longer-dated loans on offer from insurance groups. If the growth of insurance groups’ CRE lending can catalyse a shift in borrowers’ preferences away from the traditional sub-seven year lending, this would surely be better than not being able to access finance at all. However, this notion was met with scepticism amongst those that we did interview. For instance, Ashley Goldblatt put forward the view that:

“Property developers have two-year to four-year horizons and make their living by selling the property on at the end of these horizons. I am at a loss to understand how such developers are going to be convinced to take 10-year secured loans instead. What would the loan be secured on once they sell the property at the end of their usual horizon?”

What is apparent, however, is that there are clear benefits in the issuance of CRE loans for insurers that manage long-term funds.

A Senior Account Manager at a large UK insurer explained that:

“We do require long-term income from long-term assets. However, not every developer shopping for finance wants the long-term deal. But for those who do want the long-term deal, an awful lot of choice is emerging.”

**LOAN-TO-VALUE (LTV) RATIOS**

Through our research we encountered a willingness on the part of insurance groups to lend at higher LTV ratios than the current market standard. This, we suspect, is reflective of the fact that the specific deals which insurance groups would consider are likely to lie in less risky segments of the CRE market. Some insurers even indicated the possibility of issuing loans with maximum LTVs of up to 75 per cent. However, this, it was noted, would be restricted to exceptionally high-quality propositions. As noted by the Business Development Director of a large life insurer:

“Our maximum LTV is up to 75%, but it’s rare we get to that point. Most of the time it’s 55-65% broadly in line with market at the moment.”

Similarly, upon being questioned about the availability of advertised 75% LTV financing, a Senior Account Manager at a UK insurer responded:

“To be honest most of the loans we’re writing at the moment are in the 50-65% range. It all depends on what the deal warrants.”

From the borrower’s perspective, the same account manager provided the following insight:

“The difficulty for our borrowers at the moment is that lender gearings have reduced – hence they have to put in more money themselves. The other difficulty for borrowers – on top of finding finance to do the deals – is that nobody is sure where the market wants to go. And nobody wants to buy when the market is at risk of going even further down.”

**FIXED RATES**

Fixed-rate lending is a natural arrangement for insurers, who seek the certainty and predictability of returns to match the liabilities on their balance sheets. This is in contrast to the usual lending terms of banks who, because they raise funds in the short-term inter-bank markets, typically lend on a variable basis to account for variations in inter-bank rates. This is a potential advantage for insurance companies, who may be able to provide those customers who are seeking long-term arrangements with certainty around their future repayment obligations.
PREPAYMENT

There was a general aversion to early repayment of loans amongst the insurers we interviewed. This means they are likely to impose significant penalties on borrowers for doing so. This again relates back to the nature of their business model and the necessity of asset-liability matching on their balance sheets. An Investment Officer at a UK insurance company’s property lending team informed us that:

“Where a borrower wants to pay off a loan early, because that loan is backing an annuity, it needs a certain return for the remaining period. So what we would look to do is ask the borrower: ‘what can we reinvest the repayment back into that will give us the same returns as we are receiving from you for the loan?’ If we can reinvest it at the same rate, then we do. If we cannot reinvest at an equivalent rate, then the borrower would have to compensate us for the difference in the lost value.”

The long-term liabilities which the loan is backing require certain returns to meet scheduled claims by customers. Were a borrower to seek to pay their loan back early, the fund would need to identify alternative assets to invest the repaid money into in order to achieve the return which is required by the liabilities. If there are no equivalent sources of yield available for the remainder of the loan’s duration, a ‘make-whole’ payment would be necessary. This would compensate the lender for having to reinvest the capital and for losing returns while doing so. In cases where there are equivalent sources of yield available, compensation may be limited to the administrative costs of wrapping up the loan and reinvesting the funds.

However, whilst the statement above suggests a measure of flexibility in terms of how punitively to treat early repaying borrowers, the responses of others did not seem as favourable.

The Head of Investment of another UK Life insurance company informed us that: “We don’t like prepayment risk. We need known cash flows. Having prepayment risk makes the capital charge a lot higher. However, this may be unique to [us], because people use their internal models, which are all different.”
POTENTIAL IMPACT ON THE UK COMMERCIAL REAL ESTATE MARKET

This section presents the more quantitative aspects of our research. Cebr’s in-house economic models were integrated with findings from the primary research in order to project the size of CRE lending growth in the coming years. This analysis was also informed by data published by the Office for National Statistics, the Association of British Insurers and De Montfort University. Due to the constraints of available data, the following projections reflect the investment activities of the insurance sector as a whole. However, as noted in previous sections, we expect virtually all CRE lending growth from the insurance sector to be on behalf of long-term funds.

CURRENT TRENDS IN CRE LENDING

Since the financial crisis that hit the UK in 2008, lending volumes have plummeted, falling in nominal terms for three consecutive years. Despite an increase of 8.6 per cent in 2011, they remain at less than half of their pre-crisis peak. Furthermore, discounting extensions of existing loans, the volume of lending is barely higher than it was 10 years ago.

Demand for property lending has not abated in the same way, illustrated by the manner in which loan pricing, as well as covenants and terms associated with such loans, have dramatically shifted in favour of lenders. At year-end 2011, average interest rate margins for all sectors of the CRE market were the highest ever recorded by the De Montfort research, further illustrating the demand-supply imbalance and reduced risk appetite in the CRE lending market. In addition, at year-end 2011, 48 per cent of lending organisations indicated a desire to decrease the size of their loan books, and 32 per cent reported no new originations in 2011, implying a long-term total withdrawal from the market by many traditional lenders.

Current market-based trends in CRE lending have, therefore, created a profitable opportunity for new types of lender – such as insurance companies – with the capacity and willingness to make finance available to the CRE marketplace. The drop in the supply of real estate debt has not been matched by an equivalent fall in demand and insurance companies, with capital at their disposal can take advantage of this gap and anticipate the prospect of receiving returns over and above what is presently available elsewhere.

The willingness of insurers to take on CRE lending as an asset class is also being spurred by the current performance of other asset classes in which the industry traditionally invests.

Corporate bonds, which form a substantial component of most insurers’ balance sheets, have not performed well since the financial crisis. Sovereign bonds, also a favoured asset class for the industry and once considered ‘risk-free’ for investors, present a much riskier proposition since the financial crisis exposed the weaknesses of the Euro and the on-going sovereign debt crises that have been their consequence.

This world of low interest rates and low (safe) bond yields is prompting insurance groups – concerned about their ability to achieve the return on capital to meet their obligations to policyholders and maintain investment margins – to find alternative sources of growth in investment returns.

---

4 The first edition of the De Montfort survey was published in 1999. The property sectors examined include prime office, prime retail, prime industrial, secondary office, secondary retail, secondary industrial and residential investment.
Predicted growth in lending by UK insurance sector

Our analysis of a combination of historical data and our interview findings points towards the potential for a trend toward long-term insurance funds becoming more active in the commercial real estate lending market. Between 2001 and 2007, the economy-wide nominal value of insurers’ lending secured against UK CRE rose by 61.7 per cent from £6.6 billion to £9.7 billion, in nominal terms.

Historical data clearly demonstrates that the financial turmoil of 2008 and 2009 coincided with a large expansion of insurers’ lending activities. This could be due to a number of factors. The high inflation of the period provided an incentive for all investors to divest from government bonds and fixed-interest investments, which typically have their returns eroded by inflation. This high inflation in the UK during the years 2008-9 is linked to the quantitative easing (QE) programme undertaken by the Bank of England, which involved the purchase of government bonds from institutional investors, including insurance companies.

This asset purchase programme provided institutional investors with more cash to invest and lend, which incentivised the increased provision of property lending from the insurance sector. In addition, the financial distress experienced by banks caused an immediate slowdown in new debt financing, which gave rise to the ‘gap’ we still see today. This greatly-reduced supply of debt pushed the price (in the form of margins and fees) up, allowing insurance companies to take advantage of more profitable lending opportunities. The interaction between these factors led to a doubling of the proportion of their CRE debt-based assets between 2007 and 2009. Based on this knowledge and analysis, we estimate that insurer financing for CRE has increased, from a stock of £6.6 billion in 2000, to between £20.3 and £23.7 billion in 2010-2011.

Thereafter, our projections – illustrated in Figure 2 and Figure 3 overleaf and based on econometric analysis – take into account established historical relationships between CRE lending by insurers and GDP growth, considerations of financial market distress, the stock of insurers’ assets and the proportion of those assets which they allocate to commercial property financing. Using Cebr’s in-house projections for GDP growth and anticipated financial market conditions in the near-term, coupled with the findings from the primary research, we forecasted the total value of insurers’ mortgage lending secured against commercial real estate for each year until 2017.

The nominal value of insurers’ commercial property financing is expected to grow at a rate of 15.5 per cent over the 2012 to 2013 period. Over the period 2013-17, it is expected to grow at a more modest (CAGR) rate of 12.6 per cent per annum. Such growth would, by 2017, produce a total value of CRE lending by insurers of about £52 billion.

The year 2017 will not be the end of the story. Our conversations throughout the primary research and our review of the available evidence indicate that insurance groups are, over the medium-term, set to firmly establish their position as more active lenders against CRE.

Precise longer-term predictions are subject to greater uncertainty. However, having established the requisite infrastructure and ancillary expertise for commencing CRE lending, it is not unreasonable to expect that insurers’ provision of this lending will continue to expand.
The year 2017 will not be the end of the story. Our conversations throughout the primary research and our review of the available evidence indicate that insurance groups are, over the medium-term, set to firmly establish their position as more active lenders against CRE.
Potential impact on the UK commercial real estate market

Figure 2: Insurance companies’ stock of lending secured against UK CRE property, £ millions, nominal

Source: ONS, ABI, Cebr analysis

Figure 3: Forecasted annual growth in insurance companies’ UK CRE lending, £ millions, nominal

Source: ABI, ONS, Cebr forecasts 2012-2017
The back-history presented here draws on ONS and ABI data sources which refer to “loans secured on UK property”. While this does not split out commercial property as a separate asset class, the analysis takes the assumption that the figures represent CRE. This is due to the fact that the insurance industry’s provision of residential mortgages is not something that we understand occurs on a significant scale when compared with the sums under consideration here.

THE POTENTIAL IMPACT ON INTEREST RATES FOR CRE FINANCE

Our econometric analysis of historical data found the value of insurers’ economy-wide prime CRE lending to be negatively correlated with interest rate margins and with the buoyancy of the financial markets. For instance, between 2000 and 2004, margins on debt secured against prime office and prime retail rose by 13.4 per cent and 4.8 per cent respectively. At the same time, insurers’ prime CRE financing decreased by 10.1 per cent, from £6.6 to £5.9 billion, in nominal terms.

The intuition would be that, when traditional lenders (such as commercial banks) operated under ‘normal’ conditions, they provided financing to all sectors, including to commercial property. The intense competition amongst lenders in the marketplace suppressed margins, providing little incentive for insurers to get involved. With traditional commercial property lenders becoming highly distressed in the wake of the financial crisis, the situation has, indeed been reversed. Between 2007 and 2011, the financial crisis caused traditional lenders to decrease their commercial property exposure, driving up interest rate margins on prime CRE financing.

This, in addition to the low equity returns and suppressed bond yields associated with the financial crisis and QE, was accompanied by insurers increasing their stock of loans secured against commercial property. Consequently, from 2006-2011, the same prime office and retail rate margins rose by 211 and 215 per cent, respectively. This was a rise from a 96.5 to a 300.1 basis point margin in the first instance and from a 96.2 to a 303.1 basis points in the second. Over the same period, insurers’ provision of prime CRE financing increased by 146 per cent, from £9.6 to £23.6 billion, in nominal terms.

For both prime office and retail financing, our econometric analysis suggests that rate margins will continue to climb slightly for a year or two. During this time, we would also expect insurers’ provision of commercial property financing to follow the strong positive correlation with interest rate margins. We predict that rate margins will, at the end of 2012, peak at 305 basis points, 1.6 per cent higher than where they were at the end of 2011, for prime commercial real estate.

Based on the assumption that the Eurozone will not experience a disorderly breakup through sovereign defaults, and the global economy gradually recovers, traditional lenders will come under slightly less pressure. This might encourage them to undertake modest increases in mortgage financing, principally to prime CRE properties due to their lower risk. But by this stage, we would expect other non-traditional lenders (such as private equity, hedge funds, sovereign wealth funds) to also have commenced significant expansions of debt financing, also principally to the prime end of the commercial real estate market. These sources of increased supply could be expected to lower rate margins. By the end of 2015, our predictions suggest modest declines in margins to 283 basis points, or 5.6 per cent below their 2011 level. We would also expect these trends to become more established as time goes on. By the end of 2017, our analysis leads us to predict prime CRE rate margins falling to an average of 258 basis points, 1.38 per cent lower than the 2011 level.

1 For the purposes of our economic modeling, interest rate margins on prime property were examined because the insurance sector’s property lending has been, and is expected to be, overwhelmingly secured against prime assets.

2 A carefully managed break-up – as opposed to the disorderly type – is currently the only feasible assumption upon which to base quantitative estimates. In the case of a disorderly break-up arising from a sovereign default, severe economic turmoil would ensue. Some probable impacts include a renewed credit crunch as a result of institutions’ suspicion of each other’s exposures to the troubled regions; capital flight to ‘safe’ bonds plunging yields; even lower and depleting investors’ returns; a deep recession across the continent collapsing equity values as growth prospects crumble; enormous fluctuations in currency exchange rates as devaluations and capital flights transpire. It is possible that demand for prime central London real estate may remain resilient as a ‘safe haven’ asset class in such a scenario. However, risk appetite in every market would in all probability be virtually nil; and all activity in the economy would reflect this, implying a vastly-reduced availability of credit. An environment of such comprehensive upheaval, along with the probability of unknowable-in-advance policy responses, would mean that investment projections under this scenario would necessarily be spurious.
Figure 4: Average interest rate margin for prime real estate mortgage financing

Source: ONS, ABI, DMU, Cebr analysis
We predict that billions of pounds of insurance industry money will pour into commercial real estate lending over the years to 2017, with the stock of real estate debt held by the sector expected to grow by £28 billion in that timeframe to a total of about £52 billion.

There is not an expectation that it will result in a drastic increase in the rate of lending, certainly not to an extent comparable with that seen in the banking sector during the pre-crisis bubble – insurance companies are expected to remain diligent and cautious in expanding their provision of CRE debt.

This is a positive factor from the perspective of governance and public policy, as the CRE lending market adapts and rebalances in the aftermath of the peak of the banking and financial crisis. We predict that the sector will provide an annual average of between £4.2 billion and £5.5 billion of CRE lending during the course of the next five years from now until 2017. This is equivalent to some 12 to 16 per cent of economy-wide new CRE originations in 2010 and 2011.

These billions account for between five and seven per cent of total CRE originations when compared with the pre-crisis peak (see Figure 5), and will satisfy a substantial part of the economy’s demand for commercial property lending.

Figure 5: Gross annual UK CRE lending, 2002-11, £m

Source: De Montfort University

Building on this new addition of 12 to 16 per cent to the CRE lending market and, given the segments of the market in which this lending activity is likely to be focused, this debt influx will help greatly in addressing the financing needs of certain classes of borrower, particularly those seeking the stability and security of long-dated, fixed-rate loans.

Jamil Farooqi reveals that:

“Anecdotally, we’re seeing the number of active lenders reducing in the space where we’re active and, with slightly larger cheque sizes, it feels like there are not a huge number of people who are active in the space.”

An Equities Analyst with expertise in property firm research, reports that:

“They [Insurers] are not the saviour of the property industry, but decent property companies are all having interesting conversations with them.”
A unique combination of market and regulatory factors has created a coincidence of needs and wants for annuity funds and CRE. The former requires higher yielding, investment grade vehicles. The latter requires a regular source of funding at rates and terms better than that offered by traditional lenders. Carefully structured loans from annuity funds to CRE could provide the answer to the current funding gap.
INSURER-LENDERS IN THE CONTEXT OF A WIDER STRUCTURAL SHIFT IN CRE FINANCE

Our research confirms that there is a growing awareness amongst long-term funds of the potential to lend to CRE. This opportunity is created by a combination of factors including actions by the UK monetary authorities in debt markets, the volatility of the equity market, the potential for real estate asset price inflation to take hold in the UK and the lack of credit made available by traditional banking sources. One might call this situation “a coincidence of needs and wants”.

- Market factors have reduced the availability of sufficiently high yields to support the growing presence of annuity funds in de-risking corporate pension schemes;
- Regulation, such as Solvency II, has reduced the ability to build portfolios around vehicles which are less than investment grade;
- CRE is facing the potential for asset price inflation as a result of loose UK monetary policy which should provide the basis of a more liquid market for underlying real estate assets;
- Carefully structured, annuity funds could supply much needed credit to CRE at a lower cost than is available through traditional sources at terms which are consistent with corporate strategies;
- CRE lending offers annuity funds higher yields than sovereign or corporate debt at terms which are consistent with their longevity liabilities and could presage a rise in UK annuity rates.

As a result, specific long-term funds are faced with demand for lending from CRE which, appropriately constructed, could provide a unique source of yield to support their asset/liability matching strategies. Specifically, the nature of the underlying life funds may provide a basis for relatively low cost, medium dated-lending to CRE at a time when credit is in short supply and, when it is made available, tends to come at a relatively high cost.

However, our research also confirms that this form of investment is not relevant for all long-term funds. Life insurance liabilities remain too risky to be supported by relatively illiquid, long dated property lending and we conclude that these funds are unlikely to take part. Similarly, pension funds may not take advantage of this opportunity. Not because of the underlying liabilities, which could be supported at the long end by CRE lending, but because the capital markets remain very volatile, defined benefit schemes are being replaced by defined benefit schemes and emerging regulation in the form of Solvency II suggests a lower risk but higher liquidity approach to investment. That is not to say pension funds will not take part but it is more likely that annuity funds will be the primary source of lending to CRE from the wider insurance industry.

As discussed earlier, annuity funds differ from other long-term funds in several important aspects. The funds are generated in relatively large tranches (the pension funds of the annuitants and, increasingly, buy-in/buy-out structures), the investment of these funds supports lifetime annuities and there is an increasing trend towards individual underwriting. In addition, the move by companies to de-risk corporate defined benefit schemes by selling the liability onto annuity providers is growing, increasing the need to invest relatively large sums of money in medium dated, high yield investments which conform to the need for the funds to own investment grade vehicles. Finally, there now appears to be consensus amongst annuity providers that UK monetary policy will remain loose for some time, reducing the potential for debt yields to increase and, therefore, provide the scope for higher annuity rates.

In combination, these factors present CRE with a considerable opportunity to offer structured finance potential to annuity funds who are looking for a higher yield but investment grade replacements for bonds and gilts. This is a critical point to note in the development of this market. Although CRE will view this source of finance as lending, to the annuity fund it is an investment. This will determine the nature of the finance and the rates at which it is offered.

Most annuity funds are not interested in capital appreciation but in the income that the investment generates. In order to value underlying investments for the purposes of corporate accounting and regulation, annuity funds will not want to face early repayment. Therefore lending to CRE on this basis is likely to be interest only and carry penal early redemption charges.
Liquidity remains an issue for lending to CRE. This is a key factor in the lack of funds available from general insurance and, to a lesser extent, life and pension funds. However, owing to the nature of the longevity risk underwritten by annuity funds, the lack of liquidity within CRE lending is less of an issue. Indeed, several annuity funds already offer real estate lending through their equity release products, albeit that this relates to residential rather than commercial property. Equity release mortgages (also known as life time mortgages) are used by annuity funds to support the very long end of their liability “tail”. The UK equity release market is valued at some £1 billion annually but has not grown in recent years owing to the retraction of the UK housing market. Nonetheless, some form of equity release mortgage could be made available to CRE on a similar basis but with important distinctions.

The clear opportunity for both annuity funds and CRE companies is the interest rate on which any lending is based. Although there is some scope for considering an equity release mortgage structure. However, it is unlikely that this form of lending will require capital repayments alongside the coupon such that this is effectively interest-only. The annuity funds will be looking for a premium to current debt rates (either gilts or bonds), this is unlikely to be as high as that sought by traditional banking lenders.

The trend towards de-risking corporate pension funds remains the key driver for lending of this form by annuity funds to CRE. Through either buy-in or buy-out structures, annuity funds are in receipt of considerable funds and large numbers of lives at the same time. As these lives are typically at or in retirement, the longevity curve associated with the annuity is medium dated at worst. The market for these structures is extremely competitive and growing. In addition, this competition is not based on rate, as the retirees already receive a set pension, but on the size of funds required to support these payments. In that the lowest number tends to win the business, the successful annuity funds must seek higher yielding investments to support their pitch. Given that investment beneath investment grade is rare and, under Solvency II, likely to shrink, the need to find investments of medium term (i.e. 10 years or less) at relatively high yields is growing. Lending to CRE may provide the answer to this question.

We encountered a general consensus amongst interviewees that the current downturn in bank lending represents a structural rather than a cyclical shift in the market for CRE finance. There is no expectation whatsoever that banks will move back into CRE lending to such an extent that they could re-assert themselves in the very dominant manner they did before the crisis. This is down both to a greatly-reduced appetite for risk, as well as regulatory capital requirements raising the cost of providing finance.

A shift to a more diversified pool of CRE lenders might take time to fully materialise which may pose some difficulties in the near term for property investors unable to secure financing, but resulting in a positive outcome for the UK commercial real estate market in the long-term.

An Equities Analyst at an investment research firm with expertise in the property sector reports that:

“...a long list of entities outside insurance trying to put together funds: hedge funds, private equity, other vehicles. They recognise that at the moment, they can be price-setters. There’s not that much choice out there away from the top layer of publicly-listed companies…”

“A unique combination of market and regulatory factors has created a coincidence of needs and wants for annuity funds and CRE. The former requires higher yielding, investment grade vehicles. The latter requires a regular source of funding at rates and terms better than that offered by traditional lenders. Carefully structured loans from annuity funds to CRE could provide the answer to the current funding gap.”
A COMPETITIVE RESPONSE FROM THE BANKS?

Our interviews demonstrated near total agreement in respect of the assertion that banks are not undertaking a competitive response to the entry of new lenders in the CRE market – be that in the form of insurance companies or other non-traditional lenders. Banks have been actively seeking to shrink their exposure to the sector, indeed there are many instances of banks approaching the new entrants in the hope that they may be able to sell some portion of their property loans, as part of their on-going deleveraging process.

An Investment Director at an insurance company describes the banks’ response as follows:

“They are, in many cases, very happy that there’s a third party that can help take them out. Many are compelled to reduce their existing facilities, many of which need to be refinanced. So they’re more than happy to see us come in.”

A Finance Director at a UK insurer confirmed how the banks’ eagerness to divest has resulted in them receiving proposals to purchase debt on the secondary market:

“We’ve recently had calls from banks asking if we’re interested in investing in student accommodation. I’m sure you’ll find other insurers have had many conversations with banks with regards to their CRE debt books in the past few months.”

Another Investment Manager at a UK insurance company reports a similar perspective on the banks’ shrinking exposures:

“We’ve seen a couple of high-profile loan portfolio sales, with the likes of Lloyd’s and RBS executing some quite large ones. We have bought some individual loan positions from banks. But we’re not making a statistical macro play - it’s about that particular loan or that particular portfolio.”

While some bank loans have been purchased by insurance companies they are unlikely to acquire an entire loan book from a bank, which would mean an insurer committing to double or triple the size of their current CRE exposure in one transaction, something that they are not ready for from a risk management or infrastructure perspective.

Distressed loans are, in particular, unattractive to insurers, even in the case of steep discounts: the fundamentally risk-averse nature of the insurance companies who would undertake CRE lending means that their willingness to acquire non-performing assets is virtually nil. Extracting value from a distressed loan book involves labour- and time-intensive strategies which are not efficient uses of insurers’ asset management resources. Indeed, we discovered that insurance companies would prefer to be prompted into as little active management of CRE assets as possible. As one insurer put it:

“Ideally, when issuing a loan we would like to stick it in a drawer and forget about it for 15 years. It rarely works that way – but that’s the dream!”

CRE INCENTIVES SET TO ENDURE

Whilst the number of insurance companies currently active in CRE lending is relatively small the expected risk-adjusted return from such lending activity is likely to remain very attractive.

Figure 6 illustrates the extent to which average yields on prime commercial property are elevated above those of a typical ‘risk-free’ asset choice, namely the 10-year UK gilt, as well as the yields available on investment-grade corporate bonds, as represented by the Moody’s Seasoned Aaa and Baa bond indices.
Figure 6: Comparison of prime CRE yields with corporate and sovereign bonds since the 2007 financial crisis

Source: Moody’s, CB Richard Ellis, Eurostat, Macrobond Financial
The enduring sovereign debt crises and rebalancing of global growth are likely to continue and place downward pressure on ‘safe’ sovereign bond yields.

Growth in investment return is becoming increasingly important to life and pensions funds. There is a mounting need to attain revenue from income and capital gains, since premiums earned from policyholders are markedly below the claims incurred by the sector (including life assurance, annuity contracts and pensions payments), and have been so since 2007. (See Figure 7 below.) The yields on offer from CRE investments must be an important consideration when examined in this context.

Figure 7: Claims expenditure and premiums income of long-term insurance funds
DLA Piper is a global business law firm with leading real estate and insurance sectors. We have one of the largest and strongest international insurance and reinsurance practices, comprising over 300 lawyers who have experience of advising on all aspects of transactional, regulatory and commercial matters, coverage, dispute resolution and claims, competition law, restructuring and emergency response. Our team also regularly advises insurance companies on intellectual property and data protection law, real estate matters and employment law.

Our real estate practice is deeply rooted in the real estate industry. The dedicated team of over 550 lawyers has a vast range of skills and can advise on areas including investment, regulatory, tax, funds, development, construction and engineering, litigation and planning. We manage every type and size of transaction, quickly mobilising teams of any size.

DLA Piper has unrivalled global spread, with 77 offices in 31 countries and multi-disciplinary teams in all major business centres in the Americas, Europe, the Middle East and Asia Pacific. Our geographical reach enables us to offer a truly international and cross-jurisdictional service to the insurance industry.

As well as being global in our reach, we believe in delivering local expertise in each jurisdiction in which we practice through lawyers with deep experience and knowledge of the local legal and business environment.
**CONTACTS**

**Simon Cookson**  
Head of UK Real Estate  
T +44 (0)20 7796 6767  
simon.cookson@dlapiper.com

**PK Paran**  
International Sector Leader; Insurance  
T +44 (0)20 7153 7529  
PK.Paran@dlapiper.com

**Toby Barker**  
London, Head of Real Estate Finance  
T +44 (0)207 796 6778  
toby.barker@dlapiper.com

**Samantha Boston**  
PR Manager  
T +44 (0)20 7796 6554  
samantha.boston@dlapiper.com